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Country Garden's credit profile deteriorates significantly on missed bond payments and a profit warning

by Raghav Mathur

- **NUS-CRI PD for Country Garden skyrockets past the B- upper bound as the company issues a substantial profit warning and misses repayment on two bonds, entering a grace period**
- **Stress tests conducted using BuDA show that further distress in China's real estate market is likely to worsen the credit profile of China's systemically important banks, potentially leading to heightened contagion risk**

Embattled property developers domiciled in China are bracing for another wave of defaults catalyzed by the potential upcoming default of the country's biggest property developer, Country Garden Holdings Co (Country Garden). Although the trouble facing the property sector has weighed on China's economic growth over the last three years, with one of China's most leveraged real estate companies, China Evergrande Group, defaulting on its bond payments in late-2021, the latest sign of distress facing Country Garden suggests that the woes faced by China pertaining to low economic growth and consumption are compounding to the deterioration in the company's credit profile.

Country Garden has already missed payments on two of its USD-denominated notes due on Aug 6, 2023, worth USD 22.5mn, and has therefore entered the 30-day grace period to ensure repayment before technically defaulting based on NUS-CRI default definition. Country Garden currently has CNY 1.4tn of liabilities as of the end of 2022. With more than 52%[1] of its outstanding debt maturing over the next two years, Country Garden is facing immense repayment and refinancing pressures that are likely to lead to the distressed developer defaulting. As suggested by the NUS-CRI Probability of Default (PD) in Figure 1a, Country Garden's PD skyrocketed during the initial 10 months of 2022, driven by struggling sales and limited financing opportunities faced by the industry due to China's stringent zero-covid policy. However, by the end of Nov-2022, shares in the company had surged by close to 230% MoM as China eased its pandemic restrictions and investor sentiment towards developers improved on recovery prospects, improving the PD for Country Garden substantially below the B- Upper Bound when referenced to PdiR2.0 bounds[2]. However, a worsening in Country Garden's liquidity troubles suggested by the profit warning provided by its board members has seen its PD surge to above 1300bps by mid-August 2023.

[1] Data from Bloomberg

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

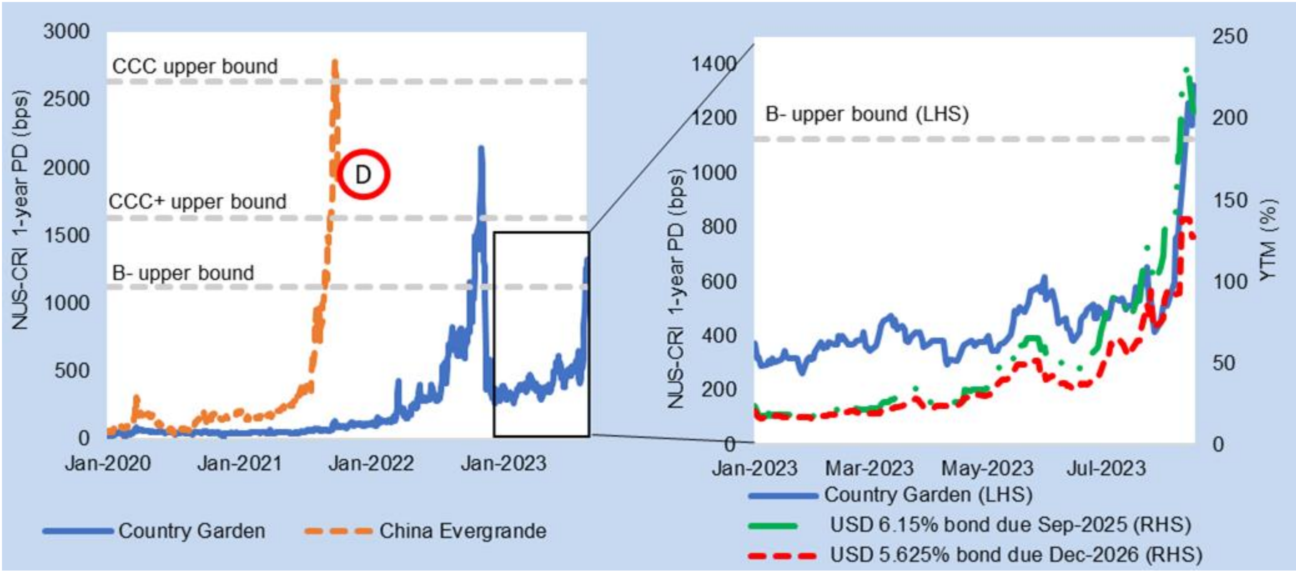

Figure 1a (LHS): NUS-CRI 1-year Probability of Default of Country Garden and China Evergrande Group with reference to PDiR2.0 bounds, highlighting Evergrande's default in 2021. Figure 1b (RHS): NUS-CRI 1-year Probability of Default of Country Garden and the yield to maturity (%) of select bonds issued by Country Garden. *Source: NUS-CRI, Bloomberg*

