China real estate developers under heightened stress as refinancing woes ripple through markets

by Amrita Parab

- **Following an uptick in defaults, China real estate sector's cost of financing soars as yields climb higher driven by investors' fear of widespread contagion stemming from Evergrande**
- **The NUS-CRI Agg Forward PD shows a gradual decrease over the next 12 months, suggesting Chinese developers may benefit from government measures to limit the fallout of the property crisis. However, refinancing risk continues to threaten recovery**

China's real estate sector is bracing for a potential wave of defaults as it grapples with a historic debt crisis, which has seen Chinese property giants such as China Evergrande under heightened distress. As of Oct-2021, China's real estate sector accounted for 46% of total distressed[1] US dollar bonds outstanding globally as an uptick in defaults drives bond yields for the sector higher. To add to its woes, tighter government restrictions such as the "Three red lines" (TRL) policy[2] have already hindered construction activity, thereby hampering cash flow generating capabilities, and further restricting financing opportunities for the sector. As depicted in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for the Chinese real estate sector began to increase from May-2021 and breached the PDiR2.0[3] BB- upper bound. The rise in PD is concurrent with an increase in refinancing risk and cost of funding for the China real estate sector, stemming primarily from the Evergrande crisis. However, the NUS-CRI Agg (median) Forward 1-year PD[4] showcases an improving credit outlook over the next 12 months, possibly due to policy responses taken by the Chinese government in an effort to limit contagion risk, and an improvement in credit metrics as companies try to adhere to the TRL policy (See Figure 1b).

[1] Source classifies distressed bonds as US dollar-denominated bonds with spreads of at least 10 percentage points above their benchmark rates.

[2] The People's Bank of China and the Ministry of Housing announced the "Three red lines" policy in 2020. Developers looking to refinance are required 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, cash to short-term borrowing ratio of at least 1. If the developers fail to meet one, two, or all of the 'three red lines', regulators will place limits on the amount of debt that can be raised. The restrictions, which aim to rein in housing prices and debt in the highly leveraged sector, will force the developers to deleverage. Furthermore, in early October, 14 publicly listed developers were in breach of all 3 red lines, while half of China's 30 biggest developers were in breach of at least one.

[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.

[4] 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.

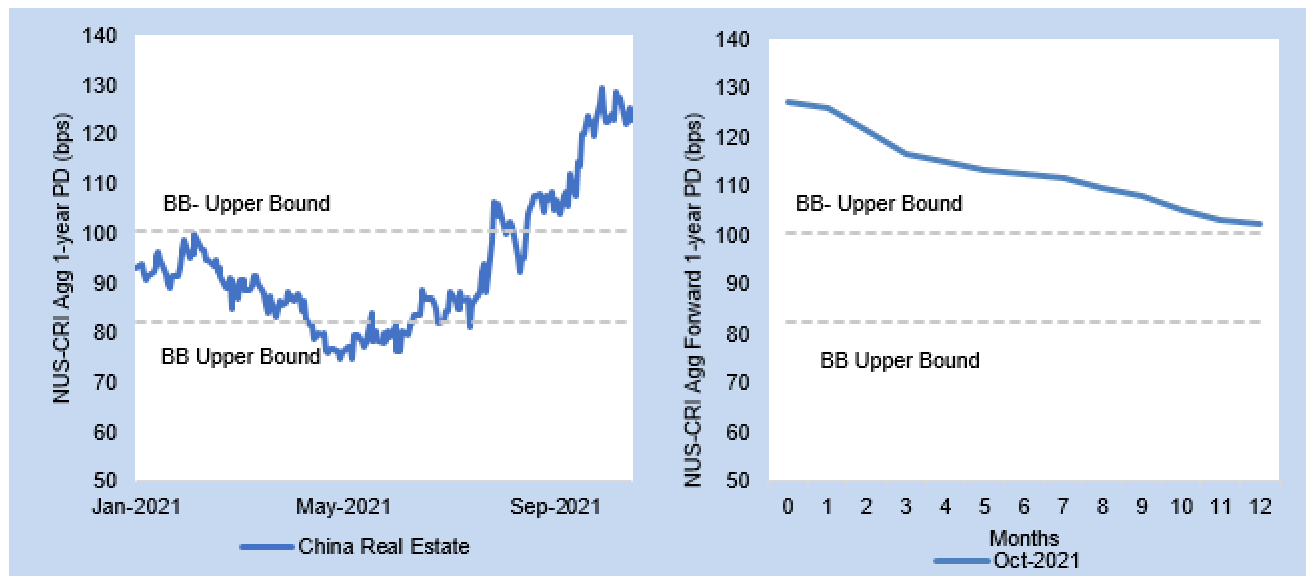

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for the China real estate sector from Jan-2021 to Oct-2021 with reference to PDiR2.0 bound. Figure 1b (RHS): NUS-CRI Agg (Median) 1-year Forward PD for China real estate sector as of Oct-2021 with reference to PDiR2.0 bound. *Source: NUS-CRI*

