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Credit profiles of Hong Kong domiciled firms deteriorate in the midst of COVID-19 and political tensions

by Tsoi Yuet Yan

In the past two years, Hong Kong has met with three major economic shocks namely, the US-China trade war, 2019 protests and COVID-19 pandemic. For years, the Heritage Foundation has ranked Hong Kong first in economic freedom until 2020, when Singapore ranked above Hong Kong. The recent NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) shows that the credit profile for Hong Kong domiciled firms has deteriorated compared to Asia Pacific developed nations domiciled firms. Hong Kong, being a global finance centre, is extremely reliant on its trade and financial sectors, both sectors contributing equally to 40% of the total GDP. With Hong Kong's biggest strength being the easy access to the China market, things changed when the US-China trade war in mid-2018 led to increased uncertainty Hong Kong's business environment and hence hurting investor's appetite for Hong Kong securities. This is one reason for the observed uptick in the Agg PD in mid-2018. Eventually, heightened tensions between the US and China resulted in the credit profiles of Hong Kong domiciled firms to deteriorate which is reflected in the NUS-CRI Probability of Default implied Ratings Version 2.0 (PDiR2.0[1]) showing that the Agg PD of Hong Kong domiciled firms surpassed the BBB+ lower bound into the BBB region. Meanwhile, the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[2]) shows that corporate credit outlook of Hong Kong domiciled firms will only stabilise and close in to that of Asia Pacific developed nations domiciled firms at the end of 2021.

[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 similar 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.

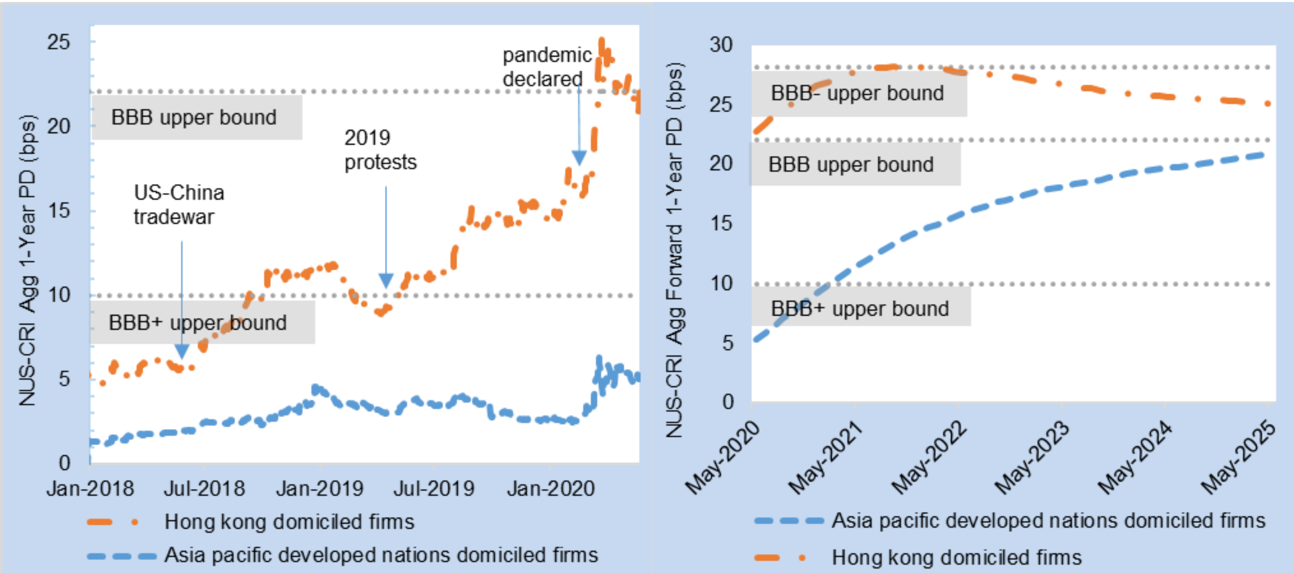


Figure 1a (LHS): NUS-CRI Aggregate 1-Year PD for Hong Kong and Asia pacific developed nations domiciled firms from Jan 2018 to May 2020 bounded by PDiR2.0; Figure 1b (RHS): NUS-CRI Aggregate Forward 1-Year PD of Hong Kong and Asia pacific developed nations domiciled firms based on information available in May 2020. *Source: NUS-CRI*

