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Credit risk of China's bad-debt managers, Huarong and Cinda, surges as property crisis impacts earnings

by Raghav Mathur

- **Huarong and Cinda, two of the largest publicly listed AMCs in China, see an uptick in their NUS-CRI 1-year PD due to an increase in impairment costs related to their exposure to the domestic property sector**
- **Though NUS-CRI Forward PD suggests that outlook is set to improve, headwinds remain due to their high leverage, high borrowing costs, and challenging domestic macroeconomic environment**

Signs of the long-lasting impact of the widespread property crisis are beginning to show in the Chinese economy. The impact on the financial performance of property developers, banks and other related industries such as construction companies have been visible since last year. However, feeling the pain on their financial performance are China's bad debt managers[1]. Since the beginning of the property crisis, they have been pegged as "white knights" to the Chinese economy as they provided much needed liquidity and financing to distressed companies that were affected by the wider contagion of in-trouble property developers such as the China Evergrande Group. However, as the property crisis lingers and the financing conditions of Chinese developers' off-shore and on-shore bonds declines, credit losses have started to seep into the financial performance of bad debt managers, themselves, impacting their profitability in the short term, and raising uncertainty regarding their solvency in the long-term. As seen by the NUS-CRI 1-year Probability of Default (PD) of two of the largest publicly-listed Chinese state-owned bad debt managers, China Huarong Asset Management Co Ltd (Huarong) and China Cinda Asset Management Co Ltd (Cinda), credit risk has been increasing since the beginning of this year primarily due to increasing expected credit losses arising from the property crisis contagion and catalyzed by the worsening wider macroeconomic context.

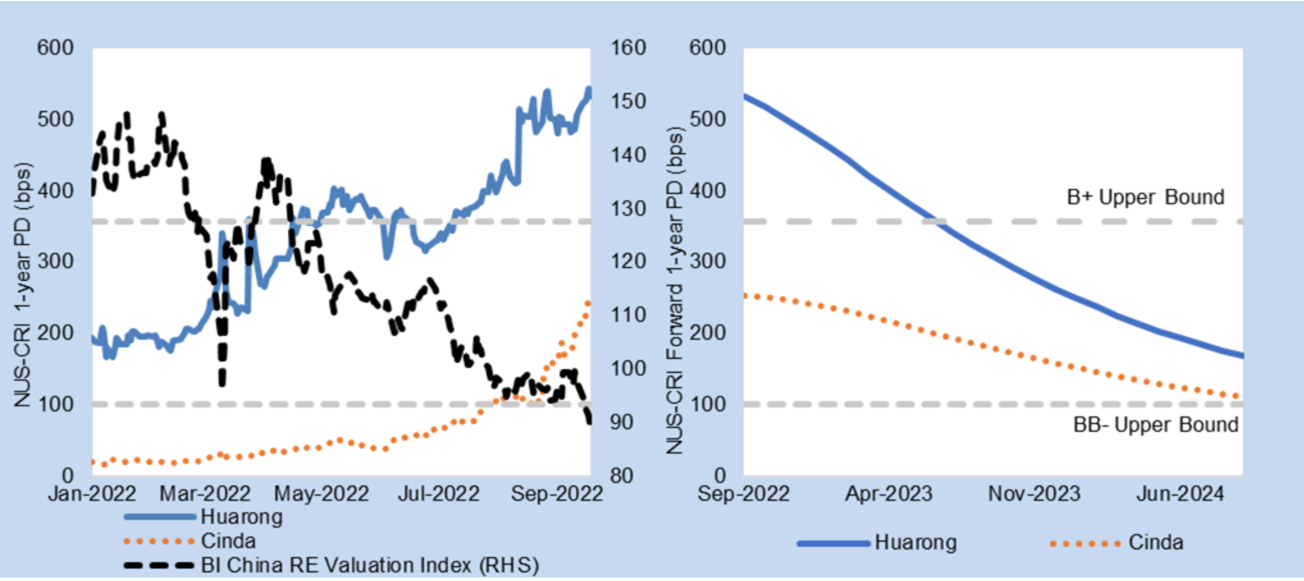

Figure 1a (LHS): NUS-CRI 1-year PD for China Huarong Asset Management and China Cinda Asset Management with reference to PDiR2.0 bounds[2] and Bloomberg Intelligence China Real Estate Owners and Developers Valuation Index from Jan-2022 to Sep-2022. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Huarong and Cinda as of Sep-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

[1] These bad debt managers are typically state-owned/backed asset managers that specialize in managing distressed debt.

