Offshore Investors' Top 10 Questions about the Credit Profiles of Chinese Bond Issuers

Lianhe Global has been outreaching to both the Chinese and international investors in the past several months. The investor population includes banks, asset management under banks, insurance and pure asset management companies. Most investors are interested in the burgeoning Chinese bond market and credit profiles of Chinese local governments and local government financing vehicles ("LGFVs"). We have summarised the most commonly asked questions and our feedback in this report.

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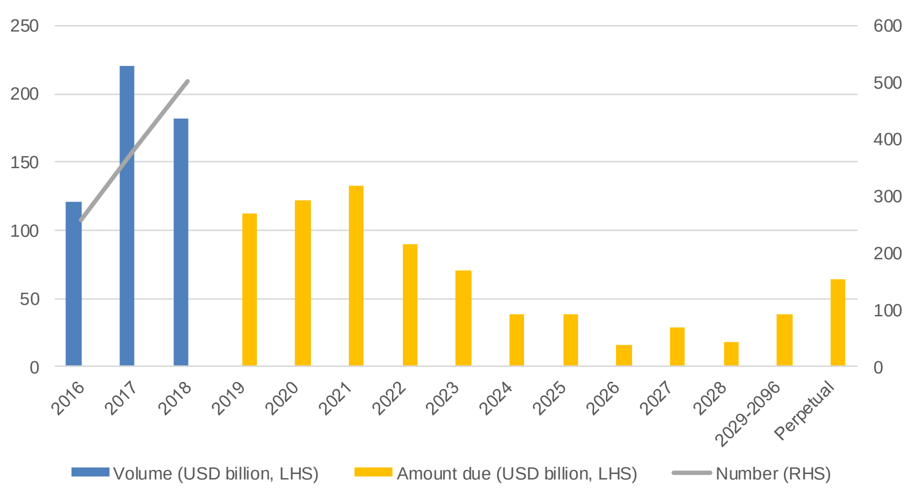
General

1. What are the prospects for 2019 offshore bond issuances by Chinese companies?

We expect China's economy to grow at a slower pace in 2019, with an annual gross domestic product ("GDP") growth rate of 6%-6.5%, when it is undergoing a structural transformation from an export- and investment-driven economy to the one led by consumption. Meanwhile, the impact of the trade tension between China and the United States on the business sentiment may pose potential downside if the bickering continues and escalates. However, the shift of policymakers' priorities to bolster confidence and stabilise the economic growth by easing monetary and fiscal policies will help alleviate the impact. That said, the Chinese central government will likely turn to deficit spending and tax cuts to stimulate economic growth.

As a result, we expect more government bonds to be issued in 2019 which may crowd out private sector issuances from the onshore market and force private companies to go to the offshore market. Additionally, many Chinese companies are facing busy redemption schedules of maturing bonds in 2019 through 2021 (see Exhibit 1 below). We expect many of them are likely to refinance their offshore bonds given the lengthy approval process of offshore bond quotas. Meanwhile, more and more Chinese issuers have tapped the offshore bond market which could be conducive for the development of the market. The number of offshore USD bond issuances increased to 502 in 2018 from 383 in 2017, although the volume dropped to USD182 billion from USD220 billion in 2017.

EXHIBIT 1: 2016-2018 Offshore USD Bond Issuances by Volume and Number and Maturity Profile