The already worsening credit profiles of Hong Kong domiciled firms after 2018 was further exacerbated by a political unrest in 2019. Exactly one year ago, more than half a million people took to the streets to protest against the now-abandoned extradition bill. The political tension and protests continued on for months. This negatively affected the business environment in Hong Kong as consumer's confidence recorded by The Nielsen Global Survey of Consumer Confidence and Spending Intentions dipped. Revenues across the board reported negative growth in their financial statements, especially in the tourism industry which we have reported previously. Even before Hong Kong could settle its political divide and recover its economy, Hong Kong, like the rest of the world, was hit by a global pandemic. Business revenues in Hong Kong experienced negative growth for the last quarter and liquidity stress has heightened with banks such as HSBC stepping in to give $3.9bn of liquidity relief to firms. The economy shrank 8.9 percent year-on-year in the first quarter of 2020, the sharpest it has contracted since 1974 and also the third consecutive quarter of negative growth, bringing the economy into deep recession. Therefore, Hong Kong's domiciled firms experienced increased credit risks after continuous waves of negative shocks (US-China trade war, 2019 protests and COVID-19) and this is reflected by the steady increase of its Agg PD in the past two years.

From an industry-level perspective, there were three sectors' credit profiles that had, on an industry aggregate level, deteriorated from investment-grade to junk rated according to PDiR2.0. They are the industrial, energy and utilities sectors. The utilities sector saw the largest deterioration of three notches. The consumer cyclical and finance sectors also face a two-step decline. This is expected: for the former mainly because export of goods in Hong Kong fell 9.9% Q-o-Q in 2020Q1 while total volume of visitor arrivals in fell by 14.2% Y-o-Y in 2019 while the latter is caused by a drop in consumer and business sentiments that cause bank profits to fall and an increase in NPL. For example, HSBC reported 2020Q1 profits almost halved after impacts of COVID-19 and worsening oil prices affected the economic outlook of the region. The bank was reportedly also one of the lenders to oil trader Hin Leong Trading which had filed for bankruptcy protection in late April. Revenue growth Y-o-Y for all the sectors in 2019 fell in comparison to 2018, with the consumer cyclical sector experiencing a negative growth in 2019. The Year-To-Date total returns on investment also recorded negative. The graph shows the deterioration of ratings of the different industries.

Sector	May-18	May-20	Notch of downgrade
technology	BBB	BBB-	1
basic materials	BBB	BBB-	1
communications	BBB+	BBB	1
consumer non-cyclical	BBB+	BBB	1
industrial	BBB	BB+	2
energy	BBB	BB+	2
consumer cyclical	BBB+	BBB-	2
finance	BBB+	BBB-	2
utilities	BBB+	BB+	3

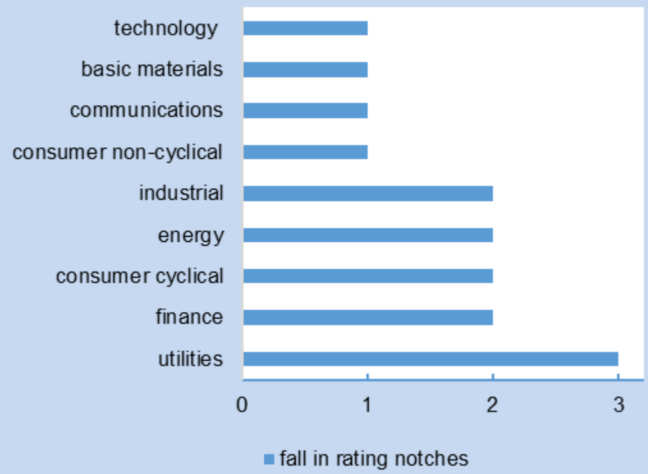
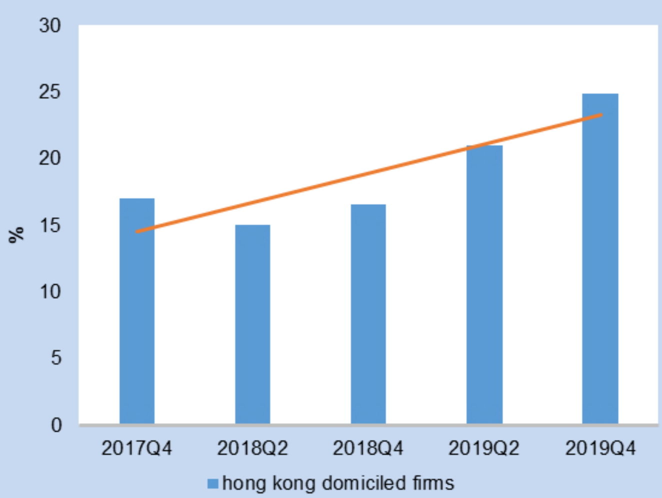


