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Weekly Credit Brief Jan 04 - Jan 10 2022

Credit risk for Chinese school operators heightens on the back of regulatory crackdowns

by Wang Nan

- **The NUS-CRI Agg PD of Chinese school operators elevated nearly tenfold in 2021, stemming from intensifying industry regulatory clampdowns**
- **The NUS-CRI Agg Forward PD shows that the credit outlook for Chinese school operators is set to improve in the long run on the back of industry's transition into vocational and higher education segments favored by government policies**

With tightening regulations[1] that aim to reduce students' workloads and overhaul the education industry that has been "hijacked by capital", the China-domiciled school operators (Chinese school operators) industry is undergoing sweeping reforms, casting a spotlight on the industry's credit health. Facing operational headwinds pertaining to cash flow generation and increased leverage, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Chinese school operators surged to a peak of over 90bps in Dec-2021 compared to around 10bps in Mar-2021 before the regulatory crackdown, soaring above the BB upper bound when referenced to PDiR2.0[2] bounds and the country's Agg PD (Figure 1a). Concurrent with Chinese school operators' efforts to adapt operations towards vocational and higher education, the credit outlook of Chinese school operators is set to improve as displayed by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[3]) in Figure 1b.

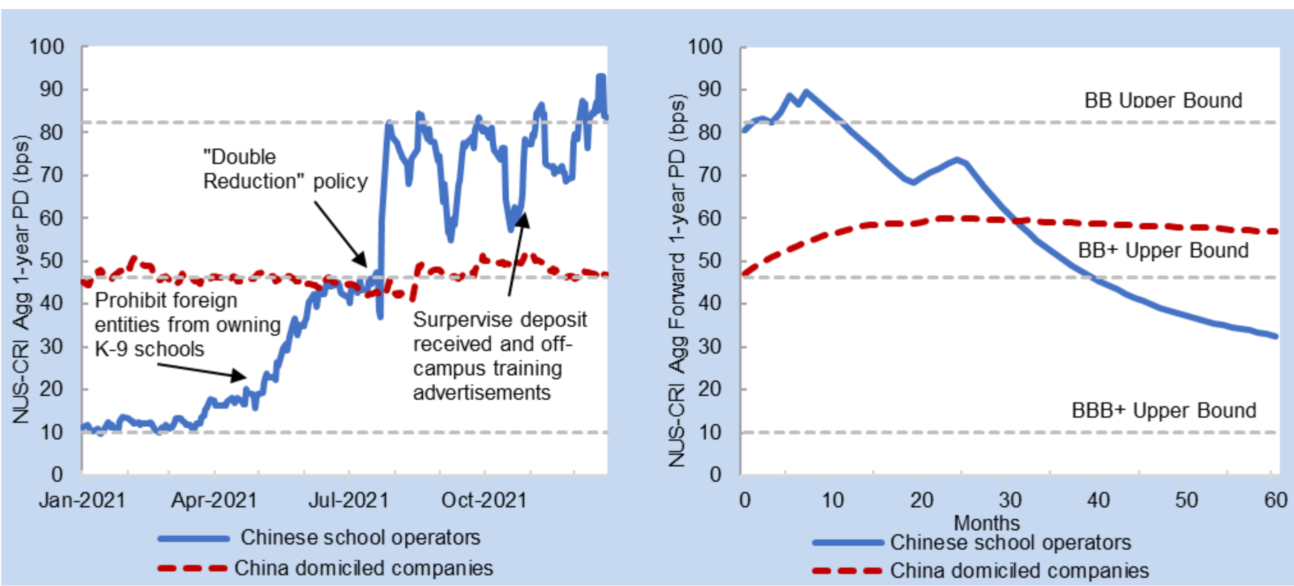

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Chinese school operators and all China-domiciled companies referenced to PDiR2.0 bounds from Jan-2021 to Dec-2021. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Chinese school operators and all China-domiciled companies as of Jan-2022 referenced to PDiR2.0 bounds. *Source: NUS-CRI*

