



中國誠信(亞太)信用評級有限公司

CHINA CHENGXIN (ASIA PACIFIC) CREDIT RATINGS COMPANY LIMITED

# China's Debt Default Alarm Under the "Economic New Normal"

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At Treasury Markets Association



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The Economic New Normal

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## Features of “Economic New Normal”

The Chinese economy has shifted gear from high speed to medium-to-high-speed growth

The economic structure is continuously improved and upgraded

The economy is increasingly driven by innovation rather than relying on input and investment

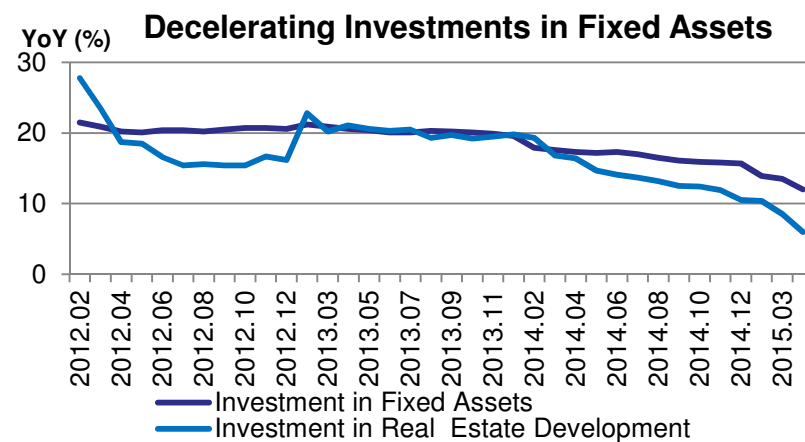
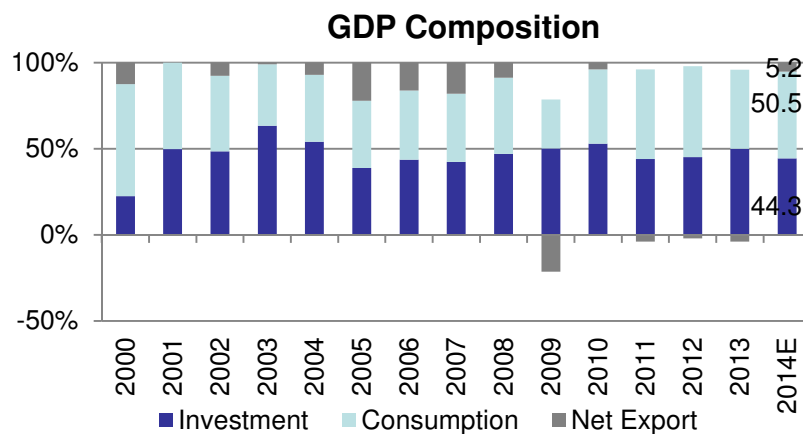
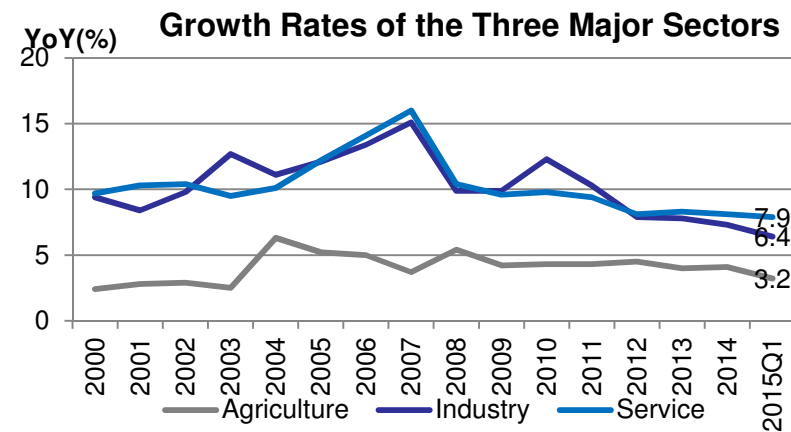
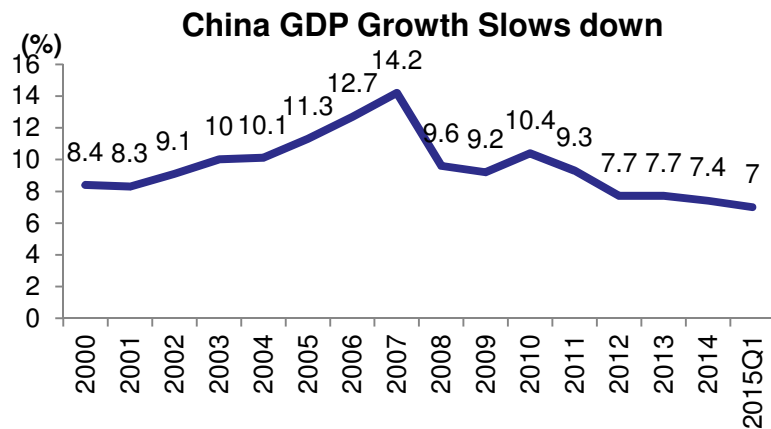
Commodity exports will be transferred to capital exports

## China's Economy 2015 Q1 At A Glance

	2015 Q1	2014 Q1
1. GDP Growth Rate (%)	7.0	7.4
The growth rate of Agriculture Sector	3.2	3.5
The growth rate of Industry Sector	6.4	7.3
The growth rate of Service Sector	7.9	7.8
2. Investments in Fixed Assets (RMB billion)	7,751.1	6,832.2
Growth Rate (%)	13.5	17.6
Total Retail Sales of Consumer Goods(RMB billion)	7,071.6	6,208.2
Growth Rate (%)	10.6	12.0
3. Export Amount (RMB billion)	3,149.3	3,002.5
Growth Rate (%)	4.9	-3.4
Import Amount (RMB billion)	2,394.0	2,899.7
Growth Rate (%)	-17.3	1.6
4. M2 Growth Rate (%)	11.6	12.1
Aggregate Financing to Real Economy(RMB billion)	4,602.2	5,630.8
5. CPI (%)	1.2	2.3

# The GDP Growth Remained Subdued

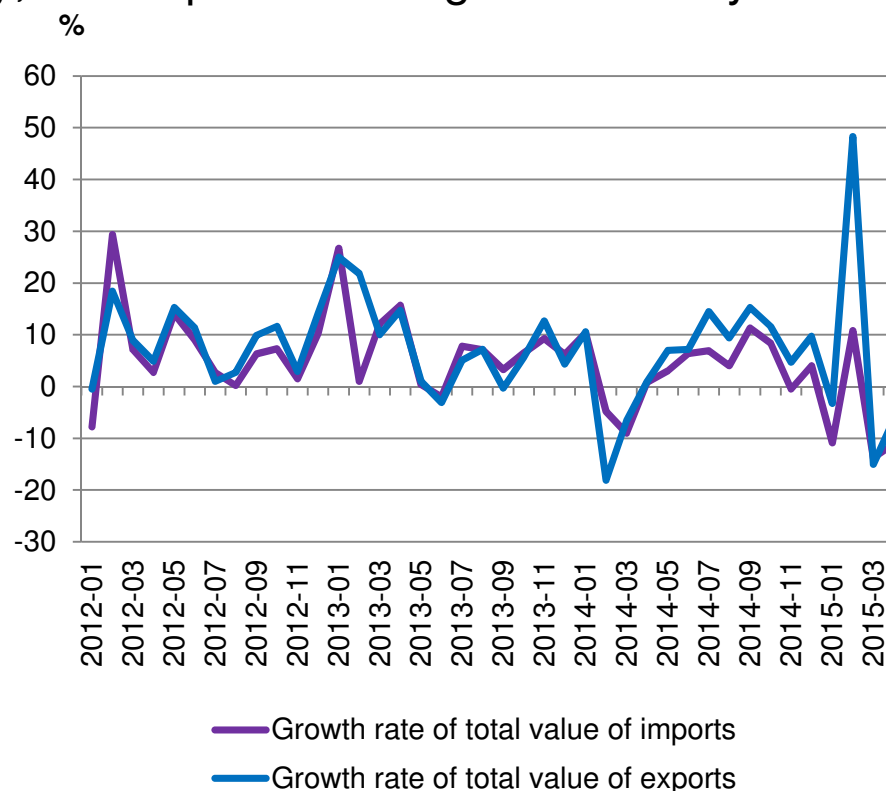
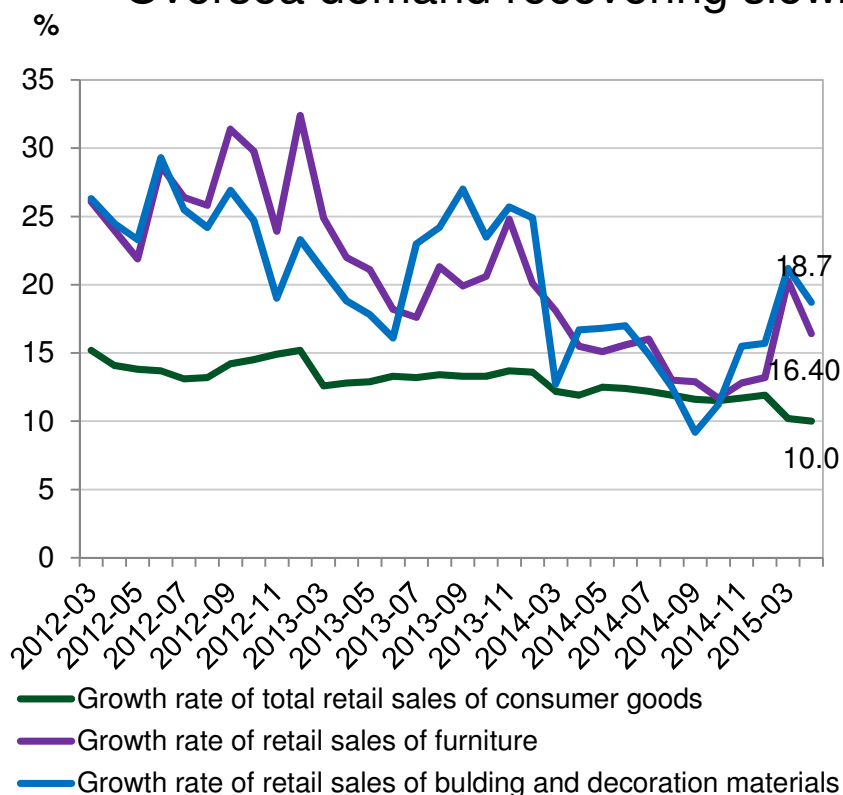
The investment growth slows down, and the infrastructure as a driven factor of economy has been weakened



