



Chinese small-to-medium size and large-scale developers' credit quality gap widens

by [Li Mengyan](#)

Amid the slowing-down in sales growth and the tightening policy targeted to cool the Chinese housing market, Chinese small-to-medium size real estate firms are becoming increasingly riskier compared to their larger counterparts. As shown in Figure 1a below, the NUS-CRI Aggregated (median) 1-year Probability of Default (Agg PD) of small-to-medium size Chinese real estate firms has in general steadily increased since Apr 2019 while the Agg PD for large Chinese developers has slightly decreased during the same period. Correspondingly, the difference in Agg PD between small-to-medium size developers (market cap \leq CNY 10bn) and large-scale developers (market cap $>$ CNY 10bn) has doubled from around 40bps in Jan 2019 to over 80bps in Jan 2020, which indicates a widening gap in credit quality between those developers for the past one year.

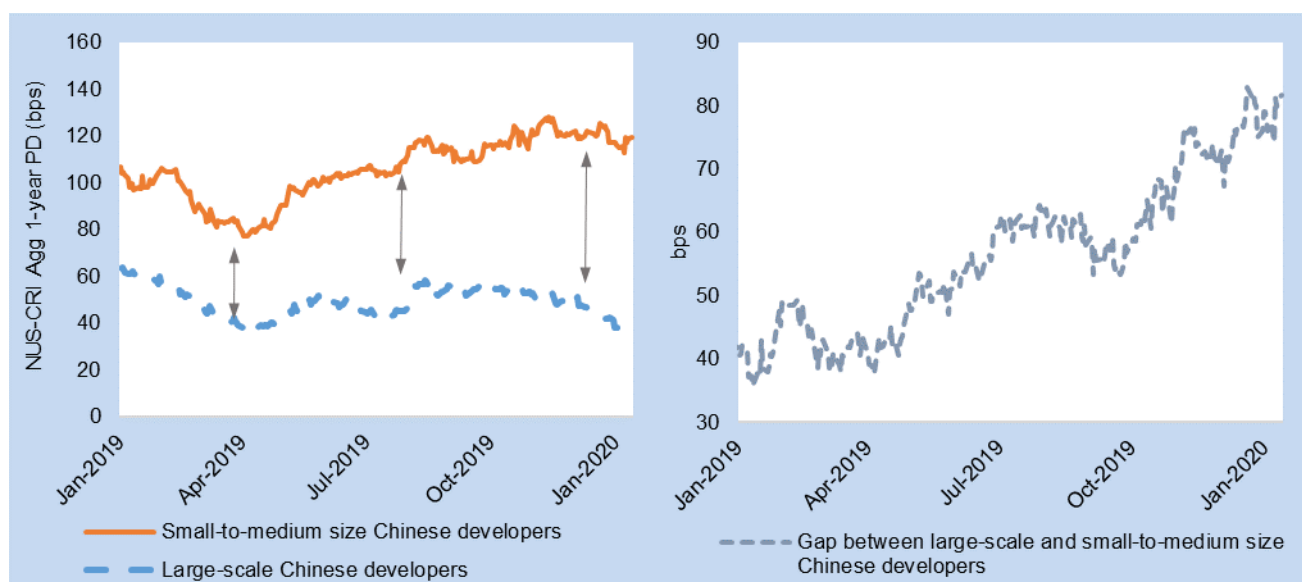


Figure 1a & 1b: NUS-CRI Aggregate 1-year PD of large-scale and small-to-medium size China-domiciled developers (LHS) and the gap between them from Jan 2019 to Jan 2020. Source: NUS-CRI

For the past few years, Chinese developers have issued more USD-denominated bonds to refinance their towering debt burdens (see Figure 2a). In January 2020, facing a relatively [loose credit line](#), Chinese developers have issued more than [USD 10bn](#) offshore bonds, roughly double the monthly average in 2019. Meanwhile, the year of 2019 has seen a total of USD 63.36bn bond issuance by Chinese developers, over 63% of which are dominated in USD. However, the financial costs of Chinese real estate companies are differentiated based on their size: large-scale developers with good financial conditions have advantages in both issuing size and borrowing cost, while small-to-medium size firms with high leverage and poor liquidity would face [more difficulties in refinancing](#) their debt. Some large-scale Chinese developers can borrow overseas at a cost lower than 5%, less than the [borrowing costs](#) for most of the small-to-medium sized firm which ranges from 6% to 15%.

