Orient Capital Research

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August 17, 2017

Bond Default Recaps

Recapitalization Patterns

Summary

As the economy slows and bad debt increase, the outcome of the current round of defaults, along with related programs like the debt-for-equity swaps, tell us a lot about what China *will do* and not just what it says it will do. We believe this initial pool of defaults provides a clue to how the state will handle defaults going forward, if, as we suspect, there is a significant increase in defaulting securities and companies. This has implications for China's companies, banks, and allocation of credit within the economy.

Orient Capital Research analyzed 79 defaulted bonds from 33 companies. We wanted to understand:

1) Who were the defaulting entities?

2) How these defaults were handled?

3) How they were recapitalized?

Our conclusion is that bankruptcy is the least-favored option. Not surprisingly, the law actually mandates that bankruptcies must be approved by the local party official before reaching the courts. According to a judge in Zhejiang Province, cited by law professor Susan Finder, "If a developer is having a crisis, government will involve itself first, and only if administrative measures don't work, will they think of judicial measures."

More than one-quarter of our sample are still under negotiation. Only a small percentage were restructured or recapitalized. **Clearly**, **Beijing is struggling to come up with a reasonable approach to failed corporates.**

Our data shows:

1. Bankruptcy. Only 2.9% underwent full bankruptcy.

2. Recapitalization. One-third achieved full or partial recapitalization through a variety of sources.

3. Negotiations. More than one-quarter of the firms are still under "negotiation" by interested parties.

4. Local SOEs. The majority of firms with defaulting bonds are private. However, both private firms and local SOEs have nearly equal amounts of debt.

Rising Bankruptcy Cases Nationally

In 2016, the number of new cases of bankruptcy in the country increased by 53 percent compared with 2015. Three provinces dominate: the number of newly accepted cases in Zhejiang, Guangdong and Jiangsu ranks among the top three, and the total number of cases accepted by the three provinces accounted for 48 percent of the total number of bankruptcy cases. As of July 31, 2017, the People's Court received a total of more than 4,700 cases of forced liquidation and bankruptcy.

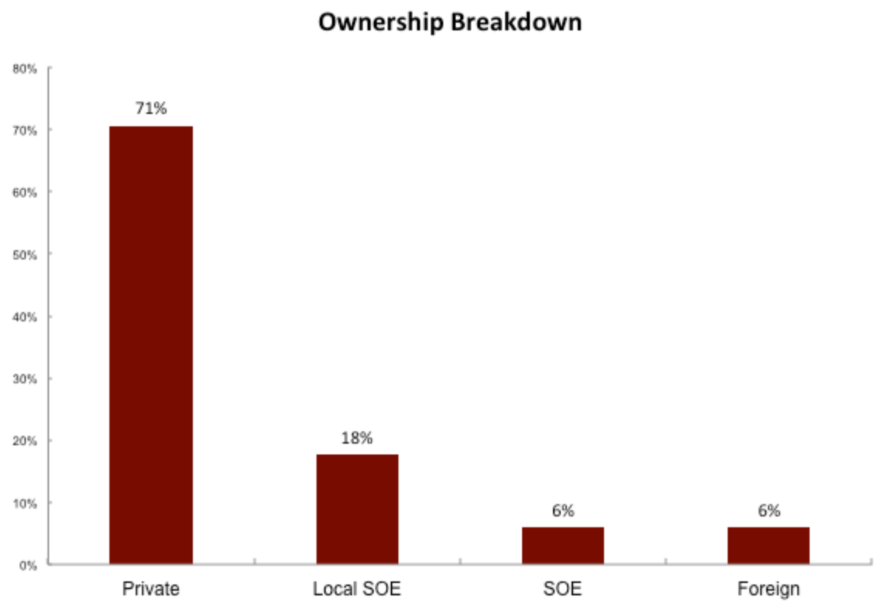
More than One-quarter are Under negotiation.

Below is a summary chart of the data on type of workout within our sample. More than one-quarter are struggling through negotiations, while 11.8% were "restructured" to avoid a full bankruptcy.

Type of Workout	Private	Local SOE	Central SOE	Foreign	Total	% Total
NA	11	1	0	1	**13**	**38.2%**
Negotiation	8	1	0	0	**9**	**26.5%**
Restructuring	0	3	0	1	**4**	**11.8%**
Employee Recap	1	1	0	0	**2**	**5.9%**
Internal Sources	1	0	0	0	**1**	**2.9%**
Provincial Recap	1	0	0	0	**1**	**2.9%**
D/E Swap	1	0	1	0	**2**	**5.9%**
Asset Sale	1	0	0	0	**1**	**2.9%**
Bankruptcy	0	0	1	0	**1**	**2.9%**
	24	6	2	2	34	