On Aug 10, 2023, Country Garden issued a profit warning stating that the group's H1 2023 net losses were approximately CNY 45-55bn, compared to a net profit of CNY 1.91bn over the same period in 2022. The slowdown in sales (decreasing 35% YoY in H1 2023) and an increase in impairment charges on property projects contributed heavily to the decrease in profit margin for Country Garden, contributing to the company's increasing PD since the start of the year. Country Garden had already been facing a decline in profits before the start of this year, which had led to an increase in the company's leverage as Country Garden's total debt to trailing 12M EBITDA ex operating leases increased substantially between H1 2022 and H2 2022 from 7.89x to 32.07x[3]. Furthermore, although the company's credit profile had remained robust during the initial property market downturn in 2021, especially during the latter part when China Evergrande defaulted (See Figure 1a) and raised contagion risk across China's property market, the current worsening of investor and consumer sentiment due to a sluggish macroeconomic recovery in China has now led to the company facing constrained cash flows and pressured financing capabilities.

As seen in Figure 1b, yields on Country Garden's USD-denominated bonds due over the next three years have skyrocketed, highlighting the immense borrowing cost the company faces in tapping the public markets for funds to refinance their upcoming debts. Though Country Garden has halted trading in over 10 of its onshore bonds, with plans to restructure the bonds to be paid back in installments over the next three years, many creditors are demanding full repayment, making restructuring difficult for the company. Access to the necessary funding may also arise in the form of inventory liquidation. Country Garden has a higher inventory of unsold properties than China Evergrande prior to its default[4]. Given the current negative sentiment for property sell-throughs in China's households, especially those in the rural area, Country Garden may find it harder to offload unsold properties to investors than Evergrande. Even if it does manage to raise funds through inventory liquidation, it is likely to be at a heavily discounted price, putting further pressure on Country Garden's profitability, and vis-à-vis, liquidity.

[3] Data from Bloomberg.
[4] Via Bloomberg Intelligence.

