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China Credits: Default Outlook From an Onshore Perspective

China's locally issued credit bonds represent a broad cross-section of the Chinese economy, with a market value of U.S. $5.5 trillion.[1] In this article, we leverage the observations of the Emerging Markets Debt onshore China fixed income investment team to assess important credit developments in the Chinese market. In the context of recovery from COVID-19 and regulatory authorities seeking to strike a balance between growth and excess, we see potential for a modest increase in default levels next year, largely due to shifts in government approach.[2]

Moving beyond negligible levels prior to 2017, China onshore defaults have gradually trended upward, to reach 1.8% in mid-2019 and, in our view, a likely 1.6% in 2020, despite early pressure from COVID-19. We expect the default rate for sovereign-owned enterprises (SOEs) to pick up as the sector becomes more market-driven. For 2021, we anticipate a moderate increase in defaults driven by SOEs and small property developers in the privately owned enterprise (POE) space. Historically, the default rate in China has been considerably lower than the global emerging markets average, but we expect convergence over time as the country adopts a more market-driven approach to default workouts.

[1] The onshore credit universe includes financial bonds, enterprise bonds, corporate bonds, medium term notes, commercial paper, private placement notes, supranational bonds, agency bonds, asset-backed securities, convertible bonds, projects notes and exchangeable bonds, based on Wind classification.
[2] For a broader perspective, read the EMD team's *High Yield Default Outlook.*

2020 in Review

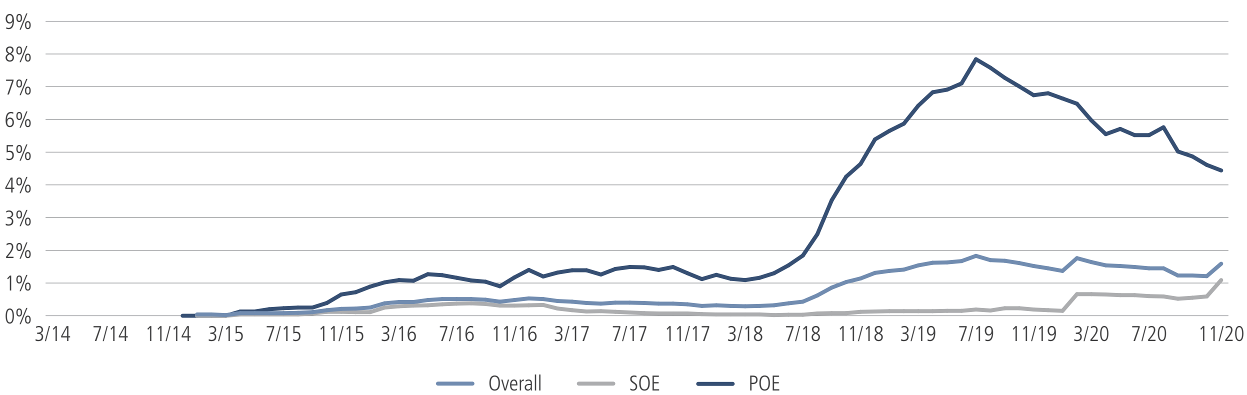
In 2020, onshore defaults by notional value exceeded those of 2019 even though the number of first-time defaulted issuers declined. One key trend made the difference: increased defaults by SOEs, reflecting a change in the government's attitude and suggesting that further increases are likely to come (see below).

Onshore Defaults: Key Milestones

- 2014: First onshore credit default
- 2018 – 2019: POE default wave
- 2019: Tewoo Group is the first 100% local government-owned SOE to default in the USD bond market since 1998; Peking University Founder Group also defaults both offshore and onshore, the first such failure involving the business arm of the top Chinese university
- 2020: Yongcheng Coal and Tsinghua Unigroup default, causing concern among investors

Historically, the default rate of POEs has always been much higher than for SOEs. For example, during the policy tightening-driven default wave of 2018 – 2019, SOEs saw minimal default levels. However, SOE defaults have trended higher since the Peking University Founder Group defaulted late last year.

ONSHORE BOND DEFAULT RATE BY AMOUNT



Source: Wind, BofA Merrill Lynch. As of November 2020. SOE default rate includes Yongcheng Coal and related default cross-triggered bonds.

