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Weekly Credit Brief
Aug 13 - Aug 19 2019

China real estate developers currently facing domestic pressures, but outlook remains reassuring

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The first half of the year has already seen a total of USD 128bn onshore and offshore bonds issued by Chinese real estate companies. While issuers are feeding in to investors' growing appetite for high-yield bonds – of which Chinese real estate firms account for majority – and the sector is topping corporate bond default in China with CNY 10.2bn defaults year-to-date, the government has started putting in measures to curb financing in the sector. In this article, we analyze the credit profile of Chinese real estate developers in the wake of slowing domestic property market, stricter government policies in the country as well as a weakening yuan.

Chinese real estate developers seem to be making use of the current ultra-low interest rate situation to appeal to investors' hunt for yield. At the same time, bond quality has been on a downward trend. The Chinese real estate sector's dominance in the Asian dollar-denominated bonds have spurred them to borrow on looser terms, selling a record of USD 41.7bn dollar bonds in the first half of the year (Figure 1). Report from Moody's Investors Service showed that Chinese real estate developers have been the greatest cause of weakening bond covenant quality in the region. Bond covenants are meant to protect bondholders against failures; yet they are getting more borrower-friendly. Credit facility carve-outs – terms allowing borrowers to make additional borrowings despite having exceeding its leverage limit – are becoming more common in the covenants of Chinese property bonds. Terms on fixed charge coverage ratios, measuring a firm's ability to pay recurring expenses including interests, have also fallen in recent years.

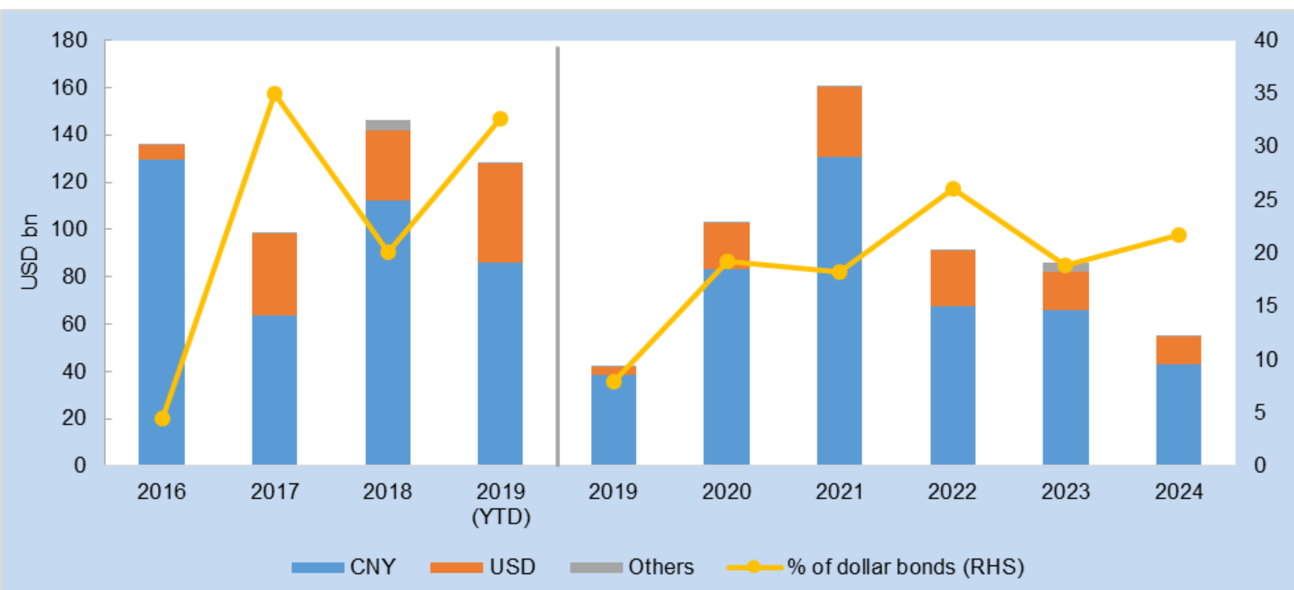

Figure 1: Amount of each currency-denominated bond issued by Chinese real estate companies as of issue date (LHS), debt maturity distribution of bonds issued by Chinese real estate companies as of issue date (RHS). Source: Bloomberg.

Domestically, the year-on-year total sales growth of buildings in China has been on a decreasing trend again this year after slight stabilization in 2018 (Figure 2a). The figure stands at 6.2% on July 31, 2019. Sales growth is expected to remain sluggish for the rest of the year given softer demand in some lower-tier cities due to reduced shantytown project targets.