The Chinese government has announced a broad set of policies for Chinese private education since May-2021 to ensure capital generation and profit-making practices are hindered in the education industry, delivering an immense shock to the industry's credit health. China's State Council promulgated the rules in May-2021 that

[1] Refer to the law published in May-2021, which prohibits foreign investors from directly investing in Chinese K9 education, and the "Double reduction policy" issued in Jul-2021, which suggests a reduction in the total amount and time of school homework commitment and a reduction in the burden of off-campus tutoring programs.
[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.
[3] 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 18 months, conditional on the firm's survival in the next 6 months.

prohibit foreign entities from profiting from K9[4] education services via Variable Interest Entity (VIE) structures. As most US-listed Chinese school operators have high exposure to K9 education services, the new set of regulations has disproportionately impacted their credit health (See Figure 2a).

Furthermore, the "Double Reduction Policy" introduced in Jul-2021 tightened restrictions on tutoring schools[5], preventing these schools from making profits and raising capital. Under this policy, all tutoring schools have had to file as non-profit organizations. Meanwhile, all "subject-based"[6] tutoring institutions are prohibited from raising funds from capital markets[7], including conducting initial public offerings (IPOs), severely impacting the industry's access to financing.

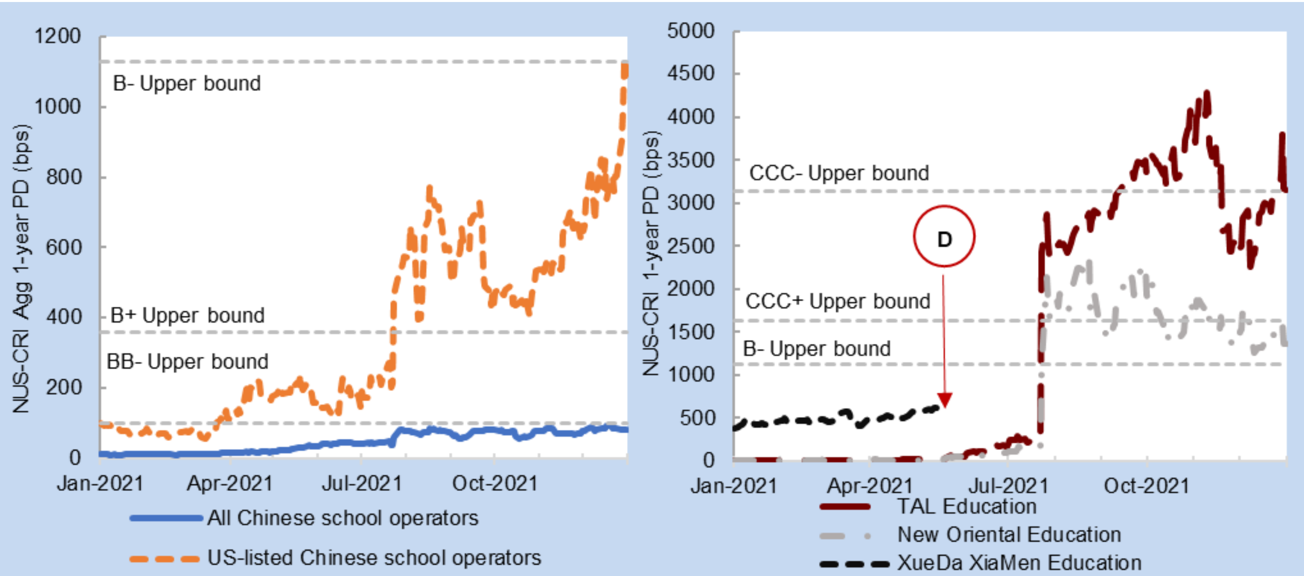

Figure 2a (LHS): NUS-CRI Agg 1-year PD for US-listed Chinese school operators and all Chinese school operators referenced to PDiR2.0 bounds from Jan-2021 to Dec-2021. Figure 2b (RHS): NUS-CRI 1-year PD for TAL Education Group, New Oriental Education & Technology Group Inc, and XueDa XiaMen Education Technology Group Co Ltd referenced to PDiR2.0 bounds. *Source: NUS-CRI*

The shortened tutoring time, combined with a government-guided tuition fee pricing system[8], poses limits to revenue derived from the K9 segment. Companies that did not leave the K9 business could face worsening repayment ability, given the potential loss of revenue in the future. With more than 80% of tutoring institutions having closed or switched to other businesses as of Dec-2021, and many industry giants have announced their exit from the K9 tutoring market, operational revenues have been negatively impacted. For example, New Oriental Education & Technology Group, whose main revenue driver comes from the K9 market is expected to lose 60% of its revenue after announcing its exit from the market.

