Orient Capital Research

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Debt For Equity Swaps

Slow Progress is Positive for the Chinese Banks

The leadership in Beijing has made debt-for-equity swaps an important part of restructuring of the state firms. However, opposition from other groups, including the banks, has slowed the program. We estimate only Rmb322 billion of swaps is under discussion, far less than the Rmb1 trillion targeted. As a result, it is unlikely the banks will incur significant losses in the near term due to political constraints.

Beijing has turned to debt-for-equity-swaps as a method for recapitalizing state firms. However, the program is controversial and faces opposition both within senior levels of government and among the banks. Although the program is moving forward, it's clear there's significant opposition that will lead to "baby steps" in swaps. Given the domestic politics, how much progress is likely to be made? The key determinants will be the **political power of the SOE, the sector debt, and the level of provincial fiscal health.**

Premier Li Keqiang is the strongest advocate of swaps. Earlier this year, he said, "We can also use such market-oriented format as debt equity swap [by commercial banks] to help bring down the corporate leverage ratio." He views the swaps as part of a long-term restructuring of the state sector – without losing the advantages of stimulating the economy. In that sense, he is less of a hard-liner than President Xi Jinping, who has put his stamp on the Supply Side Reform program, which calls for fairly drastic cutbacks in industrial capacity in the state sector. The two are not even on the same page on timing or the nature of the reform. Does that mean Li's debt-for-equity swaps are dead in the water?

No, but we are beginning to see a lot of backpedaling as everyone involved in the program jockey's for position. This jockeying is going to slow implementation – a clear positive for the banks, who would be stuck with the debt and are already forced to accept discounts on their loans being swapped into equity.

That's been the biggest surprise of the whole program: the banking industry has been surprisingly **vocal in their opposition**. Obviously, the banks know they will incur losses from the equity stakes they would hold in state firms. But to come out and say this shows the increasing pressure they face to maintain profits as margins are squeezed by competition from Shadow Banks and from interest rate reform in general. This opposition -- more than any formal policy announcements -- is a positive sign for structural reform in China.

Banks Push Back

For example, China Construction Bank Chairman Wang Hongzhang said he is not in favor of a plan that converts “bad debt into bad equity.” China Citic Bank’s Vice President Sun Deshun said that the level of swaps would have to be **capped**. Bank of China Chairman Tian Guoli said it’s "hard to evaluate" how effective debt-equity swaps will be, as so much has changed in China since the tool was used to bail out the banking system during a previous crisis in the late 1990s,” a cautious endorsement at best. Even PBOC Governor Zhou Xiaochuan in April spoke out against the plan, saying that it would mainly help large companies with excessive industrial capacity reduce bank debt.

So it looks like there will be a classic Chinese example of stop-and-go activity as the system works through the politics.

So Far – Big Discounts for Banks

The few examples we have indicate that the banks are accepting a significant discount when they arrange the swaps. So they’re right that it’s a losing proposition for them. Although there are differing permutations, as there are many financial participants in each of these swaps, the banks are being forced to write-off 40% to 80% of their loans.

What’s also interesting is that the swaps are a mix of private and state-owned firms; three out of eight we have seen so far are private. There seems to be no preference for supporting state institutions – as of yet. This could change over time as favored state actors demand to be included in the program. But for now, if these are basically weak-kneed ways to shovel state debt under the carpet, it’s an odd way to bail out the state sector. One would assume that the swaps would gravitate primarily to the biggest, most powerful SOEs – but they don’t seem to be working out that way.