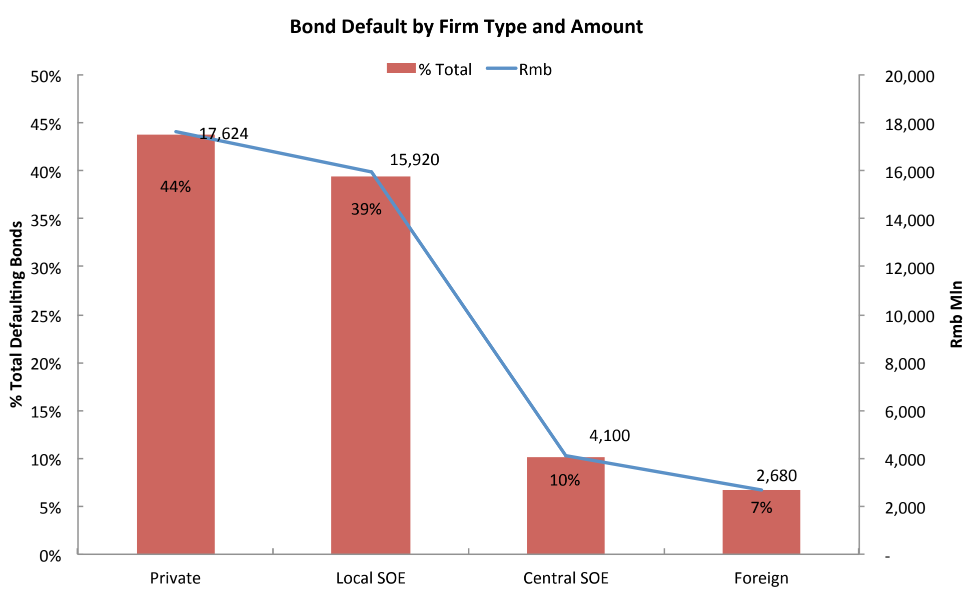
Private Firms are the Largest Group

Ownership is extremely important for debt workouts. This is an indication of which firms will be allowed to fail. Not surprisingly, three-quarters of the failed bonds were issued by private firms, while 18% are local SOEs. The big SOEs owned by Beijing directly accounted for a modest 6% of the total defaults.



Local SOEs have a Large Share of Outstanding Defaulted Bonds

However, when we look at the outstanding *volume* of yuan, local SOEs jump to 39% of the total, compared with 44% for the private firms. Clearly, the local state firms have issued much larger bonds per each corporate.

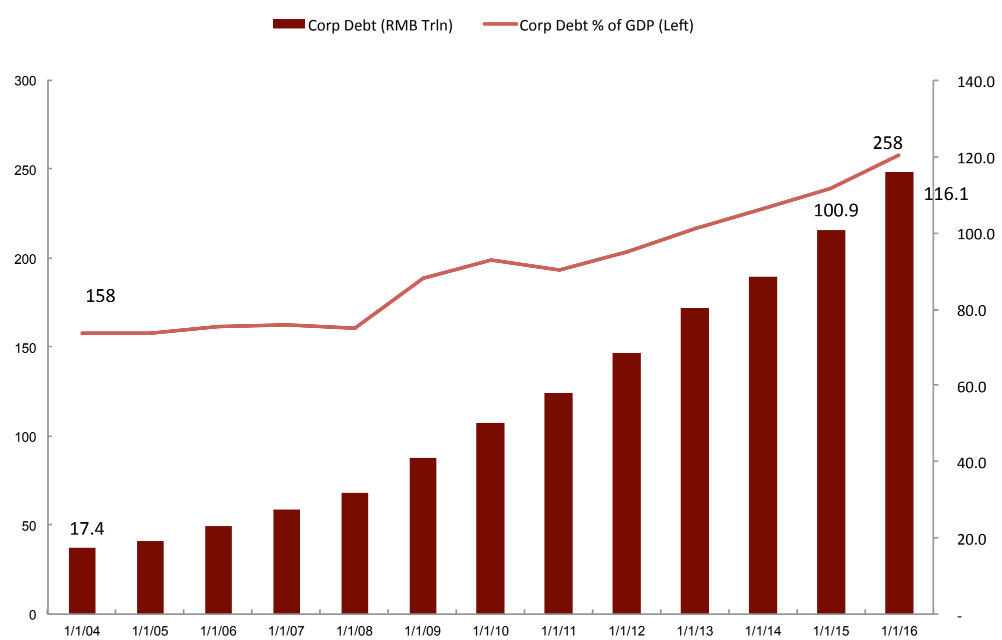


So the weak link in the chain in the future will be the local state firms, that have over-borrowed, and will have a significant percentage of outstanding debt and outstanding defaults over time.

