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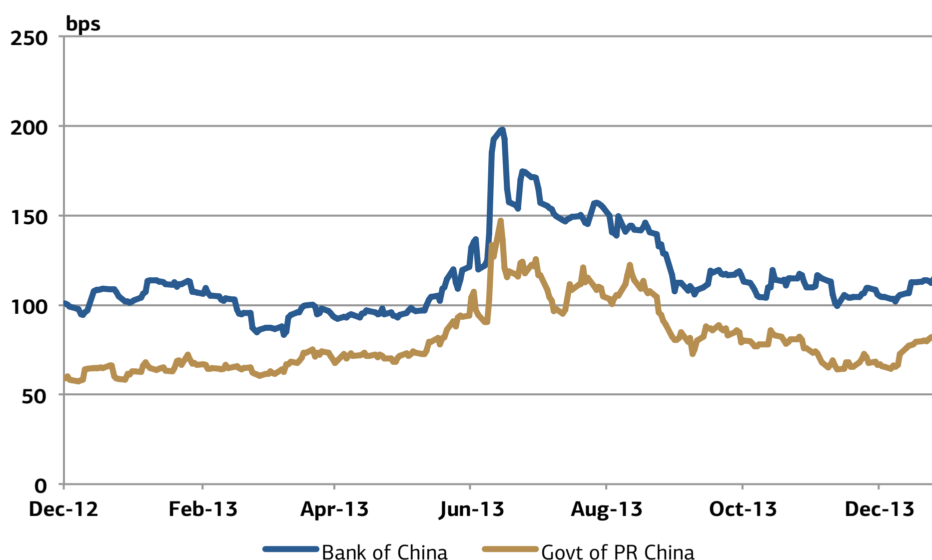
**Kevin Yeoh**
+61 413 105 488
kevin@jcapitalresearch.com

**Companies discussed**
**Evergrande (3333 HK)**
**Guangzhou R&F (2777 HK)**

**CDS, which spiked in June and rose during the liquidity squeeze in December, make a good hedge.**




Source: Bloomberg

# Year of Risk

## Property as the first wave

### + Developers' onshore bond yields shoot up

Some of China's property developers are at high risk of default, but their bonds yields do not reflect the risk.

### + USD exposure

Given low rates for US dollar debt against rising Renminbi rates in China, listed developers are issuing USD bonds. By 2013 H1, USD debt had risen to about 28% of the total for 42 listed developers. This increasing USD exposure is creating risk around a currency devaluation.

### + Using CDS to play the downturn

We examine this month the forms of hidden debt in the property sector. We see some large developers at risk of defaulting on their debt this year, while the liquidity demands at a macro level threaten more interbank crises. Those strains on the system make Credit Default Swaps a good bet for running higher.

KEY POINTS

1. Hidden risk in Chinese property
2. Increased USD debt creates currency risk.

**By Kevin Yeoh with Zac Issa**

Faced with restrictions on borrowing from banks, Chinese property developers have dominated offshore junk bond or "high yield" issuance in both the USD and dim sum (CNH) markets.

But the issuers very often lack transparency, have risky business models, and present significant structural subordination risk. These risks mean that the apparently tasty yields on offer are inadequate, and investors should demand a higher return for providing what is in essence an unsecured loan to a highly leveraged company with flaky assets.

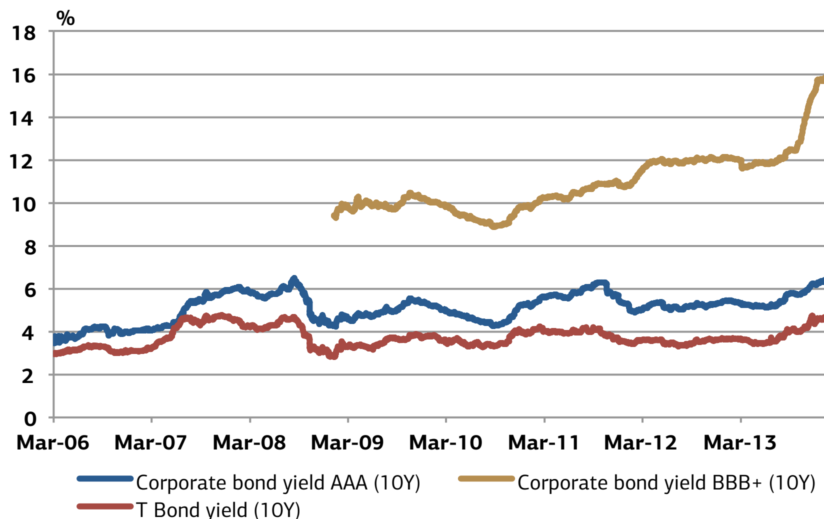
## Junk bond yields don't compensate for the risk