China Debt for Equity Swaps

Company	Debt (Rmb Bln)	Default Date	Debtholders	Nature of Debt Workout	Payout %	State or Private
MCC Paper Group	14.5	Mar-13	29 Banks	Restructuring	NA	P
Huaikuang Xiandai Logistics	15.0	Aug-15	12 Banks including Minsheng and CCB	Write off of 60%	40%	P
China Railway Materials	34	Apr-16	19 Banks	Debt restucturing after purchase by Chengtong Holdings	20%	S
Tianjin Pipe	46	Jul-05	Trading Partners, Banks			S
Dongbei Steel	3.1	Mar-16	Banks	Bank swap 70%, bondholders pay the rest	NA	S
Bohai Steel	192	2016	105 Domestic and Foreign Banks	May set up a fund with a 3% return; or debt for equity swap	NA	S
China Huarong Energy	22.6	Mar-16	Equity swap with dilution of interest	Banks accept 12.6B of debt	11%	P
Total	327.2					
Median	22.6				20%	

Source: Caixin, News Reports

Case Study #1: Fujian Province

We spoke with a senior banker with a state-owned bank in Fujian Province about the swaps. Fujian generally is on the front curve of any new financial arrangements due to its long history as a trading entrepot with Taiwan and the West. However, it's also among the provinces with the lowest integration with China's state sector. State firms employee just 19 percent of Fujian's total employment, compared with an average of 33 percent in other Chinese provinces.

The banker said the debt-for-equity swaps are "not a popular method for banks in China when dealing with NPLs." Although Fujian has the highest total of NPLs in a Chinese province, above 100 billion Rmb, he could not think of a single example of a swap.

Debt Disposal Through Other Means

Instead, he noted the most popular ways of disposing of NPLs are:

1) Selling the NPL package to AMCs, both the four Beijing AMCs and the newly established local AMCs. Usually, the banks will ask the AMCs to pay more than 30 percent of the loan.

2) Write-offs, especially for NPLs to small businesses, which have modest collateral and few growth prospects;
3) Lawsuits and auction of the borrower's assets.

He noted that difficulties implementing the swaps may include:

1) How to value the per share price when the company is in trouble.
2) Difficult approval procedures within the banks.
3) How to handle the share even if the debt equity swap is done. What if the equity can be sold to an AMC but the AMC has no interest in the asset?

Case Study #2: Political Opposition in Liaoning

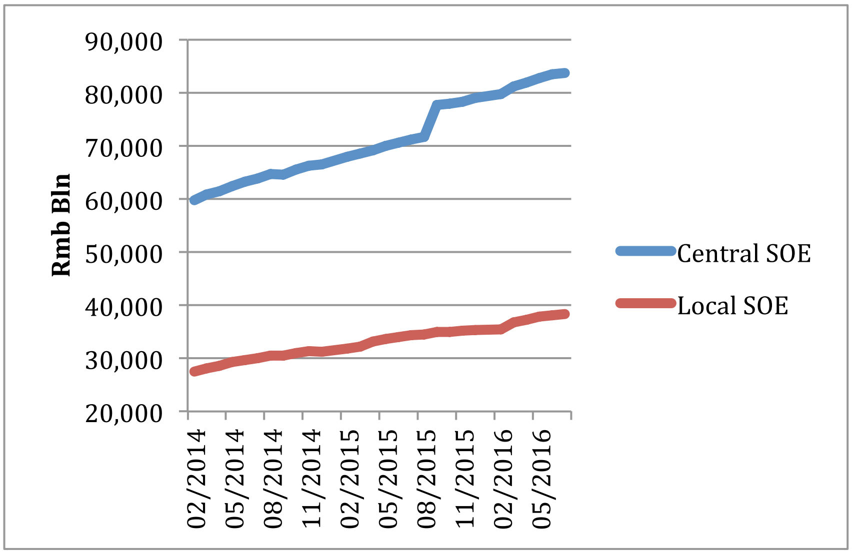
One of the more unusual cases of a debt equity swap – and an indication of how this program is a symbol of greater political battles – is occurring in Liaoning Province. Liaoning is China's industrial heartland. Fully 28 percent of workers are employees of SOEs compared with 19 percent in Fujian. As we have stated earlier (China's New Normal, August 24, 2016), Dongbei Special Steel earlier this year defaulted on the repayment of 3.1 billion yuan of corporate bonds. Liaoning Provincial Government's state arm, SASAC, which holds 46 percent of the company's shares and is the largest shareholder, proposed a twofold plan: the banks would swap 70 percent of their debt into equity, and the bondholders would lend money to Dongbei to help pay the remainder of its bonds. This was clearly a land grab by a cash-strapped local government trying to save its biggest state-owned employer.