Figure 2a (LHS): Comparison of PDiR2.0 ratings of Hong Kong domiciled firms in different sectors in May 2018 and May 2020. Figure 2b (RHS): Fall in notches of Hong Kong domiciled firms in different sectors, on a sector aggregate level. *Source: NUS-CRI*

The market capitalisation weighted total debt to total equity ratio has been increasing in the past two and a half years showing greater leverage of Hong Kong domiciled firms. Moreover, the total bond outstanding for the next four years account for 54% of the total bond outstanding with bonds maturing in 2021 taking up one fifth of the pie. Given the current tight financial conditions, firms may struggle to refinance their debts in the short term, thus increasing their risk of defaulting on their short term debts. This is well reflected in the Forward PD where it shows a worsening credit outlook for Hong Kong domiciled firms up till 2021 year-end.



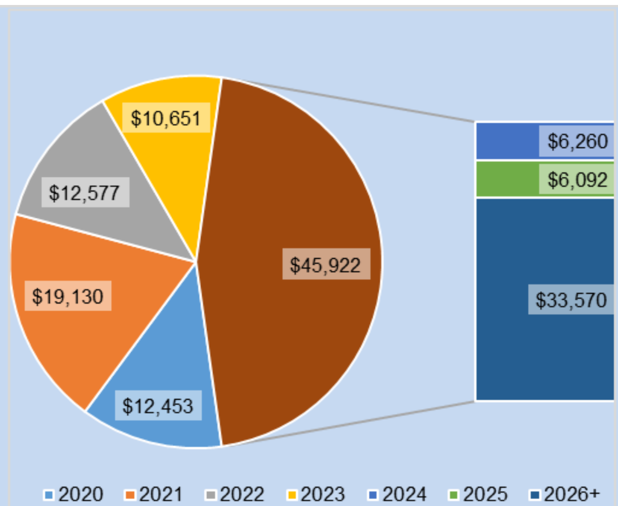


Figure 3a (LHS): The market capitalisation weighted total debt to total equity ratio of Hong Kong domiciled firms. Figure 3b (RHS): Outstanding amount of publicly-listed Hong Kong domiciled firms' bonds (in USD million) classified by maturity year. *Source: Bloomberg*

Using PDiR2.0, it can be observed that over the past two years the percentage of higher ranked investment-grade companies (rated A- and above) has halved while the percentage of non-investment grade companies has risen by 22% over the course of two years. Further reports taken from Hong Kong's official receiver's office also shows an increase in compulsory winding up and bankruptcy statistics in Hong Kong. Comparing the second half of 2019 to the first half, there was a 10.5% increase in bankruptcy orders made.