Source：Bloomberg

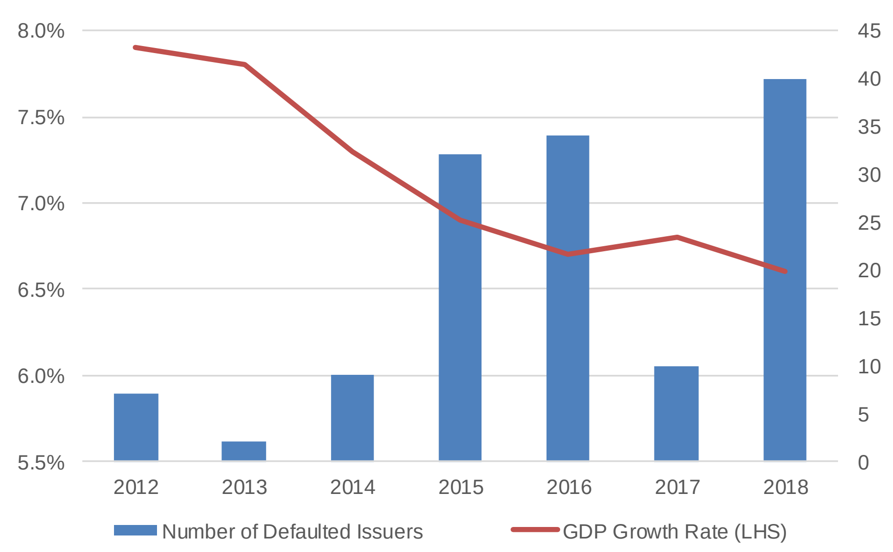
On the other hand, the onshore bond market currently offers a cheaper funding cost following the US rate hikes, while the USD/RMB exchange rate has exhibited greater volatility in the past seven months (i.e. June 2018 to January 2019). This adds uncertainty and potentially higher costs which may deter Chinese-based issuers to issue offshore USD bonds.

Against these backdrops, we expect the offshore bond issuances to remain flat at best or experience a single-digit percentage decline in the issuance volume in 2019. That said, we expect the Chinese bond market to surpass the Japanese bond market to become the world's second largest in 2019.

2. Which sector has reported more bond defaults in China's onshore market?

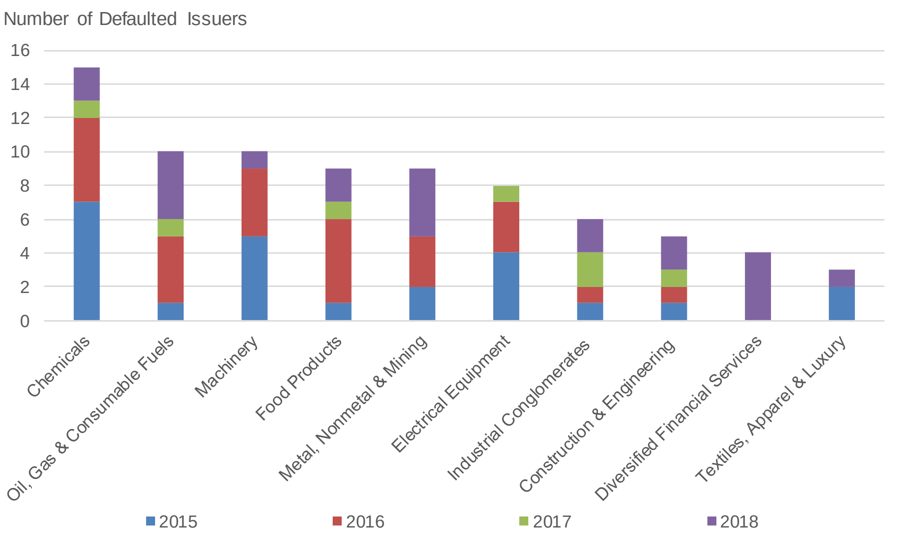
The accelerated slowdown in China's economic growth since 2014 has driven up the number of defaulted issuers (see Exhibit 2 below). We have witnessed chemical, oil, gas and consumable fuels, machinery, food products, and metal, nonmental and mining industries leading the defaults in China between 2015 and 2018 (see Exhibit 3 below). These industries face a range of challenges such as tightened environmental regulations, low profit margin in the context of large infrastructure investments, and government policies on stamping out over-capacity sectors, etc.

EXHIBIT 2: Number of Defaulted Issuers VS. GDP Growth Rate



Source:Wind, National Bureau of Statistics

EXHIBIT 3: 2015-2018 Onshore Default Breakdown by Industry (Top 10)



Source:Wind

3. Are there any concerns for offshore investors to obtain recovery from an onshore asset in China?

Structural subordination could affect the debt recovery for offshore bond investors. This arises where the creditors of a company (e.g. an offshore holding company) do not have access to the assets of the company's subsidiary (e.g. an onshore operating subsidiary holding the majority of the group's assets) until the creditors of the subsidiary have been paid off with the remaining assets which can be upstreamed to the parent. The Chinese government's considerations, such as maintaining social stability and employment, may also influence the bankruptcies and restructurings of Chinese companies which pose another challenge to foreign investors. However, we consider that a company with sufficient liquid assets (easily converted into cash with no significant loss of value) to support its overall indebtedness may mitigate these concerns. In addition, we believe concerns for debt recovery due to structural subordination would be more pronounced for lowly-rated entities given their relatively high probability of default.