Further adding pressure to the sector is the tightening of financing conditions as well as regulatory measures aimed at containing the property price increase observed since mid-2018. Despite the slowing economic growth, the Chinese government is also seeking to break its past practices of using the real estate market to stimulate the economy whenever the economy ran into trouble, as how it has been over the past decade. The intervention is taking effect, as year-on-year growth of property prices shows slowing signs across all the three city tiers[1] after peaking in April 2019, according to the National Bureau of Statistics (Figure 2b). The central bank urged banks to “reasonably” control lending to the property sector and will further increase supervision on already highly leveraged developers. It also urged banks to redirect funds to other industries. This enforcement follows a series of subtle restrictions already imposed on the property sector: banks asked not to cut mortgage rates; underwriters told to not help developers sell bonds onshore; more stringent requirements on offshore bonds issuance; and trusts (an important shadow-banking channel) told to rein in property lending.

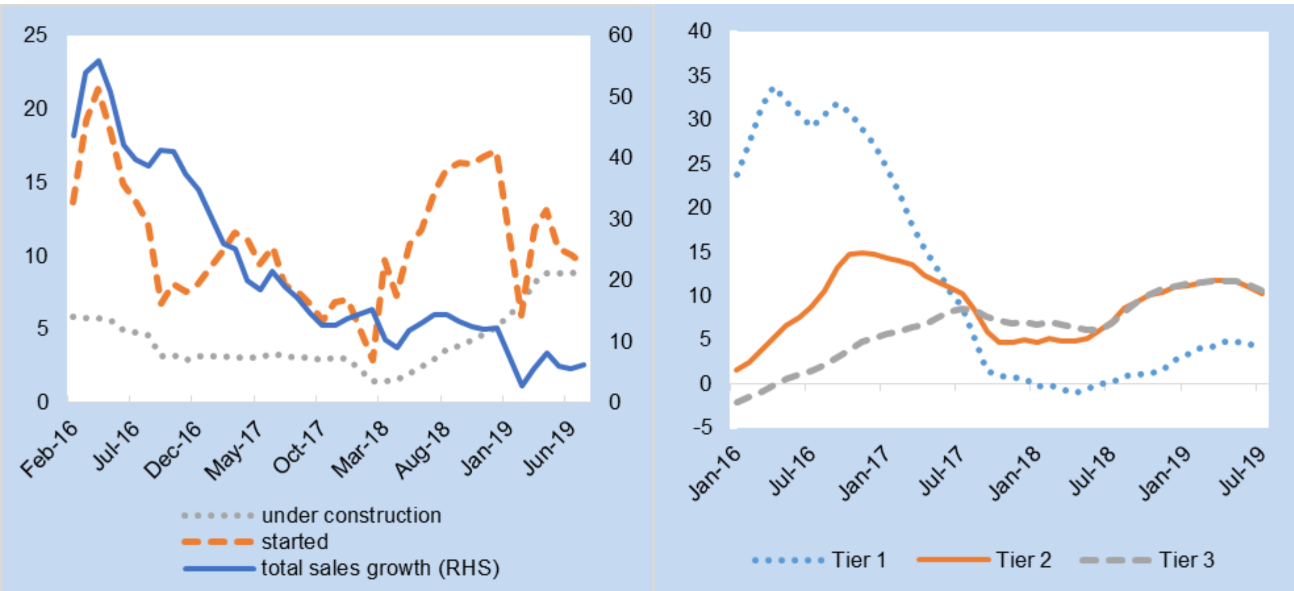

Figure 2a&b. Year-on-year change in newly started floor space and floor space under construction (LHS). Year-on-year total sales growth of buildings in China (RHS). Source: National Bureau Statistics of China, National Development and Reform Commission.

The slowing domestic market together with tightening funding condition has already started showing its marks in construction activity as well as performances of companies in the sector. Year-on-year change in newly started floor space decreased after an all-year high April this year; the rallying movement of those under construction slowed in April as well (Figure 2a). Since April 2019, the NUS-CRI Aggregate (Median) 1-year Probability of Default (Agg PD) of Chinese real estate developers increased by more than 50 percentage points, currently standing at 89 bps as of August 16, 2019 (Figure 3).

With increasing amount of bonds maturing in the coming three years (Figure 1b), the stricter credit condition may cast a concern on the refinancing needs of companies in the sector. Developers with already weak liquidity, high exposure to trust loans and small operating scale are likely to be hit the hardest, with nearly 300 small developers having gone bankrupt so far this year. A Chinese mayor recently forecast that two-thirds of China’s 97,000 registered developers could eventually also go under. All the above risk factors mean that protection for bond investors are now becoming more fragile.