Source: NBSC, CCXAP research

## Consumption Stable, Decline of Export Narrowed

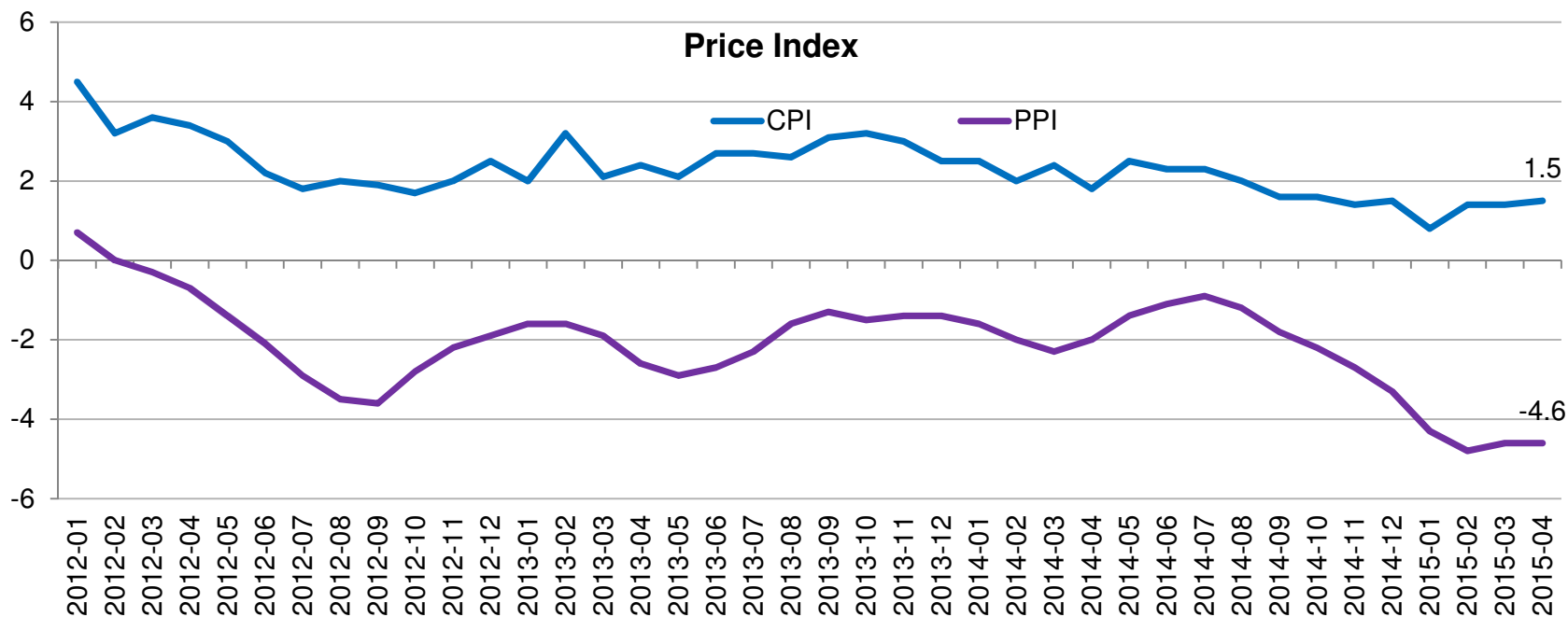
- The growth of consumption remains largely stable, with a growth rate of 10% in the April 2015
- Oversea demand recovering slowly, and export declining continuously



Source: NBSC, CCXAP research

## Differentiation of the Price Index Further Widens: CPI Rebounds and PPI Keeps Sluggish

- The CPI increased by 1.5% in April while the core CPI rebounded by 1.47%. However the index comes in lower expected.
- PPI declined for 37 months consecutively, implying the negative impact of overcapacity and economic structural adjustment continues.



Source: NBSC, CCXAP research

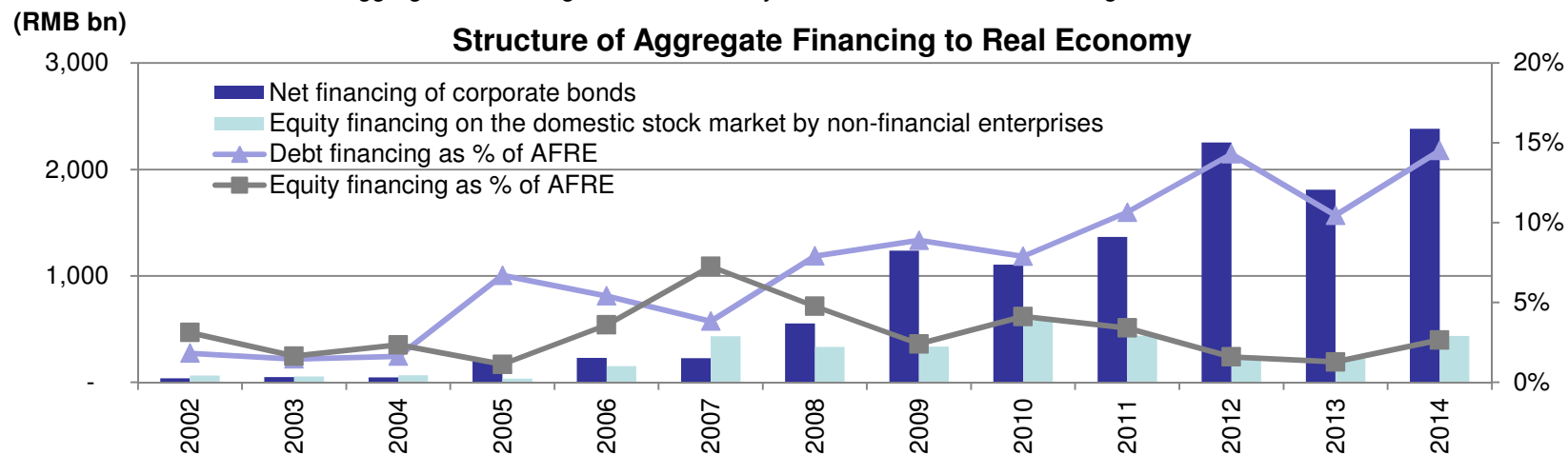
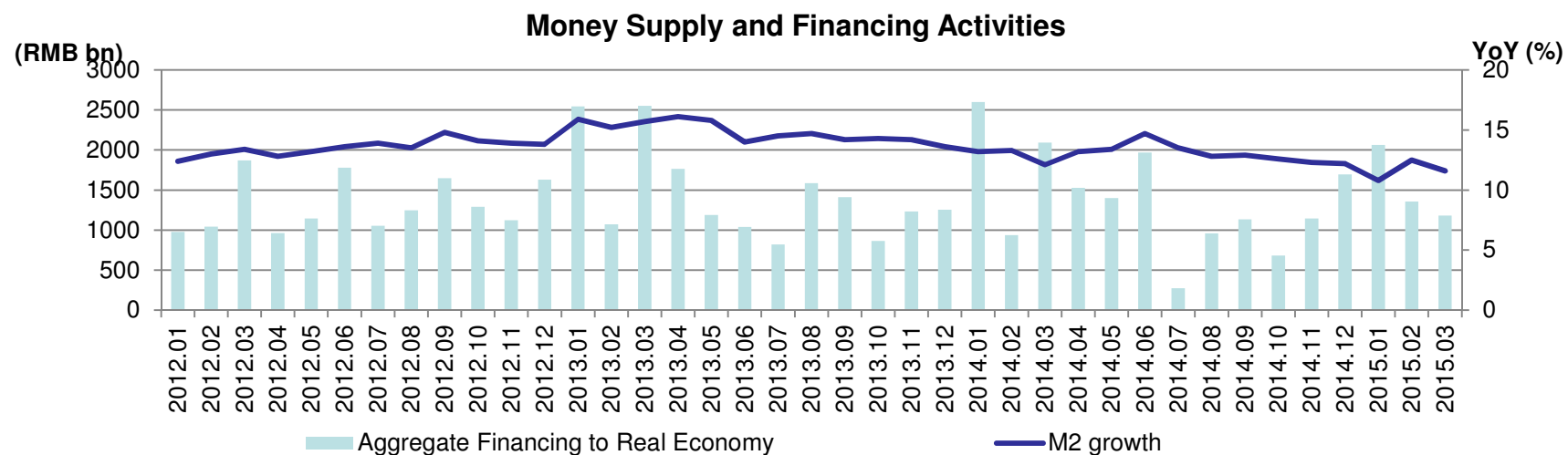


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# M2 Growth Stable, Direct Financing Increases



Source: PBOC, CCXAP Research



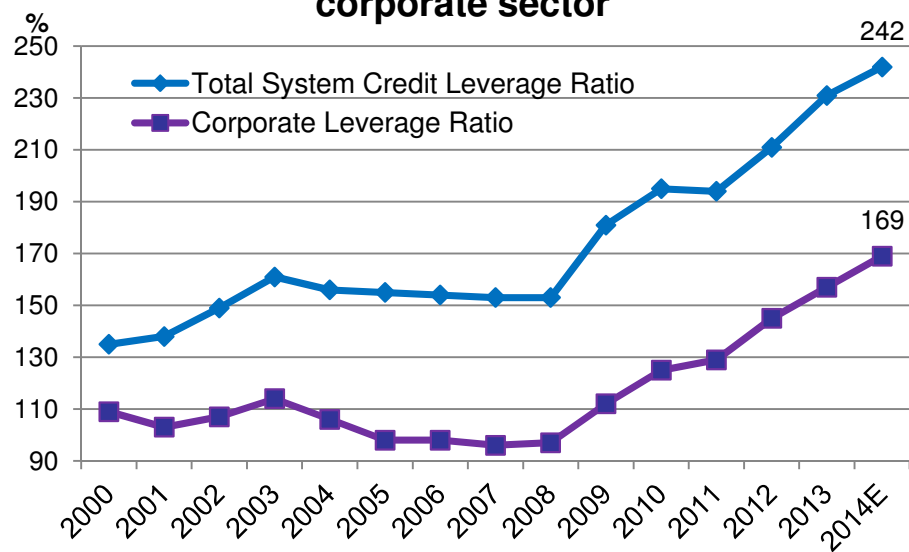
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## Focus in “Economic New Normal” 1: High Leverage Ratio in Corporate Sector

- Chinese government’s balance sheet remains healthy compared to that of its peer countries
- Corporates’ leverage ratio estimated to be 169% of GDP
- Heavy burden of interest payment, especially for LGFV’s debt

**Leverage ratio of total credit system and corporate sector**



**The proportion of AFRE to repay interest**



Source: Gildata, CCXAP research

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# Economic Deleverage on the Way