Property Developers

4. What property specific rating factors does Lianhe Global focus on for Chinese property developers?

Lianhe Global focuses on both the quality and size of land banks, as well as the cashflow of projects under development apart from financial metrics when we analyse Chinese property developers. We also compare project locations and average selling prices of contracted sales against the same of their land banks to gauge the future performance of Chinese property developers. We believe the quality and size of land banks are good signs of future performance as land is the most valuable asset to a property developer. We believe recognised revenue and contracted sales amount are reflective of Chinese property developers' respective past and present performance, while we focus more on their future performance.

In terms of financial metrics, we apply a ratio of gross debt over land bank at cost to gauge Chinese property developers' future debt repayment capability. We believe this ratio is a better indicator than the traditional debt over EBITDA ratio given the variability of EBITDA particularly for small- and medium-sized Chinese property developers with a limited number of projects under construction resulting in uneven cashflow and earnings. In addition, we may make qualitative adjustments to reflect the variability in the quality of land bank (e.g. first- verse third-tier cities).

5. What is Lianhe Global's view on the Chinese property developer sector in 2019?

We expect the Chinese property developer sector to remain stable in 2019. However, amid the spectre of a tightening financing environment and a busy redemption schedule of maturing bonds in 2019, we expect a credit divergence among Chinese property developers is likely to emerge.

We believe property developers with high leverages, aggressive expansions, weak profitability and a high level of short-term debt are likely to face liquidity challenges amid a tightened financing environment which may increase their propensity to default. On the contrary, the credit profiles of large property developers with a high-quality land bank, diversified financing channels, and a lower cost of funding/capital, are likely to remain stable.

6. Does Lianhe Global expect any major default in the property developer sector which may cause a contagion risk in 2019?

On balance, we are cautiously optimistic about Chinese property developers for 2019. While Chinese property developers face a barrage of hurdles, on aggregate they have exhibited higher profitability than other Chinese corporates and have gained experience from prior rounds of policy tightening. Moreover, the Chinese property market plays an important role in propelling China's GDP growth and providing funding to many local governments. Given its importance and the wide-spread wealth effect on the Chinese economy, we expect the Chinese government and central bank are likely to put a floor on the property market. Thus, we believe Chinese property developers are likely to remain stalwart.

We cannot rule out the risk of isolated defaults, and expect a few small and lowly rated property developers are likely to go as competition intensifies. Some small players may either put themselves up for sale or sell their property development holdings to other larger property developers. Another noteworthy issue is the high percentage of pledged shares of some property developers' major shareholders. A sharp decline of the prices of pledged shares may cause market concerns over the related property developers' financial flexibilities. These isolated incidents of default may occur but contagious and systemic risks are unlikely to materialise. We believe the Chinese government and central bank are likely to take mitigating actions as soon as there is any hint of contagious risk.

Local Government Financing Vehicles

7. How does Lianhe Global differentiate between SOEs and LGFVs?

LGFVs and SOEs are both institutions with state ownership, while LGFVs are usually directly owned or ultimately controlled by local governments. In addition, an entity to be classified as an LGFV usually acts as an extension of government functions, such as being responsible for financing and investing infrastructure construction projects and other government related activities for the region's economic development and social welfare. LGFVs are generally less profit-driven when compared with SOEs which are more market-oriented.

EXHIBIT 4: Key Features of SOEs and LGFVs

	SOEs	LGFVs
Responsibility	Support important industries with national strategic importance for the economic development and social stability	Primarily act as an extension of government functions while operating some market-oriented businesses
Business	Aerospace, shipping, military, petroleum, chemical engineering, heavy equipment and industrial machines, electronics, non-ferrous metals, etc.	Land development, infrastructure construction, water, heating, public transportation, etc.