The Chinese authority has launched [restrictions](#) on the usage of funds raised by domestic real estate companies via offshore bond offering in July 2019. Under the new rule, Chinese real estate firms are not allowed to seek fresh capital overseas, but can only use overseas bond financing to [roll over](#) their existing medium-to-long term offshore debt maturing within a year. Since there is [no indication](#) that the Chinese authority will turn on the credit taps to assist developers who struggle to meet obligations, the number of firms in real estate industry [filing bankruptcy](#) has increased to 525 in 2019 from 458 in 2018, most of which are filed by small-to-medium size

firms. Based on the NUS-CRI 1-year Probability of Default Implied Ratings (PDiR)¹, small-to-medium size developers also account for over 80% of Chinese developers with a PDiR lower or equal to BB+.

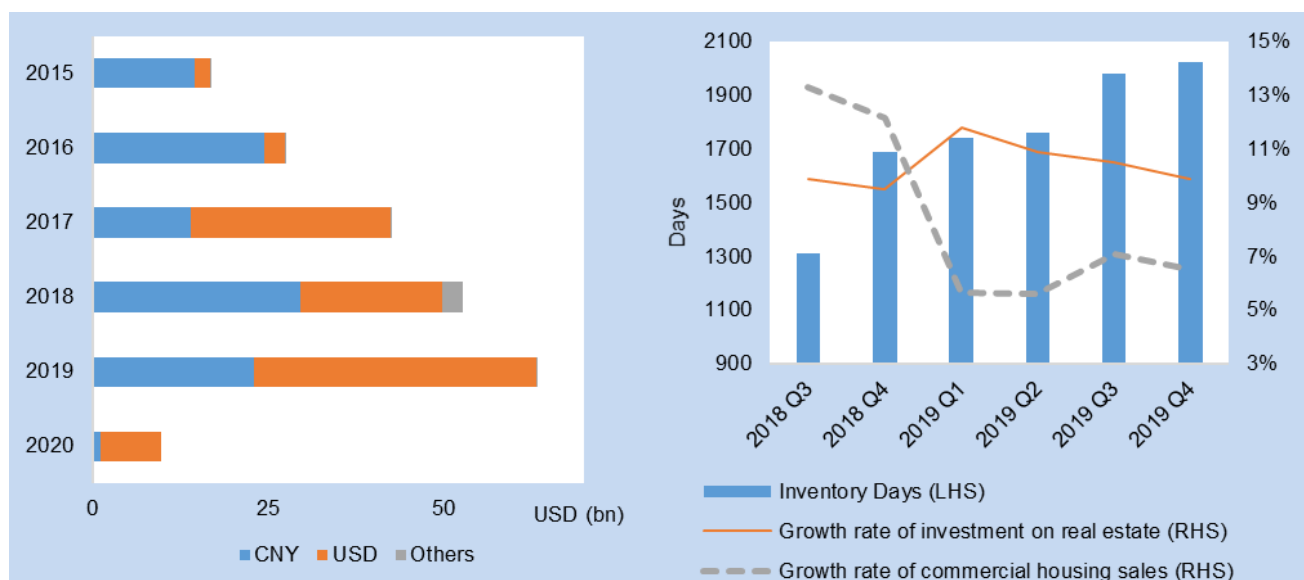


Figure 2a & 2b: Amount of each currency-dominated bond issued by Chinese developers since 2015 (LHS); Inventory days of Chinese real estate firms, QoQ growth rate of completed investment on Chinese real estate industry and QoQ growth rate of cumulated commercial housing sales since Q3 2018 (RHS) Source: Bloomberg, Wind

The liquidity pressure on small-to-medium Chinese firms also comes from the housing market slowdown. The industry growth rate of China’s commercial housing sales has experienced the fourth consecutive year of slowdown in 2019. The growth rate of completed investments in the real estate industry has also dropped from 13.3% in Q3 2018 to 6.5% in Q4 2019. Meanwhile, the industry’s average free cash flow has dropped from USD 1.19bn in H1 2019 to negative USD 1.15bn in H2 2019. Figure 2b shows increasing inventory days, indicating a worsening liquidity status since the real estate companies need to hold their inventory before selling them for a longer time and the speed of collecting cash from the business operation has slowed down. Amid the tightening policies and the slowing down of [house prices growth](#), small and medium-sized real estate companies are more [vulnerable](#) and their market share and growth space have been further [squeezed](#). Some even reported negative sales growth rate in the last quarter.