Offshore Chinese property junk bond yields range from 6-13%, which looks high in a global context, but looks can be deceiving. Compared to the 12-15% yields on offer from Chinese onshore BBB+ investment-grade corporate bonds (12.4% for 3M; 12.7% for 1Y; 14.9% for 5Y; 15.8% for 10Y), offshore Chinese junk bond yields are far too low for the risk.

Chart 1 shows the recent large spike in the Chinese onshore BBB+ corporate bond yield to almost 16%.

➲ The Chinese onshore BBB+ corporate bond yield spiked recently to almost 16%.

## Chart 1. The BBB+ yield goes vertical




Source: Wind

If onshore lenders are only prepared to lend to BBB+ secured borrowings at 12% for three months and 14% for five years, why are offshore investors prepared to charge far less for riskier and unsecured junk bonds? Onshore lenders are likely to be far better assessors of credit risk than is a foreign bondholder.

Thus, while Chinese developers have been exploiting lower offshore borrowing costs, investors shouldn't sign up unless the yields are much higher.

# Meanwhile, offshore

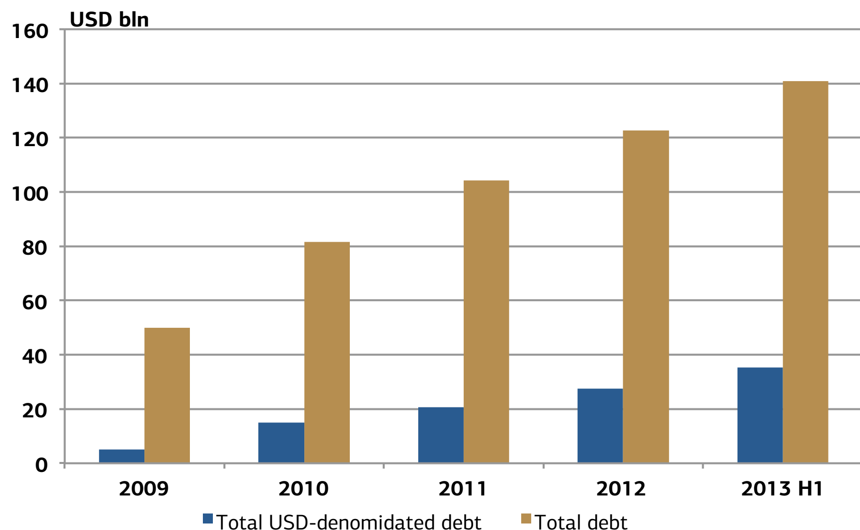
Even as rates surge into the teens onshore, Chinese property developers have been snapping up more and more USD-denominated debt. We looked at the stated debt of 42 property developers and found that USD debt has been growing vigorously across the board. In the space of only a few years, USD debt has on average increased from 11% of total debt in 2009 to 28% in 2013 H1. Although both USD and total debt levels have grown rapidly, the pace of USD debt growth has been faster.

## Tripled since 2009

Since 2009, developers' debt has been growing strongly. Average debt to equity is currently 85%, with net debt to equity at 50%. On a consolidated basis, the 42 developers have a total debt of USD 140.8 bln, which almost triples the USD 49.9 bln of total debt in 2009.

The increase in USD-denominated borrowings has been particularly noteworthy. In 2009, most developers had negligible amounts of USD debt, but, within a year, a major debt binge began, with consolidated USD debt almost tripling from USD 5.2 bln to USD 15 bln. Consolidated USD debt has grown at a faster rate than total debt and today amounts to USD 35.4 bln, up almost five-fold from 2009.