	H2 2019	H1 2020	H2 2020	H1 2021
FCFF to Debt Ratio	0.22	- 0.20	0.20	- 0.10
Debt to Capital Ratio	27.51	22.59	28.62	30.75
Current Ratio	1.12	1.38	1.32	1.15
Cash and Cash Equivalents to Total Debt	0.95	0.93	1.18	0.72

Table 1: Financial ratios (median) of Chinese school operators. *Source: Bloomberg*

One-off expenses brought about by the transition into new business segments, such as severance compensation, refunds on pre-paid tuition for classes, and other overheads like breaking leases on existing tutoring space, are also hindering cash flows. To relieve cash flow pressure, companies may have been forced to increase their borrowing. As a result, the education industry's amassed leverage, combined with the pressure on cash flows, has heightened the industry's liquidity and repayment concerns (See Table 1). Some leading school operators are experiencing heightened credit risk as shown by elevated PD (See Figure 2b). For instance,

[4] K9 refers to the education from kindergarten to 9th-grade, which is compulsory education in China.
[5] Refers to schools which target compulsory education students and offer subject-based tutoring.
[6] Subject-based generally refers to the subjects taught in compulsory education schools, including Chinese literature, history, geography, math, foreign languages, physics, chemistry, biology, morals and law.
[7] Financing activities and capital injections into tutoring institutions will be further regulated. All "subject-based" tutoring institutions are prohibited from conducting initial public offerings (IPOs) or otherwise raising funds from capital markets.
[8] Training fees for subject-based tutoring programs targeting compulsory education students will implement a government-guided price, and their tutoring operating time is also shortened.

XueDa Xiamen Education Technology Group extended its loan once again in May-2021. TAL Education's total liabilities to cash and near-term receivables ratio reached 1.15x in Feb-2021.

As these companies are shifting their business towards vocational and higher education, subsequent working capital expenditures may further hinder their liquidity positions. Meanwhile, the uncertainty of expanding into new business segments may heighten operational risk in the short term. Furthermore, the industry has been experiencing a dramatic sell-off in 2021, demonstrating investors' raised concerns about its outlook as well, which may limit financing options, especially in the context of the regulatory overhaul. The industry's financial health post-reform is likely to heavily rely on the successful transition of school operators into new business segments. As such, the Forward PD in Figure 1b sees a slight increase before decreasing in the long run.

Furthermore, the credit health of Chinese school operators is set to improve steadily in the medium-to-long term on the back of growth opportunities provided by the vocational and higher education business segments. The vocational education market is expected to grow at a CAGR of 7% from 2020 to 2030. Simultaneously, due to favorable government policies and high barriers to entry, the growth prospects of China's higher-education school operators are also expected to improve. Resultantly, Chinese school operators will face lower credit risk in the future as indicated by the Forward PD if they are able to survive the current regulatory and operational challenges.

Credit News

Bond selloff rattles markets

Jan 9. A crash in the bond market at the beginning of the year has brought the long-term yield to a new high since the start of the pandemic, shocking the financial markets. The yield on the 10-year Treasury note jumped from the year-end close of 1.496% to 1.628% at the beginning of the year, closing at 1.769% and reaching its highest level since Jan-2020. Investors expect the yields to increase in 2022 as the Fed starts hiking interest rates. Yet, the jump in yields happened faster than expected and caused severe volatility. Rising interest rates can increase corporate borrowing costs. Higher yields also drive up borrowing costs for households, reflected by the average 30-year mortgage rate reaching a nearly 2-year high of 3.22% last week. (WSJ)

