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Credit risks for Chinese developers abated amidst improved onshore markets' liquidity

by NUS-CRI Market Monitoring Team

In what seems like an unlikely turn of events, Chinese developers have emerged from the pandemic looking stronger than they were prior. The recovery has been well supported as property prices lookup amidst the boosted market liquidity. Before the Covid-19 outbreak, the industry had been making a slow recovery from the clampdown in 2018. With falling sales and the inherently leveraged nature of the industry, the slow recovery throughout 2019 was unsurprising. Recovery took a turn for the better after the Chinese government unveiled a series of interest rate and reserve ratio cuts as well as fiscal stimulus packages to deal with the economic fallout from the pandemic. These measures have restored investor confidence and allowed demand come pouring back into the property market. Amidst improving conditions, caution should not be thrown to the wind as the industry remains highly geared and dependant on some government policies.

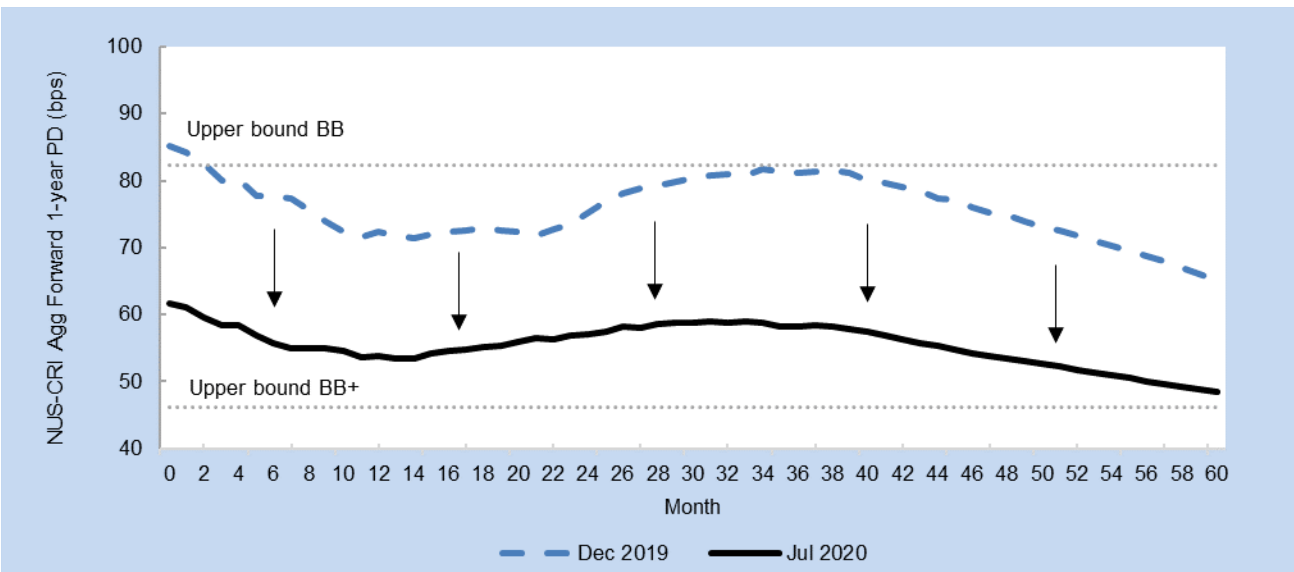

Figure 1: NUS-CRI Agg Forward 1-Year PD of publicly-listed Chinese developers based on information available in December 2019 and July 2020 with reference to PDiR2.0[1] bounds. *Source*: *NUS-CRI*

The NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[2]) above showed that the credit outlook for Chinese developers in Jul 2020 has improved relative to Dec 2019. Furthermore, the current Forward PD curve also indicates that the credit outlook will generally remain stable for the next five years. The improvement can be partially attributed to the Chinese government's support measures to the COVID-19 pandemic from both monetary and fiscal policies, which in turn resulted in more favourable financing conditions domestically. Despite the improvement in its credit outlook, Chinese developers' credit quality remains within the non-investment grade area when referencing to PDiR2.0, indicating that the credit risk in the sector remains elevated.