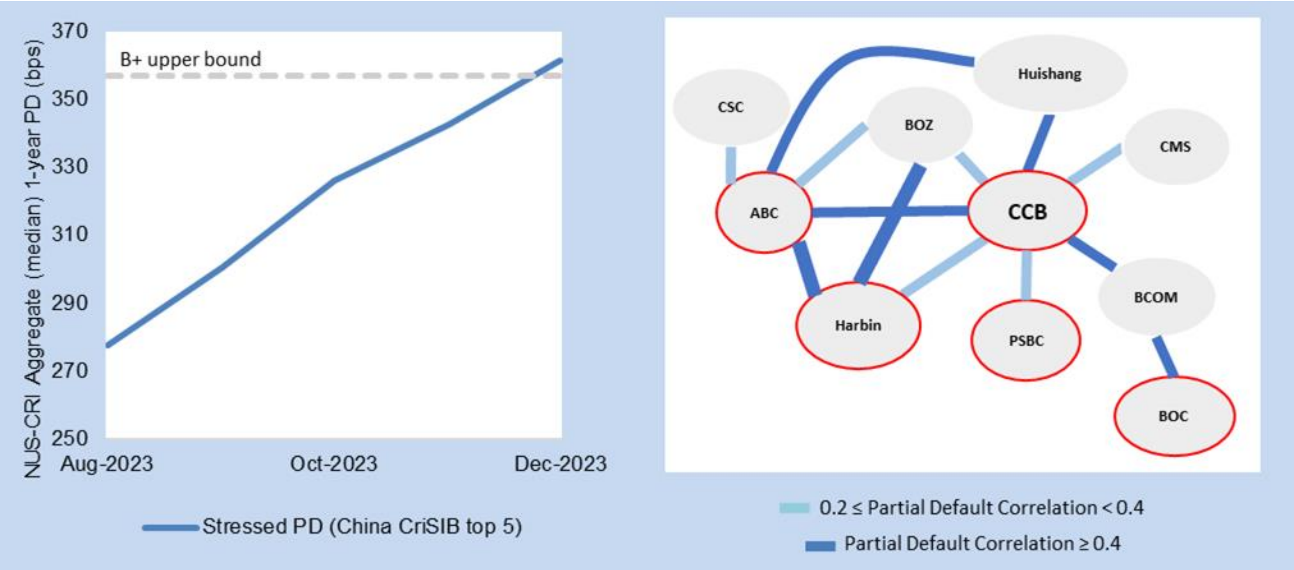

Figure 2a: NUS-CRI Stressed 1-year PD for top 5 CriSIB (Based on Jul-2023 rankings) using the NUS-CRI BuDA Toolkit. Figure 2b: Visualization of China-domiciled banks' partial default correlation (Based on Jul-2023 data) for CriSIB top 5 firms (highlighted in red) of greater than 0.2. *Source: BuDA v3.5.1, NUS-CRI*

The implications of Country Garden defaulting can ripple to the wider real estate market as well as to China's domestic financial network. The distress felt by Country Garden has so far already led to a decline in the Hang Seng Mainland Property Index (HSMPI) by close to 20% MoM in Aug-2023. As such, should Country Garden default, the HSMPI would likely fall further. To simulate the impact of a contagion-driven decline in China's property market (assuming HSMPI drop further to HKD 1000 by Dec-2023) on the wider financial network, the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA) can be utilized. As seen from Figure 2a, the NUS-CRI stressed 1-year PD for the top 5 systemically important banks in China based on Jul-2023 CriSIB rankings[5] increases by close to 80bps by the end of 2023, reflecting the potential for systemic risk build-up in China's domestic banking industry. Furthermore, as seen from Figure 2b, an increase in the credit risk of the CriSIB top five banks may increase the probability of systemic risk buildup as most of the five banks have a partial default correlation[6] of greater than 0.2 to another CriSIB. The impact is not limited to those in the top five, as other major domestic banks in China may also face the ripple effects of a property market downturn[7], especially due to increased exposure through state-incentivized credit lines extended to the developers over the past three years.

Country Garden is set to vacate its spot in Hong Kong's Hang Seng Index as its share price continues to tumble. Without further government intervention and support, Country Garden is likely to face headwinds over the next six-to-twelve months that trickle to the wider real estate market and the banking network. Though the company is not as leveraged as Evergrande before the latter's default, it does have a substantially bigger balance sheet of unfinished and unsold projects, amplifying the impact of the current sales slowdown on its financial performance and liquidity. Given its potential to impact the systemic risk of the wider banking network, its chances of surviving in the near term are based primarily on the improvement in the country's macroeconomic environment, as well as further support provided to it by the state. Regardless, without any exogenous factors that improve the company's liquidity and profitability metrics, Country Garden's default over the next twelve months seems destined.

[5] The top 5 systemically important banks based on Jul-2023 CriSIB rankings are: Agricultural Bank of China (ABC), China Construction Bank (CCB), Bank of China (BOC), Postal Savings Bank of China (PSBC), and Harbin Bank (Harbin).

[6] Partial default correlations measure only the direct connection between any two banks in terms of their future default likelihoods. For example if default events in Bank A and B are correlated, and Bank B and C are correlated, naturally A and C are going to be correlated as well. But in a partial correlation matrix, the correlation of A and C will be 0. You may find more information here.

[7] Figure 2b shows the list of firms with a partial default correlation with CriSIB top 5 of more than 0.2. These firms are as follows: BCOM = Bank of Communications, CMS = China Merchants Securities, BOZ = Bank of Zhengzhou Co Ltd, CSC = CSC Financial Co, Huishang = Huishang Bank Corp Ltd.

Credit News

Strong US economy forces investor rethink on interest rates

Aug 19. The robust US economy and ongoing inflation concerns have spurred a substantial surge in borrowing costs on both sides of the Atlantic, triggering a reevaluation of global interest rate trajectories. This week, a global bond sell-off drove US 10-year Treasury yields to levels close to their highest since 2007. Correspondingly, UK gilt yields reached their highest since 2008, and French government bonds climbed to levels unseen since 2012. This shift in yields is a response to encouraging US economic indicators and central banks' cautious approaches. Investors are recalibrating expectations, pushing out rate cut predictions. The bond market upheaval has taken some investors by surprise, questioning the notion that interest rates had peaked. (FT)

