Despite policy-related tailwinds, credit risk for Chinese developers remains high

by Aditi Kamath & Elaine Uy

- **NUS-CRI Agg 1-year (median) PD suggests that the credit risk of Chinese developers remains heightened in the face of several high-profile defaults**
- **NUS-CRI Forward PD suggests that the credit risk is set to improve, though remaining at heightened levels, for the industry as further credit is extended to the industry, and as Chinese cities emerge from lockdowns**

The People's Bank of China (PBOC) slashed the 5-year Loan Prime Rate (LPR) by 15bps on May 20th, 2022 in an attempt to incentivize banks to extend credit and aid the recovery of the domestic property market. The relief came after Sunac China Holdings (Sunac)[1] defaulted on its offshore bond earlier this month, dealing another blow to the credit health of China-domiciled property developers (Chinese developers) that have witnessed an increasing number of high-profile defaults. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Chinese developers has generally worsened since 2021, highlighting its continued distress (See Figure 1a). Even though the Chinese government has rolled out several policy measures to support the industry, Chinese developers are still struggling to service their debt obligations as falling demand for housing limits their revenue-generating abilities. At the same time, increasing refinancing costs signal lenders' wariness of the industry's deteriorating credit health as refinancing continues to remain expensive. The impact of the restorative policies and measures introduced by the government can be gleaned from the shape of the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]). With operational and financing headwinds persistent in the short-term, credit risk remains heightened (See Figure 1b). Nevertheless, as major cities in China begin to emerge from COVID-19 related lockdowns and as demand for properties is expected to partially recover, due in part to the lending rates decreasing, the industry might see an improvement in its credit health.