The deteriorating credit health of Chinese real estate developers is highlighted by the increasing number of defaults in the sector resulting from tightened refinancing conditions. The latest defaults in the sector were those of Fantasia Holdings Group Co. and Xinyuan Real estate in the first half of October, followed by Sinic Holdings on 18th Oct 2021 and Modern Land China Co.on 26th Oct 2021 (Table 1 provides pertinent details regarding the following default events). In the first half of 2021, real estate companies accounted for 30% of total bond defaults in China. The wave of defaults has led to further shrinking of the sector's financing channels as uncertainty around repayment capabilities gathers steam. Domestic banks, which are highly exposed to the sector, are now holding back on extending new loans to distressed developers citing higher credit risk and slowdown in profitability associated with the sector. Additionally, with an aim to control prices and leverage, in Jan-2021, regulators imposed caps on bank loans to the real estate sector, further limiting the sector's accessibility to loans. As per the new rules, loans to the property sector will be capped at 40% for state-owned banks and mortgage plans should not exceed 32.5% of total credit outstanding.

Company Name	Default Date	NUS-CRI PD on Jan 1 (bps)	NUS-CRI PD one day before default (bps)	Default event
Fantasia Holdings Group Co Ltd	5/10/2021	36	253	Defaulted on USD 206mn bond payment due Oct. 4
Xinyuan Real Estate Co Ltd	15/10/2021	171	899	Distressed debt exchange
Sinic Holdings Group Co Ltd	18/10/2021	2	741	Default on USD 250mn note due on Oct 18
Modern Land China Co Ltd	26/10/2021	162	225	Default on USD 250mn dollar bond due Oct 25

Table 1: Individual PDs on Jan 1, 2021 and the day before default of Chinese real estate companies that defaulted in Oct-2021. *Source: NUS-CRI*

Dollar-denominated bond sales by Chinese property developers have also come to a standstill recently as fears of widespread defaults keep investors at bay. The effective index YTM of the Bloomberg Asia-Ex Japan USD Credit China High-yield index, which tracks Chinese dollar-denominated high-yield corporate bond issuers, jumped to 20% (See Figure 2a) in mid-Oct, reflecting the contagion risk that is being priced in by offshore investors across the high-yield market. The crisis at Evergrande has served as a catalyst in the deterioration in the cost of funding for the highly indebted sector which was already struggling to meet its debt obligations. The

contagion effect can especially be felt on China-domiciled banks, with their Agg PD movement being highly correlated to that of the real estate industry (See figure 2a). As of June, Chinese developers had USD 5.2tn debt outstanding and an estimated 46% of it is in the form of bank loans. NPLs from the real estate sector has already increased by close to 30% for the five biggest banks in China, and further slowdown in construction activity due to lack of liquidity and funding will exacerbate bad loans as repayment pressures mount across the industry.