[1] China’s city-tier classification is an informal system that categorizes cities based on three macroeconomic categories: GDP, population and politics. First-tier cities represent the most developed areas of the country with the most affluent and sophisticated consumers, densely population urban metropolises and huge economic, cultural and political influence in the country.

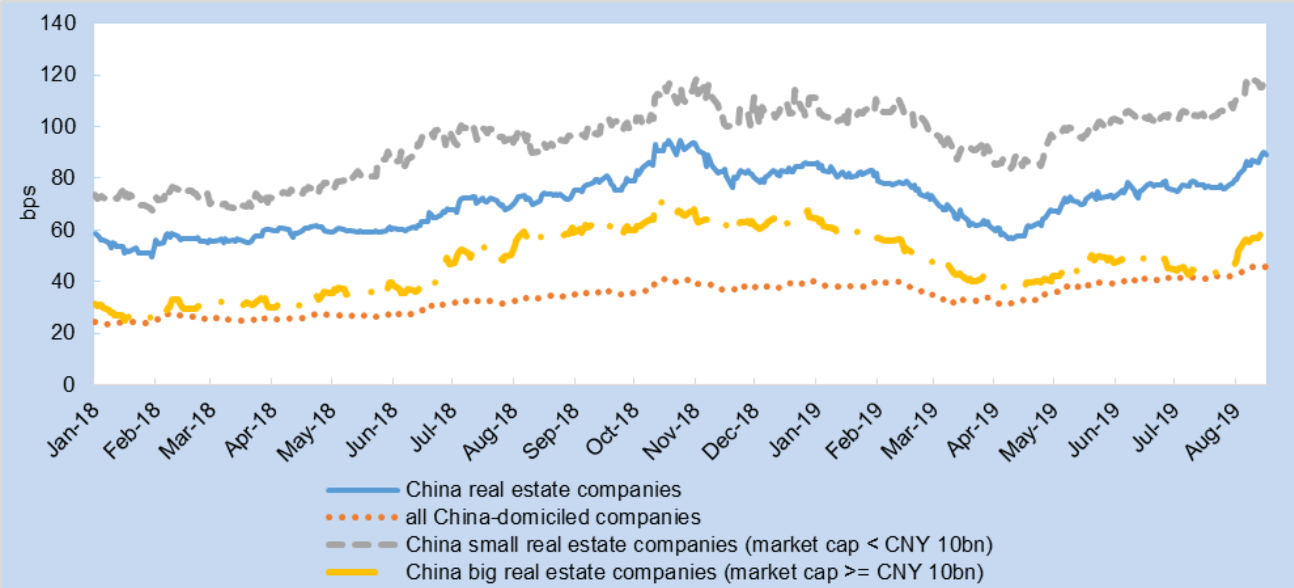

Figure 3. NUS-CRI Aggregate 1-year PD for Chinese real estate companies (categorized based on market capitalization) and all China-domiciled firms. Source: RMI-CRI

All is not doom and gloom, however. [The improved liquidity position] of companies in the sector, coupled with falling amount of debt maturing after 2021 (Figure 1b) may render a more optimistic outlook for the future. The NUS-CRI Forward 1-year Probability of Default (Forward PD) term structure for all Chinese real estate developer companies show a converging and decreasing trend in the 5-year horizon (Figure 4).

Yet in the near future, property developers with active dollar-denominated bonds face a degree of currency risks with more dollar-denominated bonds maturing in the coming five years (Figure 1b) as well as heightened yuan volatility. With the yuan showing continuous weakening movement this year, the Chinese USD credit is expected to be most adversely impacted. The first spike occurred on May 13, 2019 where it reached USD 6.9121 and the second hike to an unprecedented high of USD 7.0987 was seen on August 9, 2019. Concurrently, the Forward PD of Chinese real estate companies issuing dollar bonds show increasing trend in the next year as compared to their yuan-issuing counterparts (Figure 4).