Operation	Market-oriented, responsible for their own profits and losses	Rely on earnings from profitable businesses and/or government subsidies to support daily operations
Profit target	Profit focus to preserve and increase the value of state assets	Not profit focus but mainly to support local governments' policies and missions
Staff size	Generally large	Relatively small

Source: Lianhe Global

8. How does Lianhe Global decide to adopt the top-down or bottom-up approach in assessing the credit profiles of LGFVs?

The role of an LGFV in the context of a local government and the inter-relationship between the two parties are key considerations when we decide which approach (top-down or bottom-up) to adopt in assessing its credit profile.

In most cases, we choose the top-down approach for the sole or largest LGFV (which is significantly larger than the second one and hardly replaceable) within a jurisdiction as the probability of the LGFV receiving support from its local government owner is high. The LGFV usually has advantages in various aspects such as accessing to major government projects and receiving large asset transfers from the government or other LGFVs and significant financial subsidies.

When there are several LGFVs operating under the same administrative government, we mainly look at each LGFV's contribution to the local economy, its business monopoly, and the impact of its failure to the region. The top-down approach may be considered if an LGFV has demonstrated strong importance to the local government and the region's economy. Otherwise, the bottom-up approach would be adopted.

Taking Liangshan State-Owned Investment & Development Co., Ltd. (LSID, 'BBB-'/Stable) as an example, we have adopted the top-down approach as LSID is Liangshan's largest and most important investment and financing platform. LSID has undertaken various major projects to support the economic development in Liangshan and has received ongoing government support, including capital and asset injections from the Liangshan government directly or indirectly from state-owned entities.

9. How does Lianhe Global evaluate the support ability of a local government and the sustainability of the support?

The support ability of a local government to an LGFV within a jurisdiction is primarily based on the government's fiscal fundamental which is usually associated with its administrative level.

A local government generally relies on three fiscal revenue sources: tax revenue, land sale revenue, and transfer payments from higher governments. We favour sustainable and diversified tax revenue which would contribute to a stable fiscal income. Strong land sales and persistent transfer payments would also support a local government's fiscal strength. Additionally, the higher the administrative level of a local government, usually the better the fiscal condition of the government and therefore the stronger support ability the government may have.

A local government's fiscal stability and its ongoing willingness to support are major factors affecting the sustainability of the support for an LGFV. A resilient and diversified economic structure usually indicates stable and sustainable economic growth which would contribute to a steady increase in a local government's fiscal income and provide resources to support its underlying LGFVs. The strategic importance of an LGFV to a local government and potential contagious effects of the failure of the LGFV on the other LGFVs would influence the local government's ongoing willingness to support.

10. Does Lianhe Global expect any major default in the LGFV sector which may cause a contagion risk in 2019?

We do not expect any major default in the LGFV sector which would cause a contagion risk in 2019 as we believe local governments will continue to support their underlying LGFVs' normal operations given LGFVs' important role in supporting China's economic development and social stability. In particular, the Chinese government has introduced several measures since the second half year of 2018 to ease financial and monetary conditions amid a slowing economy, sluggish stock markets and the renminbi depreciation pressure. We foresee that China will accelerate public sector spending, particularly infrastructure investments (one of LGFVs' major functions), to underpin its economic growth while local governments' direct financing capacity would remain insufficient to support their capital spending needs. Additionally, any default of major LGFVs would have a significant adverse effect on the creditworthiness of associated local governments and their economic development.

Stan Ho
Chief Executive Officer
(852) 3462 9568
stan.ho@lhratingsglobal.com

Analysts
Joyce Huang, CFA
Senior Director
(852) 3462 9578
joyce.huang@lhratingsglobal.com

Alex Kung
Senior Director
(852) 3462 9577
alex.kung@lhratingsglobal.com

Business Development Contact
Joyce Chi
Managing Director
(852) 3462 9569
joyce.chi@lhratingsglobal.com

Elsa Yu
Associate Director
(852) 3462 9581
elsa.yu@lhratingsglobal.com

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