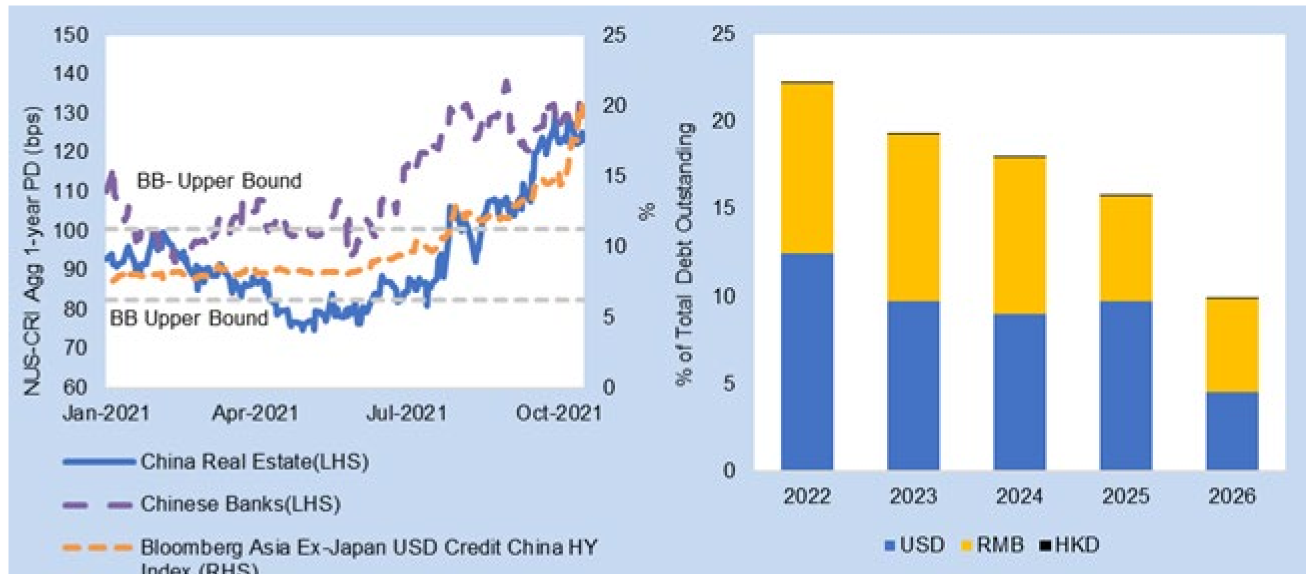

Figure 2a (LHS): NUS-CRI Agg 1-year PD for the China real estate sector and Chinese Banks from Jan-2021 to Oct-2021with reference to PDiR2.0 bound; YTM of Bloomberg Asia Ex-Japan USD Credit China HY Index. Figure 2b (RHS): Debt maturity breakdown by currencies for China real estate developers from 2022 to 2026. *Source: NUS-CRI, Bloomberg*

Non-compliance with red lines further curbs their ability to refinance their debt to meet repayment obligations and adds to the slowdown in the sector which has historically depended on debt-fueled expansions. Publicly listed companies in the sector have close to 45% of outstanding debt maturing in 2022 and 2023, the majority of which is dollar-denominated (See Figure 2b). If current refinancing pressures persist, markets may potentially witness more defaults within the sector.

As developers scramble to meet the three red lines and fulfill their debt obligations, companies in the sector are forced to look for alternative sources to raise cash buffers. Several developers have resorted to offering deep discounts on produced units in order to shore up cash balances, as well as liquidating assets and business segments to build cash buffers. Spinoffs of property management businesses are also being used as another avenue to raise cash. In 2021, shares of property management companies rallied on the back of government support. Debt-laden developers saw this as an opportunity to take advantage of higher valuations witnessed by their property management counterparts to raise capital from equity markets, largely from these spin-offs.

With the aim to reduce contagion, China is easing restrictions on home loans at some larger banks in an effort to ring-fence the fallout from defaults in the domestic property sector, including reducing the thresholds for the minimum down payment required for loans and speeding up approvals for new home mortgages. Higher and faster loan approvals may relieve the liquidity crisis faced by the developers to some extent, as access to mortgage funds may allow them to resume construction activity. The government also requested banks to avoid completely cutting off lending to the property sector, indicating its inclination to protect healthy real estate companies. PBOC has also allowed banks to issue more residential mortgage-backed securities (RMBS) with the aim to facilitate lending to the real estate sector. The issuance of RMBS reached its highest level YTD in September.

Going forward, the government will try to prioritize the interests of homeowners and ensure that projects under construction receive continued support from lenders. Around 1.6mn homeowners have invested in Evergrande units which are yet to be completed. Authorities aim to protect homeowners and may facilitate delivery of the residential units promised. The steps taken by the government to limit the damage caused by the property sector crisis could potentially alleviate some pressure faced by real estate companies. The NUS-CRI Forward PD showcases a gradual reduction in the Forward PD as policy measures reduce the fallout of the Evergrande crisis on the wider real estate industry, as financing headwinds continue in the short term.

Credit News

China Evergrande makes overdue interest payment on dollar bonds, state media says

Oct 22. China Evergrande Group paid international bondholders a delayed interest payment within its grace period, allowing the property giant to avoid default. The Chinese real estate developer transferred USD 83.5mn to the trustee for the dollar bonds on Thursday, who will pay bondholders. After failing to make the interest payment on around USD 2.03bn of dollar bonds on September 23, Evergrande was nearing the end of a 30-day grace period before the missed payment would be considered a default. Many overseas investors had predicted Evergrande would default on its dollar bond payments before the grace period expired. In recent weeks, the business has also failed to make other coupon payments, and it currently owes roughly USD 20bn. However, Evergrande must pay USD 45mn by October 29, when the grace period on another missing interest payment expires. (WSJ)

