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SPECIAL COMMENT | China's Bond Market

2015 Review and 2016 Outlook: Expansion and Deepening of Credit Risk**Executive Summary**

- **Default gradually became a normal phenomenon in China's bond market in 2015. Three features of the market were noted.**
 - (1) The range of default issuers expanded. Among the issuers of default bonds, private companies still accounted for the largest proportion, but some state-owned enterprise bonds no longer have implicit bailout by the government.
 - (2) The type of default bonds increased. Apart from SME private placement bonds, there are also default cases of medium-term notes, corporate bonds and super short-term commercial paper in 2015 (public offering bonds).
 - (3) Debt resolution varied: Most default bonds were repaid by guarantors, parent companies, or self-raised funds. But there were still cases where secured parties refused to compensate. Some investors made concessions and agreed to lower interest payments and longer maturities.

- **Negative credit actions revealed the expansion and deepening of credit risk.**
 - (1) The number of negative credit actions increased. After being downgraded, most companies received a negative outlook, or were put into watchlist, meaning that their credit quality may further deteriorate. Companies with lower ratings face a higher default risk when interest or principal payments approach.
 - (2) The contagion effect of credit risk existed among related companies, and revealed the cross default risk of different bonds. In a faltering economy, the financial institutions have tightened their lending to the companies with bad credit quality. The brakes in capital turnover have brought about a deepened credit risk in the market. It has become an important task to prevent systematic default and a debt crisis.

- **Credit risk is heading in the following trend in 2016.**
 - (1) There will be structural reforms, especially "supply side reforms". The release of the credit risk of over-capacity industries and traditional manufacturing industries will speed up and defaults in the bond market will be more common.
 - (2) The policy baseline is to avoid any systematic risk. Thus for companies with high influence on local economy and employment, local governments tend to support their bonds from default. However, as fiscal strength vary across various regions, whether lower tier governments can rescue the companies and repay the bonds are not certain.
 - (3) While bailout becomes ineffective and the market begins to accept default, the default resolution procedures vary, and loss given default may increase significantly in 2016.
 - (4) The debt risk is highly concentrated in the banking systems, and the growth rate of non-performing loans is rising, which will bring pressures to the whole financial system. Thus more policies may be issued to deal with banks' non-performing assets. The Securitization of these non-performing assets may develop rapidly.

1. Default became normalized: Number of credit events increased, default bonds missed deferred repayment, and loss given default became the new focus

1.1. Credit risk events occurred frequently, especially in over-capacity industries. State-owned enterprise (“SOE”) bonds began to default, and the failure in corporate governance should be paid attention to.

Overdue interest payments of the “11 Chaori Bond” in 2014 became the first default case in the Chinese bond market. In 2015, the number of credit risk events rose. 25 credit events took place and 16 bonds actually defaulted. The credit risk has spread from private placement bonds to public offering bonds. For the 11 bonds involved in credit events in 2014, except for one super short-term commercial paper and two corporate bonds, the rest were all SME private placement bonds, set bonds, and set notes. During 2015, 5 SME bonds were exposed to credit risk and defaulted; this took place at the start of the year. Since then, medium-term notes, corporate bonds, company bonds and super short-term commercial papers have also defaulted. Bond issuers facing the default risk expanded from small and medium enterprises (“SME”) and private owned companies (“POE”) to SOEs like Tianwei and Erzhong. In total, 8 SOEs experienced credit events, and some listed companies face similar risk, including Zhuhai Zhongfu, which was a leading listed company in the industry.

Over-capacity industries contributed most to the default crisis during the year. In an economic downturn, their lack of cash liquidity increased their risk. Most of the default risk was concentrated in the new energy industry and other traditional cyclical industries. The photovoltaic industry was one of the new energy industries that had excess supply. The issuer of the default bond “10 Yingli MTN1”, Tianwei Yingli, was once a global leading producer in the photovoltaic industry. Tianwei’s large expansion in the photovoltaic industry caused several of its subsidiaries to go bankrupt. Some traditional manufacturing industries also experienced overcapacities, and more than 10 credit events happened in these industries in 2015, including “12 Gui Youse MEN1”, “12 Long Meikong MTN1” issued by local energy SOEs and “08 Erzhong Bond” issued by central enterprises. As the economy is still far from recovery, companies need time to curb capacities. The credit risk in lower rated bonds of over-capacity industries would continue release.