[1] 1 The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

Looking at the domestic interest rate environment, the People's Bank of China (PBOC) has cut both its one-year and five-year loan prime rate (LPR) twice this year, with the latest cut happening in Apr 2020. This lowers the borrowing cost for companies. The one-year LPR was lowered to 3.85% from 4.15% while the five-year LPR, which mainly affects mortgage loans, was lowered to 4.65% from 4.80%. Furthermore, the PBOC has also lowered its reserve ratio requirement (RRR) by 50-100bps for banks that have met inclusive financing targets, therefore releasing CNY 550bn in liquidity to the economy. In terms of fiscal policy, the Chinese government has also announced a CNY 3.6tn of fiscal stimulus in forms which include but not limited to fee reductions and business tax cuts.

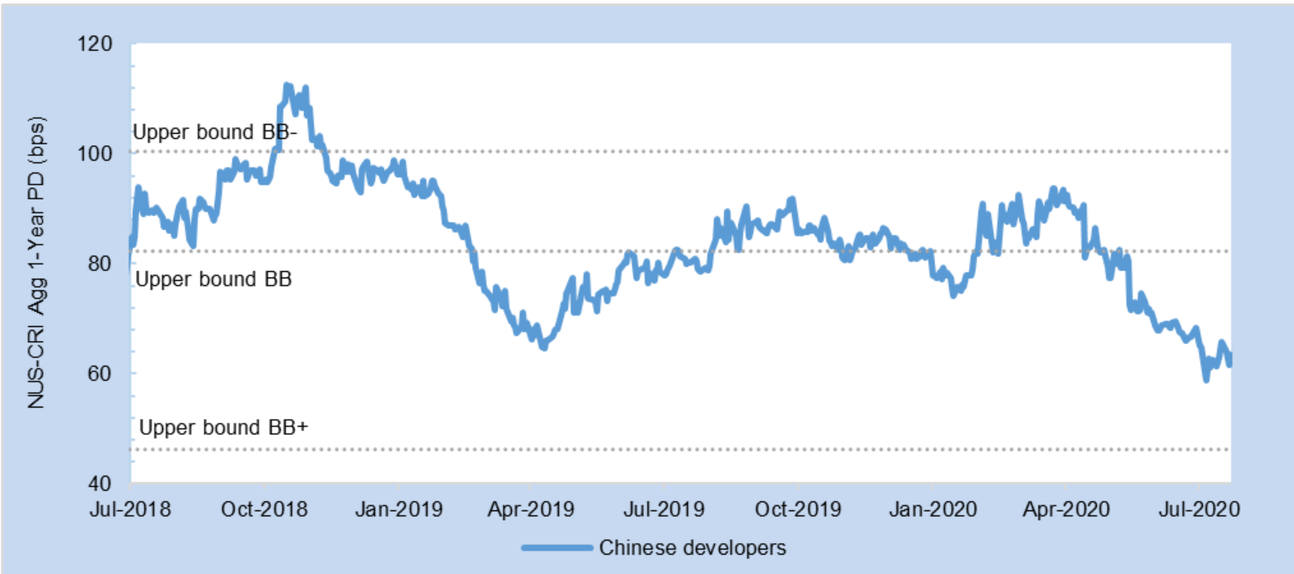

Figure 2: NUS-CRI Aggregate 1-year PD for publicly-listed Chinese developers from 2018 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

In response, Chinese developers are quick to take advantage of the favourable financing conditions which were made available by the policy-makers' desire to boost the country's economy. In particular, this condition has presented an opportunity for Chinese developers to refinance their offshore borrowings by raising funds domestically. Initially, the pandemic caused Chinese developers' USD-denominated bond yields to jump as investors scrambled for dollars. Today, yields in China's bond market fell as authorities lowered interest rates and pumped liquidity into the economy. Faced with around USD 50bn of USD-denominated bonds maturing in the next 2 years (see Figure 3b), Chinese developers shifted towards onshore funding to get lower funding costs or refinance their offshore debts. The NUS-CRI Aggregate 1-year Probability of Default (Agg PD) seems to support this notion that the loosening monetary policy has contributed to lowering the developers' credit risk, at least in the short-run, with its Agg PD now reaching its 2-year low.