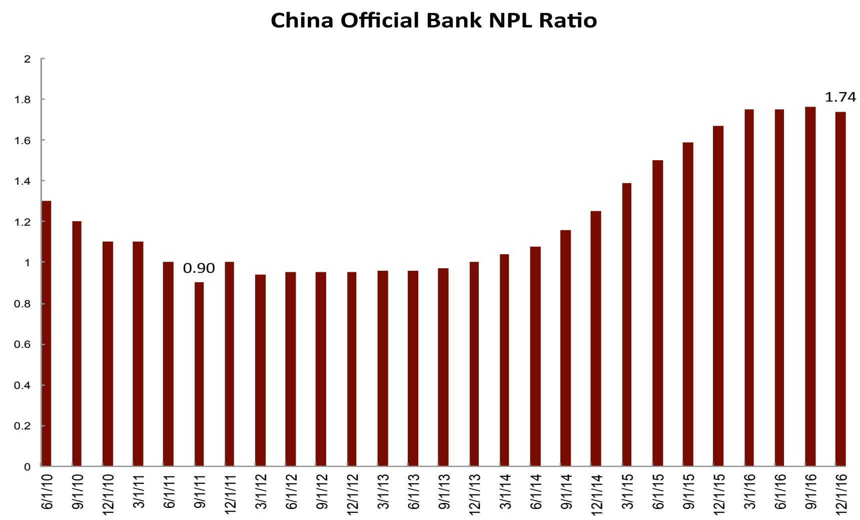
Macroeconomic Implications

The most important question for China's economy is the impact on corporates – and the Chinese economy -- if default rates increase significantly. How big will the defaults affect corporation activity and how will the government handle defaulting institutions? Will Beijing recapitalize only state firms? Which ones?

First, we look at overall corporate debt and the expected default rates. The chart below shows corporate debt at Rmb116.1 trillion or 258% of GDP at end of 2016, up 16% from 2015.



The official NPL ratio, although rising, is still quite low and likely unrealistic. If we accept that number of 1.74% then total corporate NPLs would be Rmb2.02 trillion. We think the number is much higher.



Interest Coverage Ratio

An alternate method to calculate potential default rates used by the IMF is based on the interest coverage ratio. We downloaded Chinese firms from the Bloomberg data set that had data for the interest coverage ratio. This yielded 655 firms. Of these, fully 37.9%, or 248 firms, have an interest coverage ratio of less than 1, implying that cash flow is insufficient to pay interest costs. If we apply this percentage to all Chinese corporate debt (not firms), then **the amount of debt likely to be unable to pay interest– much less their principal – is Rmb43.9 trillion**.

Chinese Corp Debt - Interest Covg Ratio	
Total Firms with interest coverage data	655
Firms with Ebit/Interest ratio above 1	407
Firms with Ebit/interest ratio below 1	248
Firms below 1 - percent total	37.9%
Total Corporate Debt (Rmb T)	116.1
% Likely unable to meet interest payments (Rmb T)	43.96

What Happens to Debt During a Downturn?

We doubt the leadership has the appetite to recapitalize Rmb43 trillion in defaulting corporate debt – a scenario that is unlikely, in any case. However, what does our data tell us about how Beijing would allocate defaults in the system?

Conclusions

There are a number of implications from our data for China as the economy slows and defaults increase of bonds and other financial products.

- **Avoid Bankruptcy.** First, the courts and local political institutions will avoid bankruptcy unless absolutely necessary or politically expedient.
- **Political Negotiations.** Second, the recapitalization will occur through groups of involved parties that will negotiate to allocate the new capital – "sharing the pain" through political mediation. This will be time consuming. The debt-equity swap for Dongbei Steel in Liaoning has been under discussion for more than a year with no resolution in sight.
- **Increase in Mergers.** Third, many firms eventually will be merged with larger entities to avoid political embarrassment and bury the debt in better-capitalized institutions. For example, Baosteel acquired Wuhan Iron and Steel just before Wuhan was going to declare bankruptcy. Prior to the acquisition, Baosteel convinced the banks to agree to a debt for equity swap that offloaded some of Wuhan's debt.
- **Local SOEs and Private Firms to Suffer.** Private firms account for 44% of the defaulting bonds in our sample, while local SOEs are 39%. We can assume that our Rmb43 trillion in corporate loans will include a large portion of defaulting debt from these two groups. However, recapitalizations may only go to the state firms – it is too early to tell.

One last point: The tightening of shadow banking under the macro-prudential assessment, along with the outcome of the Financial Working Group meeting July 8 in Beijing, will have little impact on the nature of the default workouts as they increase over time. There will be tighter credit on the margins, but the rising Total Social Financing, and loopholes for access to credit, including securitization of loans to households, means that overall credit continues to be relatively strong. This will slow the pace of defaults but we expect continued increases – particularly if there is private investors begin to back away from buying the highly liquid wealth management products.

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