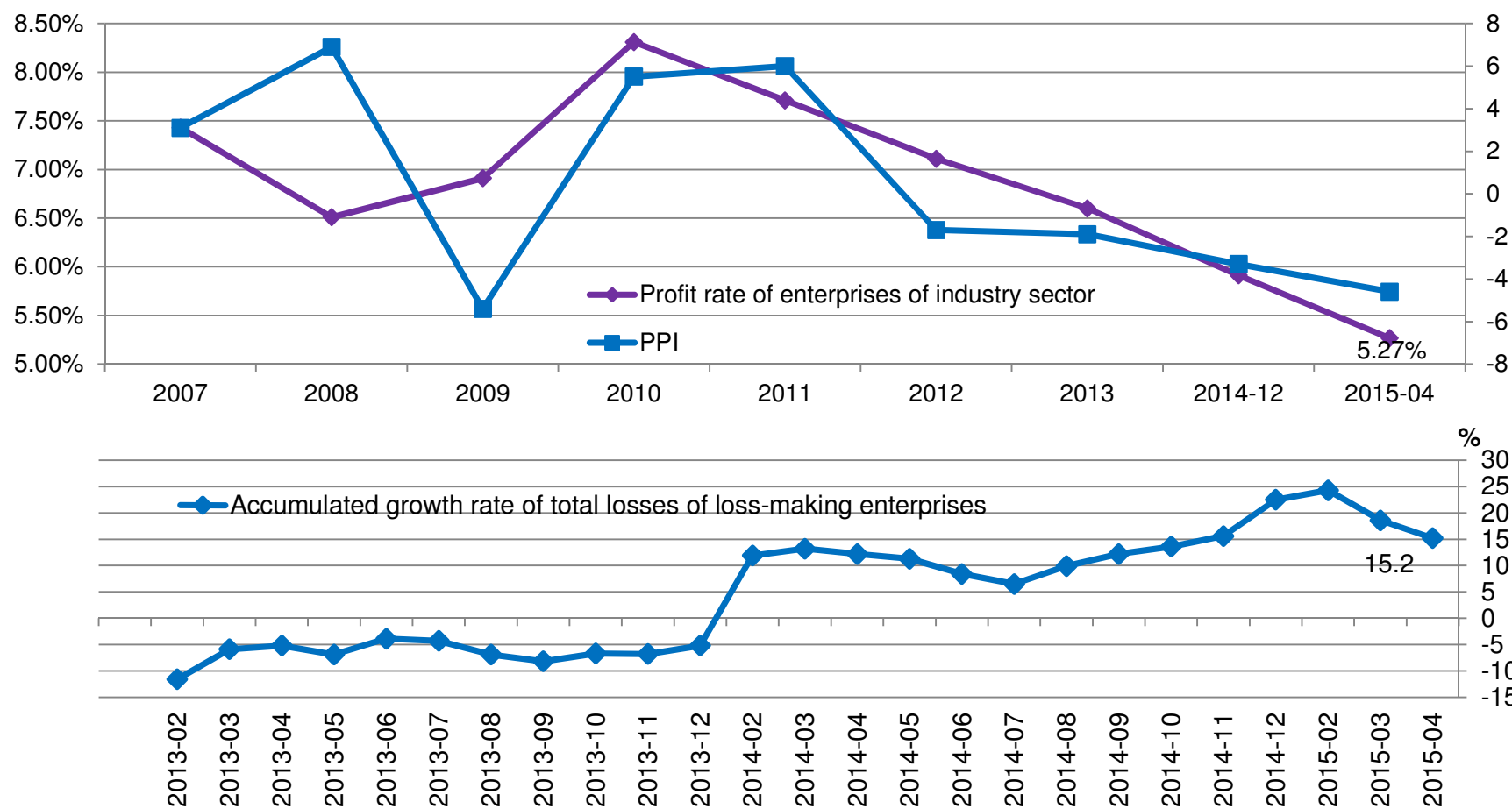
## Solutions for Deleveraging:

Roll over the debt and allow individual default case

Reduce interest payment stress: replace the LGFV debt of high cost with the government debt of lower cost

Expand capital base of corporates: bloom the stock market to encourage corporates raising funds by equity financing

## Focus in “Economic New Normal” 2: Enterprises of Industry Sector Suffer the Profit Declining



Source: NRSC, CCXAP research



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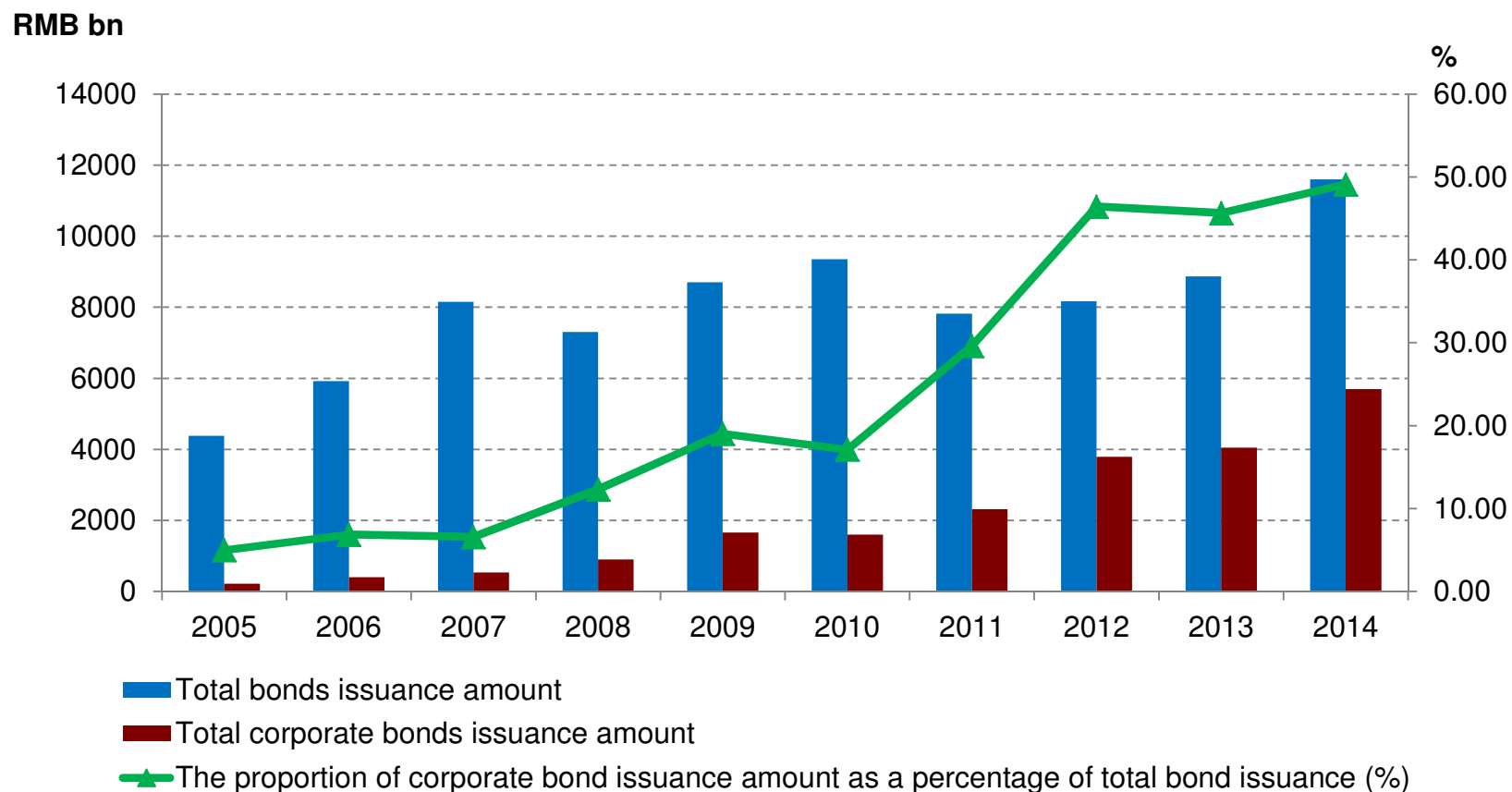


## An Overview of China's Debt Market

- Two debt market places: the interbank market and the exchange markets (Shanghai Exchange & Shenzhen Exchange)
- Three regulators:
  - National Association of Financial Market Institutional Investors (“NAFMII”)
  - National Development and Reform Commission (“NDRC”)
  - China Securities Regulatory Commission (“CSRC”)

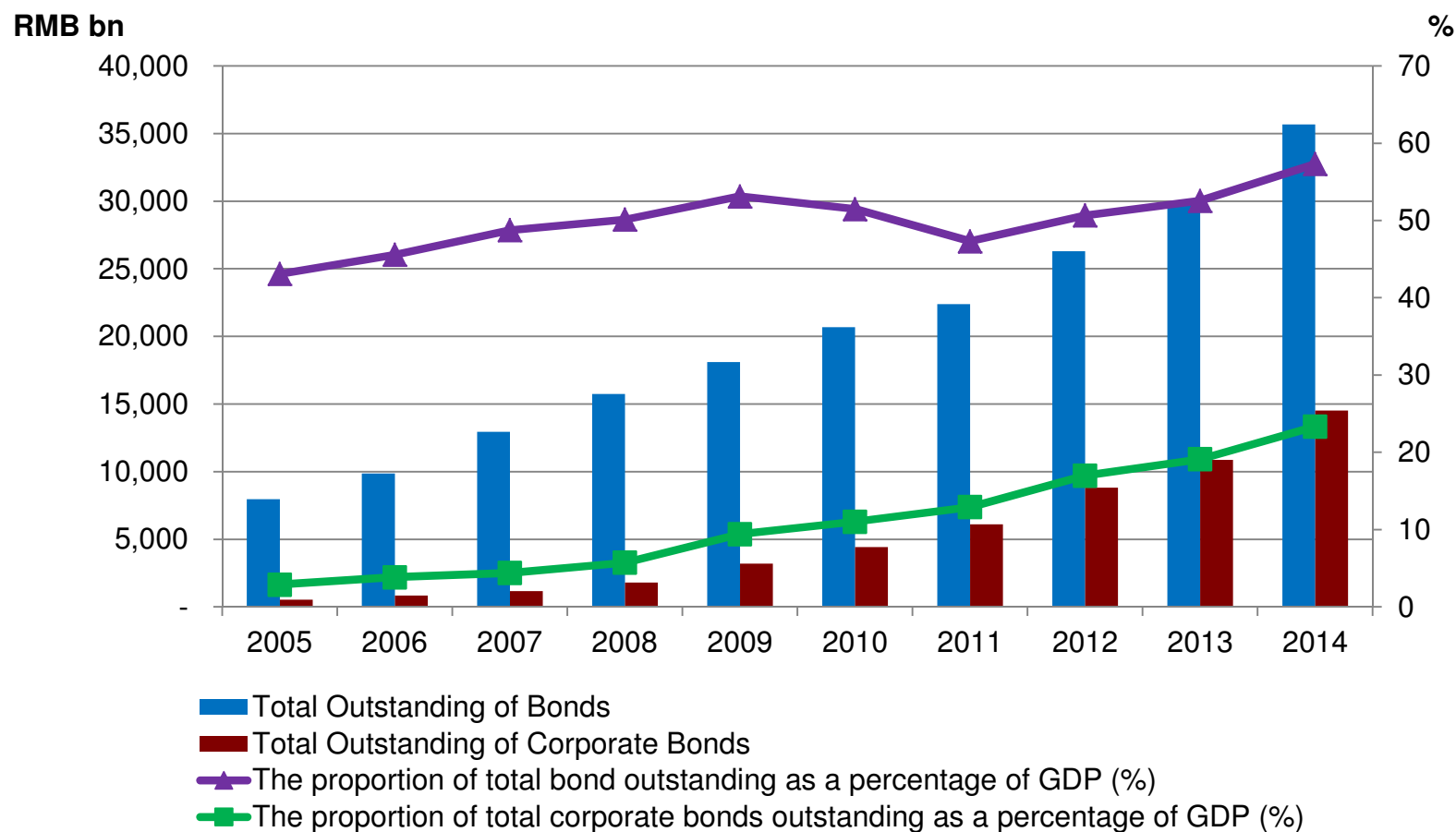
China's Debt Market		
	The interbank market	The exchange markets
Issuance Amount in 2014 (RMB trillion)	10.7	0.9
Outstanding Amount as of 31 December 2014 (RMB trillion)	32.4	3.3
Major debt products traded in the two markets	Treasury bond, Local government bond, Policy financial bond, Central bank bills, Non-policy financial bonds, Enterprise bonds, Medium-term notes (MTNs), Commercial papers (CPs), Private Placement Note, Assets-backed Securities, SME Collection Note, Collection bond, International Institution bonds	Treasury bond, Local government bond, Policy financial bond, Non-policy financial bonds, Corporate bonds, Enterprise bonds, Collection bond, Convertibles bonds, Bonds to support small and micro enterprises, SME Private Placement Bonds, Assets-backed securities
Investors	Commercial banks accounting for 63% of the trading volume of the market	Insurance companies, funds, securities institutions and foreign investors are the major players

