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Weekly Credit Brief
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Chinese property sector risk in focus: government support does little for structural demand downturn

by Raghav Mathur

- **NUS-CRI Agg PD for Chinese property owners and developers shows credit risk has marginally elevated YTD as new housing demand and financing hurdles cloud the sector's outlook. A large increase in PDs' interquartile spread suggests that tail risk is rising.**
- **NUS-CRI Forward PD suggests a worsened credit outlook for 2024 for the sector, as it faces structural demand challenges. The rising risk is also spilling over to Chinese LGFVs, which have seen their median credit risk increase.**

Distress in China's real estate crisis continues as more high-profile developers face financing and liquidity pressures. The industry, which has been beset by a myriad of defaults and an elongated downturn over the past three years, has also witnessed a plethora of new regulations and policy support that aim to improve new home sales in the current deflationary market. As seen from Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) has gradually elevated YTD, despite showing marginal improvement due to the announcement of the relief measures. Given the continuous stream of high-profile defaults amidst distressed developers, the Markit iBoxx USD China High-yield real estate index has also lost close to half its value over the same period, suggesting that the market sentiment pertaining to the real estate sector is yet to receive a boost despite the central government's efforts. In addition, as seen from Figure 1b, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) suggests that implementation of the new policy has not provided an immediate reprieve to the credit outlook of the industry, with the outlook for 2024 worse in Dec-2023 than in Jan-2023. However, as the policies take effect and Chinese household demand for new homes recovers, the credit outlook of developers and owners may improve as suggested by the downward-sloping term structure of the Forward PD.

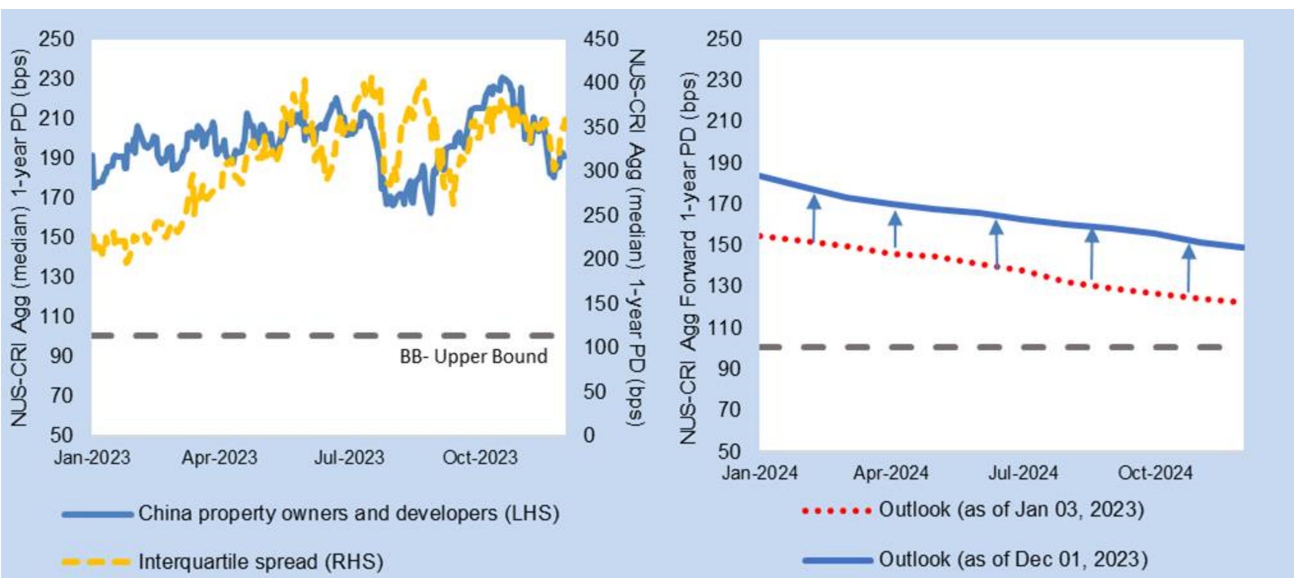

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for China-domiciled property owners and developers (LHS axis) and its interquartile spread (RHS axis) with reference to PDiR2.0 bounds[2]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for China-domiciled property owners and developers as of Jan 03, 2023, and Dec 01, 2023, with reference to PDiR2.0 bounds. *Source: NUS, Bloomberg.*

[1] 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.