The deteriorating credit outlook of small-to-medium size Chinese developers can also be reflected by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD²) time series plotted in Figure 3. Figure 3 exhibits Chinese developers’ credit outlook looking to Jun 2020 based on information from Jun 2019 to Dec 2019. As time draws closer to Jun 2020, the Forward PD of small-to-medium size and large-scale Chinese developers shows a diverging trend with the Forward PD of small-to-medium size developers increasing while the Forward PD of large-scale developers decreasing. This means that while the credit outlook of large-scale developers are improving in recent months, small-to-medium size firms have seen a worsening credit outlook for the past 6 months.

¹ The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P’s rating categories.

² 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 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm’s survival in the next 3 months

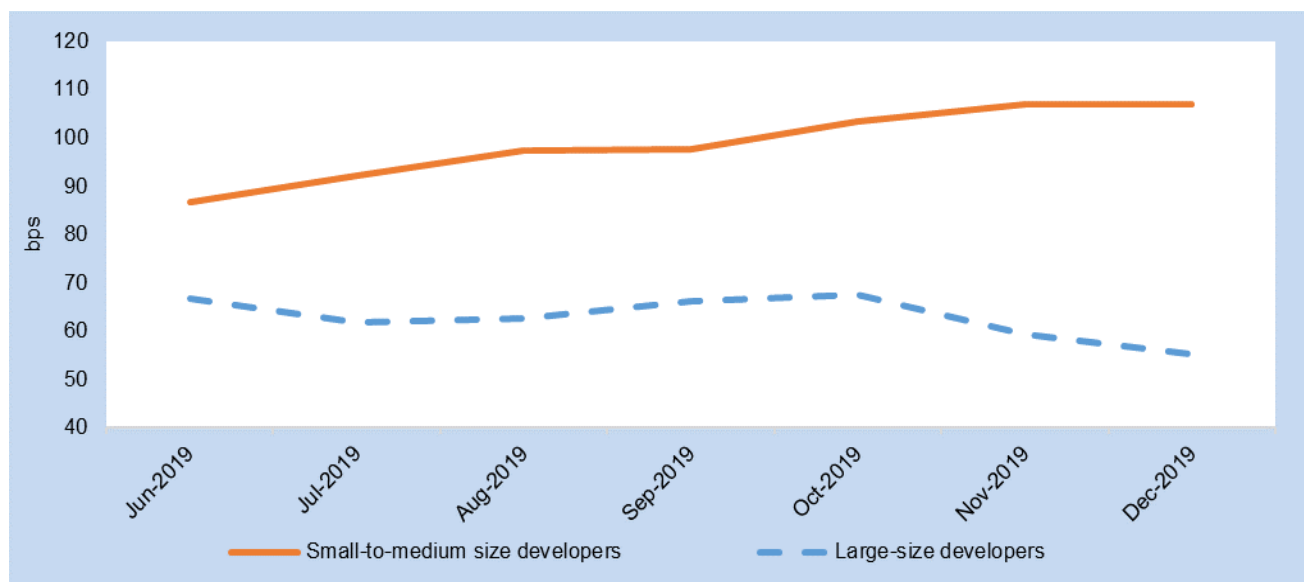


Figure 3: NUS-CRI Aggregate Forward 1-year PD time series for large-scale and small-to-medium size China-domiciled firms in real estate industry from different historical months looking to Jun 2020. Source: NUS-CRI

In all, small-to-medium size developers in China could face mounting credit risk should sales growth continues to slow and the local funding condition remains tight. Looking forward, the Chinese real estate industry has shown a tendency of [consolidation](#): large-scale developers are becoming more competitive over small-to-median size firms, and [over two-thirds of China’s property companies are expected to vanish](#) in the coming ten years.

Credit News
<p>Investors give up stocks for bonds despite frothy returns</p> <p>Feb 1. Despite having one of its best annual performance in recent years, investors shunned equities until the final few months. Investors started the year with a fear of global recession and the central banks responded by rate cuts and other quantitative easing policies. Those moves prompted investors to move into safer assets. The US money market funds, which investors use as holding accounts, scooped up USD 552bn last year, lifting the total amount held in the low-risk products to USD 4tn, the highest level since at least 2009. Some investors returned to equity funds in the final quarter of the year as trade tension loosened and the outcome of Brexit became clearer. (FT)</p>
<p>Lebanese banks shed Eurobonds in “prisoner’s dilemma”</p> <p>Jan 31. Beirut’s USD 1.2bn eurobond that matures in March has dropped about 5 cents since Tuesday to 77 cents on the dollar. Analysts stated that the sell-off reflected local banks cashing out at knockdown prices in a scramble for foreign currency. As one of the world’s most indebted countries, Lebanon is struggling with simultaneous currency, fiscal, and economic crises, which have cut the value of the Lebanese pound by at least 30% against the official rate. Dan Azzi, a retired bank chairman, likened the local banks’ sell-off to the “prisoner’s dilemma”, and argued that by leaving their positions the local banks have “increased the probability of default for sure”. (FT)</p>
<p>Europeans make record investments in sustainable funds</p> <p>Jan 30. European investors poured more than twice as much cash into sustainable funds last year than in 2018 amid mounting fears about the threats posed by climate change. According to Morningstar, a record</p>