## Bond Issuance Amount from 2005 to 2014



Source: Gildata, CCXAP research

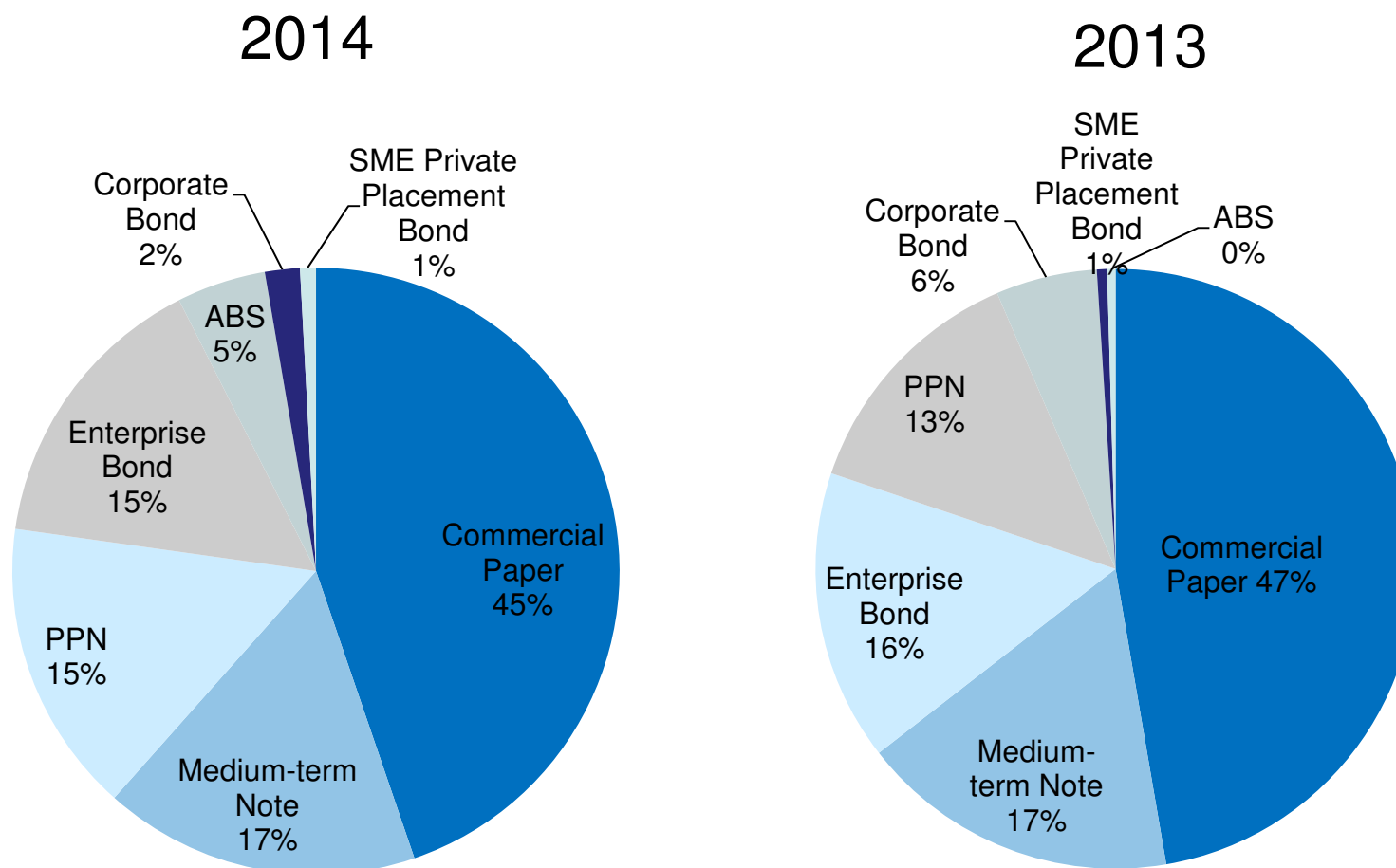
# Outstanding Amount of Debt Issues from 2005 to 2014