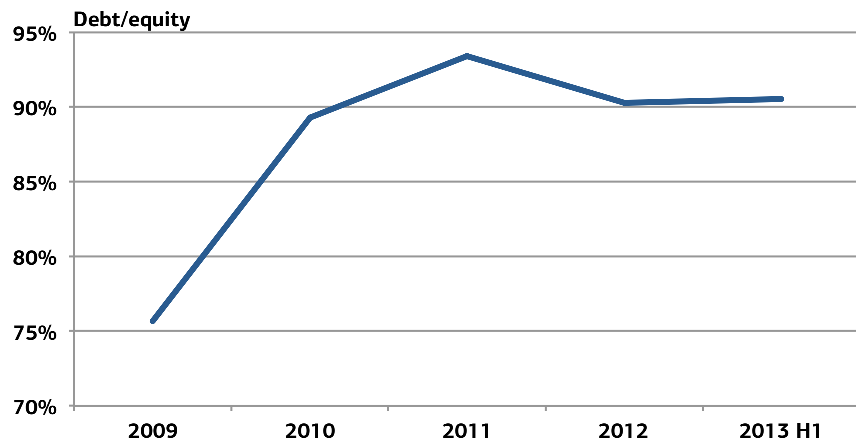
## Chart 2. USD debt and Total debt




Source: Company data, J Capital

There doesn't appear to be any rush to deleverage either: during 2013 H1, consolidated debt to equity remained stubbornly high at 90.5%, a touch below the 2011 peak of 93.4%.

## Chart 3. Consolidated debt/equity: 42 developers




Source: Company data, J Capital

## Becoming addicted to offshore debt

Since Chinese developers were given the green light for offshore issuance, they haven't held back.

Sunac China (1918 HK), for example, had no USD debt in 2011 but took on USD 2.5 bln in 2012 and, within six months, had more than tripled this figure to USD 7.9 bln. Other firms with explosive USD debt growth include:

- KWG Property (1813 HK) increasing USD debt by 185%, from USD 2 bln in 2010 to USD 5.7 bln in 2011.
- Country Garden's (2007 HK) USD debt more than tripled, from USD 2.6 bln in 2009 to USD 8.9 bln in 2010.

Lower-rated firms tend to carry larger proportions of USD debt, which suggests they may receive less financial support on the mainland. Take Renhe Commercial (1387 HK), a firm with a Moody's Caa1 negative rating, for which USD debt represents over 70% of its total borrowings in 2013 H1, down from 100% on 2010.

## Table 1. Developers with high USD-denominated debt

| Developer | USD debt % total debt 2013 H1 | Moody's rating |
|---|---|---|
| Renhe Commercial (1387 HK) | 74% | Caa1 Negative |
| Soho China (410 HK) | 69% | Ba1 Stable |
| Central China Real Estate (832 HK) | 60% | Ba3 Stable |
| Lai Fung (1125 HK) | 59% | B1 Stable |
| Road King Infrastructure (1098 HK) | 54% | B1 Positive |
| Kaisa Group (1638 HK) | 51% | B1 Stable |
| China SCE Property (1966 HK) | 48% | Ba1 Stable |
| Golden Wheel (1232 HK) | 43% | B2 Stable |
| KWG Property (1813 HK) | 40% | Ba3 Negative |
| Yanlord Land (YLLG SP) | 40% | Ba3 Stable |

Source: Company data, J Capital

In contrast, higher-rated firms tend to have less of a need to access offshore capital markets. Unsurprisingly, they are mainly SOE-backed developers.

## Table 2. Higher-rated firms have lower USD debt

| Developer | USD debt % Total Debt | Moody's rating |
|---|---|---|
| China Resources Land (1109 HK) | 15% | Baa1 Stable |
| China Vanke (200002 CH) | 14% | Baa2 Stable |
| Poly Real Estate (600048 CH) | 11% | Baa2 Stable |
| China Overseas Grand Ocean (81 HK) | 3% | Baa2 Stable |

Source: Company data, J Capital

## Raise equity. . . then raise debt?

Recent IPOs haven't quenched the thirst for borrowing. Normally, a newly listed company would not require a fresh injection of funds so soon after their IPO. However many of these newly listed developers have raised USD debt only 3-5 months after their IPOs. They include:

- Wuzhou International (1369 HK): USD 100 mln, 13.75% senior notes due 2018.
- Modern Land (1107 HK): USD 150 mln, 13.875% senior notes due 2018.
- CIFI Holdings (884 HK): USD 225m, 12.25% senior notes due 2018.

Current debt to equity for these companies is relatively high considering their IPOs. For instance, Wuzhou's debt-to-equity ratio is 100%, and net debt to equity is 58%.

When will all of this debt mature?

- USD 26.9 bln (or 22%) of consolidated total debt matured in 2013
- USD 30.5 bln (or 25%) in 2014
- USD 43.3 bln (or 35%) matures from 2015-17

This means that this and next year will see almost half of the developers' refinancing needs. This is a large short-term liability for a heavily geared industry.