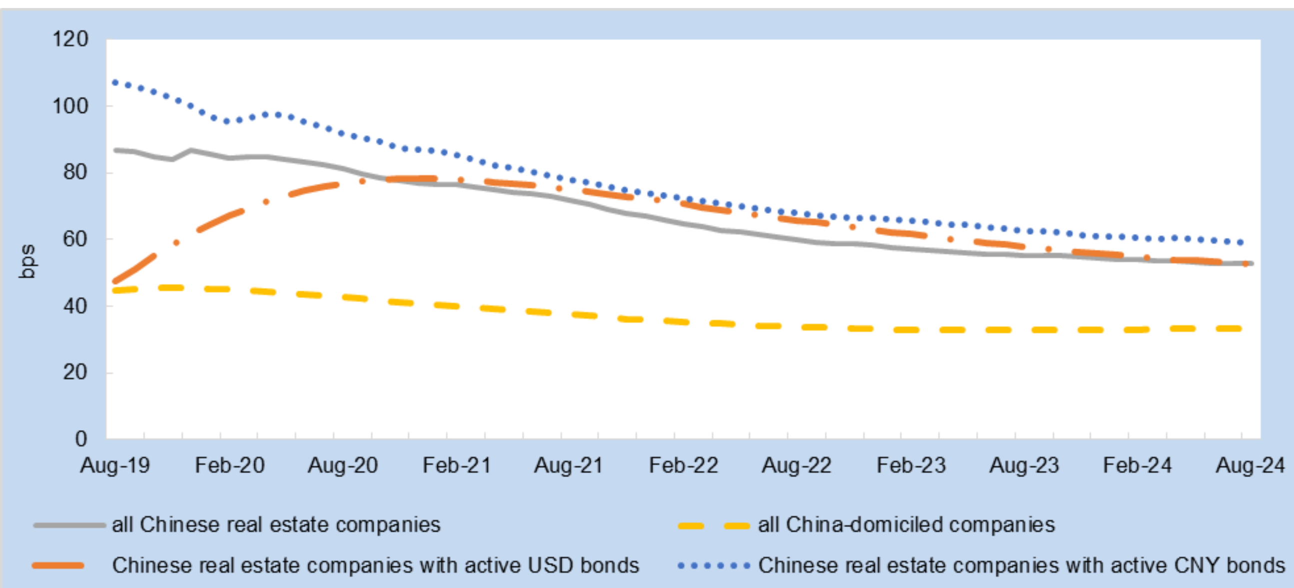

Figure 4. NUS-CRI Forward 1-year PD term structure for Chinese real estate companies, all China-domiciled firms and Chinese real estate companies with active bonds (categorized based on currency of issuance) based on information on August 16, 2019. Source: RMI-CRI, Bloomberg

The real estate sector in China is a systemically important sector in the country as it is the biggest driver of economic activity in the country, playing a significant role in investment and financial market behavior, and is by far the most popular collateral in the banking system. Hence, the performance of the housing market will also determine sentiment in the household lending scene. While the government needs to curb poor lending practices, contain high leverage among developers and prevent a property bubble, a slowdown in real estate investment may hit the country's GDP growth. According to an analyst from Financial Times, with all things equal, a fall in real estate investment from 11% in the first half of the year to 5% will lead to a 0.8bps fall in nominal GDP growth.

Other NUS-CRI WCBs on Chinese real estate sector:

China's developers facing refinancing pressure

Chinese real estate developers under pressure as real estate demand slows down

China's top property developers face tougher business environment

Credit News

Credit downgrades accelerate on all sides in US-China trade war

Aug 19. Credit rating agencies have downgraded listed companies worldwide at rarely seen levels this year, underscoring the risks to the global economy posed by the prolonged U.S-China trade war. The 487 downgrades for financial and nonfinancial companies through Aug 13 outpaced the number of upgrades by 60, according to data from S&P Global ratings. Net downgrades among American companies are at the highest in 3 years while among Chinese enterprises, the gap between credit downgrades versus upgrades has reached its worst in two years. The downgrades have been most pronounced in the energy, automotive and apparel sectors, those exposed directly to the trade war. Net profit among listed companies worldwide dipped 4% on the year in the April-June quarter but the current presence of monetary easing policies which were in effect after the global economic crisis allowed businesses to load on debt cheaply. (Nikkei Asian Review)

Large firms trim debt, fueling surge in bonds at center of leverage concerns

Aug 18. Debt reduction has been a top priority which is somewhat unorthodox in corporate America but it has been appreciated on wall street, where assessing the economic fundamentals of a handful of giant, heavily indebted companies has consumed investors and analysts for months. The newfound restraint of these firms is behind one of the most surprising developments in financial markets: BBB-rated corporate debt this year has outpaced other grades, belying fears that a sector that has ballooned during a recent boom in mergers and buybacks was vulnerable to a wave of potential downgrades. There has been strong demand for triple-B companies as they are both safer than speculative-grade debt and higher-yielding than other investment-grade bonds. Some investors are concerned that the increase in triple-B bonds is worrisome as they could be downgraded during an economic downturn. This could lead to further economic concerns as businesses will face an increase in their borrowing costs. (WSJ)