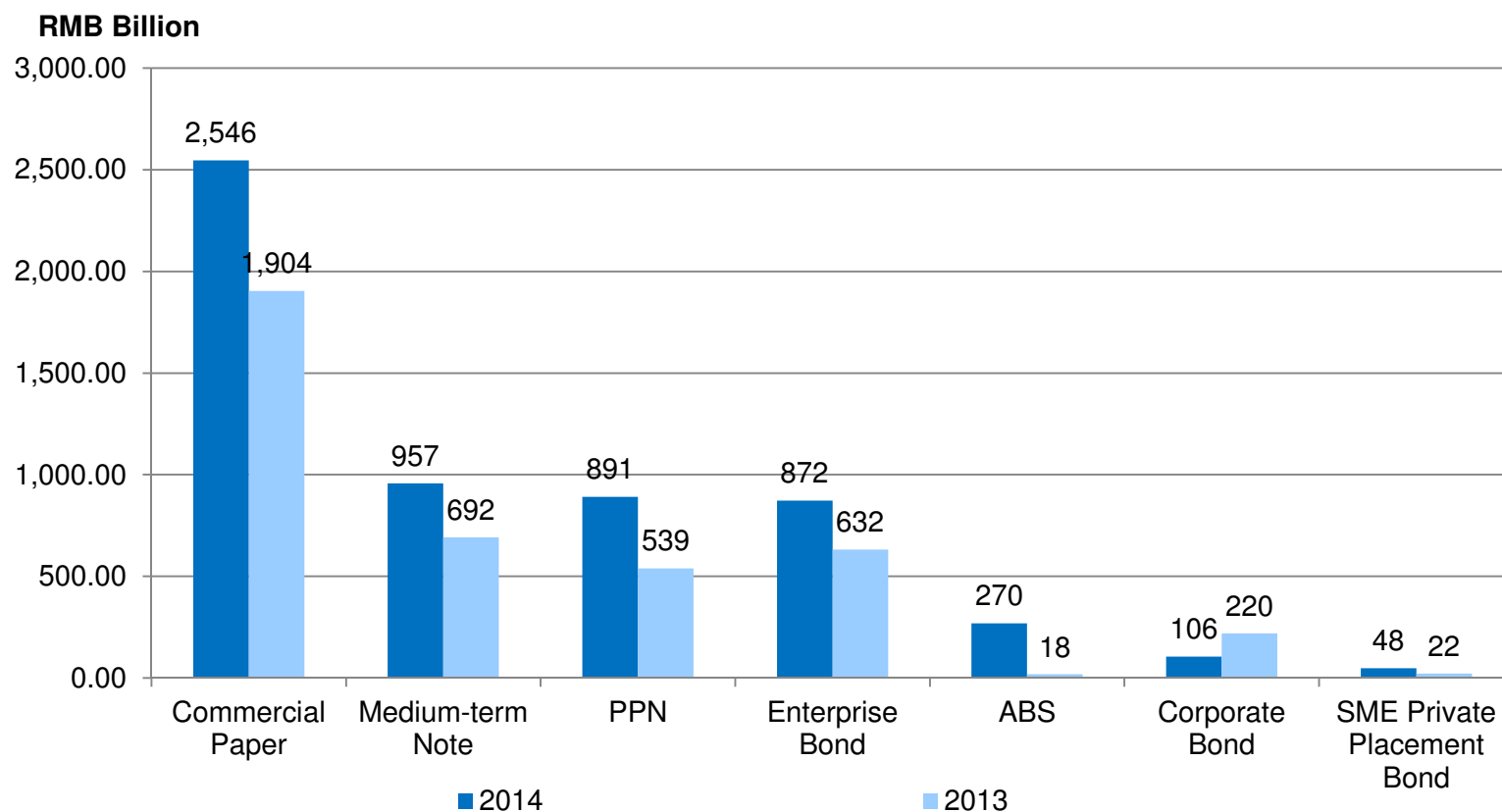
Source: Gildata, CCXAP research



## Main Debt Products Issued in 2013 and 2014



## Changes in Debt Products Issued in 2013 and 2014



Source: Gildata, CCXAP research

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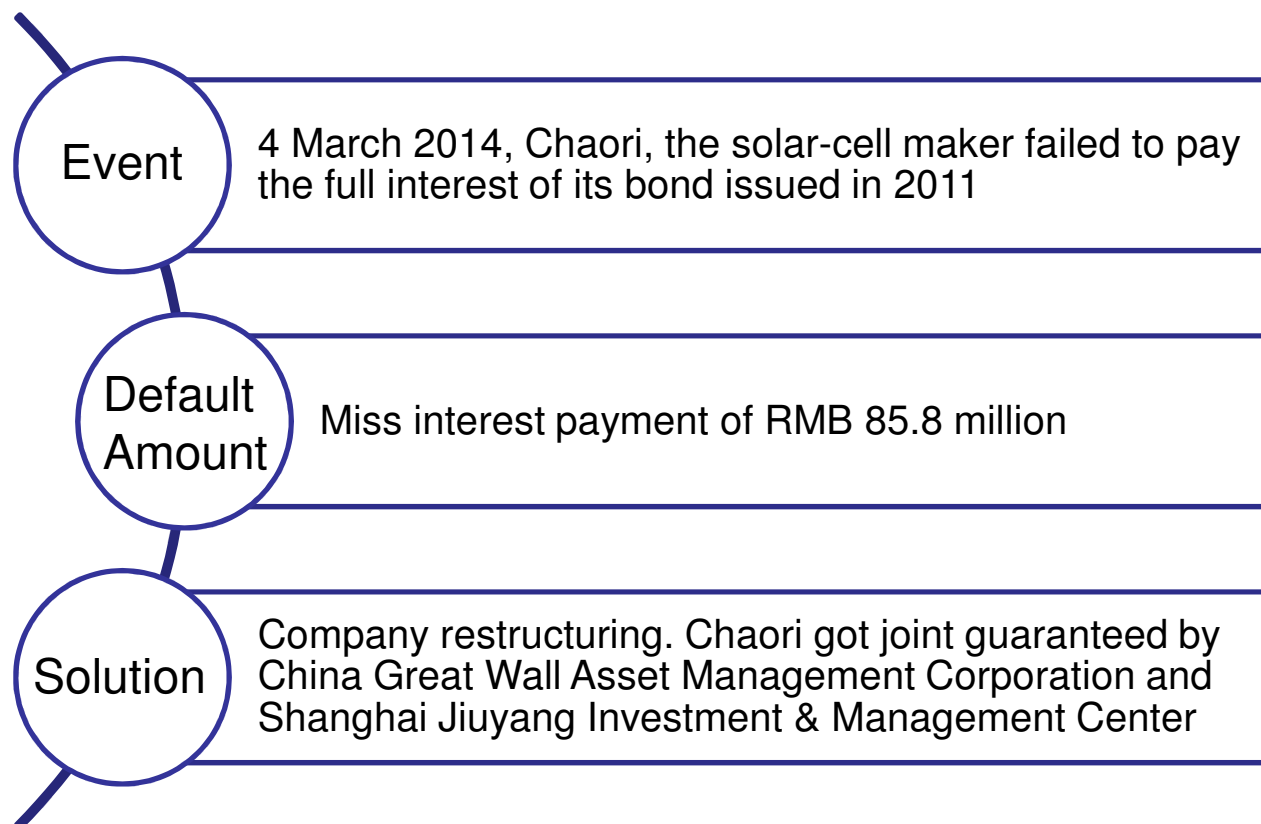
2 An Overview of China's Debt Market



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## 2014, The First Debt Default Happened in China



## Issuer's Credit Risk Events Records

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2006.7	Shanghai Fuxi Investment Holding Company Limited	POE	Transportation	Commercial Paper	Shanghai Fuxi was involved in the Shanghai Social Security Fund embezzlement scandal, its assets was froze by the local court.	Local government, regulator and lead manager coordinated and managed to repay the debt and interest
2011.9~2013.4	Shandong Hailong Company Limited	SOE	Textiles & Garments	Commercial Paper	The issuer was downgraded to CCC by credit rating agency	Probably repaid by a bank's bridge loan
2012.1	Beijing Dijie Communication Co., Ltd	POE	Electronic Information	SME Collection Note	The issuer was not able to repay the principle and interest of RMB 44.14 million	The principle and the interest were repaid by Zhongguancun Guaranty
2012.4~2012.1	LDK Solar Co., Ltd	POE	New Energy	Commercial Paper	The issuer was downgraded by credit rating agency	Probably repaid by the local government or local bank
2012.9~2012.1	XinJiang ChalkisTomato Co., Ltd	SOE	Food Processing	Commercial Paper	Because of the deteriorated financial strength, the issuer was downgraded by the credit rating agency	Probably repaid by the shareholder

## Issuer's Credit Risk Events Records (Cont')

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2012.1	Beijing Kangte Rongbao Electronic Co., Ltd.	POE	Electronic Information	SME Collection Note	The issuers suffered liquidity problems as it had to fulfill the guarantee responsibility for compensation for its related company	The principle and the interest were repaid by Beijing Capital Investment & Guarantee Co., Ltd
2012.12	Harbin Huijiabei Food Co., Ltd	POE	Food Processing	SME Collection Note	The issuer was not able to repay the principle and interest due to the deterioration of its revenue and profit	The principle and the interest were repaid by Shenzhen SME Credit Financing Guarantee Group
2012.12	Changzhou Gaolik Colour Coated Steel Manufactory Co., Ltd	POE	Building Materials	SME Collection Note	The issuers ceased operations and its pledged assets including plants and equipment were sealed off as it had to fulfill the guarantee responsibility for its related company	The principle and interest were repaid by the issuer in advance
2014.01	TJ Innova Engineering & Technology Co. Ltd	POE	Automobile	SME Collection Note	The issuer was not able to repay the debt due to liquidity problem	Repaid through shareholders' rights issue
2014.01	Changzhou Wintafone Chemical Co., Ltd	POE	Chemical	SME Collection Note	The issuer filed for bankrupt restructuring	The counter-guarantor, Changzhou Qinghong Chemical Co., Ltd repaid the principle and interest for the issuer

## Issuer's Credit Risk Events Records (Cont')

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2014.03	Shanghai Chaori Solar Energy Science & Technology Co. Ltd	POE	New Energy	Corporate Bond	The issuer was not able to repay the interest due to deteriorated business operation	Company restructuring, and Chaori got joint guaranteed by China Great Wall Asset Management Corporation and Shanghai Jiuyang Investment & Management Center
2014.03	Xuzhou Zhongsentonghao New Building Board Co., Ltd	POE	Chemical	SME Private Placement Bond	The issuer was not able to repay the interest	Repaid by the Sino-Capital Guaranty Trust Co., Ltd
2014.03	Zhejiang Huatesi Polymer Technical Co Ltd	POE	Chemical	SME Private Placement Bond	The issuer filed for bankruptcy restructuring	Probably repaid by its Guaranty Company
2014.07	Huatong Road & Bridge Group	POE	Conglomerate	Commercial Paper	As the Chairman was involved in the government's investigation before the maturity date of the commercial paper. This result in the uncertainty of the debt repayment	Repaid by the issuer with the help from the local government
2014.07	Jiangsu Hengshunda Bio-energy., Ltd	POE	New Energy	SME Collection Note	The issuer was not able to repay the principle and interest as its bank loan was overdue and business operation was ceased	Repaid by Jiangsu Re-guarantee

## Issuer's Credit Risk Events Records (Cont')

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2014.07	Huzhou Jintai Science and Technology Co., Ltd	POE	Mechanical equipment	SME Private Placement Bond	The issuer was not able to repay the debt	Default
2014.07	Tianjin Tianlian Binhai Composite Materials Co., Ltd	POE	Chemical	SME Private Placement Bond	The Chairman of the issuer could not be reached, and the issuer was not able to repay the debt	Default, Haitai Guaranty only repaid interest for half year of RMB 2.25 million
2014.08	Huazhu Quanzhou Shoes CO., Ltd	POE	Textiles & Garments	SME Private Placement Bond	The issuer was not able to pay the interest of 8 million due to liquidity problem	Default
2014.09	China Rongsheng Heavy Industries Holding Co., Ltd	POE	Ship Building	MTN	Overcapacity and aggressive business strategy	Planned to repay the debt after restructuring and selling assets
2014.11	Sinovel Wind Group Co., Ltd	POE	Mechanical equipment	Corporate Bond	Overcapacity and aggressive business strategy	Introduced strategic investors



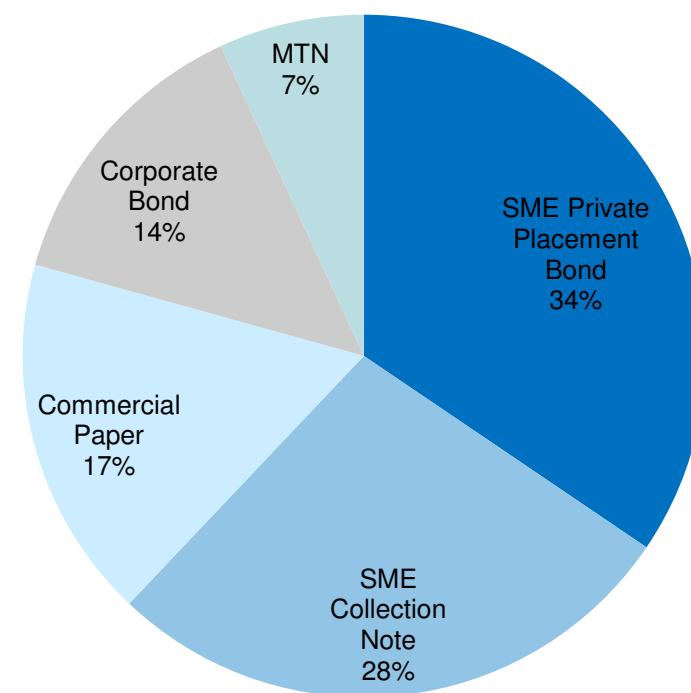
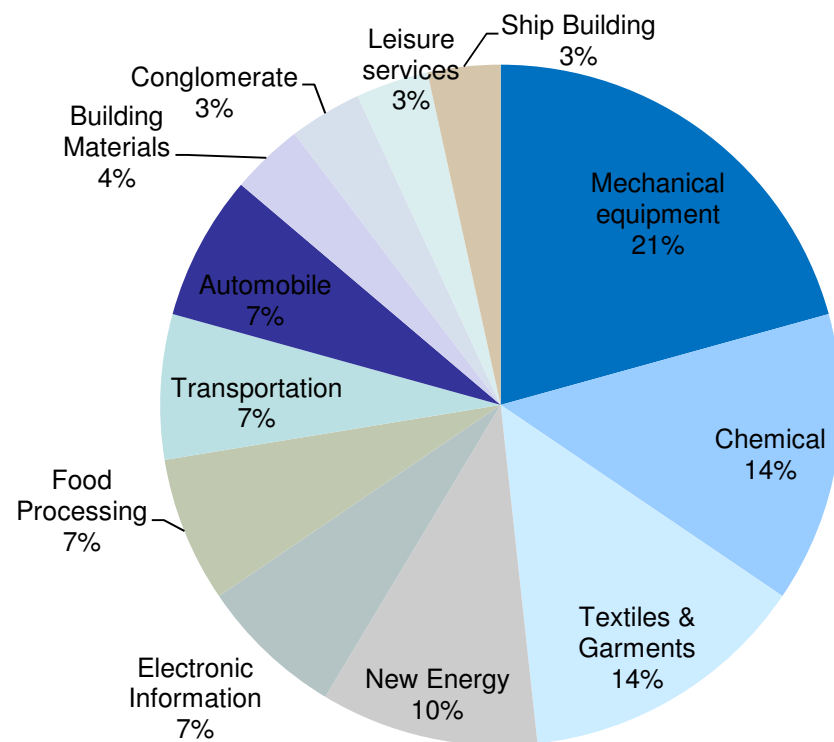
## Issuer's Credit Risk Events Records (Cont')