As for USD-denominated debt maturities, Chart 4 shows that 2016, 2017 and 2018 are the big years for refinancing, with USD 6.3 bln, USD 9.6 bln and USD 8.4 bln of consolidated USD debt maturing in each of these years.

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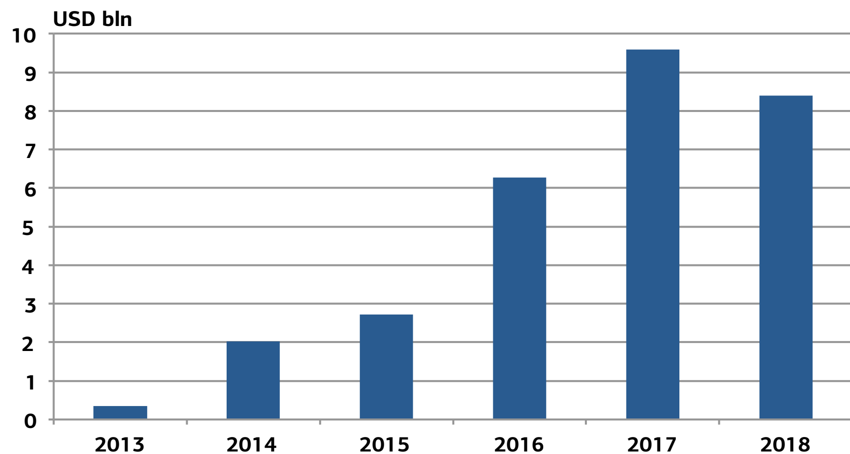
## Chart 4. Consolidated USD-denominated debt maturity schedule




Source: Company data, J Capital

Companies that face significant short-term debt maturities include:

- China Vanke (200002 CH): USD 5.8 bln in 2013 and USD 4.4 bln in 2014, vs. USD 11.7 bln in total.
- Guangzhou R&F (277 HK): USD 2.2 bln in 2013 vs. USD 5.1 bln in total.

➲ What do onshore bondholders know that foreigners don't?

## Still shooting up

At least USD 6 bln worth of new bonds were issued in 2013 H2. This is a very large amount considering it is only for a five-month period, yet it is just shy of 2016's total USD-denominated debt maturities. One of the larger deals include China Vanke raising USD 2 bln for debt maturing in 2017, and Evergrande and China Overseas Land both raising USD 1.5 bln for various maturities.

Will the growth in USD issuance continue? In a low-rate world offshore investors have been willing to overlook the high gearing of developers given the relatively high bond yields they offer. So, if global interest rates remain low, the Chinese developers may be able to continue exploiting their get-out-of-jail card via the offshore bond markets.

However, with greater reliance on USD debt, developers are exposed to Fed tapering concerns leading to potentially higher offshore interest rates. Overseas liquidity could quickly evaporate and the heavily indebted developers could find themselves in a pickle when it comes time to refinance.

## Evergrande and R&F's real asset values

To illuminate the large credit risk of Chinese developers we have produced Debt Reports on two of the most aggressive developers—Evergrande and Guangzhou R&F ("R&F"). Both companies are risky concerns. They have extremely high leverage, are reliant on lender generosity to continue funding their debt-addicted business models and show no signs of de-levering—they are hooked on attempting to build large, egotistical projects across China.

We reveal the hidden debt of both companies—for Evergrande, it is the buyback agreements and deposits backing bank acceptances, while for R&F, it is the contingent guarantees for JV projects.

In addition we provide detailed, on-the-ground analysis of the state of Evergrande and R&F's actual projects. Evergrande's report reveals a world of capital mismanagement, abandoned construction and unoccupied apartments.

For R&F we look at its recent latecomer Malaysian land splurge, which looks set to be a dud and the broken promises on its Huizhou project, leading to online complaints. Both reports cast a pall over the developers' stated asset values.

➲ Investment recommendation: just say no until the yield is over 15%.

**AVOID Chinese property junk bonds** until the unsecured risk is adequately reflected in the yield. Given onshore BBB+ investment grade corporate bonds yield 14.4% for five-year maturities, offshore junk bonds of a similar maturity need to yield far in excess of 15% to justify the risk.

An example is Evergrande's recently issued five-year bond maturing in October 2018. This unsecured bond pays an 8.75% coupon and is rated BB- by S&P, so it is three notches below an investment grade rating and five notches below a BBB+ rating. This yield is 40% lower than the yield an onshore BBB+ issuer would be charged, despite the considerably lower credit quality of Evergrande's offshore bond.