China property purge hammers weak players while the strong gain

Oct 21. China's property sector is undergoing its biggest credit-market shakeout in years as policymakers try to clamp down on over-indebted developers without affecting their healthier rivals. Companies with the worst balance sheets are especially facing an increase in their borrowing costs. At least three developers have defaulted in October, one may struggle to pay the interest due Friday, and another failed to get a three-month extension for a note maturing Monday. As authorities seek to defuse moral hazards and deleverage the economy, some companies are being allowed to fail as long as the spillover into the broader financial system is minimized. While Evergrande sank 14% on Thursday, shares of higher-rated developers like Longfor Group Holdings Ltd and Country Garden Holdings Co. rallied after regulators assured that China could contain and ring-fence the fallout. (Bloomberg)

UK's first green savings bond offers lower rate than competitors

Oct 22. The inaugural UK green savings bond issued by the National Savings & Investments will offer a fixed rate of 0.65% over three years, which is lower than the return on the leading bank savings bonds at 1.8%. The green bond also offers lower yields than the three-year government bonds, which stand at 0.68%. Amidst a period where bond yields have risen rapidly in response to the Bank of England's hints that it could raise rates soon, the main concern is there may not be enough demand by rate-sensitive retail investors for these green savings bonds. However, bond investors have proven to be willing to accept a lower yield over traditional government debt in the UK's latest green borrowing program, where the government raised GBP 16bn from two sales of green gilts. (FT)

Muni-bond niche defies sales slump as banks seize on cheap rates

Oct 23. Municipal-bond sales are surging as banks aim to secure low-cost financing, bucking the broader slowdown in borrowing by government agencies. Issuance of prepaid gas bonds has jumped to USD 6.5bn this year, more than four times the amount sold in 2020. While a recent surge in natural gas prices may be giving utilities a reason to borrow to lock in prices now, the increased use of such bonds has been driven by the difference between tax-exempt and taxable yields. That gap widened earlier this year as investors shifted into municipal bonds on speculation that tax rates will rise under President Joe Biden. While two-year tax-exempt bond yields have been roughly the same as those on Treasuries over the past two decades, the municipal bonds were yielding about 49% of Treasuries by the close of trading on Oct 21. In August, that ratio hit a record low of 26%. (Bloomberg)

Credit robots are descending on junk bond markets

Oct 22. Credit-trading robots have evolved and are now able to trade in less-liquid debt markets. Large market movements during the pandemic enabled developers to understand securities performance to train their algorithms under stressed scenarios. Banks can execute more trades via automated trading, allowing human traders to work on larger, more sophisticated transactions. Most algorithm trades now are responses to quotation requests on electronic credit trading platforms, which witnessed a surge in activity, especially in the high yield market. Moreover, the growth of exchange-traded funds and portfolio trading offers more opportunities for automation, while the expanding scale of the corporate bond market necessitates trading

through algorithms. However, Emerging markets remain a challenge for credit-trading robots due to fragmented markets and a lack of transparency and data. (Bloomberg)

High-grade credit sales to slow but loans will get busy (Bloomberg)

China sells USD 4bn of dollar bonds, borrowing cheaply once again (WSJ)

Kaisa bonds fall after investor meetings cancelled this week (Bloomberg)

Regulatory Updates

Fed official says lingering inflation could change interest-rate outlook

Oct 20. If high inflation persists into next spring, the Fed would have to consider raising interest rates earlier than expected. Fed governor Randal Quarles expects high prices to ease next year when bottlenecks and supply disruptions cease. However, consumers and businesses may expect higher inflation due to prolonged supply-chain disruptions. Additional government stimulus could also stimulate the demand, further pressurizing prices and forcing the Fed to hike the rate. The Fed officials have decided on bond tapering beginning next year and ending by next June. However, they are respectively weighing the timing of rate hikes in the context of surging inflation. Except for the outlook in inflation and fiscal policy, another source of uncertainty is who will be the next central bank chair person. (WSJ)

Brussels warned not to delay tighter capital rules for EU banks

Oct 24. Brussels' draft proposal suggests giving a two-year extension on the deadline for the implementation of the final phase of the Basel reform to European banks. The Basel reform package will come into effect by 2023. It will set consistent, new standards for the capital adequacy of international banks to increase the resilience of the banking system following the 2008 global financial crisis. Brussels' proposal also includes the phasing of the implementation of Basel III, with some measures not fully in force until 2032. Regulators are concerned that a delay by the EU could prompt other jurisdictions to follow suit. According to the European Banking Authority, 89 out of 99 banks have no shortfall on regulatory capital requirements, meanwhile, ten would have to raise EUR 27bn of capital to meet the new criteria. (FT)

Fed-backed Libor replacement SOFR holds at lower level amid cash deluge (Reuters)

RBA forced to defend bond target for first time in eight months (Bloomberg)

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Contributing Editors: Yao Xuan, Raghav Mathur