Investors face intensifying credit risks with US high yield corporate bonds

Aug 17. Non-financial corporate debt in the forms of loans and bonds is now about USD 16tn which equates to 75% of U.S GDP. This represents over 50% rise since 2007. Presently, a third of that debt is in the form of leveraged loans, which majority are covenant-and document-lite, and high yield bonds, also known as below investment grade bonds and junks bonds. If the Federal Reserve Bank cuts interest rates again, this will allow companies to continue pilling on debt. Investors are chasing for yield and pilling into corporate junk bonds. High-yield issuance slowed in August, but LCD data shows that thus far activity rose about 25% year to year in 2019. Moody's North American Covenant Quality Indicator (CQI) has showed that it has worsened to 4.56 in July from 4.49 in June and sits 117 basis points weaker than its record best of 3.39 in April 2011. With a worsening CQI, the spreads have narrowed. The implications for financial regulators and high yield bond investors suggests that investors are not being compensated for covenant risk. (Forbes)

Negative yields force investors to plunge into riskier debt

Aug 16. Victoria, a UK based company, tried to tap the bond market last year but the deal fell through due to concerns over its financial health. In July, however, the company managed to issue a 330m euro five-year bond that drew more than 1bn euro of orders. The popularity of the bond was due to the relatively high 5.25% yield that was offered. Two decades ago, well over half of the global bond market boasted yields of at least 5 per cent. The post-crisis splurge of central bank bond buying and rate cuts lowered the rate to under 16 per cent a decade ago but investors still had options of higher yielding debt. Today, a mere 3 per cent of the global bond market yields more than 5 per cent which is the lowest level on record. Negative interest rates in Japan and the Eurozone and expectations that the US Federal Reserve will increase rate cuts have led to the increase in the pool of bonds with sub-zero yields to more than USD 16tn which makes up 27 per cent of the global bond market. Investors are being pushed to search for riskier options in the bond market such as fragile countries, heavily indebted companies and exotic financially engineered instruments. This could lead to big problems such as encouraging the use of excessive leverage and creating asset bubbles that could eventually burst. (FT)

Over USD 5tn of corporate debt due through 2024, says S&P

Aug 15. Over the past year, the volume of US corporate debt falling due through 2024 has grown by 2% despite the efforts of companies to refinance and term out their maturity profiles, S&P said. The USD5.2tn figure includes bonds, loans and revolving credit facilities from financial and non-financial companies in the US and its tax havens. It represents 45% of global rated debt expected to mature during the period. In the face of market volatility, recent issuance of bonds and loans has been more than sufficient to meet upcoming maturity demands, said the report. While companies have been able to deal with near term maturities with new debt at cheap rates, investors still need to be wary of companies which are loading up on their balance sheet. Meanwhile, the median debt-to-Ebita for Triple B and Double B rated public companies is at its highest levels since 2006. (International Financing Review)

Argentina faces fresh turmoil from resignation, debt downgrades (Bloomberg)

Bond traders are hostage to a global gloom (Bloomberg)

Investor aversion to riskiest US corporate debt nudges yields higher (FT)

Regulatory Updates

China to introduce market-driven lending rate

Aug 18. People's Bank of China (PBOC) announced that it will make the loan prime rate (LPR) the benchmark for lending to replace the current system where lending rate is set daily by the central bank. According to a statement by the central bank, the move was a "market-based reform measure that will lower real lending rates". Under the new regime, the LPR pricing will be linked to the one-year medium-term lending facility, which is closer to market rates. The lending rate under the old regime was 4.35%, while the one-year medium-term lending facility, to which the new LPR will be linked, was 3.3%. Thus, the new measure is expected to lower funding cost for companies (FT)

Why the ECB will stuff free money into bank pockets again

Aug 16. The European Central Bank (ECB) is using every tool it has to boost the sluggish euro-zone economy as inflation in the euro area is currently below its 2% goal. It utilizes the Targeted Longer-Term Refinancing Operations (TLTROs) to get financial institutions to step up lending to companies, therefore stimulating economic activity and creating jobs. However, the risk from using this tool is that banks may become overly reliant on ECB for long-term funding, making a return to a normally functioning financial market much more difficult. Currently, the ECB has cut interest rates so low and bought up many bonds to the point that it has almost exhausted all of its tools, making it more urgent for European governments to move away from austerity and start spending more. (Bloomberg)

Hong Kong regulator probes Chinese corporate borrowing (FT)

As recession concerns mount, dozens of central banks are cutting rates (NYT)

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