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2015.01	Dongfei Mazuoli Textile Machinery Co., Ltd	POE	Mechanical equipment	SME Private Placement Bond	The issuer was not able to repay the principle and the debt, while the guarantor refused to make the payment	The fund for the debt repayment was froze by the court
2015.02	An Hui NBO Machinery Group Co., Ltd	POE	Mechanical equipment	SME Private Placement Bond	The issuer was not able to repay the debt	Need further information
2015.02	Suqian Zhifu Leather Industry Co., Ltd.	POE	Textiles & Garments	SME Private Placement Bond	The investors exercised the right to require early repayment, but the issuer was not able to repay	Need further information
2015.02	Shenyang Mingchen Automotive Ltd.	POE	Automobile	SME Collection Note	The issuer was not able to repay the debt	Repaid by its Guaranty Company
2015.03	Inner Mongolia Hengda Road Development Co., Ltd	POE	Transportation	SME Private Placement Bond	The issuer was not able to repay the debt due to tight liquidity. The guarantor refused to make the payment	Need further information

## Issuer's Credit Risk Events Records (Cont')

Year	Issuer's Name	Company's Nature	Industry	Debt Product	Credit Risk Event	Solution
2015.04	Cloud Live Technology Group Co., Ltd	POE	Leisure services	Corporate Bond	The issuer was not able to repay the debt	The issuer planned to raise funds from banks loan and receivables to repay the debt. However, it is not clear when the funds could be raised
2015.04	Baoding Tianwei Group Co., Ltd	SOE	Mechanical equipment	MTN	<b>The issuer was not able to pay the interest of RMB 85.5 million</b>	<b>Need further information</b>
2015.04	Jiangsu Dahong Textile Group Co., Ltd	POE	Textiles & Garments	SME Private Placement Bond	The issuer was not able to repay the debt due to tight liquidity. The guarantor refused to make the payment	Need further information
2015.05	Zhuhai Zhongfu Industrial Co., Ltd	POE	Mechanical equipment	Corporate Bond	The issuer was not able to repay the 65% of the principle on the mature date due to the liquidity problem.	The issuer had made commitment to take the five pieces of land and its plant as the guaranty of the repayment.

## Industry and Products Distribution of the Credit Events



## Credit Risk in China's Corporate Bond Market

- Identifying outstanding corporate bonds with higher risk
  - For corporate bond issuers with a record of losses in two consecutive years, their bond trading is suspended by the exchanges.

As of June 1, 2015	Outstanding Amount (RMB bn)
Corporate bond issuers with a record of losses in two consecutive years, 2013 and 2014	559
- SOE	548
- non-SOE	11
Total corporate bond market	15,020
Risky bonds as % of total	<b>3.72%</b>

Source: Gildata, CCXAP research

## Why There Was No Public Debt Default in China's Onshore Bond Market before 2014?

### *Before 2005*

- Undeveloped debt market
  - Small debt market size
  - Limited debt product types
  - Only SOEs with low credit risk as the debt issuers
  - Guarantee from banks became normal practice

From 2002 to 2005, 72 enterprise bonds were issued with total issuance amount of RMB 165.9 billion. Among these issues, 60 (or 83%) were guaranteed by the banks, which amounted to RMB 121.1 billion (or 73%).

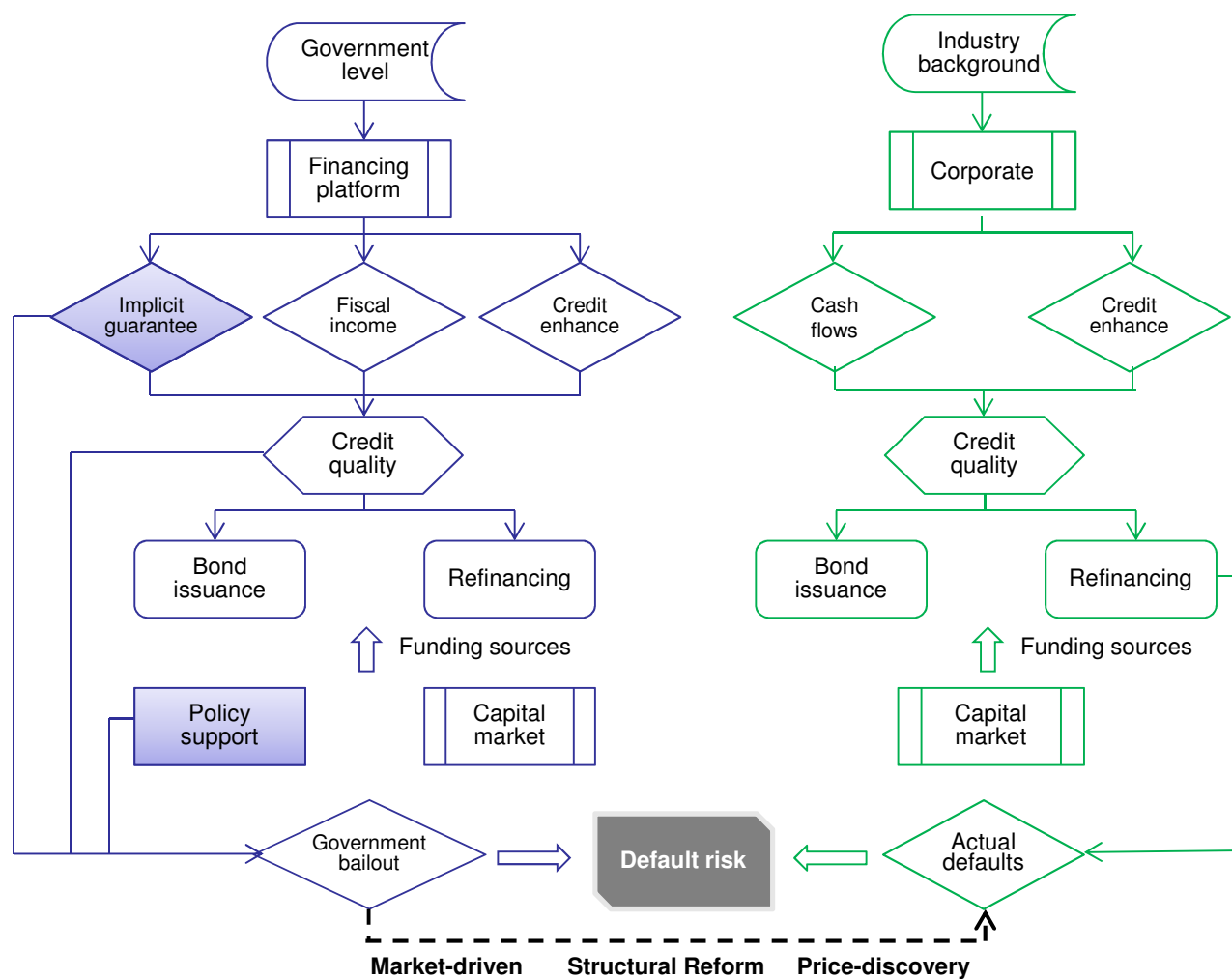
## Why There Was No Public Debt Default in China's Onshore Bond Market before 2014?(Cont')

*After 2005*

Year Introduced	Debt Products
2005	Commercial paper (CP)
2006	Enterprise bond without guarantee
2007	Corporate bond
2008	Medium-term note (MTN)
2009	SMEs collection note (SMECN)
2012	SMEs private placement bond

- High barriers are set for qualified issuers or guarantors (e.g. domestic credit rating of minimum AA)
- Government intervention to bailout distressed bonds

# No Default versus Actual Defaults



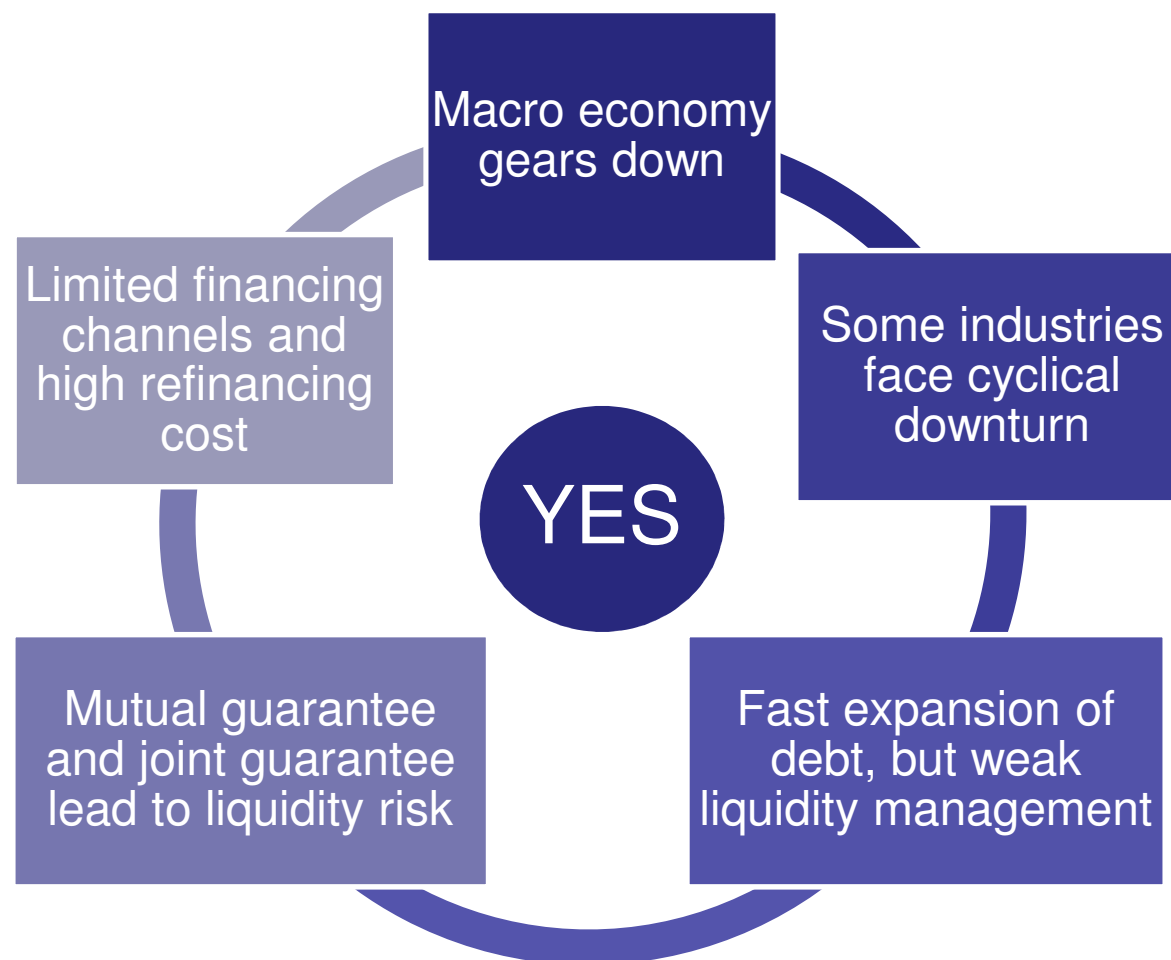
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## Why There Was No Public Debt Default in China's Onshore Bond Market before 2014? (Cont')

- Legislation and regulatory systems
  - Credit control system
  - Bankruptcy and liquidation procedures
- Lack of product innovation
  - Derivatives to hedge risks