Apart from the over-capacity problem, some credit events were triggered by improper management by the bond issuers. The issuer of “ST Xiang Bond”, Cloud Live Technology, used to focus on catering business. As its high-class catering business was affected by the governments’ anti-corruption campaigns, the company moved its main core to big data industries. However, the transformation was unsuccessful and the financials of the company deteriorated. The Yurun Group and Hebei Financing Investment Holding Group were also good examples of bad management strategies. As the demand for meat products declined, Yurun invested heavily in real estate projects, and its company performance declined further. Hebei Financing Investment Holding Group failed to regulate its investment decisions and faced imminent crisis. The default of Shangdong Shangshui Cement Group super short-term commercial paper also revealed a big loophole in the company’s management structure. The fight for controlling rights that was triggered earlier due to a large amount of debt tightened the cash flow and the unstable share structure deteriorated the fund-raising environment, causing the commercial paper to default at last. The Zhuhai Zhongfu case was similar. The changes in actual controller harmed the company’s liquidity. These credit events show that the effect of management’s strategies on companies’ solvencies should not be ignored. Once a company’s management board makes irrational decisions, or if there is a loophole in company’s management structure, the company’s financing ability will be limited.

1.2. Various default resolution procedures: More guarantee parties refuse to back up default bonds. Some central SOEs went bankrupt and were reorganized. Local SOEs still have implicit guarantees.

If a bond has specific collateral or third-party guarantees, normally the guarantor would repay the bond when default takes place. One example would be the SME collective note "13 Shenyang SMECN1", which was repaid by the guarantor. However, this protection for bondholders does not assure that all buyers of default bonds will be repaid. In 2014, two guarantors refused to repay default bonds. In 2015, more guarantors broke their promises. The guarantor for the SME private placement bond "12 Dongfei Bond" denied its responsibility to repay due to loopholes in the letter of guarantee. The guarantor for "13 Dahong Bond" and "12 Meng Hongda Bond" also refused to repay. For the "13 Dahong Bond", the local government urged the previous secured company, Shenyang City Investment Company to repay for the default bonds. For the "12 Meng Hongda Bond", as its guarantor failed to back up due to its lack of cash liquidity; currently, investors have applied for arbitration over this matter. Thus when the market is exposed to credit risk, guarantors with different financing abilities will result to different outcomes.

For unsecured bonds, there are also multiple resolution methods. Baoding Tianwei and Erzhong both applied for restructuring and Erzhong is currently undergoing restructuring procedures. Two local SOEs, Longmei and Guangxi Nonferrous Metal Group, were supported by their local governments before the payment date. Recently large amount of bonds issued by the Yunnan Coal Chemical Industry Group reached their maturity, and the local provincial government injected cash to avoid the default of the bonds and to head off the bankruptcy of the company. Some bond issuers repaid their default bonds by self-financing or by reaching a deed of debt arrangement with the investors. The bond issuer of "12 Zhongfu 01" repaid the interest through bank loans and other sources. "ST Xiang Bond" reached an agreement with investors that the bond and interest payments would be repaid by the Zhongxiang Company. Apart from this, several bonds lowered their coupon rate or extended their maturity. "12 Su Feida" decreased the bond coupon rate for the unsold part of the bond, and the "10 Zhonggong Bond" lengthened the puttable registration time twice. These measures are also efficient in solving credit problems.

It is quite obvious that the regulator has carried out a "selective bailouts". Some local SOEs received direct support from their local governments. The regulator made efforts to avoid credit events from taking place. Local government financing vehicles were urged to repay the "13 Dahong Bond". The "12 Yurun MTN1" was also repaid through the efforts of the Provincial government and the Provincial Banking Regulatory Committee. The People's Bank of China had also arranged the China Construction Bank to provide loans for "11 Tianwei MTN2" when default occurred, but the issuer chose to go bankrupt. The regulator is willing to help solve credit events, but the ultimate result relies on the fiscal strength of the government, the local financing environment, and the support from different parties.