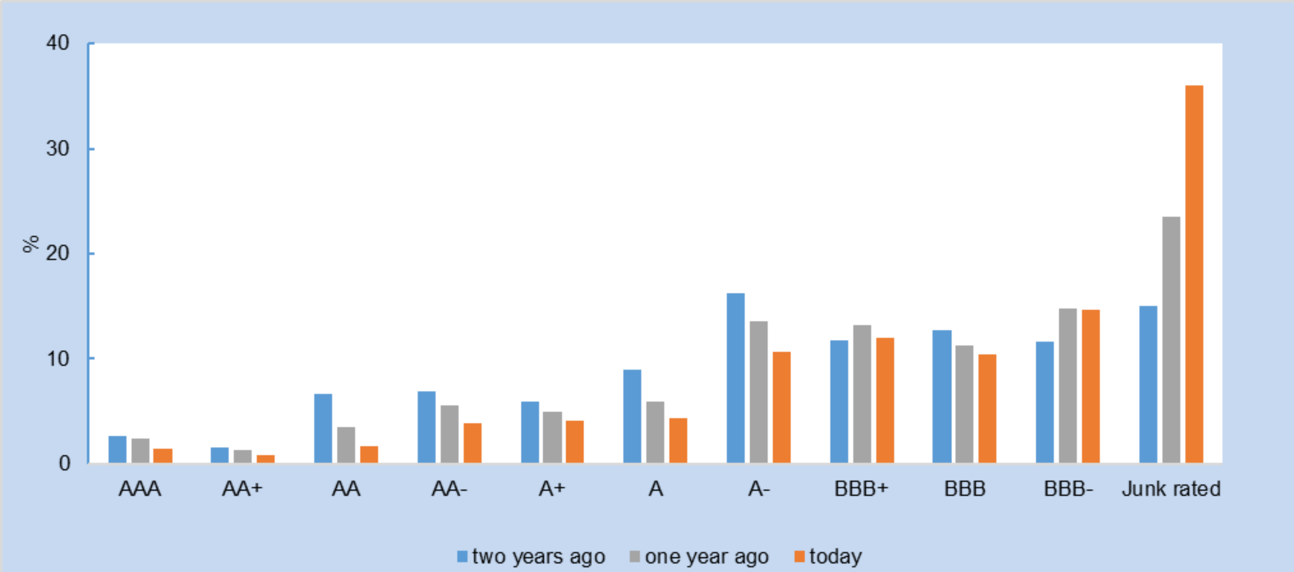


Figure 4: Distribution of Hong Kong domiciled firms' ratings using PDiR2.0 in May 2018, May 2019 and May 2020. *Source: NUS-CRI*

Fitch has, for the second time in seven months, downgraded Hong Kong long term foreign currency issuer default ratings (IDR) from AA to AA- in response to the political unrest in Hong Kong which was devastated businesses. This will greatly affect the ability of corporates in Hong Kong in raising funds as following the previous downgrade back in September, the Hong Kong 10-year government bond yield, in which long term interest rates are benchmarked against, increased by the end of 2019 and the downgrade also indicates that outlook for Hong Kong is less optimistic. Moreover, China's threat to tighten control over Hong Kong through its national security law has also caused uncertainties to rise and the benchmark Hang Seng Index (HSI) to slump 5.56 percent on Friday May 22, 2020. In condemnation of the act, the United States also announced on 27th May that Hong Kong will no longer be given special treatment under US laws. Economic sanctions such as the suspension of Hong Kong's preferential tariff rates for exports to the US may pose a threat to Hong Kong's economy and position as a world financial hub as the US is Hong Kong's second largest trading partner.

However, some hope in the nation is restored after China's foreign ministry commissioner in Hong Kong announced "China will create a stable business environment for foreign investors" amidst the violent forces. The city also burnished its appeal for U.S.-traded companies last week when the compiler of the city's benchmark Hang Seng Index said it would change its rules to admit secondary listings and companies with dual-class share structures, this might restore Hong Kong as one of the world's largest fundraising hub amidst the strained US-China economic environment but effects of these policies have yet to be realised.