[2] 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.

Asset management companies (AMCs), such as Huarong and Cinda, were set up post the Asian Financial crisis to aid the recovery of state-owned Chinese banks in managing their high-risk assets. However, these firms have been pivotal in driving the growth in China's real estate sector by providing debt financing prior to the COVID-19 pandemic. Though this strategy deviates from the ethos of AMCs' initial mandate of providing prudent risk management for Chinese banks' bad loans, AMCs benefited from increased profitability from larger spreads during times of economic growth and upswing in the credit cycle. AMCs' financial health took a turn for the worse in 2020 due to a combination of the COVID-19 pandemic and the Chinese government's efforts to deleverage the highly indebted property sector as property sales declined and investor confidence in the sector deteriorated (See Figure 1a). Since, these AMCs have been facing heightened credit risk as their property sector holdings expose them to the full brunt of the incumbent downturn. Currently, both Huarong and Cinda hold a combined exposure of CNY 200bn to the property sector, accounting for nearly half of their restructuring and acquisition business. Expectations of the property crisis worsening have seen these AMCs become prudent in their loss recognition. Huarong is expecting credit losses amounting CNY 16.9bn over the next 12 months, increasing its impairment cost by close to 2.4x compared to last year, whereas Cinda is expecting credit losses to increase by close to 85% amounting to CNY 5.9bn over the same period. These companies' deteriorating financial position and performance highlight the worsening environment in which they operate, however, early recognition of these impairment charges may benefit their future profitability metrics, especially should the regulatory environment become more favorable or alternatively, should the crisis deepen, through potential bailouts[3] by the Chinese government, as suggested by the NUS-CRI Forward 1-year PD (Forward PD[4]) in Figure 1b.

The impact of these AMCs' worsening asset quality is not only limited through its effect on profitability, but also through its effect on borrowing costs, and vis-a-vis access to cheap financing. With global investors pricing in heightened interest rates after multiple rounds of the Fed's, and other major central banks', hawkish moves since the beginning of the year, confidence in riskier assets, which were used to hunt for yield during the initial onset of the pandemic, is weakening globally. China has been at the forefront of this capital flight with foreign investors reducing their exposure to the domestic markets[5]. Bad-debt managers, due to their exposure to the distressed property sector and the resultant increase in impairment costs, have not been immune to this phenomenon. For example, yield on Cinda's 4.4% USD-denominated perpetual bond has increased by almost 1 percentage point to 7.4% since the beginning of this year, and Huarong's 4.25% USD-denominated perpetual bond has increased by close to 2.5 percentage points over the same period to around 12% (See Figure 2a). Adding to the troubles is the increasing leverage of these AMCs. Huarong has seen its leverage levels increase in the first half of this year, with its Total Debt/12M trailing EBITDA rising to 31.01x in H1 2022, compared to 16.78x in H2 2021. Cinda has also seen a similar increase, although marginally, with its leverage increasing to 17.68x from 16.95x over the same period. It will not be surprising if these AMCs continue to rely heavily on debt financing moving forward, given that their market capitalization and access to equity financing has taken a hit due to their exposure to domestic headwinds.

[3] Huarong has already received a CNY 42bn bailout nearing the end of last year from state-backed investors.

[4] 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 18 months – this is conditional on the firm's survival in the next 6 months.

[5] Capital flight has been catalyzed by the property sector crisis and its implications for the wider high-yield market. More recently, the depreciation of CNY due to rising US interest rates can cause an uptick in repayment pressure felt on foreign-denominated debt.