Chinese developer Shimao puts all property projects on sale

Jan 10. After its default on a trust loan last December, Chinese property developer Shimao Group Holdings has put its entire residential and commercial property projects on sale. Shimao has agreed to sell its commercial property Shimao International Plaza Shanghai to a Chinese state-owned company for over CNY 10bn. Currently, Shimao still has around CNY 34.2bn of asset-backed securities and USD 5.72bn of dollar bonds outstanding. (Reuters)

Huge wave of upgrades is surging to U.S. corporate bond market

Jan 8. The Covid-19 induced recession has driven the most corporate downgrades since the 2008 financial crisis, but the amount of investment-grade debt currently being evaluated for a potential upgrade has grown to USD 203bn, the most since 2010, marking an accelerating recovery in the markets from the pandemic. Dell Technologies has seen its debt upgraded from junk to investment-grade, and big names such as Netflix and Kraft are expected to follow suit. A bond's impending upgrade is highly likely to be reflected in its price, therefore limiting the scope for inflated returns in the future. (Bloomberg)

Top emerging-market bond fund bets on Sri Lanka default gain

Jan 10. Vontobel Asset Management in Zurich, which profited off Ecuador's restructured bonds in 2021, is currently expecting Sri Lanka to default on its debt by mid-year to buy more of its bonds at a discount. Since the start of the pandemic, a huge chunk of Sri Lanka's external bonds has lost half of their value as the country's tourism industry took a hit from the pandemic and foreign reserves shrunk. Currently, the country still has about USD 15bn of outstanding external bonds with its next principal payment on Jan 18. Sri Lanka has requested the restructuring of debt payments lent by China and is also deliberating a bailout from the International Monetary Fund. (Bloomberg)

China's Dec new yuan loans seen lower, hit record in 2021

Jan 7. China's new bank loans in December were projected to fall, despite the record-high lending in full 2021 as the central bank maintained policy support for the economy. The estimated amount of new yuan loans issued by Chinese banks last month was CNY 1.25tn, lower than the CNY 1.27tn in November. Based on the forecasts, total new lending in 2021 would reach CNY 20.07tn, breaking the record of CNY 19.63tn in 2020. China's central bank also cut the reserve requirement ratio (RRR) on Dec 15 for the second time in 2021 to inject long-term liquidity for business activities and lowered the rates on the re-lending facility by 25bps to support the rural sector and small companies. Broad M2 money supply grew 8.7% in December, compared to 8.5% in the previous month. Outstanding yuan loans were projected to increase 11.7% in December YoY, the same as in November. (Reuters)

China's Kaisa pressured by local government to repay wealth product investors (Reuters)

Key Bund yield on brink of turning back above zero (FT)

IMF says emerging economies must prepare for Fed policy tightening (Reuters)

Regulatory Updates

ECB may need to act if energy price rises more persistent: Schnabel

Jan 8. Rising energy prices may force the ECB to temper high inflation, especially if the green transition proves inflationary. Inflation hit a record high of 5% last month, but the bank has not tightened policy so far, arguing that price growth will abate on its own as it is mainly driven by transitory one-off factors. ECB board member Isabel Schnabel said there were two scenarios in which the ECB would have to change policy. The first is if high energy prices spill over to other sectors of the economy and alter price-setting behavior, while the second is if energy prices, heavily impacted by carbon taxes and the green transition, threaten to push headline inflation above target. (Reuters)

Fed's Daly: reduce balance sheet sooner, go gradual on rate hikes

Jan 8. San Francisco Federal Reserve Bank President Mary Daly participated in a debate on when to wind down the Fed's balance sheet. She expects this to happen shortly after one to two rate hikes by the US Fed. She claimed that the Fed's balance sheet is a powerful tool but the Fed has little experience with it. She prefers to see the Fed gradually adjusting policy rates and start balance sheet reduction quicker than that witnessed in the last cycle. Once the impact of balance sheet reduction on the economy can be seen, the Fed can alter the policy rate accordingly. (Reuters)

Ex-IMF official urges China to add carbon to monetary goals (Bloomberg)

Big Czech rate hikes can continue, central banker Benda says (Reuters)

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