The deleveraging and de-productivity of traditional over-capacity industries will spread more credit risk to the market overall, and most of the companies facing the risk are SOEs. They play an important role in the local economy and employment. To prevent systematic industry and geographic risk, the government will still be active in rescuing local SOEs. However, this does not mean that no default will take place. In the long term, SOEs will be reorganized as planned and this will help curb over-capacities. Whether private companies can survive will be determined by market mechanisms.

In conclusion, more credit events occurred in 2015. Credit risk spread from private bonds to public bonds, central and local SOEs, and even publicly listed companies were involved. In an economic downturn, distressed over-capacity industries caused most of the credit events, while poor management also contributed

to the default. The resolution procedures included the guarantor or the parent company's repaying or the bond issuer repaying by self-financing, or by lowering the interest payments or lengthening the maturities. In 2016 there will still be credit risk in the market, and it remains to be seen whether default bonds can be repaid by relying on the financial conditions of the government.

2. Credit risk deepened: More negative credit actions, and higher cross default risk

2.1. Negative credit actions increased, more issuers received a negative outlook after the credit action, with higher credit risk in the future.

In the first 11 months of 2015, 85 issuers were in total downgraded 108 times, both figures increasing from the previous year. There were 232 issuers that received a negative outlook or were put into watchlist in 2015. There were a hundred downgrades of bond ratings, involving 66 bonds. The times that a single entity or bond receiving downgrades increased significantly. From the latest credit rating outlook, among 85 issuers who were downgraded, 56 still have a negative outlook, or being put into watchlist. In general, credit actions occurred more frequently in 2015 than in 2014, the number of negative actions continued to increase, which revealed a rise in the market's credit risk.

2.2. The credit conditions of the over-capacity industries continued to deteriorate. Debt swap program eased the risk of local government financing vehicle ("LGFV") debt, but some LGFVs without strong government support still need attention.

Chemical companies received most of the downgrades. Electric devices companies, steel companies, and companies in the coal, new energy, and machinery equipment industries were also frequently downgraded, continuing deterioration in their credit quality. The accelerated capacity in the previous over-heated period led to a mismatch of supply and demand cycle and eventually the failure of the over-capacity industries. The decrease in both price and quantity caused a fall in revenue and net profit. Apart from over-capacity industries, the downgrade of issuer ratings also occurred in the agricultural industry and electronic products manufacturing industries. In a faltering economy, the deteriorating operating environment lowered the credit quality of these companies.

By the end of November, there were four downgrades of issuer ratings for LGFVs. The Ministry of Finance released three batches of local government bonds, which amounted to 3.2 trillion yuan total, to tackle existing local government debt. This action would help manage the risk of the LGFV debt, but as the fiscal strength of local governments varies, the debt swap plan does not mean that all LGFV bond will be bailout in the future. LGFVs in less developed regions or with less support from local governments are still at credit risk.

2.3. Shandong entities recorded the largest number of downgrades in issuer ratings, following by those incorporated in Jiangsu, Henan, and Sichuan.

Shandong received the largest number of downgrades, 14, much higher than that of other regions. Hebei was second with 11 downgrades. Entities in Henan and Sichuan were downgraded 9 times, while issuers in Jiangsu, Inner Mongolia, and Guangdong were downgraded 8, 8 and 7 times respectively. Jiangsu, Henan, and Sichuan continued their upper ranking in the list, revealing that the credit quality in these regions had further deteriorated. There are a large amount of SMEs in some of these regions, for example Jiangsu, Shandong, and Guangdong. Some are closely related to the energy and raw material industries, for example Hebei,

Henan, and Inner Mongolia. SMEs and companies with over-capacity are vulnerable in an economic downturn, and thus regions having these companies experience larger credit risk.

2.4. The contagion effect of credit risk existed among related enterprises, and the cross default risk of different types of bonds rose.

A deteriorating operating environment increases the depth and span of credit risk. More companies are involved due to the operating failure of related companies, the inability to collect accounts receivables, or the buy-back of loans by the banks. In 2015, the number of companies that owe interest or could not repay their debt increased significantly, including some SOEs. Banks became more cautious in making loans, which made it hard for companies to refinance. Banks may apply to the court to freeze the assets of a company, the capital chain of the company breaks and the default risk spreads from loans to bonds. Though the regulator has issued policies to lower the financing cost of companies, the risk adverse financial institutions still lack the incentive to support companies, which will further add credit risk in the market.