The banks protested, the bondholders vowed to boycott future Liaoning bonds, and the whole process came to a halt. What happened earlier in September was an eye-opener. Last week, Beijing said as many as 45 members of the Liaoning delegation of the National People's Congress, or almost half that provincial delegation, had been elected by fraud. Fraud crackdowns are not unusual, but this one was big, and it came suspiciously during a local fight over SOE restructuring. Also, Bo Xilai, a princeling and former challenger to Xi Jinping, had been governor of Liaoning. Coincidence? Maybe…but if you're going to take a sword to lop off the head of entrenched SOEs, start with the SOEs and if that doesn't work, attack the local party itself. This could indicate growing pressure by Li Keqiang and others in Beijing to push the swaps…but they will still encounter dissent.

The Debt is Rising

Debt of the state sector is rising rapidly and now totals Rmb122 trillion. The share of the local state firms is declining, falling to 31.4 percent currently from 38.6 percent in 2000. This most likely reflects the fiscal indebtedness of local governments.

Chinese SOE Liabilities

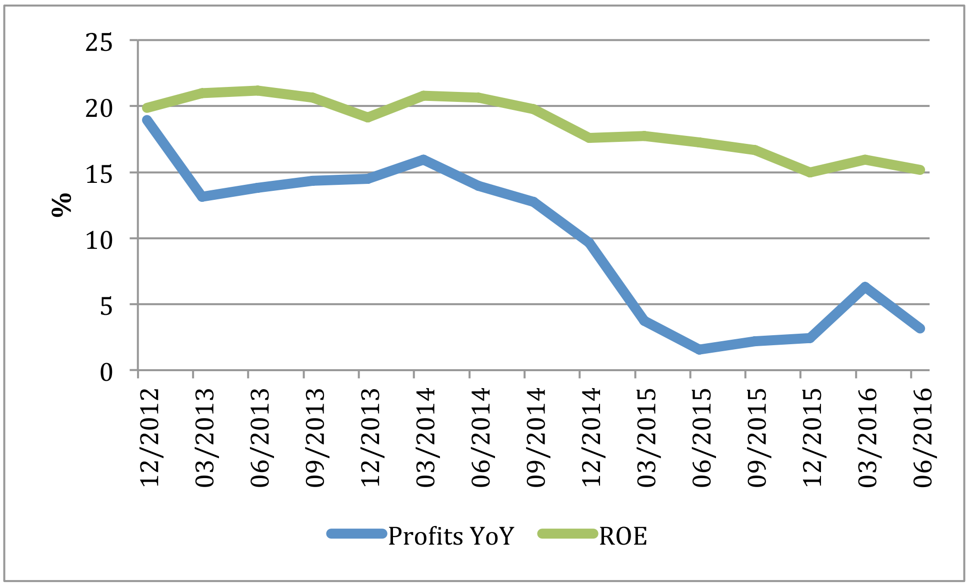


Source: National Bureau of Statistics

Bank Profits Declining

Meanwhile, bank profitability is getting squeezed by competition from non-banks and interest-rate liberalization. Tightening NIMs will make it harder for the State Council to rely on the banks for continued support to unprofitable SOEs. However, the total swap market is currently only Rmb 1 trillion, and we've only seen Rmb 322 billion still in the negotiating stage. The banks don't need to be nervous – yet.

Chinese Bank Profits and ROE



Source: CBRC

Conclusion

It's not clear whether the Liaoning crackdown signals support for Xi Jinping (Supply Side Reform and drastic cutbacks of industrial SOE production) or Li Keqiang (debt-for-equity swaps.) Either way, it looks like Beijing is sending out a message that it is serious about SOE reform and is willing to pay a high political price to achieve it. But local opposition still stands in the way.

1) **Genuine Policy Differences.** The Xi Jinping/Li Keqiang dispute is probably as much about policy differences as it is about power.
2) **Messy Reform.** SOE reform will occur….but it will be messy.
3) **Slow Progress.** The debt to equity swaps will also be prolonged as banks, corporates and local governments negotiate the terms.

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