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Yurun Group in the eye of Chinese credit storm

by Justin Hsiao

Yurun Group is the 8th largest private group in China, covering a wide array of industries - food, real estate, commerce, logistics, finance, etc. The group has two listed companies: China Yurun Food Group Ltd (Yurun) listed in Hong Kong and Nanjing Central Emporium Co Ltd (Central) listed in Shanghai. Yurun is the major business of the Yurun Group and it is China's second largest pork producer in terms of sales. Its logo can easily be seen in supermarkets across China. Central operates a century-old shopping center in Nanjing and is the commerce and real estate arm of the group. With its core food business under pressure and its massive expansion in real estate investment exposing it to a large amount of debt, Yurun Group has witnessed the credit health of both of its listed entities deteriorating significantly since 2015. One subsidiary even defaulted in March this year.

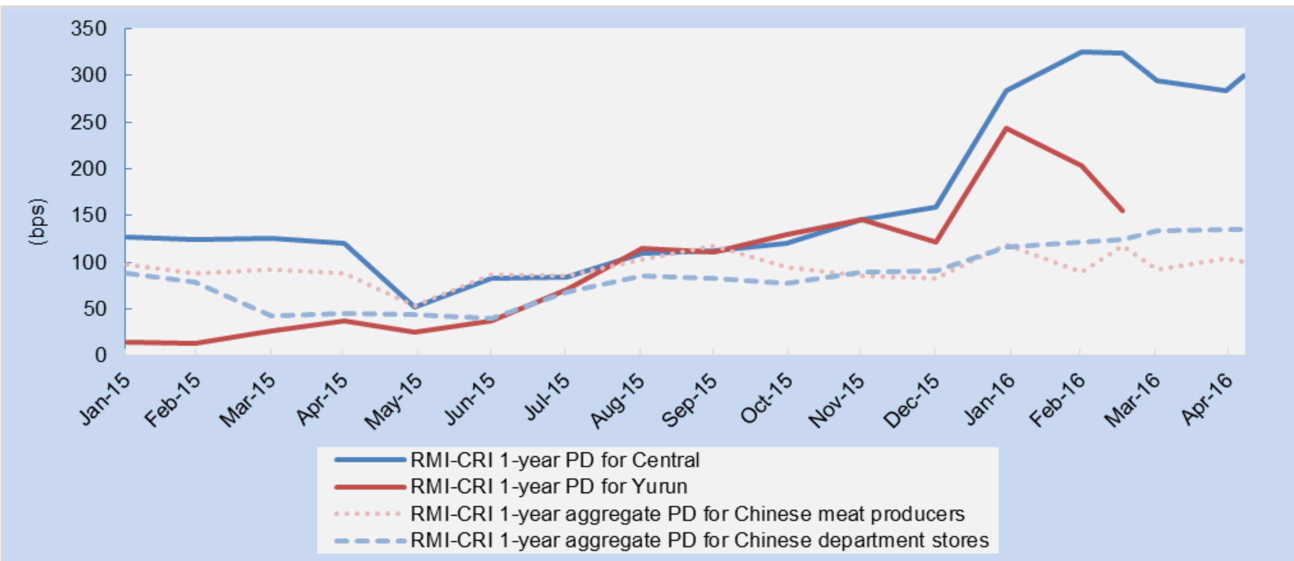

Figure 1: RMI-CRI 1-year PDs for Yurun and Central; and RMI-CRI 1-year aggregate PDs for 12 meat producers and 18 department store operators in China. *Source: RMI-CRI*

The RMI-CRI 1-year Probability of Default (PD) for Yurun started to increase in 2015 (see Figure 1). In Sep 2015, the PD for Yurun surpassed the aggregate PD for its peers and reached its highest level of 243bps on Jan 29, 2016. The PD estimation for Yurun was halted on Mar 17 due to a default of a wholly-owned subsidiary on a RMB 500mn note. In the same period, the RMI-CRI 1-year PD for Central doubled from 127bps at the beginning of 2015 to 300bps on May 6, 2016.