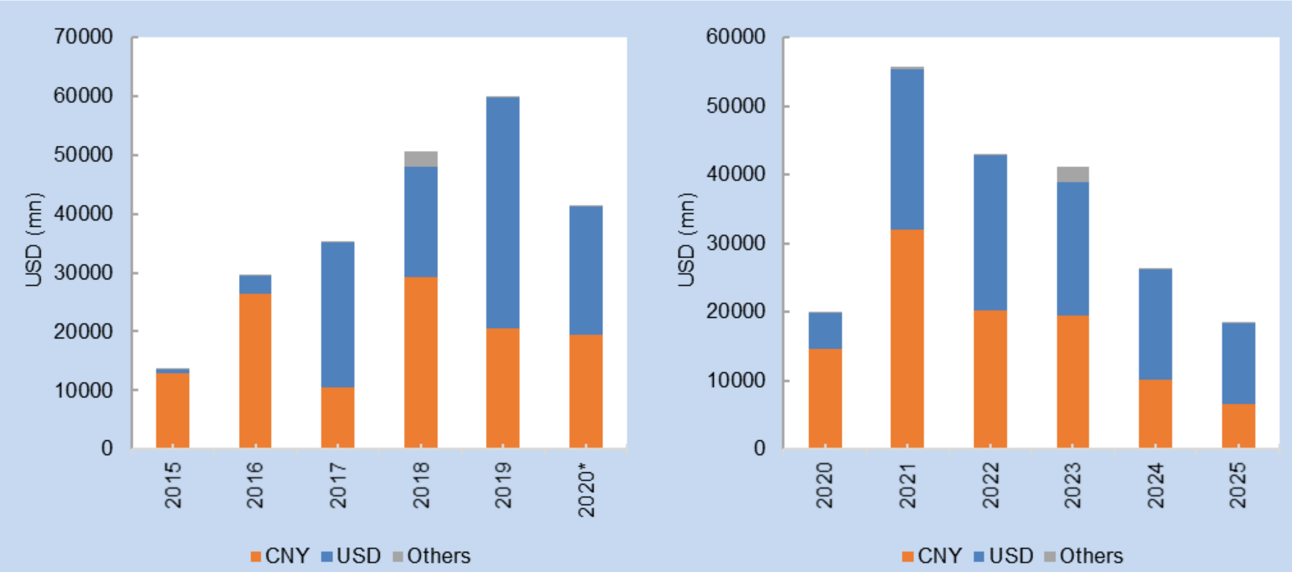

Figure 3a (LHS) & 3b (RHS): Amount of each currency-denominated bond issued by publicly-listed Chinese developers as of issue date (LHS), debt maturity distribution of bonds issued by publicly-listed Chinese developers (RHS). *Source: Bloomberg*.

The lower mortgage rates have also translated to higher property sales in recent months. The Jun 2020 sales figures amongst 30 major Chinese developers have seen an average increase of 18% year-on-year. This is coupled with the CRIC Leading Mainland Property Developer Index retracing back to its Dec 2019 levels. Furthermore, the relaxation of household registration systems in some lower tier cities also helped to boost demand. Residential sales are expected to remain strong throughout the second half of 2020 and this confidence is well supported by the seemingly strong property demand, low mortgage rates and loosened buying restrictions.

One must, however, remain cautious as they partake in the sector despite the recent improvements. The looming macroeconomic uncertainties could still put pressure on the economy. Correspondingly, this could result in slower property sales. Furthermore, the sector remains highly leveraged with its Debt/EBITDA currently standing at 4.5X. The highly geared nature can be compounded by the industry's considerable debt maturities over the next 3 years. This would result in the following increase in default risk should another downturn happen as the Chinese developers could face difficulties in debt fulfilment or refinancing. In all, this should necessitate Chinese developers to proceed with caution to maintain and improve their credit quality.