More recently, the default of Yongcheng Coal in November has prompted market-selling across the credit universe, especially focused on weaker commercially driven SOEs and some distressed Local Government Financing Vehicles with more commercial elements. Contributing to the volatility is the amount of likely defaulting bonds tied to Yongcheng (more than 50 billion yuan), a general fear of fading government supports to SOEs, concern that institutional investors will unload positions with similar features to the coal company (i.e., in the same region, relatively weak finances, an oversupplied sector), suspicion of related parties' transfer of assets before default, and a freeze of credit bond issuance in certain provinces, which might increase the refinancing risks to the entire credit space.

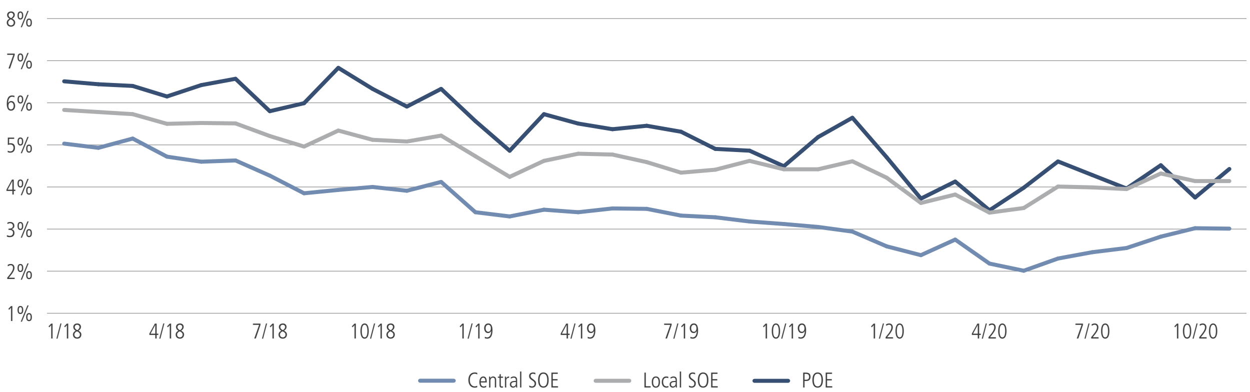
Authorities are paying close attention to SOE-related credit events, both with a desire to break any "moral hazard" of risky behaviors and to mitigate systemic risk. These will be ongoing themes as we move into 2021.

Outlook for 2021

Looking into next year, we expect the blended first-time default rate in China to increase, and to see further convergence of SOE and POE default rates. Rising funding costs, large maturities and macroprudential measures on deleveraging could pose risks for corporate refinancing.

Rising funding costs: Funding costs have been rising since a low in 1Q 2020 and are likely to continue to follow this trend in 2021, with negative implications for high yield corporates and interest coverage generally.

WEIGHTED AVERAGE COUPON RATE

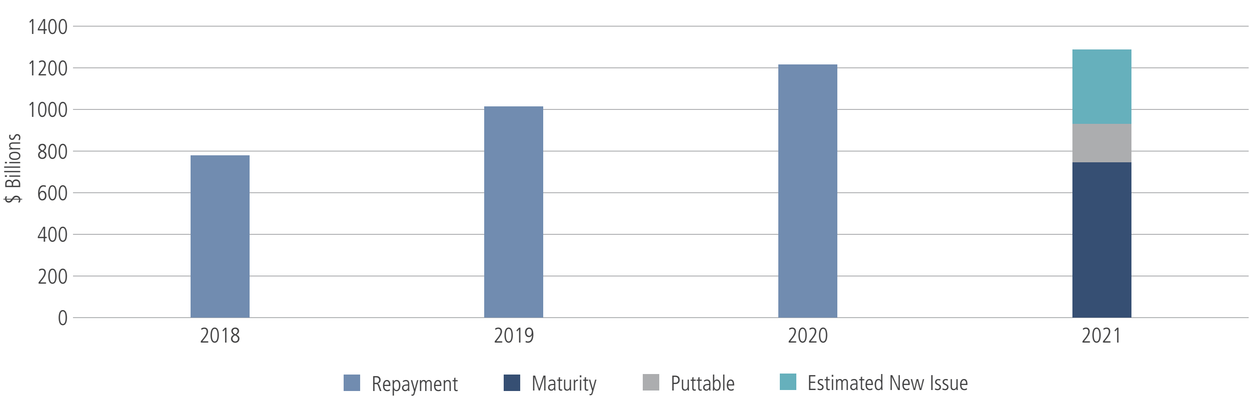


Source: Wind, Neuberger Berman. As of November 2020.