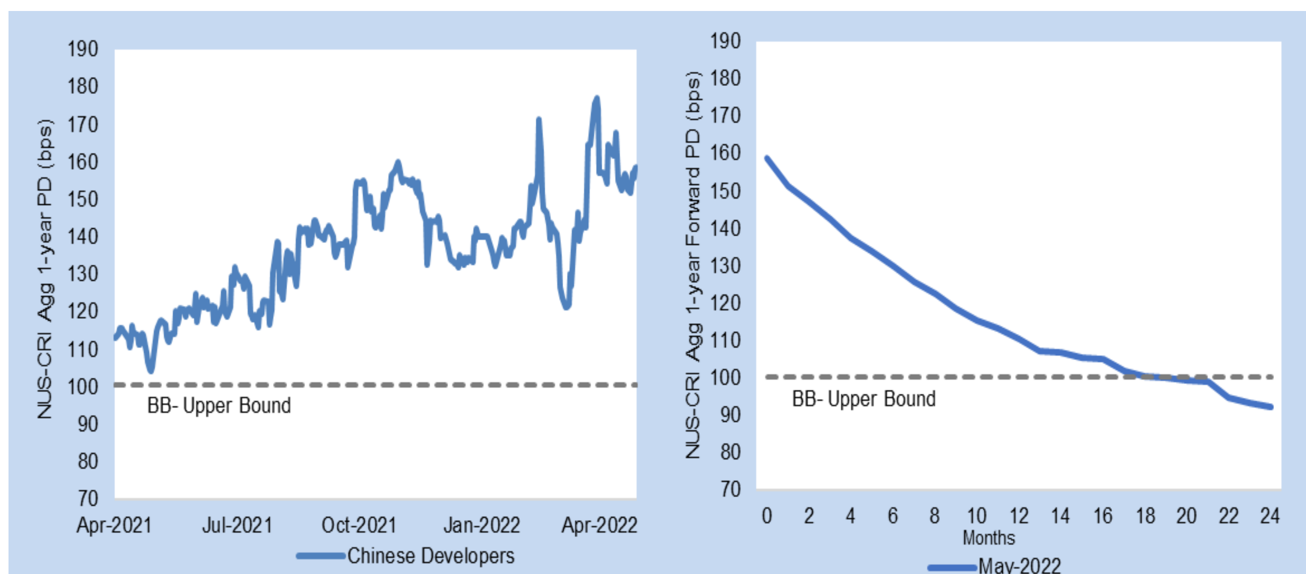

Figure 1 (LHS): NUS-CRI Agg (median) 1-year PD for Chinese developers from Apr-2021 to May-2022 with reference to PDiR2.02[3] bounds. Figure 1b (RHS): NUS-CRI Agg (median) 1-year Forward PD for Chinese developers as of May-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] Sunac is the fourth largest property developer (in terms of sales) in China, and its demise followed the series of defaults of major developers such as China Evergrande, China Properties Group, Zhenro Properties group since the adoption of the TRL policy in 2020.

[2] 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.

[3] 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.

The introduction of the "Three Red Line" (TRL) policy[4] kickstarted the wave of defaults in Chinese developers in 2021, as the government aimed to reduce the industry's highly-leveraged capital structure[5]. As property developers have decreased borrowings to more prudent levels in the face of heightened refinancing pressures and high-profile defaults, the industry's median leverage ratio has improved and stabilized to around 45% (See Figure 2a). Moreover, the stringent lockdowns in Shanghai and Beijing, because of the recent COVID-19 outbreaks in 2022, have posed additional headwinds for the industry's credit profile as sales of houses are down 47% in Apr-2022 compared to Apr-2021[6]. These difficulties prompted the Chinese developers to lower prices[7] to meet sales targets at the expense of their bottom line. As margins contract, Chinese developers also face a potential liquidity concern especially as 35% of their obligations are maturing by 2023 (See Figure 2b). With limited access to additional external borrowings, Chinese developers may turn to equity financing to meet operating and liquidity needs. Even then, the consecutive high-profile defaults of major property developers have made investors reluctant about the current condition and outlook for the industry, causing significant withdrawals and driving stock prices downward.

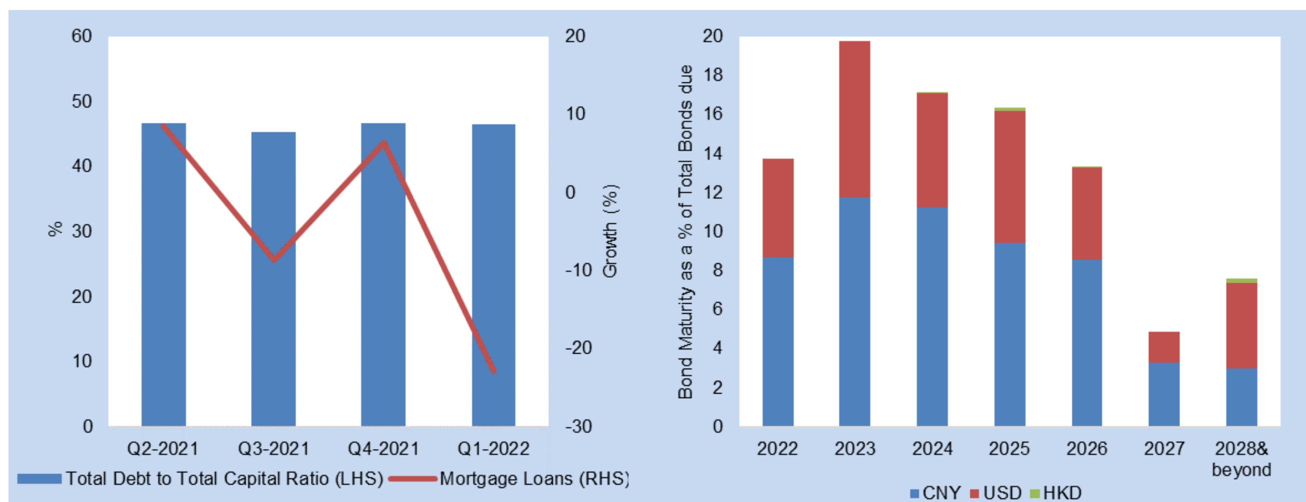

Figure 2a (LHS): Median leverage ratio & growth in total mortgage loans for Chinese developers. Figure 2b (RHS): Bond maturity as a percentage of total bonds due by year. *Source: Bloomberg, National Bureau of Statistics*