The chart below shows Evergrande's 2010 five-year bond with a 13% coupon. The Yield-to-Maturity has fallen to a low 6.19%, given the perception of less risk, as there is just over one-year to maturity. However, in the past the yield spiked to above 30% in September 2011 and was still above 15% in June 2012.

Which begs the question: has the global financial environment improved so much over the last year to warrant Evergrande issuing its most recent bond at an 8.75% coupon?

## Chart 5. Evergrande 13% 1/2015 Yield-to-Maturity

Source: Bloomberg

## How real are those stated asset numbers?

Bankruptcy in property development provides one of the most illuminating ways to understand the Chinese property sector. It is here that fairy floss numbers crumble against the crunch of the real world. We looked at 31 bankrupt developer cases reported in the Chinese media in 2013, 20 of which occurred in 2013. H2 The cases were spread across China with a high incidence of trust products.

We examined two of the bankruptcies in greater detail. One was from a trust where the underlying collateral value fell 66% from the original value. The second case shows what actually happens if a bankruptcy makes it to a restructuring court; it demonstrates that bankruptcies are not solely about the highest-ranking creditor.

We also looked at China's first "Trust Risk Assessment Report", published by Shanghai Jiaotong University. The report found that a 20% loss in collateral value would see 50% of trusts become insolvent and 83% unable to pay short-term obligations. These alarming results do not bode well for China's property sector, particularly if property bankruptcies continue to increase.

## Trust me

Trust products feature regularly in the bankruptcy cases. Nine out of 31 cases we looked at were from trust products, showing developers' strong (and desperate) reliance on high-interest shadow banking and the tightness of China's financing environment. Most collateral-backed trust products are property—land, buildings, and projects.

There were also nine instances of the developer's CEO fleeing the country, highlighting fraud risk. With CEOs fleeing, it is unlikely that creditors would be able to recover anything. In fraud cases, detecting bankruptcy from normal credit analysis would be difficult.

In cases that were able to overcome the numerous red-tape obstacles to debt recovery and actually proceed to a sale of collateral, the underlying assets were worth less than liabilities. This was despite the original valuation being much higher.

CITIC's Qingdao Shusi Beier Property Project Trust ("QSB") was one such case. CITIC is one of the main issuers of trust products, and the QSB Trust was issued in August 2010 for a total issue size of RMB 710 mln. The underlying land-use rights collateralizing the trust were initially valued at RMB 1.275 bln. So the initial gearing of the trust was apparently 55%.

However, due to property tightening and poor management, the project fell behind on payments. CITIC resolved to auction the collateral to recover the debt but found it hard going. After three auctions to find a buyer, CITIC was able to recover only approximately RMB 400 mln (less than one-third of the original valuation!), meaning the project was in negative equity to the tune of 310 mln. This also shows that the presence of a trust product manager does little for governance or risk management.

## Stress-testing trusts

China's first "Trust Risk Assessment Report" provides another window into the murky world of trusts and their underlying collateral. This report was published by Shanghai Jiaotong University's Institute of Finance and stress tested solvency and liquidity for 60 of China's 66 Trusts.

The solvency stress test (Table 3 below) found that, if a 10% loss were modeled, eight of the 60 Trusts (or 20%) would be insolvent, with a RMB 15.2 bln funding gap. However, if a 20% loss were modeled, then a massive 50% of trusts would be insolvent, with a funding gap of RMB 66.7 bln. A 20% fall is certainly feasible in light of CITIC QSB's 66% fall in collateral value.

### Table 3. Trust solvency stress test

| Loss % | 5% | 10% | 20% |
|---|---|---|---|
| Trusts that can't cover losses | 2 | 8 | 30 |
| Funding gap (RMB) | 1.6 bln | 15.2 bln | 66.7 bln |

Source: Shanghai Jiaotong University

While the insolvency results are alarming, the liquidity results are even more striking. The liquidity stress test (Table 4) found that, if a 10% loss were modeled, 26 of the 60 Trusts (or 43%) would be unable to pay short-term obligations, with a funding gap of 33.8 bln. With a 20% loss, 50 out of the 60 trusts would be unable to pay short-term obligations and the funding gap would be a huge RMB 115.6 bln.