Market liquidity drives credit divergence: The primary market has seen increased issuance cancellation since the Yongcheng Coal default. After the market reopens to higher-quality regions and financially stronger issuers, there will likely be further pricing divergence among credits. Weaker commercially driven SOEs and some distressed POEs could face increasing liquidity stresses as refinancing become more difficult, potentially contributing to a higher default rate.

Refinancing needs remain high: We expect 2021's credit maturity, including puttable amount, to surpass the level reached in 2020—an already high approximately U.S. $1.2 trillion.

CREDIT BONDS REPAYMENT AMOUNT



Source: Wind, CICC and Neuberger Berman. As of November 2020. Estimated new issue amount mainly consists of short-term commercial paper issued from late 2020 through the first half of 2021 that will mature in 2021.

Sector Assessments

POEs: Property in the Hot Seat

We believe that the property sector has higher potential default risk in 2021 than other sectors. Developers with small-scale, low-quality land banks and limited funding channels (i.e., no offshore bond market access) may become more vulnerable.

The sector has the highest put amount and the highest POE concentration among all sectors. In addition to significant repayment pressure, it faces the "three red lines" policy,[3] which is designed to prevent overheating in the housing and land markets. Some developers have already been restricted to issuing 85% of their maturity amount in order to refinance onshore bonds.

Still, we believe larger developers with high-quality land banks, strong execution and offshore bond market access should be able to weather the current tightening cycle with relatively low default risk.

POEs: Non-Property Sectors Stabilize

We have seen some stabilization of non-property sector POE defaults in 2020, after a sharp spike in 2018. China is the first major economy to have resumed full operations in the pandemic, which has allowed its manufacturers to gain global market share and has supported industrial sector credit fundamentals. While some reversal is possible in the second half of 2021 as other economies re-engage, we believe that China's government policy of boosting internal consumption should continue to offer some support. Moreover, the repayment pressure in most sectors is relatively low compared to the property sector, suggesting that default risk in these areas will remain idiosyncratic.

SOEs: Gradual Exits From the 'Zombies'

While its overarching policy theme remains systemic risk prevention, the Chinese government appears increasingly willing to guide a market exit from "zombies," or companies with ongoing losses. As a result, we expect the default rate of SOEs to increase in a controlled manner in 2021, concentrated in weaker commercially driven SOEs. The reduction of implicit government support should drive greater focus on SOE fundamentals and standalone operating capabilities.

The timing of government efforts is no coincidence. The China deleveraging campaign accelerated after late 2017, but increased trade tensions and the COVID outbreak derailed existing plans. With relatively swift domestic containment of the virus, China's financial conditions stabilized, and the government was able to resume tightening policy around mid-2020, moving deleveraging back into focus as a policy goal. Indeed, recent policy papers have urged the bond market to follow more transparent practices in default resolution and bond investor protection, while the judiciary has provided specific guidance on handling legal cases related to bond disputes. These developments reflect the government's "zero tolerance" of fraud (quoting a recent meeting of the Financial Stability and Development Committee) and its push for the SOE reform to achieve healthier financial markets.

Conclusion: Reliance on Credit Differentiation

With an expectation of rising default rates in 2021, we believe that excess return in the China onshore market will likely be derived from flight-to-quality trades and bottom-up credit differentiation.

This is particularly the case for SOEs, where, as noted, policy direction continues to trend toward system deleveraging and reducing moral hazards. Meanwhile, the POE default rate should remain similar to 2020, with some concentration in smaller property developers, but mostly idiosyncratic cases.

In our view, the recent default wave is a sign that the government is seeking to guide the market out of zombie entities and to reinforce the belief that implicit government support is diminishing. We view these steps as positive for the overall system in the long run. Should the market continue repricing, there will be investment opportunities in the onshore credit space. In the near term, should the market continue repricing, we will rely on fundamental analysis and our understanding of local economic and market dynamics in seeking opportunities in the onshore credit space.

[3] The policy categorizes developers based on three leverage metrics in order to limit borrowing growth. The more "red lines" a developer crosses, the less it is allowed to borrow.

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