Lianhe Ratings Global

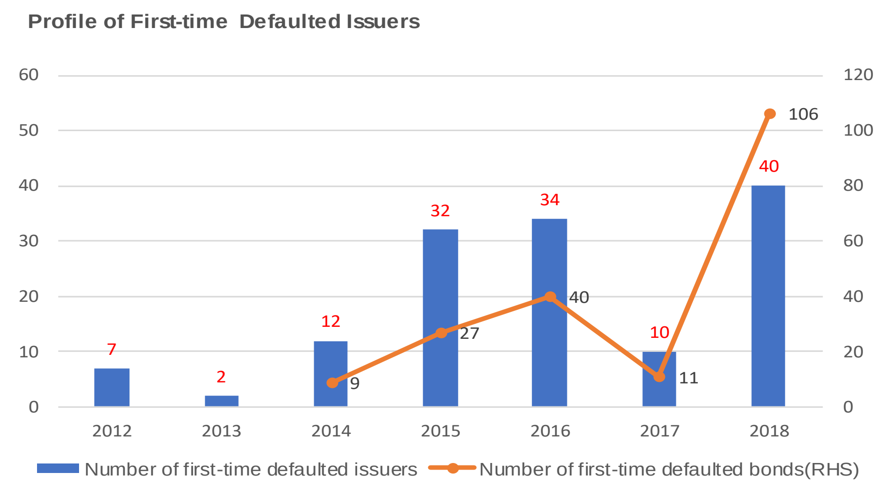
Non-Rating Commentary
4 March 2019

China Onshore Bond Market 2018 Default Study and 2019 Outlook

I. Review of 2018 China bond defaults

China bond first-time defaulted issuers notably increased in 2018

40 issuers defaulted for the first time in China bond market in 2018, which reached a historic high and involved 106 defaulted bonds totalling approximately RMB86 billion. This significant increase in bond defaults could mainly be attributed to the slowing economic growth momentum, a tightening financing environment, trade tensions between China and the United States, and a large amount of bonds due in 2018 (about RMB7.6 trillion).



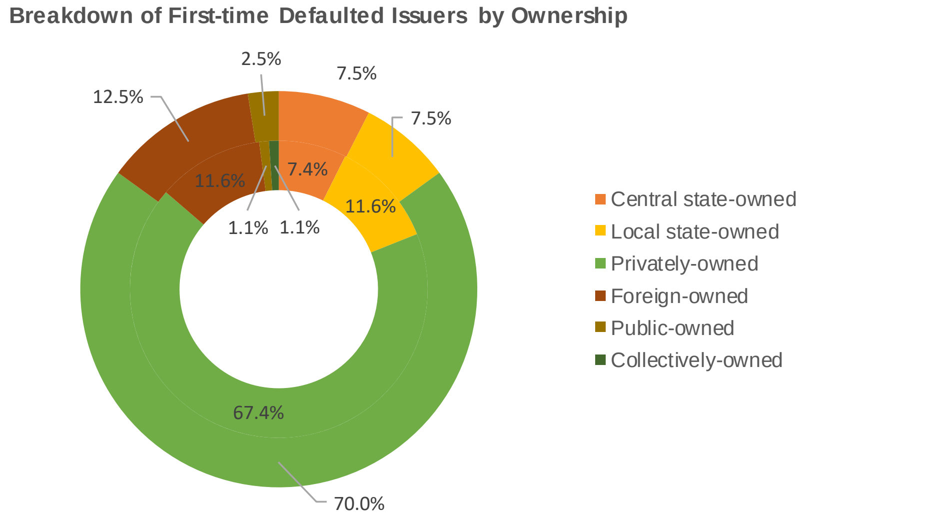
Note: Technical defaults are excluded
Souce: China Onshore Bond Market 2018 Default Study and 2019 Outlook, China Lianhe Credit Rating Co.,Ltd, United Credit Ratings Co., Ltd

The year-on-year GDP growth rate continued to fall to 6.6% in 2018, which negatively impacted some Chinese companies' operations due to weaker market demands. The year-on year growth rate of Chinese industrial enterprises' total profit in Jan-Nov 2018 moderated to 11.8% from 21.9% in Jan-Nov 2017, while the number of industrial companies incurring losses was 61,534, 24.57% higher than that of the same period in 2017 (49,398). The Sino-US trade friction has also adversely affected related industries in China, especially those which are highly dependent on the US market and subject to increased tariffs (such as electrical equipment, machinery, and chemicals).

The strengthened regulatory supervision on credit expansions since 2018 has reduced investors' risk appetite and posed greater challenges to Chinese companies' refinancing. The Fed's unwinding of its balance sheet and interest rate hikes have added RMB depreciation pressure and reduced market liquidity and offshore financing availability. Some companies therefore defaulted as they were unable to refinance their matured debts successfully.

The proportion of private companies among all first-time defaulted issuers remained high

Privately-owned entities had been the largest proportion of the first-time defaulted issuers, which accounted for 70% of the total 40 defaulted companies in 2018 and included 12 listed private companies. In addition to the macro factors as mentioned earlier, corporate governance deficiencies, poor management including undue business expansion and financial leverage and tightened credit facilities contributed to the frequent defaults of private companies.