[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.

In Oct-2023, major cities, such as Beijing, Guangzhou, Shenzhen, and Shanghai saw new home prices drop by 0.3% on average, despite Shanghai managing to increase prices by 0.2% MoM. Investment in real estate over the past ten months has also dropped by 9.3% YoY, while total new home sales by floor space also tumbled by 7.8% YoY over the same period. Despite policy support that saw an increase in first-time home buyers' ability to get cheap mortgages and lower down payment rates in Sep-2023, sustained demand recovery in the sector has shown limited prospects. The Chinese government is finding it difficult to catalyze growth in the real estate sector as consumer confidence continues to wane. Although the economy as a whole improved marginally in Oct-2023, with industrial production leading the recovery and increasing by 10bps compared to Sep-2023 on a yearly basis, short-term improvement in the credit outlook of the real estate sector is likely to be minimal, with the Forward PD in figure 1b suggesting that the 1-year credit outlook to still be above the BB- upper bound according to PDiR2.0 estimates for the industry on aggregate.

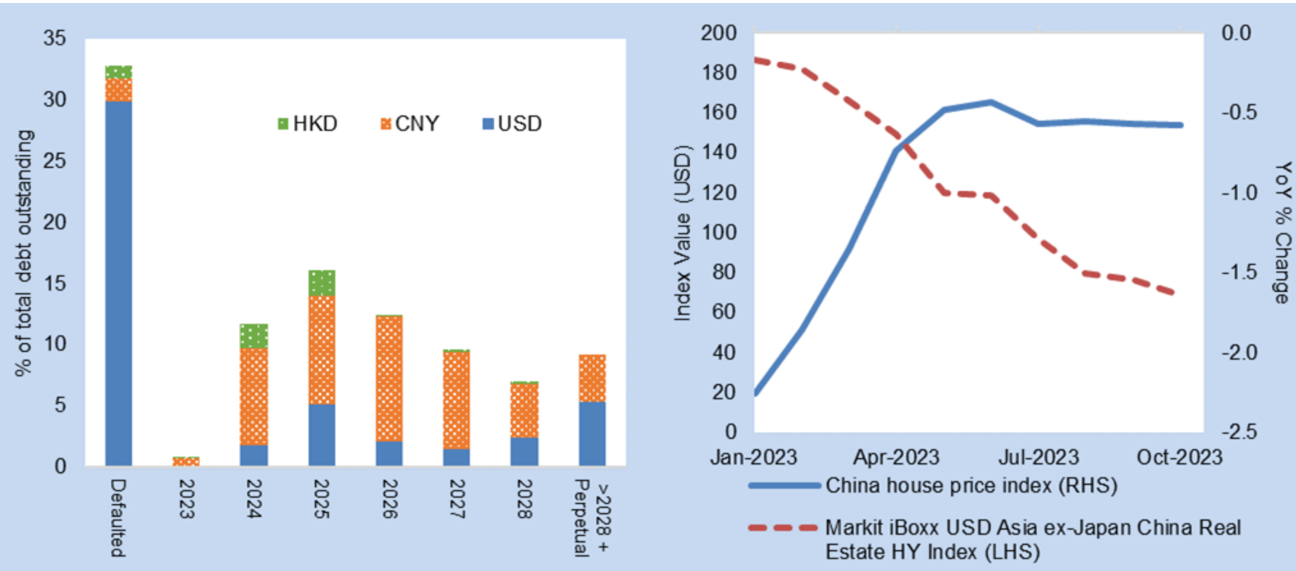

Figure 2a (LHS): Debt distribution, as a % of total debt outstanding, of Chinese real estate developers and property owners' upcoming maturities as of Dec 05, 2023, broken down by currency. Figure 2b (RHS): Markit iBoxx USD Asia ex-Japan China real estate high-yield index (LHS axis) and China 70 cities newly built commercial residential buildings prices YoY average (RHS axis). *Source: Bloomberg.*