## Will the Number of Debt Defaults Increase? Why?



## Which Debt Sectors Are Facing the Biggest Challenges of Default?

Mining Industry

Chemical Industry

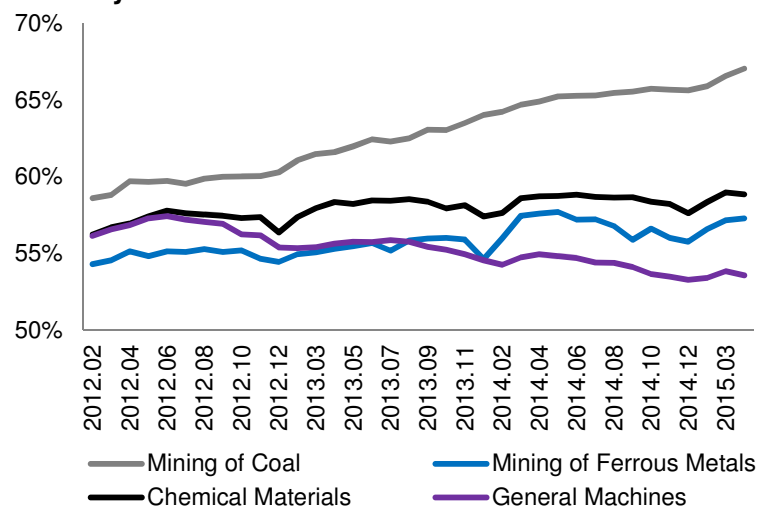
Machinery and Equipment Industry

Property Industry

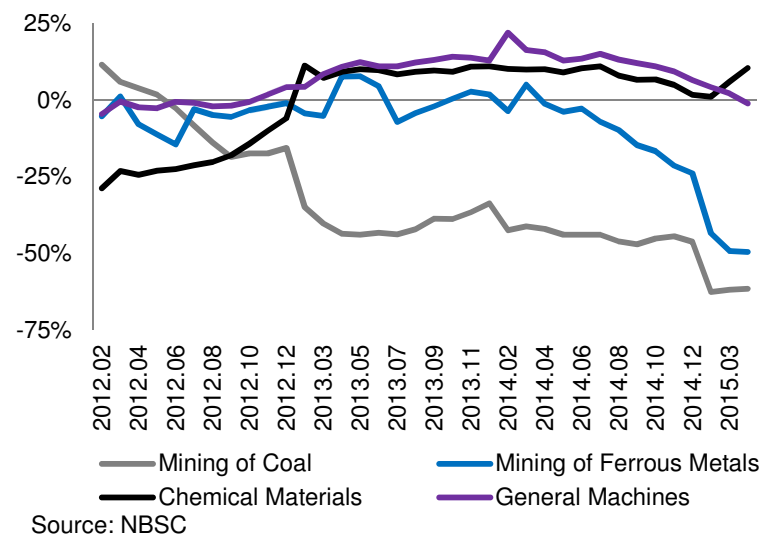
## Overcapacity Industries Show Deterioration in Creditworthiness

- Industrial sector is facing the situation of overcapacity, high leverage and low profitability.
- Amid weak demand and prices, stringent pollution controls and tightened credit conditions, China will experience more companies running into repayment difficulties.

**Liability-to-Asset Ratio**

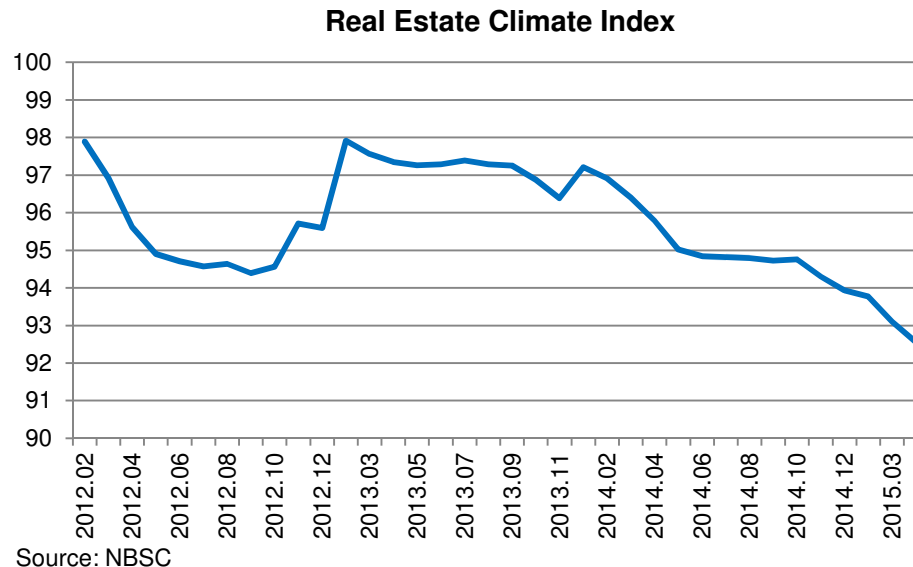


**Profits Growth**



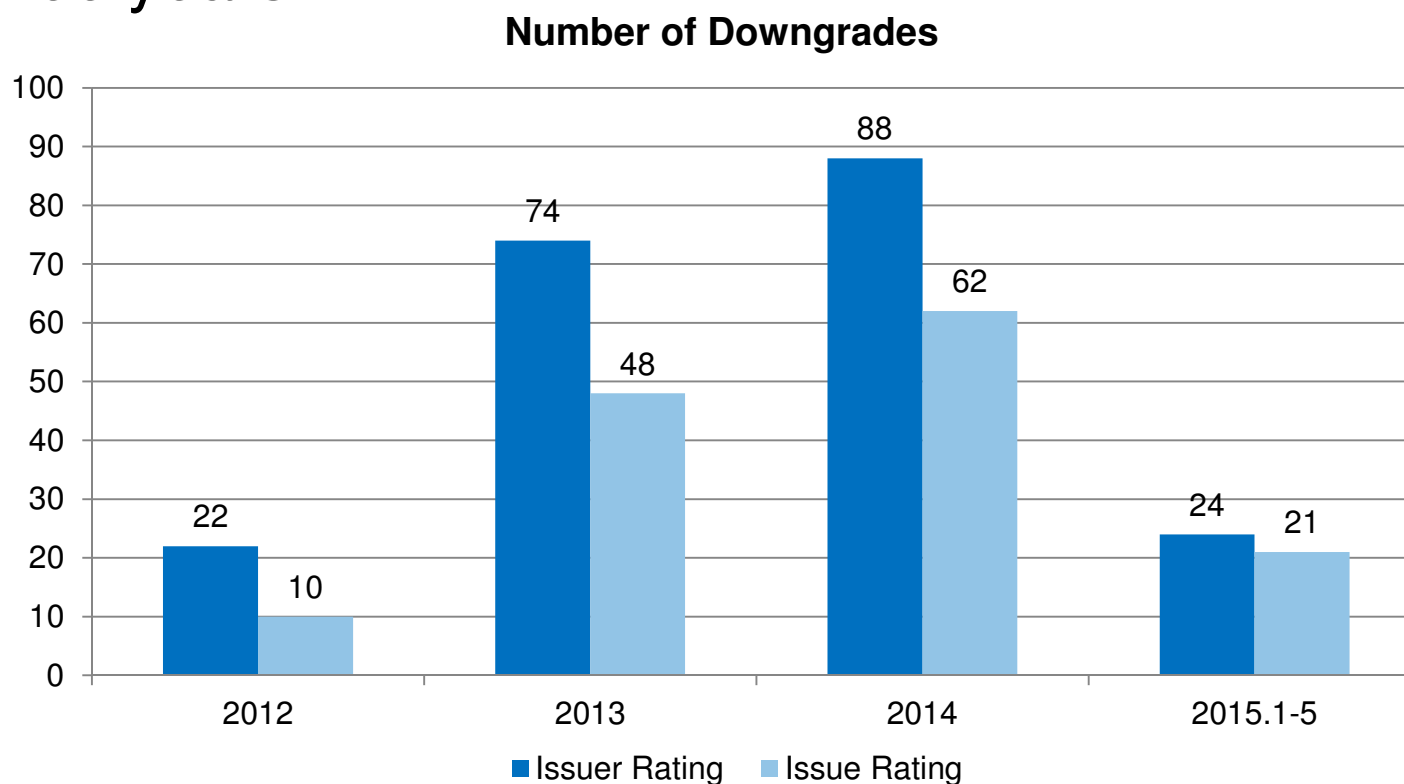
## Property Industry Undergoes Downward Correction and Market Consolidation

- The Chinese government moved to loosen its regulatory control over the property market. Although the latest policies may prevent a huge slump, the downward trend will not be completely reversed.
- Discrepancies are foreseeable for different cities. Prices in lower-tier cities will be under pressure due to oversupply in properties.



## Credit Ratings in Downgrade Trend

- Number of downgraded ratings increases in the past three years



Source: CCXI



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## Credit Ratings in Downgrade Trend (Cont')

- Industries in which issuer ratings were downgraded

2014		2015.1-5	
Industry	Downgrades	Industry	Downgrades
Mechanical equipment	14	Chemical	5
Power equipment	7	Power equipment	4
Coal	6	Papermaking	3
Photovoltaic solar	5	Mechanical equipment	2
Steel	4	Coal	2

Source: CCXI

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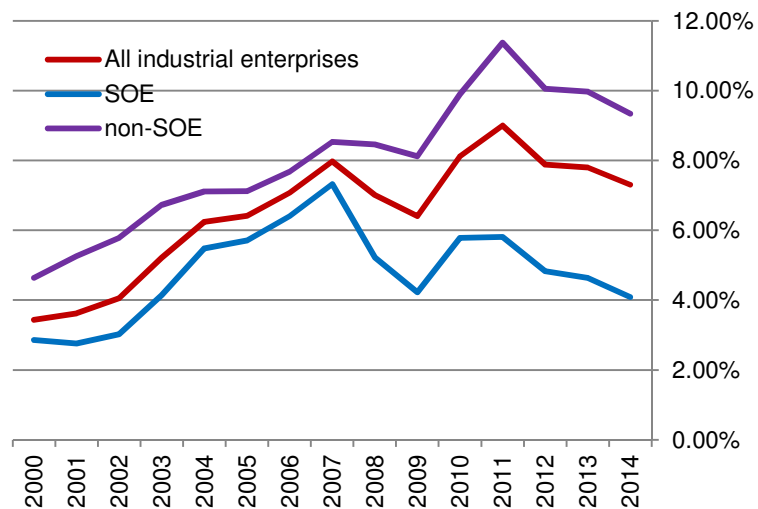
**SOEs and LGFVs**



