AKE Insights

CHINA CORPORATE DEFAULTS

KEY POINTS

China's high-profile defaults by state-owned enterprises (SOEs) in November 2020 amplified a number of issues in its corporate debt market and the wider economy, which include:

1. The country's enduring debt problem
2. Credibility of domestic rating agencies
3. Tacit assumption of state support.

Additionally, whilst SOE defaults should be welcomed as a part of Beijing's efforts to rein in its growing debt and rebalance the economy, there is an economic contradiction between deleveraging and President Xi Jinping's commitment to the state's role in Chinese economy by repeatedly reaffirming his support for SOEs.

OVERVIEW

Since China's first onshore default in late 2014, when Chaori Solar failed to repay a CNY1bln (US$152.4m) coupon, defaults in the local market have grown expontentially in the past years. A Bloomberg report indicated that bond defaults through November 2020 totalled CNY104bln (US$16bln), making 2020 the third consecutive year in which corporate defaults topped CNY100bln (US$15.3bln). If the latest defaults by state-owned enterprises (SOEs) fit into the recent trend, why is the market then so concerned? Shoundn't insolvent firms be allowed to go bankrupt so their assets can be re-purposed to productive uses? Foreign investors are predominately uneased about three aspects: first is the country's overall financial health; second, there are increasing fears of a widespread liquidity crunch amid a sharp COVID-19-induced economic downturn; and third, a potential reversal of state support, although SOE default risks remain below that of private entities.

Such concerns are important. But from a policy perspective, defaults by SOEs should be welcomed as they partly reflect Beijing's willingness to allow unproductive firms to exit, a process deemed structurally positive for the wider economy. This would enable Chinese regulators to effectively assert financial discipline and deleverage, as intended by a campaign launched in 2016 to curb the country's mounting debt by disciplining SOEs and local governments that borrowed excessively. At the same time, the state is also seemingly utilising recent defaults as a warning to state-owned or backed firms to be more responsible and cautious, which should be regarded as a part of the broader efforts to reduce financial risk through deleveraging in areas such as local government debt.

This, however, stands in inherent contradiction to the high value placed on SOEs by President Xi Jinping, despite the well-known fact that they are fundamentally unproductve. As China becomes ever more ambiguous under President Xi, both domestically and globally, SOEs are playing an increasingly important role in the Chinese economy and are also crucial instruments for implementing the Chinese Communist Party's policies and strategic initiatives. In fact, President Xi's belief in the importance of SOEs, especially as drivers for innovation and growth, is closely linked with the emerging discourse about self-reliance and independence from imports of key technologies, such as semiconductors.

DEFAULTS AND IMPLICATIONS

The month of November has been particularly turbulent for China's corporate debt market. On 10 November, Yongcheng Coal and Electrity issued a statement that it could not meet a maturing payment of US$152.4m, although the coal miner managed to strike an ageement with creditors to postpone the payment by nine months. The reprieve was reportedly brokered with the help from the Henan provincial government since Yongcheng Coal's parent company, Henan Energy and Chemical Industry Group, is the province's largest SOE by assets. However, it is yet unclear how the company will come up with the money for repayment.

According to Fitch Ratings, Yongcheng Coal only became the sixth SOEs to default in the first 10 months of 2020. Prior to that, Huachen Automobile Group defaulted on a CNY1bln (US$152.4m) principal and interest that matured on 23 October. Huachen is the state-owned parent of Brilliance China Automobile, an automaker that partners with BMW and produces luxury cars for the country. But within a fortnight, Tsinghua Unigroup, a major state-backed technology group founded by the prestigious Tshinghua University, would also default after failing to repay a CNY1.6bln (US$198.4m) debt. But given Tsinghua Unigroup's strategic importance in Beijing's high-tech ambitions and its aims to become more independent amid risks of foreign sanctions, it is expected that state support will continue.

The recent turmoil has not only rattled China's corporate bond market, of which SOEs account for more than half, but also magnified a number of key issues.

First and formost, it once again highlighted the country's ballooning national debt that has expanded to more than three times its gross domestic product (GDP). Meanwhile, local governments are also under growing pressure to meet debt obligations after years of splurging, with trillions of yuan set to mature in 2021. This condition was exacerbated by the COVID-19 outbreak, which once again pushed the central government towards debt-fuelled growth by increasing local government debt quota to steady the economy through infrasturature spending. In other words, Beijing is again banking on infrastructure projects to curb the economic fallout amid surging local debt, through which SOEs will play a prominent part. This is the major issue facing

China economically and a reason why its multi-year campaign to deleverage has not been very effective – Beijing wants to deleverage and rebalance the economy, but relies on SOEs to achieve a certain level of growth, usually in the form of major infrastructure projects. This model worked well during the 2008 global financial crisis since China needed infrastructure, but with the country now being saturated with infrastastruture, this will inevitably contribute to further indebtedness and risk of default simply because SOEs will struggle to produce sufficient return.

Secondly, it raised concerns about the credibility of domestic credit rating agencies as manifested in the default of Yongcheng Coal, a triple-A rated mine operator. This had prompted greater scrutiny by authorities of local bond issuance. The National Association of Financial Market Institutional Investors, a group controlled by the Central Bank, has initiatited a number of investigations into the financial institutions, credit agencies and accountants involved in the Yongcheng bond. Thus far, two former exectuives at state-owned credit ratings agecy Golden Credit Rating have been probed. The executives were accused of taking bribes to inflate the rating of certain companies. The central government in Beijing has also warned of a crackdown on misconduct, with Vice-Premier Liu He, the country's economic czar, chairing a special committee following the string of defaults. Such measures are welcome since the main reason why foreign investors have been reluctant to enter China's bond market, despite being the second largest in the world, is because of the lack trust in domestic ratings. With more than 70 per cent of corporate and government debt rated at triple-A, it is particularly difficult to identify true weaknesses.

Thirdly, the developments also dented investor confidence and pushed up borrowing costs for many corporates. This in turn led to a pause in domestic bond issuance, with Caixin News estimating that at least 57 companies either cancelled or delayed plans for new debt issues totalling CNY44.2bln (US$6.72bln) in the domestic market. All cited recent market turmoil. In particular, since Yongcheng Coal's default, no Henan-based SOE has succeeded in issuing bonds. And as a result, a number of firms are facing substantial capital-related pressure.

Finally, although recent defaults are a tiny portion of China's US$13tn onshore bond market, they have shaken a long-standing perception that local government will always support SOEs under their control. Investors typically operated on the assumption that SOEs are better credit risk than their private counterparts because of implicit government support. As a result, the recent wave of SOE defaults appears to have challenged this tacit assumption. Yet, to say government support has dwindled or ended is perhaps an over-statement. A visible shift in the prevailing view of inplicit government support would most likely lead to disruptions and force a repricing of risks in SOE bonds, but recent defaults are unlikely to rock the foundation of implicit guarantee. It is important to note that to a large extent, state support is also contingent upon a number of factors, namely strategic importance, the social-political ramifications, the financial implications, and links with elite families at both national and local levels.

OUTLOOK

It is expected that corporate defaults in China's onshore market are lilkely to continue in 2021 as Beijing begins to phase out some of its COVID-19-related economic stimulus, although private companies are more at risk than SOEs. While the economy is on path to positive growth following its first-ever quarterly contraction, China's economic recovery remains uneven, with domestic demand still weak. The recent defaults are positive steps towards greater financial discipline, but the lack of SOEs reforms is likely to hamper deleveraging and re-balancing efforts.