In March this year, Nanjing Yurun Foods Co (Nanjing Yurun), a subsidiary of Yurun, failed to make full its payment for a RMB 500mn onshore bond due on Mar 17. Nanjing Yurun has been suffering from higher production costs, and softer demand for pork among catering services due to the Chinese economic slowdown and the anti-corruption campaign. Moreover, China agreed in Oct 2015 to lift the restrictions on American pork import and thus, increasing the competition for domestic players.

Based on Nanjing Yurun's financial report in Q1 2016, the fixed assets and construction-in-progress accounted for 60.9% of its total assets, a ratio higher than that of other meat producers. According to some analysts, many meat companies piled into real estate investments because they saw bigger margins. However, it appeared that the company's strategy was affected by the slowdown in China's broader economy. The large and illiquid real estate investments made Yurun struggle to cope with its debts. On May 13 this week, another RMB 1bn of Nanjing Yurun's debt is going to mature. The firm has already filed an announcement with the Hong Kong Stock Exchange, expressing uncertainty over the fulfillment of its debt obligations in a timely manner.

In the consolidated financial statements of Yurun (see Table 1), the net income margin dived into negative territory in 2015. In the latest preliminary result, Yurun reported a net loss of RMB 2.4bn in 2015. The declining cash ratio indicates Yurun's draining ability to fulfill its short-term debt obligations, while the rising net debt to EBITDA ratio shows the firm's soaring leverage.

	H1 2014	H2 2014	H1 2015	H2 2015
Net Income Margin (%)	0.18	0.40	-7.55	-21.29
Cash Ratio	0.22	0.12	0.09	n.a.
Net Debt to EBITDA	7.65	9.25	258.60	n.a.

Table 1. Credit metrics of Yurun (H2 2015 is based on the preliminary result). *Source: Bloomberg*

Central is also highly geared (see Table 2). The firm's total debt to equity ratio increased from 476.03% in 2014 to 529.53% in 2015. The firm had net cash outflows from operation of RMB 2,048mn in 2014 and RMB 1,289mn in 2015. The high level of, and the increase in, the cash conversion cycle (CCC) also indicate that Central has mismanaged its working capital. CCC expresses the length of time, in days, that it takes for a firm to convert resource inputs into cash flow. In Central's case, the CCC was 416 days in 2014 and surged to 578 days in 2015.

	2014	2015
Total Debt/Equity (%)	476.03	529.53
Cash Flow from Operation (RMB mn)	-2,048.0	-1,289.1
Cash Conversion Cycle (days)	415.51	577.63

Table 2. Credit metrics of Central. *Source: Bloomberg*

Zhu Yicai, the group's founder and long-time chairman, is currently under house arrest by the officials, which indirectly has had an impact on the group's operations and reputation, putting Yurun Group in an even thornier situation. In 2016, China's debt market garnered global attention as a record RMB 3.7tn of local bonds is coming due through year-end. Moreover, an unprecedented number of more than 20 bond defaults have been confirmed so far in 2016, as many debt-laden companies feel the pain of China's economic slowdown. Even Yurun Group, one of the biggest conglomerates in China, has been caught up in the eye of this credit storm.

Credit News

Shadow lending crackdown seen forcing China banks to sell bonds

May 9. Chinese banks are issuing bonds to comply with new loan provision disclosure rules. According to analysts' estimates, lenders will need an additional RMB 1tn of capital over the next few years as banks have to make full disclosure for loan rights transferred to other financial institutions. Chinese lenders have been recording the loans as receivables via asset management plans on their balance sheet, allowing the banks to sidestep capital requirements. However, with the new rules in place, banks may find it more difficult to understate their delinquent loans and cut provisions. (Bloomberg)

World corporate debt far exceeds pre-Lehman financial bubble, warns IIF

May 9. The Institute of International Finance (IIF) warned that the level of corporate debt across the world has far exceeded the pre-Lehman bubble. Emerging markets saw a five times increase in corporate debt while junk bond issuance hit new records in developed economies, such as the US and Europe. Larger portion of debt has also been used on dividends, shares buyback, and M&A rather than capital spending. Corporate defaults were at their peak since the financial crisis and they are not only restricted to the energy sector. (IBT)