In an effort to rein in the current property crisis, the decrease in LPR[8] by the Chinese government aims to reduce the cash-flow problems faced by property developers. Though housing sales in China have remained weak in the first four months of 2022 compared to those in 2021, the expected increase in credit extension to mortgages should improve domestic property sales in the short term, though the widespread recovery in sales to pre-2021 levels prior to the TRL policy is unlikely as property buyers and households are cautious regarding future lockdowns should China continue its zero-COVID policy. In fact, even as the government had eased lending requirements[9] to stimulate demand, mortgage loan growth is still slower in Q1 2022 compared to the same period in the last year. In the meantime, while the expected result on consumer behavior remains unrealized, these policies enacted by the PBOC can help the cash-strapped property developers improve their short term debt-servicing capability by systemically allowing banks to extend credit into the sector. Indeed, loans to property developers witnessed an upward trend in Q1 2022 after four months of decline. However, it may also act as a double-edged sword as it hinders the deleveraging efforts that were at the forefront of the government's TRL policy over the past two years.

[4] The TRL policy, which was introduced in 2020, requires developers to comply with the three thresholds or "red lines": a 70% ceiling on liabilities to assets (excluding advance proceeds from projects sold on contract), a 100% cap on net debt to equity, and cash to short-term borrowing ratio of at least 1.

[5] TRL policies have also been used by investors and banks to screen against riskier property developers, limiting the latter's ability to secure new financing or refinance existing ones. By the end of 2021, between 30-40% of the industry is compliant to the TRL policy.

[6] Prospective customers were either unable to travel and visit property listings or are redirecting expenditures towards necessities, hindering new sales of housing throughout the country.

[7] House prices have been decreasing for four consecutive months while residential units sales have declined by 64% YoY in May-2022.

[8] The 15bps rate cut in May-2022, comes as the second and the largest cut in 5-year LPR since the start of the property crisis, following an initial reduction of 5bps in Jan-2022. PBOC had also approved a 10bps reduction in 1-year LPR in Jan-2022.

[9] Several local governments have introduced measures to ease accessibility of mortgage loans by reducing down payment, fees, and taxes while improving loan approval procedures, and easing regulations for owning multiple properties.

Currently, Chinese developers face multiple headwinds arising from the pandemic-stricken housing market as dwindling demand since the beginning of this year has significantly reduced revenues. Furthermore, with upcoming near-maturing debts, the availability of refinancing avenues has continued to remain limited, which could decrease the probability of survival for vulnerable firms in the industry[10]. While policies rolled out by the Chinese government are expected to bolster housing demand, their effectiveness would ultimately depend on favorable consumer and investor outlook for the industry. Therefore, the risk of default going forward, as suggested by the Forward PD, is set to fall conditional on whether the firms can survive the current market conditions, despite them having worsened since the beginning of this year.

[10] State-owned developers have a stronger credit profile as they receive access to cheaper financing. As private developers face leverage restrictions due to the TRL policy, their influence in land auctions have been limited, driving down auction prices hence allowing state-owned firms to procure land at cheaper rates.

Credit News

Bonds rally everywhere in May with bulls saying selloff is over

May 31. After investors have factored in the risk pertaining to recession and monetary tightening into pricing, and propelling the yields up in the previous weeks, the bond market is finally recovering. The high yields have previously made the bonds more attractive but have since fallen as more investors flee toward less volatile assets. The bond rally has pushed the US 10-year yields down to 2.84% from a 3-year high of 3.2% in May, with other similar bonds following suit. However, investors still maintain reservations about Chinese debt considering the impact of the lockdowns and continuing uncertainties in the property sector. Overall, the recovery might still be interrupted by new inflation concerns especially as central banks have signaled the possibility to further hike interest rates until price pressures ease back to target. (Bloomberg)