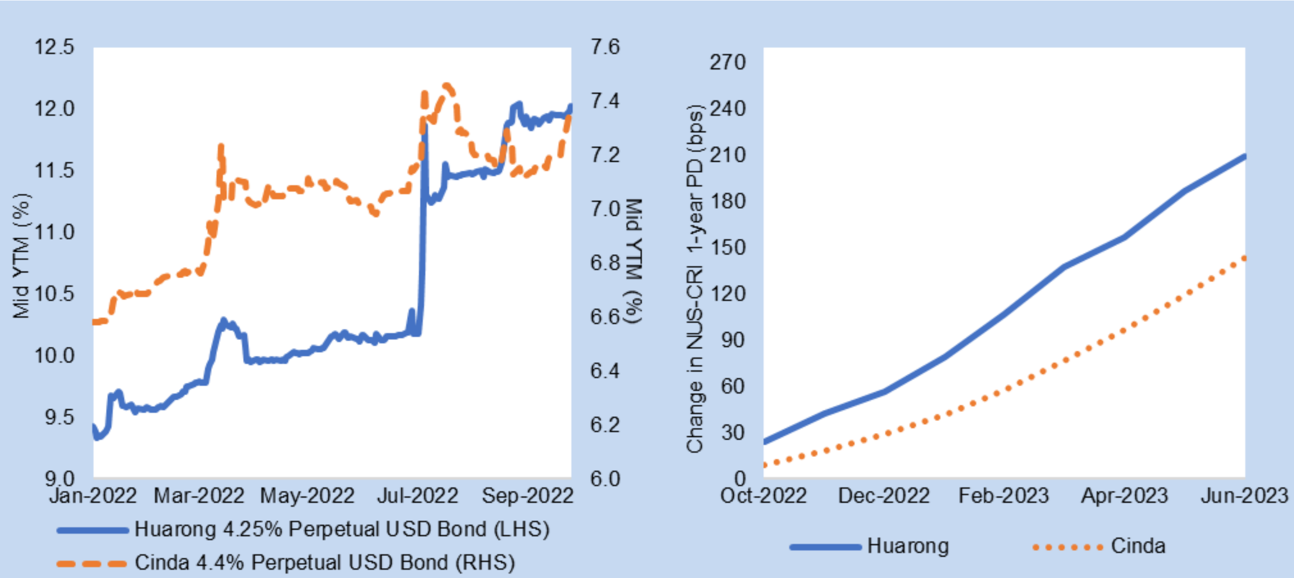

Figure 2a (LHS): Mid Yield-to-Maturity of Huarong's and Cinda's USD-denominated bond from Jan-2022 to Sep-2022. Figure 1b (RHS): Change in NUS-CRI 1-year stressed PD compared to Sep-2022 levels for Huarong and Cinda based on stress tests conducted on increasing credit risk in China's Banking and Real estate industry. *Source: Bloomberg, BuDA v3.5.1*

Taking a more holistic view of the domestic operating environment, Huarong and Cinda are likely to still face significant headwinds in the near term. Dealing with a combination of the government's zero-COVID policy in conjunction with declining consumer sentiment towards the property sector in the form of mortgage boycotts, China's banking industry's exposure to the property sector is most likely going to continue to increase its aggregate credit risk. This is especially going to be the case if the PBOC continues to emphasize on keeping borrowing costs low in an effort to extend credit in the corporate sector to boost domestic production. Using the NUS-CRI Credit Cycle Indices (CCIs) for China's banking and real estate sector, stress tests can be conducted to gauge Huarong's and Cinda's sensitivity to an increase in the aggregate credit risk for the banking and real estate sector, arising from a deepening property market crisis. As seen in the results of the stress tests conducted using NUS-CRI Bottom-up Default Analysis (BuDA) Toolkit in Figure 2b, a steady increase in China's Banking and Real Estate CCIs until Q2 2023, increases the simulated PD for both Huarong and Cinda with the effect compounding in the longer term compared to levels seen in Sep-2022. This may arise as a worsening credit profile of both banks and property developers increases the likelihood that the government utilizes AMCs as a vehicle to reduce the impact of non-performing assets, thus potentially worsening the quality of assets that AMCs themselves hold. Examples of such a scenario have already taken place in the sector when Henan Asset Management Corporation was asked to start funding distressed real-estate projects in the Henan province to provide support to the domestic banks. Thus, even though the Forward PD term structure in Figure 1b does suggest an improving outlook for Huarong and Cinda, significant headwinds do remain should local authorities ramp up the use of local AMCs in taking on further distressed real estate projects as assets when the asset quality of the domestic banking industry worsens.

Looking forward, though the tail-end of the property crisis is yet to be seen, the government recognizes the role played by the property and construction sector in driving China's growth. On the back of accommodative monetary policies by the PBOC, it is possible that the government increases its ammunition against the incumbent property crisis by providing further fiscal stimulus. Estimates regarding the amount of stimulus that the government could pump into the distressed sector do suggest that it has more than sufficient "fire power" to fill the funding gap and manage the crisis going forward, reducing the amount of impaired assets AMCs such as Huarong and Cinda will face in the future. However, it is unlikely that the government will completely step-in and bailout the whole sector, given its initial deleveraging efforts and move to clamp down moral hazard. Therefore, though further stimulus can be expected, the effect on AMCs might be two-fold. Firstly, the stimulus may provide initial breathing space for the AMCs to tackle the immediate threat of further profitability woes, but the long-term negative impact on their leverage and asset quality may sustain. As such, despite the improving credit risk outlook over the next two years as suggested by the Forward PD term structure in Figure 1b, the intrinsic Forward PD is still above the BB- Upper Bound when referenced to PDiR2.0 bounds.