Credit News

Asia leads rally as emerging markets return to raise dollar debt

Jun 1. In April, demand for high-yield bonds started to return in Asia. In contrast, this cannot be said for other emerging market economies, such as Latin America, Middle East or Africa. Borrowers in Asia have been successful since they are supported by the demand of local investors and Asia's junk universe is currently dominated by Chinese borrowers. However, creditors are discriminating more between investment-grade and high-yield debt. While the amount of raised money from emerging market dollar bond sales reached a record for the first five months of the year, the number of sellers dropped to a four-year low. (Bloomberg)

China to stop green bond financing for "clean coal" projects

May 29. In a landmark move that could help convince foreign investors to play a greater role in its huge sustainable debt market, China is set to halt green bond financing for so-called clean coal projects. The exclusion of clean coal is subject to public consultation and comes alongside plans to better align with international standards across China's regulatory bodies. However, the efforts are still likely to fall short in bringing China in line with the global best practice since China's state planner does not mandate that all money raised from green bond issuance must go towards sustainable assets. In addition, not all listed companies in China are required to disclose environmental, social and governance risks. (FT)

Federal Reserve adds just USD 1bn of new corporate debt to balance sheet

May 29. The Fed's emergency lending facilities attracted little additional use over the past week, as an expansion of the US central bank's purchases of bond funds and the commercial paper was partially offset by continued declines in other programs put in place to prop up financial markets in March. Many of the programs have financial backing from the Treasury in order to protect the Fed against credit losses. While USD 96bn of the Fed's firepower has been deployed through the facilities last week from USD 95bn a week earlier, it is still less than the 4% of the at least USD 2.6tn the central bank has said it would make available across and unprecedented ranged of asset classes. (FT)

Riskier European companies draw EUR 32bn from bank credit lines

May 27. Since February, at least 104 companies with non-investment grade ratings have drawn about EUR 32.2bn of their credit lines from global banks to help stay afloat through the coronavirus impacts. Thereby, consumer discretionary companies, including retail, leisure and car companies, accounted for nearly half of the EUR 32bn drawdown. Prior to this crisis, lenders offered low-cost revolving credit facilities to attract new business from clients. Originally, using these credit facilities should serve as a last resort for distressed companies. Now, with credit downgrades looming however, this option has come to be seen as the best option on the table. (FT)

Top-rated companies raise USD 1tn in 5 months to fill "war chests"

May 27. Highly rated companies including Disney, Apple and ExxonMobil have borrowed USD 1tn in 5 months as they seek to strengthen their balance sheets against the economic downturn caused by the coronavirus outbreak. The total amount of bond issuance which includes debt raised by financial institutions, outpaces the USD 540bn issued over the same period in 2019, and is closing in on the USD 1.3tn full-year average over the past five years. The Federal Reserve has cut its target interest rate to between 0 and 0.25%, helping drag down the average yield on investment-grade bonds to 2.6%. As investment-grade companies have built enough of a war chest, Bank of America analysts expected the pace of new bond issuance to slow for the rest of 2020, predicting between USD 200bn and 300bn over the second half of the year. (FT)

Dubai Inc. debt distress emerges as a risk for corporate sector (Bloomberg)

Fontainebleau, James Bond's Miami Beach hotel, is shaken, not stirred, by debt (WSJ)

Macy's pledges stores as collateral in USD 1.1bn bond deal (FT)

Regulatory Updates

Days from launch, Fed officials eye "Main Street" program expansion

May 30. The Federal Reserve Chair on Friday said central bank officials are open to expanding the Main Street Lending Program to businesses that may not currently qualify but need assistance to avoid shedding workers. The Main Street Lending Program, which targets medium-sized and small-sized businesses facing financial strain because of the coronavirus pandemic, is currently not open to nonprofit organizations, but the Fed is now evaluating the feasibility of adjusting the program criteria. However, the Fed has not disclosed a specific launch date for the program. (Reuters)

China launches 5th central bank bill swap in 2020

May 26. China's central bank has conducted the 5th central bank bills swap this year to improve the liquidity of perpetual bonds that are issued by commercial banks. This swap is valued at CNY 5bn and is due at the end of August 2020. Furthermore, the central bank injected liquidity into the market through CNY 10bn of seven-day reverse repos with a 2.2% interest rate. Since the People's Bank of China lowered the reserve requirements ratios by 12 times since 2018, a total of CNY 8tn of long-term funds have been released into the financial markets. In general, banks are expected to further cut fees to lower the financial burden on enterprises. Therefore, practices such as requiring companies to make deposits for credits or bundle sales of financial products are prohibited. (Asia Times)

Columbia cuts rates to record low (Central Banking)

South Korea cuts rates to record low as pandemic hits economy (Straits Times)

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