Focusing on the sector's debt repayment position, the sector seems to be facing heightened refinancing pressure over the next two years, with the debt repayment burden reducing marginally in the longer term. As seen from Figure 2a above, the debt distribution for the Chinese real estate sector highlights a near-term maturity wall, with more than a quarter of the total debt outstanding maturing by 2025. To highlight the distress faced by the sector during the incumbent slowdown, more than 30% of the outstanding debt of companies in our sample is currently under default, the majority of which are denominated in USD. With a plethora of USD-denominated bonds trading at distressed levels, yields have skyrocketed, making refinancing expensive. The sector has also seen a rise in the participation of distressed debt funds that are purchasing bonds and loans of struggling companies at a discount in the hopes of higher returns post-restructuring. However, failed restructuring efforts, such as China Evergrande Group's scrapped USD 35bn restructuring plan, have posed headwinds to their efforts, hurting demand for distressed debt purchases.

The prolonged impact of the property market downturn is likely to impact local government financing vehicles (LGFVs) as well. Although the sector has deleveraged over the past couple of years, the systemic importance of the real estate sector to the economy has seen a widespread build-up of risk across sectors. LGFVs are facing a liquidity crisis, as revenue from local land sales dropped by 20% in H1 2023, raising the risk of default as LGFV's liquidity comes under strain. Using Criat's iRAP China toolkit[3], the median 1-year PD of all China's LGFVs has increased from 37bps in Aug-2020 (the beginning of China's three-red-line policy) to 84bps as of Dec-2023. Although LGFVs' median credit risk is still rated BBB- by Criat's PDiR, more than a quarter of the LGFVs in China have ratings that are non-investment grade. Support by the central government has allowed LGFVs to increase the issuance of shorter-term bonds to raise the necessary financing to ride out the current downturn.

The Chinese property sector, which has already faced a long battle in a bid to deleverage, is yet to face further hurdles as government support does not improve the sector's credit outlook. The Forward PD in Figure 1b

[3] iRAP (intelligent Risk Analysis Platform) China toolkit is a software developed by Criat for conducting both firm-level and portfolio level credit analysis for firms and LGFVs domiciled in China.

suggests that short-term risk in the sector has elevated, despite the term structure remaining downward sloping. To make matters worse, the recent change in outlook by Moody's on China's sovereign ratings to negative, risks further contagion spreading against Chinese public markets. A continued slump in consumer demand for new houses, as well as wider negative investor sentiment pertaining to the distressed sector, suggests that further aggressive stimuli from the Chinese government are required to catalyze recovery.

Credit News

Foreigners flood back to Indonesian bonds on bets Fed is done

Dec 04. Indonesia's bonds have attracted significant foreign investment following the central bank's rate increase and improved perceptions of emerging market assets amid expectations of a U.S. Federal Reserve rate cut by mid-2024. In November, international funds invested USD 1.5bn in Indonesian sovereign notes, the highest since January, marking a potential first annual foreign inflow in four years. This follows a period of reduced foreign investment due to a diminishing interest rate differential with the U.S. and anticipated local debt rise. The Bank Indonesia rate hike in October, preceding the Fed's early pause, widened this differential, leading to a decrease in the yield on Indonesia's 10-year note by over 60bps from its October peak. (Bloomberg)

Turmoil from BOJ policy bets shakes up Japan credit market

Dec 04. For years, the yen bond market has benefited borrowers with its low and stable costs. However, rising speculation about the Bank of Japan potentially tightening its monetary policy is now posing risks to this market. Currently, there's a decrease in investor demand for corporate bonds, even as companies hasten to secure funds at these low rates while possible. Market volatility has already led to the cancellation of some bond deals. In response, borrowers are considering new pricing strategies to attract investment. This situation signals a period of uncertainty for the Japanese bond market in 2024, a market previously known for offering inexpensive funding compared to other currencies where borrowing costs have risen. (Bloomberg)