Moody's: Singapore banks' first quarter results support negative ratings outlook

May 5. The first quarter results of the three-largest Singapore banks pinpointed rising challenges and aligned with the negative outlook on their ratings assigned by Moody's. These banks have revealed a further weakening in their asset quality and profitability since the end of 2015. While only OCBC saw its domestic loan quality worsen, all the three banks reported higher NPL ratios for their foreign lending. Moody's expects more pressure on profitability for all three banks, as the economic and trade growth in Asia remained slow and additional provision is required for oil and gas companies. The silver lining is that the pre-provision income remains robust and sufficient to prevent the rising credit costs from eating into the banks' capital buffers. (Moody's)

China fertilizer default highlights rising credit risk

May 5. China's overall debt reached a record high of RMB 163tn (USD 25tn), or 237% of GDP, at the end of March. Growth has slipped from 6.9% in 2015 to 6.7% in the first quarter of 2016. Inner Mongolia Nailun Group has failed to meet interest and early redemption payments due on Thursday and became the 12th Chinese company to default on a domestic bond so far this year, compared with 19 for all of 2015. More than RMB 700mn worth of bonds were submitted for early redemption out of the RMB 800mn seven-year bonds sold in 2011. Despite the view that the recent defaults are unlikely to trigger systemic risk, analysts expect further defaults this year. Rating agencies have issued 49 downgrades of domestic bonds so far this year, compared with 126 in 2010. (FT)

Helicopter operator CHC Group files for bankruptcy protection (WSJ)

US oil industry bankruptcy wave nears size of telecom bust (Channel News Asia)

Greece passes austerity measures as creditors remain deadlocked over bailout terms (WSJ)

Regulatory Updates

Agencies propose net stable funding ratio rule

May 9. The US federal banking agencies have proposed the Net Stable Funding Ratio (NSFR) rule, requiring large banking organizations to maintain a minimum level of stable funding. The proposal seeks to improve banking resiliency and financial stability by reducing possible disruptions to a bank's sources of funding that may compromise its liquidity position. The rule will be adjusted to the risk of the banking organizations with more stringent requirements on larger firms. The NSFR would come into effect on January 1, 2018. (Federal Reserve)

India takes steps to overhaul creaking bankruptcy code

May 8. Earlier on Thursday, the Lok Sabha, India's lower house of parliament, passed the Insolvency and Banking Code, which will reduce the time it takes to wind up a company and speed up the process of recovering debts from firms that default. Compared with the new code, which will force troubled companies to resolve bankruptcy proceedings within 180 days or face liquidation, the existing century-old laws give banks a hard time recovering bad debt, with the case of Kingfisher tycoon Vijay Mallya, who owes banks more than USD 1.3bn, bringing the issue into sharp focus. (FT)

Banks face new rule that magnifies loss reserves in weak economy

May 6. The new accounting rules - to set aside provision on all loans based on expectation on future performance and the economic situation – will go into effect in 2020. The provision on all loans is to increase by 13% on average at the current credit condition as estimated by Keefe, Bruyette & Woods (KBW) or 30% to 50% in a recession scenario as estimated by a KBW analyst. The difference between the loan-loss reserves at current credit conditions and that during a recession scenario could be eightfold for the four largest US lenders. The purpose of this new regulation is to prevent profit cannibalization eat into the capital of the US lenders as well as to prevent losses to jump in a time of crisis. A London-based KBW analyst estimates that every 1% of growth in lending would cause a negative 0.1% effect on earnings and capital, with the new accounting rules. (Bloomberg)

New proposed rule to support US financial stability by enhancing the resolvability of large financial firms

May 3. Under a newly proposed rule, US global systematically important banks (GSIB-s) and US operations of foreign G-SIBs are required to amend contracts for common financial transactions to prevent the immediate cancellation of the contracts if the firms enters bankruptcy. G-SIBs are known to conduct a large amount of financial transactions and a massive cancellation of the contracts may lead to panic selling and asset fire sales. The proposed rule is consistent with the Dodd Frank and Consumer Protection Acts that advocate the orderly resolution of financial institutions in a manner compliant with the International Swaps and Derivatives Association Protocol. (Federal Reserve)

Systematically important Mexican banks ready to meet additional capital buffer for G-SIBs (Reuters)

Bank of Canada aims to develop stress test framework (Reuters)

Saudi Arabia will continue to support banks despite new law on the resolution of financial institutions (Gulf Business News)

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Contributing Editor: Khaw Ker Wei