Note: The circles outside and inside represent the breakdown of defaulted issuers in 2018 and 2012-2018 respectively.
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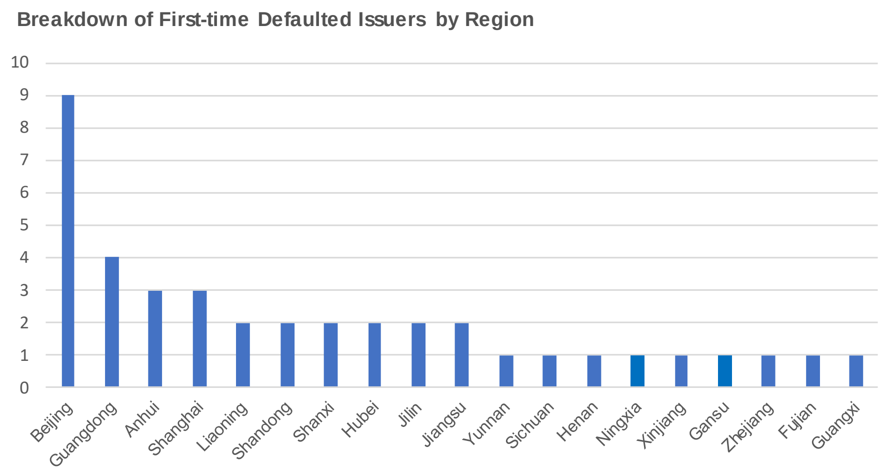
The coverage of defaulted industries became more extensive

There were 24 industries involving 2018 first-time defaulted issuers in China, 12 of which appeared defaulted issuers for the first time, including financial services, real estate management and development, retail, communication equipment, etc. The defaults in 2018 were still concentrated in chemical, food, electrical equipment, machinery, oil, natural gas and fuel for consumption, metal, non-metal and mining industries from the perspective of industry default rates.

The involved regions of defaulted issuers continued to increase

Defaulted issuers were concentrated in regions involving overcapacity industries and China's southeastern coast which were more developed and had a large number of bond issuers. The 2018 first-time defaulted issuers were mainly located in Beijing (9 issuers), Guangdong (4), Anhui (3) and Shanghai (3), while the amount of defaulted bonds in Shanghai (RMB25,843 million), Shanxi (RMB14,740 million), Beijing (RMB13,419 million), Zhejiang (RMB9,131 million) and Anhui (RMB5,085 million) accounted for nearly 80% of total defaulted amount in 2018.



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Some defaulted issuers had significant goodwill or a high proportion of shares pledged by their parent companies

The scale of goodwill grew rapidly in recent years as a result of increased mergers and acquisitions in the A-share market. The failures of mergers and acquisitions negatively affected some issuers' credit profiles as they suffered notable impairments in goodwill. In addition, parent companies of some listed companies pledged a large portion of their shares. They were forced to dispose of their shares due to a sharp fall in stock prices, resulting in ownership changes.

In addition, more and more companies, especially those with high debt leverage, issued short-term bonds for refinancing in recent years. The shortened debt payback period resulted in greater liquidity pressure and default risk. The varieties of defaulted bonds in China also increased as the exchangeable bonds defaulted for the first time in 2018, involving a total of five issuers with the amount of about RMB2.43 billion.

II. Outlook for 2019 China bond defaults

Defaults will continue to occur, but the number and amount of defaults will not increase significantly compared with 2018

Some enterprises may face greater pressure in business operation and credit profile deterioration amid the slowdown of global and domestic economic growth. However, we expect that the market liquidity and the financing environment will be relatively benign due to more supportive regulatory policies to facilitate private companies' funding activities.

Credit risk will still be concentrated in private companies

Debt repayment pressure remains intact for private companies, with the number (1,395) and amount (RMB772.45 billion) of bonds due in 2019 accounting for about 15% of the total maturating bonds. Private companies with weak creditworthiness, aggressive investment expansion, or subject to potential event risks require greater attention.

Credit risk of local government financing vehicles (“LGFVs”) will increase

As the Chinese regulatory authorities have gradually strengthened control over the risk of local government debt, the credit linkage between LGFVs and local governments has continued to weaken. The narrowed funding channels for LGFVs have resulted in rising pressure on their financing and business transformation plans. A credit divergence among Chinese LGFVs will likely continue. LGFVs in more developed economies which have effectively transformed their business to be more self-sustainable would be more resilient. On the other hand, credit risk would be relatively high for those LGFVs located in less developed regions and with weak liquidity and significant contingent liabilities.

More cautious in overcapacity, real estate and trade industries

The overcapacity industries, especially for some middle and downstream industries, such as chemical, machinery manufacturing, power and power grids, are still exposed to high credit risk due to the economic slowdown, industrial restructuring and continuous overcapacity reduction.

In terms of the real estate sector, the difficulty in sales has increased and the cash collection speed has slowed down, affected by the government’s controlling polices. Furthermore, liquidity pressure for property developers has increased significantly due to a large amount of bonds due in 2019 and greater barriers for bond issuances.

Credit risk is expected to increase in the trade sector as a result of the uncertainty over trade friction between China and the US, the increasing fluctuation of RMB exchange rate as well as the increase in overall operating costs.

Greater credit risks of issuers located in northeast China, Jiangsu and Zhejiang provinces

The high credit risk in northeast China can be attributed to the low economic growth rate in the region and the high pressure on business transformation especially for companies in the heavy industry. Although the level of economic development in Jiangsu and Zhejiang provinces is relatively high, plenty of private companies mainly concentrating in trade, manufacturing and export sectors are vulnerable to the negative development in the macroeconomic environment.

Perpetual debt issuers require attention

There will be a succession of perpetual bonds entering the exercise period to redeem. For issuers who choose not to repay but take on higher coupon rates may indicate weaker financing capabilities.

For more details, please refer to the Chinese report:
《2018 年中国债券市场违约回顾与 2019 年展望》
http://www.lhratings.com/lock/research/168df877c3f

Source: China Onshore Bond Market 2018 Default Study and 2019 Outlook, China Lianhe Credit Rating Co., Ltd, United Credit Ratings Co., Ltd, published on 13 February 2019.
Note: In case of any discrepancies between the English version and the Chinese version, the Chinese version shall prevail.

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