'Zombie' CLOs are new hurdle in European debt restructurings

Nov 30. The complexity of the Collateralized Loan Obligation (CLO) industry in Europe is posing a significant challenge for companies seeking to restructure their debt. European CLO lenders are finding themselves constrained by their own investment deadlines, which hinders their ability to participate in deals that would allow for the extension of repayment terms for struggling companies. This situation is forcing companies in financial distress, such as PlusServer GmbH and Tele Columbus AG, to incur additional costs as they are compelled to engage in costly and protracted legal processes to restructure their debt. This issue emerges as a new hurdle for distressed companies already burdened by rising borrowing costs, hitting them at a time when they are most vulnerable. (Bloomberg)

US bonds on track for best month in nearly 40 years

Nov 29. US bonds are poised for their strongest monthly performance since 1985, as optimism surrounding potential Federal Reserve interest rate cuts fuels a rebound. The Bloomberg US Aggregate bond index surged 4.3% in November, turning its yearly returns positive and echoing global bond market gains. Interest rate futures now fully anticipate a quarter-point cut by the Fed in May 2024, a notable change from mid-October projections. This rally has led to lower yields on 10-year Treasuries, and investment-grade corporate bonds are experiencing a robust recovery, with significant inflows and narrowing spreads. (FT)

Mortgage rebound slows pace of eurozone credit contraction

Nov 28. Eurozone bank lending, experiencing a significant slowdown, showed signs of stability in October, driven by a notable rise in monthly mortgage credit flows, as reported by the European Central Bank. A substantial EUR 12bn increase in net mortgage lending, fueled largely by a surge in French home loans, marked the highest monthly growth in over a year. This development follows a period of sluggish mortgage growth attributed to rising interest rates impacting property transactions. Despite the recent uptick, analysts remain skeptical about a quick rebound in lending, and the ECB underscores the challenging prospects for credit growth amid ongoing rate hikes. (FT)

China Evergrande's offshore winding-up case adjourned yet again (Nikkei Asia)

Companies are buying back their own debt at deep discounts (Bloomberg)

Chinese borrowers default in record numbers as economic crisis deepens (FT)

Regulatory Updates

China's central bank to support real economy, guard against financial risks further

Dec 03. PBOC Governor Pan Gongsheng outlined key objectives, including enhanced support for the real economy, and managing financial risks. In an exclusive interview, Pan stressed the importance of cross-cyclical adjustments, maintaining reasonable credit growth, and supporting national strategies and innovation. The PBOC aims to reduce financing costs for businesses, keep interest rates suitable, and ensure stability in the renminbi exchange rate. Pan highlighted manageable financial risks and outlined measures for local government debt. The PBOC intends to advance yuan internationalization, facilitate trade, and actively participate in global financial governance and cooperation, aiming to increase China's influence in shaping international financial rules. (China Daily)

Bank of Japan's paper loss on JGB holdings grows to record USD 71bn

Nov 29. The Bank of Japan (BOJ) grapples with a substantial unrealized loss of JPY 10.5tn (USD 71.2bn) on its Japanese government bonds as of end-September, marking the third consecutive half-year loss and the largest since 2004. Concerns arise over the impact on currency markets and interest rates, although the BOJ assumes a hold-to-maturity strategy. Lawmakers closely scrutinize as the BOJ considers exiting its easing program. Despite surging U.S. interest rates and Japan's 10-year JGB yield, the BOJ maintains a reserve for potential losses. On a positive note, the BOJ benefits from a stock market rally, recording unrealized gains of JPY 23.58tn on ETFs. (Nikkei Asia)

Vietnam orders central bank probe over slow loans, Media say (Bloomberg)

Mexican central bankers talk about rate cuts as inflation comes down (WSJ)

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