Credit News

Bond sell-off worst since 1949, BofA says

Sep 23. As central banks globally continue to take an aggressive stance against stubborn inflation, yields are pushed to record highs, causing bond prices to plummet. If the situation worsens, government bond losses could escalate higher than the losses in 1949. Because of this, investors might opt to cut their losses and sell off their holdings, contributing to the USD 6.9bn outflows for the week. Moreover, the outlook for the bond market is unlikely to be optimistic considering that the investors expect central banks to further tighten their respective monetary policies, even at the risk of a recession. (Reuters)

Loans are cheaper than bonds for some highly rated companies

Sep 21. Bank term loans become an attractive alternative financing instrument as banks adjust their rates relatively slower than credit markets. Discrepancies in funding rates could be as large as 50bps as time lags of several weeks are expected to persist. This is especially helpful for those corporates facing short-term maturities, who can leverage the relatively lower cost of financing. As term loans are short-term loans, they also act as cheap insurance until the bond market reprices. (WSJ)

Record 38% plunge in bond ETF leaves bearish traders exhausted

Sep 20. iShares 20+ Year Treasury ETF has plummeted over 38% from its Aug 2020 peak – as it experienced its biggest drawdown since its inception in 2002. Likewise, short interest dropped to a new low of 0.15%, relative to its 13% peak earlier this year. There are fewer bets on higher rates as growth rolls over. In addition, sentiments are leaning towards an earnings recession which deters investors from shorting the long end. (Bloomberg)

In brutal year for bonds, trading has become exciting again

Sep 20. In previous years, the fixed income market has been dubbed as flat and boring because of limited movements in yields anchored on rates that are kept within a certain target band. Such is not the case recently as the central banks' action to fight the biggest inflation shock since the 1980s has made the bond yields volatile. More volatility means more opportunities for trading gains. For instance, Citadel Securities had made a record USD 4.2bn net trading revenues just in the first half of 2022. Moreover, the central banks' retreat from the bond market, in an effort to reduce their balance sheets, frees up the bond market for more natural trading. The downside, however, comes in terms of liquidity as investors who are not accustomed to massive rate swings and sudden market volatility tend to overreact. (Bloomberg)

China bond funds restrict inflows as investors pile in to take shelter

Sep 24. As stocks continue to tumble alongside banks cutting deposit rates, an increasing amount of bond funds in China have announced measures to restrict new purchases. Notably, China Asset Management said that they will reject individual subscriptions exceeding USD 140,000 a day to protect existing holders. CSI300 has fallen over 20% so far this year while Chinese bond funds have seen an AUM growth of over 18% to CNY 4.8tn. (CNA)

Italian election threatens to shatter quiet in its bond market (Bloomberg)

Royal Caribbean taps junk-bond market for USD 2bn refinancing (Bloomberg)

Banks struggle to offload Citrix debt glut in sign of weak credit market (FT)

Regulatory Updates

Fed raises interest rates by 75bps, Powell signals more pain to come

Sep 22. The Fed has hiked interest rates by 75bps for the third consecutive time while signaling more large increases in the future. Aside from expected rate movements, the Fed also reiterated its conviction to stabilize prices and bring inflation down to the 2% target, even at the expense of slowing growth and weakening the labor market. The markets have weighed in on the policy statement and set their expectations on another possible 75bps hike by Nov-2022 to ultimately reach 4.4% by the end of the year. As a result of higher bond yields following the rate hike, the S&P 500 slid further while the USD rallied. (The Straits Times)

BoE raises rates to 2.25%, despite likely recession

Sep 22. Despite recessionary alarms, BoE raises interest rates by 50bps in Sep-2022 as central banks worldwide cope with post-COVID labor shortages and surging inflation. Signs of a bleak outlook prevail as Britain's output fell in Q2 2022, along with an estimated 0.1% fall in Q3 2022. Along with monetary tightening through interest rates, BoE is also considering reducing its government bond holdings by GBP 80bn over the next year to shrink its balance sheet. (Reuters)

BOJ announces unscheduled bond buying as yields stay at ceiling (Bloomberg)

Swiss National Bank exits negative rates era with 0.75% hike (Reuters)

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