ShoreVest
新岸資本

China Debt Dynamics

SOE Bond Defaults and China's Deteriorating Credit Environment

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In recent months China's capital markets have been rocked by a spate of large bond defaults by state-owned enterprises (SOEs), a sign that the pandemic has spread distress to parts of the economy previously assumed to be immune from default risk.

From the early stages of the pandemic, Beijing focused its relief efforts on providing support for small firms which, as a group, suffered most from the lockdowns and subsequent economic slowdown. However, it was widely assumed that SOEs were relatively insulated from the crisis, having better access to credit and being able to rely upon state support in an emergency. The recent defaults not only signal that the financial position of some SOEs has deteriorated during the pandemic, but that the pandemic has taken such a toll on the finances of some local governments that they don't have sufficient resources with which to bail out their SOEs.

Over the medium term, the shock of the recent defaults will drive the repricing of SOE bonds to better reflect default risk. But in the short term, the defaults signal that China's credit environment has significantly deteriorated under the pandemic.

Up until now, the pandemic has had little impact on official measures of asset quality. At the end of September, the nonperforming loan (NPL) ratio for China's banks was 1.96%, up only marginally from 1.86% at the end of 2019. That's in large part due to government policies encouraging loan forbearance. At the end of 2020, China's banks had allowed borrowers to postpone repayment of about 6 trillion yuan worth of loans, equivalent to about half of the increase in outstanding corporate credit last year. Similarly, in the immediate wake of the pandemic regulators, issuers, and investors all cooperated to prevent bond defaults. In the first half of 2020, only five issuers defaulted on their bonds, although many others renegotiated terms with bondholders.

Such measures have managed to keep a lid on corporate distress, but the lull is only temporary. Forbearance policies are due to come to an end on March 31, after which banks' recognition of bad loans will accelerate. Already the banking regulator has warned of a coming wave of bad loans and has told banks to accelerate the pace of NPL disposal in preparation. However, Beijing may be having second thoughts about what it's about to unleash. 21st Century Business Herald, a Chinese financial newspaper, recently reported that the People's Bank of China has decided to prolong the forbearance policy for loans to small firms, but rather than impose a hard end to the program it is asking banks to defer repayments for as long as possible. Meanwhile, bond defaults accelerated in the second half of 2020 with 62 issuers failing to meet their obligations.

Rethinking SOE risk

Every level of government in China has its own SOEs. The central government itself only owns about 100 companies, although each of those typically has dozens of subsidiaries. Meanwhile, provinces, cities, townships, and counties have more than 100,000 SOEs. While it was once generally assumed that all SOEs were equally free from default-risk, in 2015 a SOE defaulted on a bond for the first time. Since then, the number of defaults annually has gradually increased, but has nonetheless remained small.

In 2020, nine SOEs defaulted on their bonds, up marginally from six in 2019 and four in 2018. But while the number of SOE defaults remained small last year, they roiled markets because of their size. SOEs defaulted on about 49 billion yuan worth of bonds, up from about 12 billion yuan the previous year. Moreover, it was widely assumed some of the SOE defaulters were too-big-to-fail.

Three defaults in particular captured the market's attention. On October 23, Liaoning SOE Huachen Automotive Group Holdings Co.—the parent company of Brilliance Auto Group Holdings Co., BMW's joint venture partner—defaulted on one of its bonds when it failed to repay bondholders 1 billion yuan. The market started to get jittery shortly after when on November 10 Henan-based SOE Yongcheng Coal and Electricity Holding Group Co. defaulted on a 1 billion yuan short-term bond. And then on November 16, Tsinghua Unigroup, a Beijing-based semi-conductor manufacturer and wholly-owned division of Tsinghua University, defaulted on a 1.3 billion yuan bond.

While the initial defaults were relatively small, all three firms and their corporate groups are massive borrowers. Yongcheng and its parent—which is heavily dependent on Yongcheng for income—had borrowed tens of billions of yuan from the bond market. Meanwhile, Huachen owes more than 33 billion yuan to banks alone. And, Unigroup has total outstanding debt of about 150 billion yuan.

The Yongcheng and Huachen defaults came as something of a surprise. Yongcheng had its triple-A credit rating reaffirmed in October and disclosed in its third quarter earnings more than enough cash to cover its obligations. Meanwhile, Huachen had told creditors in May that it had sufficient funds to cover debts maturing throughout the year.