Credit News

Worsening India Inc. health pushes bond buyers to tighten grip

Aug 3. The Indian central bank has warned that the bad loan ratio of lenders could reach the highest level in two decades. With that in mind, creditors are demanding more protection as many Indian companies' balance sheets deteriorate at the worst ever recorded pace. They are doing this by purchasing local-currency denominated bonds whose interest rates increase every time credit ratings are downgraded. Issuance of these notes in India has been the highest in the world in recent years. This trend is set to continue as many companies are expected to be downgraded after the coronavirus lockdowns. (Bloomberg)

US junk bonds notch up best month since 2011

Aug 2. Holders of the US junk bonds enjoyed one of the highest returns in the past nine years. This is lifted by the Fed stimulus, which provided significant reassurance for yield-seeking investors. Despite the drop in yield, the asset class remained desirable for cautious investors. According to Refinitiv, Non-Investment Graded companies attained more than USD 150bn through the debt capital market since Apr 2020. The long-term survival of many firms remains in question as some state and local governments reverse reopening plans. (FT)

Pimco warns 'significant pain' still lies ahead for malls and hotels

Aug 1. Pimco Chief Investment Officer Dan Ivascyn has warned that the USD 1.2tn market for bonds backed by mortgages on commercial properties should be avoided. He sees hotels and malls as particular concerns due to the risk of elevated losses across commercial real estate debt and equity. AAA debt has returned close to levels seen before the Coronavirus due to the support from the federal reserve. However, premiums on BBB- bonds remain just 3% higher than where they started the year and analysts note that it would take just 7% of these instruments to default to result in losses for bondholders. Delinquencies on deals backed by smaller mortgage pools are expected to rise and could trigger this. The depth and breadth of the downturn could weigh more heavily on commercial real estate than the 2008 crash. (FT)

A USD 158bn CLO bet is putting the insurance industry at risk

Jul 30. Collateralized loan obligations are alternatives to the low yielding assets offered by the US's asset managers. The accumulation of CLOs has become alarming as insurers added Non-Investment Graded CLOs into their portfolios. In a recent stress test, it was found that a severe recession could result in losses of capital and a surplus of over 40 firms. The results are highly dependent on the ability of states to contain the pandemic and make way for economic recovery. (Bloomberg)

Cash-rich companies halve corporate bond issuance in July

Jul 29. The record-breaking surge in corporate borrowing brought about by the Federal Reserve's measures to support the economy has led to the levels of corporate bond issuance this year already surpassing 2019's totals. With many companies now flushed with cash, there is less of an imminent risk of bankruptcy and less of a need to issue more bonds. This has seen global corporate bond issuance slow in July to USD 259bn having slumped by half of June's USD 529bn. The drop was particularly pronounced for higher-rated investment-grade companies. Lower rate issuers on the other hand have continued to struggle to lure investor support due to their questionable solvency. (FT)

Global investors drive record inflows into Chinese bonds in July (Reuters)

Noble Corp. files bankruptcy to erase USD 3.4bn of debt (Bloomberg)

Ford will defer some quarterly payments on US Energy Department loan (Reuters)

Regulatory Updates

China sets out new rules on corporate bond swaps to manage default risks

Jul 31. The USD 3.53tn corporate bond market has, no doubt, became a critical source of funding for the industries in China, putting emphasis on local bond defaults. As such, the regulators are leveraging corporate bond exchanges as a mean of mitigating default risks. The new move allows bondholders to exchange new bonds for maturing debts on voluntary and equal grounds. (Reuters)

Phase out Sibor in 3-4 years and replace it with Sora, consultation report recommends

Jul 29. A consultation report supports using the Singapore Overnight Rate Average (Sora) to be used as the main interest rate benchmark for Singapore's financial market. The transition to Sora from the Singapore Interbank Offered Rate (Sibor) would allow for more transparent loan pricings and more efficient risk management. However, to ensure a smooth shift from Sibor, the process has to be phased out. The verdict on Sibor will come in on Nov 2020 after the end of the consultation. (Straits Times)

Columbia cuts key rate to record as virus ravages biggest cities (Bloomberg)

Mexico may have multiple rate cuts, central banker says (Bloomberg)

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