EUR 120bn was plowed into the products, more than double the EUR 48.8bn of net inflows gathered in 2018. Most asset managers have shied away from divesting from fossil fuel producers in favor of engaging with such companies but they are becoming increasingly aware of the investment risks posed by stranded assets held by fossil fuel companies. It is estimated that between EUR 260bn to EUR 300bn a year of new investment will be required for Europe to meet the ambitious goals to limit global warming agreed at a landmark conference in Paris in 2015. ([FT](#))

US 20-year relaunch seen boosting corporate bonds

Jan 30. The relaunch of the 20-year Treasury note will likely boost the overall liquidity of the bond market and have a positive influence on corporate bond issuance, especially in the 20-year sector. Companies could consider issuing more 20-year bonds to lock in cheap long-term funding amid the ultra-low interest rate environment and the 20-year Treasury note will serve as a good benchmark. Wall Street analysts project the Treasury would sell USD 11bn-USD 14bn in May, followed by a USD 9bn-USD 11bn reopening in each of the next two months and Goldman Sachs forecast the annual issuance could eventually to USD 200bn-USD 250bn, replacing some medium-dated government debt. The supply will be well received by liability-driven investors, insurance companies, and pension funds. ([IFR](#))

US energy 'junk' bonds hammered by oil plunge

Jan 29. Junk-rated energy bonds' price plummeted after the spread of coronavirus hit oil prices, highlighting the strains on a sector that already led US defaults last year. Despite pressure on US natural gas prices from a relatively mild winter, junk-rated energy bonds had enjoyed a very positive end to 2019 as yield-starved investors piled in to the riskiest assets to chase yield. Now the reversal is causing discomfort for some issuers and companies whose debt was already in territory considered "distressed" are running out of options. Sales of new corporate bonds ground to a halt on Monday as fears surrounding the coronavirus grew. According to the chief macro strategist at Academy Securities, fears over coronavirus, and its effects on global travel, continued to hold sway in the market, and the drop in the oil price had "followed straight through into bond prices" ([FT](#))

PG&E pushes Newson for plan to fund bankruptcy with bonds ([Bloomberg](#))

Intelsat bonds fall on fears over FCC auction plan ([WSJ](#))

Intu hit by new debt blow on flagship Gateshead shopping center ([FT](#))

Regulatory Updates

China to inject USD 174bn of liquidity on Monday as markets reopen

Feb 2. China's central bank said it will inject CNY 1.2tn (USD 174bn) worth of liquidity into the markets via reverse repo operations on Monday as its stock markets prepare to reopen amid an outbreak of a new coronavirus. Chinese authorities have pledged to use various monetary policy tools to ensure liquidity remains reasonably ample and to support firms affected by the virus epidemic. According to an announcement by the People's Bank of China, the total liquidity in the banking system will be CNY 900bn higher than the same period in 2019 after the injection. ([Reuters](#))

Federal Reserve stands firm on interest rates

Jan 30. The Federal Reserve (Fed) left its main policy rate unchanged last Wednesday with federal funds rate at a range of 1.5 to 1.75 percent but made a technical nudge to one of the levers it uses to manage that rate, underscoring that one of the central bank's key challenges in 2020 will be its tools rather than its policy

stance. Fed's Open Market Committee raised by 5 basis points the interest it pays banks on the reserves they hold on the Fed's balance sheet, to 1.6 percent from 1.55 percent. This "interest on excess reserves", or IOER, is one of a few short-term interest rates the Fed uses as a tool to keep the fed funds rate within its target band. ([FT](#))

Fate of Turkey's next rate cut at stake with inflation near peak ([Bloomberg](#))

Japan plans new rates for benchmark to replace Libor by mid-2021 ([Reuters](#))

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