Moreover, Yongcheng's parent is one of the biggest state firms in Henan province, and Huachen one of the biggest in Liaoning. Meanwhile, as a semiconductor maker, Unigroup is a significant player in an industry Beijing has identified as being central to China's long term economic security. Bondholders had generally assumed that the firms were too-big-to-fail. Yongcheng and Huachen were so important to their provincial economies that it seemed fair to assume that support would always be forthcoming even if the authorities didn't have the resources to bail out smaller firms.

Change at the margin

Understandably, there's been plenty of speculation that the defaults mark an end to the practice of local authorities implicitly guaranteeing the debt of their SOEs. Certainly, Beijing has been trying to dismantle the implicit guarantees that previously backed all types of financial products—from wealth management products to loans made using P2P platforms—and it clearly has a much higher tolerance of defaults than in the past. Moreover, Beijing is currently in the midst of a major overhaul of China's capital markets, part of which involves ensuring that markets improve risk pricing. Tellingly, a judge recently ordered one of China's domestic credit rating agencies—Dagong Global—to compensate bondholders of a company rated by the agency that subsequently defaulted. The judge found that Dagong, along with the company's auditor and law firm, hadn't done sufficient due diligence.

Still, it seems unlikely that local authorities will stop backstopping their SOEs any time soon as long as they have resources to provide the backstop. No local government would willingly permit one of their SOEs to default. Local authorities fear that if the market doesn't believe that one of their firms is backed by the government, then all of their SOEs will see funding costs increase. Rather, what's changed is that some local authorities no longer have the capacity to cover their SOE's debt under all circumstances. The still small number of SOE defaults suggests that most local governments remain capable of quietly and efficiently propping up their state firms when necessary. But despite their best intentions, some local authorities will find themselves having to perform triage—intervening to help those state firms they can save and letting go those that would pose an unsustainable burden. For investors, that raises the prospect that SOEs they had assumed were too-big-to-fail are in fact too big to save.

Local government finances have been deteriorating for years now, but the pandemic has exacerbated the problem. The slowdown in growth has reduced revenue. Tax cuts designed to support firms has further reduced local government income. Meanwhile, local authorities have had to spend more on social services and poverty alleviation in response to Beijing's policy priorities. And a sharp increase in local government borrowing last year—mandated by Beijing as part of efforts to stimulate growth—has added to local authorities' burden.

Old tricks, new tricks

Further complicating things is the contraction of shadow banking, which had previously allowed SOEs to manage financial difficulties without government help. "Shadow banks" in China refers to non-bank institutions or platforms that provided a lightly regulated and more nimble source of private debt liquidity that SOEs could tap whenever they needed to repay bank loans or bondholders. However, a regulatory crackdown focused on reducing systemic risk has resulted in shadow banking contracting significantly in recent years, making it difficult for over-stretched SOEs to manage their liquidity. Similarly, local governments have long been able to lean on local banks to lend to favored SOEs, but with banks now under pressure from the regulators to recognize and dispose of bad loans, local banks are ill positioned to ramp up their lending to distressed borrowers, even if they're politically connected.

Such constraints have led some authorities to find creative solutions. The corporate parent of Kweichou Moutai—the producer of China's premium brand of baijiu, and the most successful firm in Guizhou—has been tapped by the provincial government to acquire debt of other SOEs in the province. Still, not all provinces have cash-cows on a par with Moutai. After initially allowing Yongcheng to default, the Henan government has since stepped in with a relatively conventional rescue package. On December 1, Yongcheng announced that the Henan authorities will provide 15 billion yuan in cash to the firm, as well as injecting it with the equity of another Henan SOE, which Yongcheng will be able to use as security to borrow against.

Conclusion

While SOEs seldom default on their bonds, banks routinely have to deal with SOE delinquencies. ShoreVest has benefitted at times from acquiring SOE NPLs from banks and working them out, although this is not a major part of our business. However, the very public default of large provincial SOEs on their bonds is a clear signal that credit conditions for certain SOEs and local governments is getting worse. It also speaks to the urgency with which the banking regulator is pressing banks to accelerate their disposal of bad loans. Further, with shadow banking less available, China's SOEs and private companies alike have a need for alternative sources of credit, such as ShoreVest provides in its special situations investments.

While it appears to us that China's authorities are capable of cleaning up the banking system without financial instability emerging, credit conditions have clearly worsened.

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