# State-Owned Enterprises

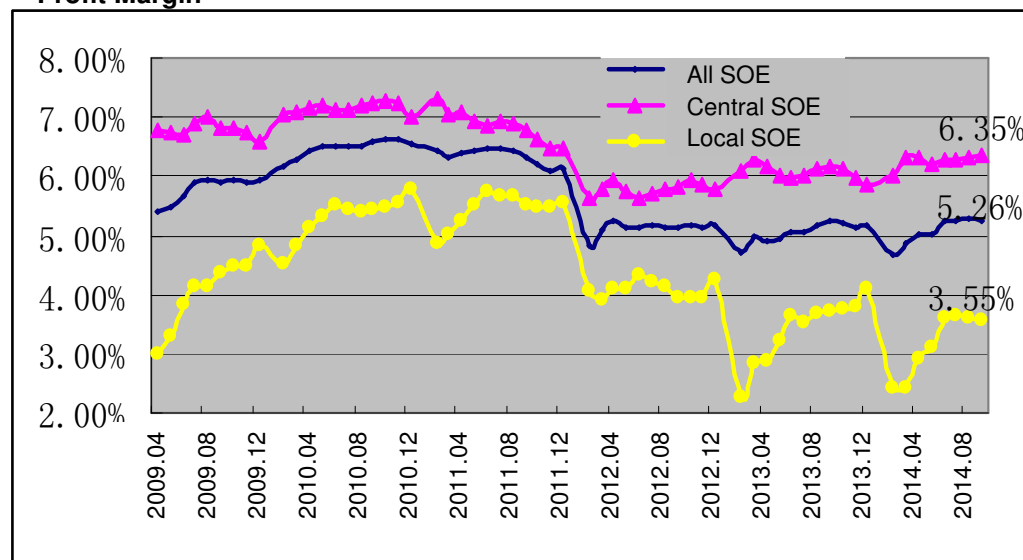
- SOE inefficiency
  - Government-mandated monopolies
  - Easy access to credits
  - Massive government subsidies

Return on Assets



Source: NBSC

Profit Margin





# Reforming State-Owned Enterprises

- SOE reform initiatives
  - To foster stable and sustainable economic growth
  - To resolve internal problems, including mismanagement, inefficiency, and inaccurate accounting
  - To open up monopolized areas to private capital
- Mixed ownership
  - **Sinopec**: to sell its stake in retail unit to private investors
  - **CITIC Group**: to transfer assets from unlisted parent to listed subsidiary
  - Local SOEs

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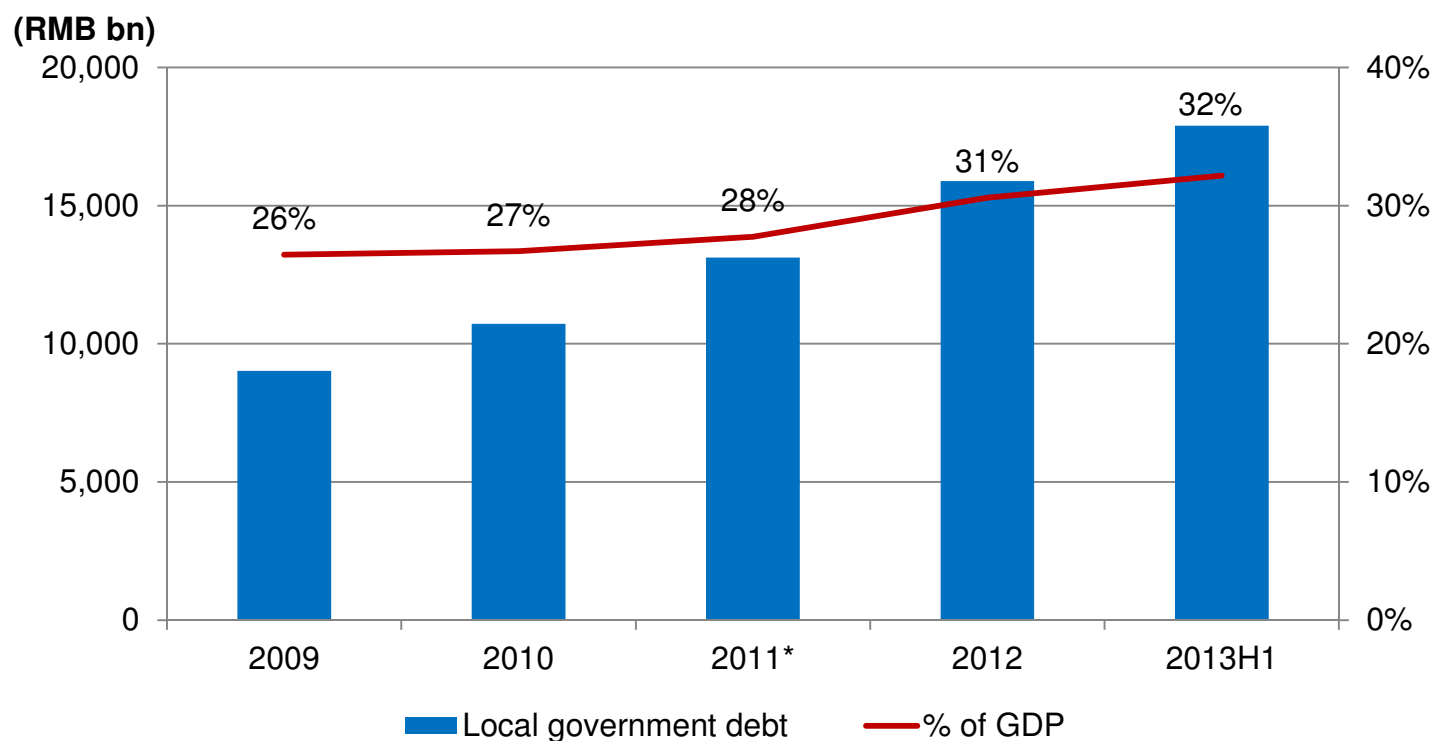
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## Reforming State-Owned Enterprises (Cont')

- Orderly managed default process
  - Market oriented reforms will improve the standalone credit quality of SOEs.
  - Strategically important SOEs will continue to receive government support.
  - Distressed SOEs in non-strategic sectors may face higher risk of default.

## Local Government Debt

- Local government debt amounted to 32% of GDP as of 2013H1



Source: NAO, CCXAP research



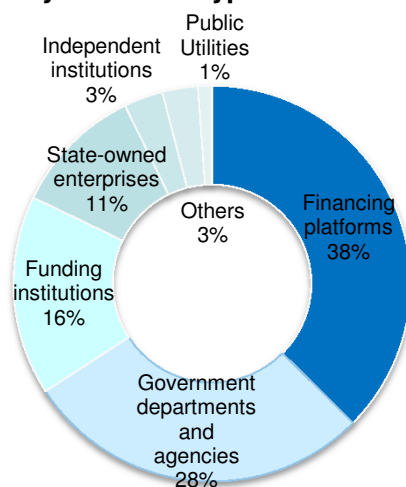
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## Local Government Debt (Cont')

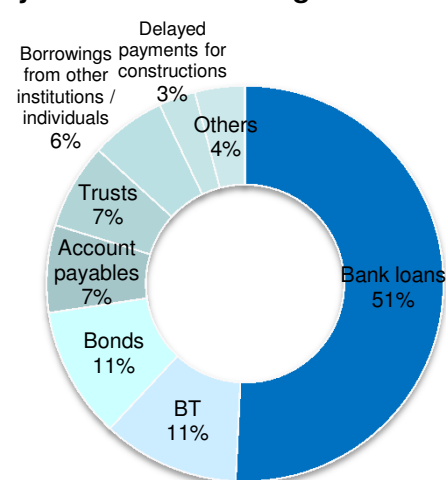
- For local government debt with repayment obligation, the debt maturing in 2015 is estimated to be RMB 2.3 trillion.

By Borrower type



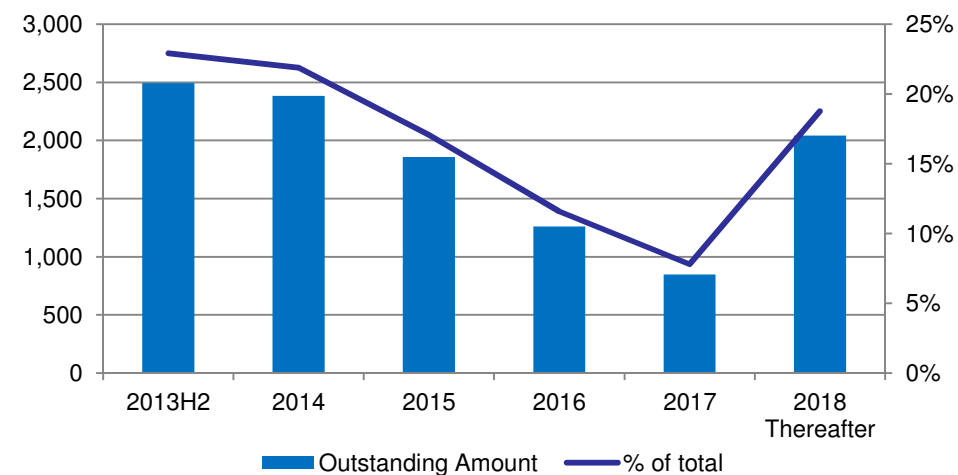
Source: NAO

By Source of financing



By Maturity

(RMB bn)



## Local Government Debt Swap

- In October 2014, the State Council issued guidelines for local government debt (Article 43) which aimed to reduce reliance on local government financing vehicles (LGFVs).
- In March and June 2015, the Ministry of Finance has approved local government bond issuance quota of RMB 2 trillion to replace the debt directly borrowed by local governments.

### General Local Government Bonds

- Projects with no or some revenue
- Repaid by fiscal income and government subsidies

### Special Purpose Bonds

- Projects with sufficient revenue
- Repaid by cash flows generated from the projects

### PPP

- Corporation with private capital
- Repaid by the SPVs funded by local government and private capital

## Local Government Debt Swap (Cont')

- Macro measures
  - Stabilize government investments in infrastructure and minimize macroeconomic fluctuations
  - For capital markets, lower risk-free rates to mitigate systematic risk
  - For commercial banks, optimize assets structure
  - For local governments, reduce funding costs and enhance fiscal flexibility

**Loans and shadow banking**

Rate: 7-8%

Duration: 2-3 years

**Local government debt**

Rate: 2.8-3.5%

Duration: 3-10 years

## Local Government Debt Swap (Cont')

- During transition period
  - On 9 April, NDRC opens new windows for special purpose bond issuance in key areas, i.e. strategic emerging industries, elderly services, parking lot construction, and utility tunnel construction.
  - On 15 May, the State Council released policy which allows bank lending to support the financing needs of existing LGFV projects.
  - On 27 May, NDRC relaxes rules on bond issuance by LGFVs.

## Conclusion

- Economic reform is necessary in the current declining trend and positive for the long term development of the onshore bond market.
- Overcapacity industries are facing a higher default risk.
- SOE reform can improve efficiency. The government will selectively bailout those SOEs to meet their financial obligations.
- Local government debt swap program can effectively reduce the default risk of LGFVs.
- Actual debt defaults have not caused panic, and it helps in developing a mature debt market in China.



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