Russia's whipsaw week ends with default clock ticking

May 29. The Russian government is again facing a default threat as they missed payment due last Friday for coupon payments in EUR and USD worth USD 100mn, triggering the 30-day grace period. However, the Russian government stated that the amount was debited in favor of depositors' accounts to the NSD, suggesting that the payment had been made, but not settled with creditors. This comes at a time when the Russian government is facing increased repayment, with close to USD 400mn due in June. The government, which has been spending heavily on its military due to its invasion of Ukraine, still aims to solidify its position as a credible and reliable borrower, though US' sanction exemption, which is expiring soon, may hinder that position. (Bloomberg)

Evergrande discussing staggered payments, debt-to-equity swaps for USD19bn offshore bonds

May 27. China Evergrande Group is considering repaying offshore bondholders owed around $19 billion with cash installments and equity. Its 22.7 billion worth of offshore debt is deemed to be in default after missing payment obligations late last year, and the developer's woes led to a wave of defaults in China's property sector. After the default of Evergrande's bonds, Guangdong provincial government has been leading the restructuring. According to the proposal by Evergrande, the offshore bonds will be repaid in installments over a period of 7 to 10 years. Offshore creditors also will be allowed to swap a portion of their debt into stakes in its Hong Kong-listed property services and electric vehicle units. (Reuters)

UK's credit market tells a grim story of a looming cash crunch

May 29. The high-grade bonds market had contracted in 2022 amidst the compounding unfavourable macroeconomic factors such as increasing interest rates, a cost-of-living crisis with record-high inflation levels, and the added fallout from Brexit. The decline was gauged by an index, whose market capitalization had shrunk by USD 48bn, worst-to-date since 2000. With the current inflationary economic conditions, issuers UK corporates struggle to service debt, and should they need to refinance, are forced to pay higher coupons because of higher borrowing costs. Likewise, the threat of stagflation is driving up volatility in the credit markets causing banks and other lenders to exercise caution in providing liquidity. (Bloomberg)

Convertible bonds drop as investors cool on once-hot tech companies

May 24. The turbulence in the bond markets has affected even the yields of convertible bonds issued by tech companies that have soared to popularity during the pandemic. Prices of the convertible bonds have dropped following the declines in the stock prices, as investors have become pessimistic that the shares will be able to recover and reach the levels required to allow for conversion. The recent poor performance of these tech stocks may have offset the features included in the debt component of the securities such as protection from shareholdings dilution and lower borrowing costs. (FT)

China state-backed builder rocks bond market with delay plan (Bloomberg)

Bets against US Treasurys rake in gains as Fed raises rates (WSJ)

Plagued by default fears, Russian e-commerce player Ozon boosts spending (Reuters)

Regulatory Updates

Lagarde prepares for ECB liftoff with yet more record inflation

May 29. Inflation for the eurozone is expected to accelerate with the median estimate pegged at 7.8%. The statistic comes as the ECB is deciding on whether an aggressive approach to tightening monetary policy will be taken. Aside from the inflation statistics from its member countries, the ECB is also considering factors such as the impact of supply chain disruptions, the Russia-Ukraine war, and China's zero-COVID policy. Likewise, the recent actions by the Fed will be factored into the ECB's decision to determine the speed at which the rate hikes would need to happen. The ECB had previously signaled and is expected to end bond purchases in June before it starts increasing rates. (Bloomberg)

Fed embraces 50-basis-point rate hikes in June, July to curb 'very high' inflation

May 26. This month's 50-basis-point hike in the Fed's benchmark overnight interest rate was the first of that size in more than 20 years, and most participants at the Federal Reserve's meeting judged that further hikes of that magnitude would "likely be appropriate" at the Fed's policy meetings in June and July, according to the minutes of U.S. central bank. Inflation data in America has yet to show a convincing turn lower, and some analysts, meanwhile, have raised the risks of a recession. The policy path after July will depend upon the trajectory of inflation and progress toward correcting the imbalances in the labor market. (Reuters)

European banks led by BNP to benefit from Basel rule change (Bloomberg)

RBNZ confident of 'soft landing' despite rapid rate hikes (Bloomberg)

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