### Table 4. Trust liquidity stress test

| Loss % | 5% | 10% | 20% |
|---|---|---|---|
| Trusts with repayment difficulties | 14 | 26 | 50 |
| Funding gap (RMB) | 7.5 bln | 33.8 bln | 115.6 bln |

Source: Shanghai Jiaotong University

## Flaky asset values?

The stress tests illustrate the severe asset/liability mismatch that underpins the trusts: they are funded against illiquid assets of questionable value. The issue of collateral values also leads to the question of how believable are the total asset figures of listed property developers.

Based on its stated assets, Guangzhou R&F currently has extremely high leverage with Debt/Equity of 174% and Net Debt/Equity of 123%. A 10% fall in the stated value of R&F's assets would see Debt/Equity of 193% and Net Debt/Equity of 136%.

Such hypothetical forecasting is largely irrelevant in R&F's case, given its 100%+ leverage ratios, levels which have seen many other companies declare bankruptcy. But for developers with lower, but still high leverage ratios (in the 60-80% range), the implications of over-valued assets are a big warning sign to potential lenders.

CDS hedge

Long government and Bank of China CDS below 100 bps

## Courts and debt restructuring

If a bankruptcy case actually makes it to court, debt restructurings are complicated because of the myriad of interests and relationships common to developers.

As it is always the case, social and political stability are the underlying factors for Chinese courts. A local Guangdong court made this point during Jiayue Group's bankruptcy proceedings. Jiayue, one of the biggest developers in Zhanjiang city, had 34 subsidiaries with total debt of RMB 6.12 bln, against assets of RMB 4.95 bln.

The Zhanjiang City Intermediate People's Court ordered restructuring proceedings in December 2012 and the first meeting of 307 creditors was held in June 2013. The second creditors meeting in August elected restructuring committee members and included representatives from the Industrial and Commercial Bank of China and union officials.

Maintaining social stability was a key priority for the court. The court made public statements about preventing social unrest—highlighting that Chinese bankruptcy proceedings are not simply about the highest-ranking creditor.

In particular, the Court cited a restructuring case in Wuchuan, a neighboring city, where the court ordered RMB 20 mln be paid to workers prior to the Spring Festival holiday to ensure workers had a "happy Spring Festival".

In the Jiayue case, local Chinese social media was awash with rumors that the Court had mishandled proceedings and that the 2,000 workers would lose out. In response, the court stressed that part of the workers' claims would be repaid in full and that any new investor in the restructured entity would need to take on all existing Jiayue staff and not be allowed to lay off more than 10% within the first year of ownership.

Ultimately, in bankruptcy cases, creditors need to be aware that there is no primacy of creditors—China's political imperatives and competing social interests mean that these abstract elements will have to be satisfied before any offshore demands.

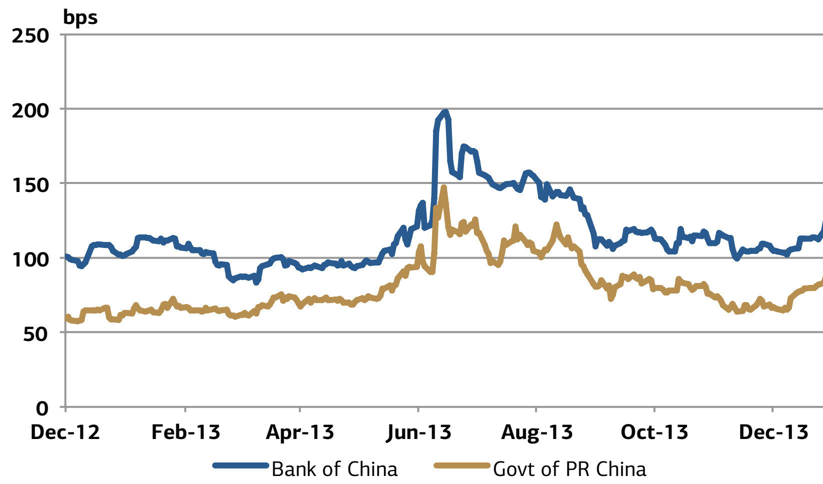
## The CDS hedge

**LONG five-year Credit Default Swaps of the Government of People's Republic of China below 100 bps and Bank of China CDS below 100bps**

Buying the CDS of the PRC Government and the Bank of China are ways to play the mispriced risk of China's financial system. The CDS premium of the PRC Government spiked in the June 2013 interbank funding debacle to 147 bps and then calmed down to trade around 65 bps, when we first recommended the trade.

Following the December 2013 funding crisis, the premium has started to spike again and, at the time of writing, is 87 bps.

## Chart 6. Government of PR China and Bank of China CDS




Source: Bloomberg

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