In conclusion, there were more negative credit actions in 2015. A large number of companies still hold a negative outlook or are on the watchlist after being downgraded. In future, their credit quality may worsen. In general, the conduction effect of risk through related enterprises became larger, and the risk that different types of bonds cross default rises. In a faltering economy, the worsening solvencies of companies encourage financial institutions to tighten their lending. Without sufficient funds, companies' capital chain fractures and deliver a larger credit risk to the market. An important task in 2016 will be to prevent a systematic default and debt crisis.

3. In 2016, credit risk will partially be released at a higher speed and larger investment loss may occur, and policies will focus on the non-performing loans (“NPL”) of the banks

3.1. Over-capacity industries face higher credit risk, selective bailouts still exist, but there is uncertainty whether local governments can secure bonds.

In an economic cycle, depressing external environment and inefficient stimulating policies make it hard for the economy to recover significantly, while the Chinese government would continue on the structural change. In this process, the release of credit risk is inevitable. The supply side reform would be conducted in 2016, and the government would monitor the adjustments in the over-capacity industries. This means the rise of emerging industries and the fall of traditional manufacturing industries. In the bond market, most of the issuers are from traditional manufacturing industries and over-capacity industries. Thus in 2016, a larger credit risk in the bond market will make default a common practice, and negative credit actions will increase. However, to protect growth and a stable macro environment for structural change, the government needs to implement policies to avoid systematic risk. The local debt swap will continue be promoted, and the support of local governments to the LGFVs would remain. Thus most of the LGFVs are safe. The government will also support companies that are crucial to local economies and employment, but the effect depends on the financial power of the region.

3.2. Results of default bonds vary, investors may experience larger loss.

When bailouts become ineffective and the market begins to accept default, it becomes harder and harder for the repayment rate to reach 100%. If there is a strong guarantor or parent company, the default bond can

quickly be repaid. Listed companies have better management and have the incentive to follow resolution procedures after default. Their company value will also attract external financing, and thus listed companies have a better repayment rate. Unlisted companies, on the contrary, have low refinance ability and are more likely to go bankrupt.

3.3. NPL ratio hikes; policies will deal with the non-performing assets of the banks

The larger credit risk in the bond market reveals the debt risk of Chinese companies. The expansion of the debt size of Chinese companies has hampered the transition of the Chinese economy and is the key barrier to economic development. Banks undertake the loans, and hold 40% of credit bonds. Loans and bonds take up 3/4 of the total debt structure in China, which means that the debt risk is heavily concentrated within banks. During a debt crisis, risk can easily spread from companies to banks, thus threaten the whole financial market. Since 2015, the NPL ratio has increased to 1.59% by the end of the third quarter, while the net interest margin decreased to 2.53%, making it increasingly harder for banks to operate. The credit risk released or swapped in the bond market are the banks' NPLs, which harm the stability of the banking and the whole financial system. Thus NPLs are the target of several regulating policies. The regulators restarted securitization in 2012, and the size of securitization has expanded since then. This is one of the measures to solve the problem of NPLs.

In conclusion, we estimate that in 2016 policies will focus on solving the problems of NPLs. Recent news shows that the four large Chinese banks were given quota of securitization of non-performing assets. Policies may also encourage banks to issue write-down bonds, senior bonds, or subordinated bonds to supplement bank capital, and the government may provide funding to help reduce NPLs for some underperforming banks if necessary. To improve the risk management of banks, arbitrage products which have a similar effect with CDS will be welcomed by the market. The Chinese derivative market may further develop. As most of the default bonds received negative credit actions before their default, the market needs to pay attention to the bonds that receive downgrades or that are approaching their maturity or buyback date. Financial institutions need to deleverage low quality bonds.

This report is written by Elle Hu (Senior Analyst) David Zhu (Credit Analyst), referring to the information in the Chinese report “信用风险广度深度双向扩张——2015 年债市信用风险回顾与 2016 年展望” by China Chengxin International Credit Rating.

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