Debt crisis risks are rising in Korea on credit union woes

Aug 21. South Korea is facing renewed concerns of a financial crisis as credit unions grapple with souring loans less than a year after a debt crisis hit the country. MG Community Credit Cooperatives, one of South Korea's largest credit unions, recently closed a branch after reporting a USD 45mn loss on real estate-related loans, triggering deposit outflows amid fears of rising default rates. Delinquency rates at MGCCC climbed from 3.59% at the end of the previous year to 6.18% in late June. Additionally, spreads on three-year won debt from a category of these lenders have approached a four-month high reached in July. The majority of South Koreans rely on floating-rate loans to finance their real estate holdings, making them vulnerable to further delinquencies if interest rates continue to rise. (Bloomberg)

Chinese banks challenged as economy wobbles and property market woes mount

Aug 18. Chinese banks are facing a number of operational challenges amid economic and property market instability. These challenges could lead to increased provisions in late 2023 and early 2024, partly due to Country Garden Holdings Co.'s delayed payments on dollar bonds. Additionally, the banks are under scrutiny as troubled shadow bank Zhongrong International Trust Co. has defaulted on multiple products and is planning debt restructuring. These issues highlight the financial sector's vulnerability to problems in the property sector and a sluggish economy, exacerbated by exposure to local government financing vehicles and deflationary pressures. Despite concerns about the worsening economic outlook, Chinese banks made a smaller-than-expected reduction in their benchmark lending rate, emphasizing the need for increased lending to support economic recovery. (Bloomberg)

Bond yield hits highest since 2008, adding pressure to borrowing costs

Aug 16. The 10-year U.S. Treasury note yield reached a 15-year peak at 4.258%, causing concerns on Wall Street about potential repercussions in stock, bond, and housing markets. This key interest rate benchmark surged due to solid economic data, prompting a shift in investor sentiment away from a looming recession. The rising yields have triggered unease, given their history of market destabilization. While they're still below the Fed's short-term interest rate level, analysts fear continued increase could disrupt markets and upend yield-based strategies. Higher yields could lead to lower bond prices and impact mortgage rates. This milestone reflects a changed economic landscape since the pandemic's onset, with inflation and central bank policies playing a significant role. (WSJ)

China taps public funds to ease risks from small, midsize banks

Aug 21. Chinese local governments are escalating fundraising efforts to aid small and midsize banks, aiming to mitigate financial system risks as bad loans surge. Between January and July, they issued CNY 147.3bn (USD 20.3bn) in special bonds, exceeding the full-year 2022 amount by 130%. These bonds, sold to domestic banks, offer higher yields than government bonds and were authorized for bank rescue since 2020. Pandemic challenges and interest rate cuts have hindered bank profitability, driving reliance on public funds. Strict COVID-19 policies contributed to rising bad loans, impacting banks. While official data suggests stabilized bad loan ratios, experts contend lenient assessments mask deeper issues. Economic recovery challenges persist due to declining real estate and structural problems. Small and midsize banks must swiftly reform with public funds to boost profits, else regional debt concerns could exacerbate. (Nikkei)

Mortgage rates hit 7.09%, highest in more than 20 years (WSJ)

China Evergrande seeks U.S. court approval for USD 19bn debt restructuring (WSJ)

Vietnam hopes property shakeup will remedy supply-demand mismatch (Nikkei)

Regulatory Updates

China cuts loan rate less than expected as calls grow to stimulate economy

Aug 21. China has reduced its benchmark lending rate by 0.10% to 3.45%, aiming to protect bank profits while addressing a slowing economy, weakening currency, and property market challenges. The move surprised markets, leading economists to lower growth forecasts, with Citigroup revising its projection to 4.7%. The muted action suggests Beijing's reluctance to provide significant stimulus, contrary to expectations of policy support. The one-year loan prime rate was lowered, but the five-year rate remained unchanged. This decision reflects efforts to maintain bank stability and protect net interest margins, while concerns grow about China's economic prospects amid a complex landscape of financial challenges. (FT)

BOJ's record-bond buying is driving need for YCC tweaks

Aug 21. The Bank of Japan (BOJ) has been buying government bonds at a record pace in 2022, likely in response to rising interest rates. The BOJ has doubled the effective cap on benchmark yields twice this year, but this has not significantly reduced its bond buying. As a result, the BOJ may need to make further changes to its policy settings in order to rein in purchases. The increase in buying after each policy tweak raises the question of whether the BOJ moved too slowly in adjusting its settings. If market pressure does not relent, the BOJ is projected to buy JPY 124.6tn in government bonds this year, up 12% from 2022. This would be the highest level of buying since 2016, when the BOJ launched yield-curve control. (Bloomberg)

India central bank allows infra debt funds to raise money via foreign loan route (BT)

Latin American central banks take lead in cutting rates as inflation cools (WSJ)

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