HONG KONG MONETARY AUTHORITY

Research Memorandum 09/2017

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USD BOND ISSUANCE BY MAINLAND PROPERTY DEVELOPERS

Key Points:

- *Mainland property developers (MPDs) have increased their issuance of bonds denominated in US dollar (USD) sharply since mid-2016, arousing concerns that they are potentially more vulnerable to any strengthening of the USD.*

- *However, a closer look at the data suggests that a significant portion of these bonds were actually issued to refinance matured debt. Moreover, many MPDs have called back their callable bonds before maturity and re-issued them at lower yields. Therefore, their overall debt burden, though remaining at high levels, has not increased despite the surge in new USD bond issuances.*

- *More importantly, bank loans remain the single most important source of financing for MPDs and foreign currency bank loans have accounted for a declining proportion of the total in recent years.*

- *Nonetheless, as only a few MPDs commit to hedging their foreign exchange exposure and their revenues remain predominantly RMB-denominated, vigilance is still required for their currency mismatch risk.*

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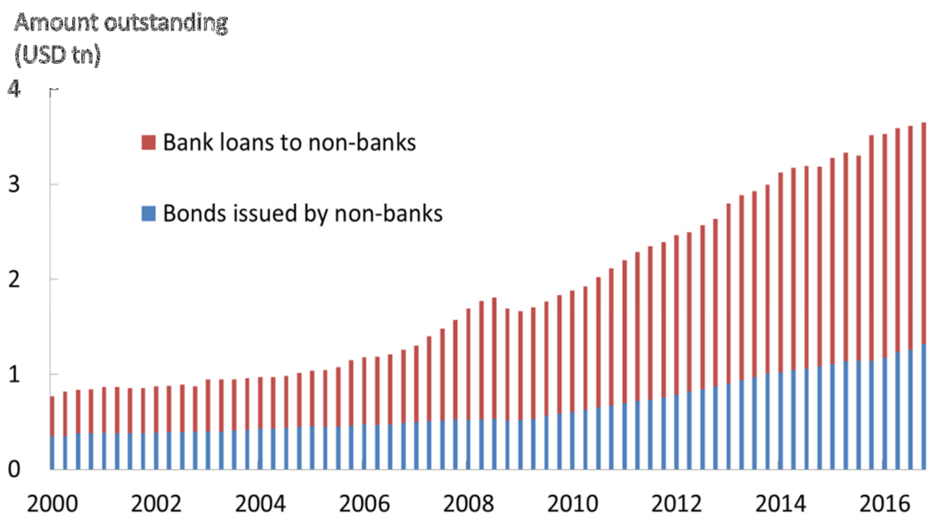
I. INTRODUCTION

USD credit to non-bank corporates in EMEs has been growing rapidly since the global financial crisis. According to the Bank for International Settlements (BIS), USD-denominated credit to non-banks in EME has more than doubled since 2008, reaching US$3.6 trillion at the end of 2016 (Chart 1). While their USD borrowing is mainly in the form of bank loans, USD denominated bonds have also gained popularity. In view of the rapid growth, international financial organisations (e.g. BIS, IMF) and credit rating agencies have reiterated their concerns about the risk of currency mismatch.[1] Mainland property developers (MPDs) serve a notable example of such concerns as they have tapped the offshore bond market aggressively since 2010, with their USD bond issuance rising from US$7.4 billion in 2010 to US$21.5 billion in 2014 before slowing down.[2] Nonetheless, their USD bond issuance has again picked up markedly since mid-2016, reaching USD10.8 billion in the first quarter of this year, almost at par with the USD11.5 billion for the whole of last year (Chart 2). Meanwhile, their renminbi (RMB) denominated bonds issued onshore and offshore have dropped drastically (Table 1). As a result, the share of USD bonds in their newly issued bonds jumped to 50% in the first quarter of this year, much higher than the 7% in 2016 or 12% in 2015. Against the backdrop of the monetary normalisation in the US and a highly uncertain outlook for the RMB exchange rate, the rapid growth poses increasing concerns about the vulnerability of MPDs to currency mismatch risk. Therefore, in this study, we take a closer look at the surge of USD bond issuance by MPDs and the associated risks.

[1] In its December 2015 Quarterly Review, BIS emphasized that the high level of dollar debt can leave borrowers in EMEs vulnerable to rising dollar yields and dollar appreciation. A subsequent study by Standard & Poor's titled "*Asia-Pacific Refinancing Study-Nearly $1 Trillion Of Rated Corporate Debt Is Expected To Mature Through 2020*" dated 23 February 2016 also points out that USD appreciation could lead to increased foreign exchange risk among Asia-Pacific countries. More recently, IMF stressed the importance of monitoring EMEs firms' foreign exchange exposure in its April 2017 issue of *Global Financial Stability Report*.

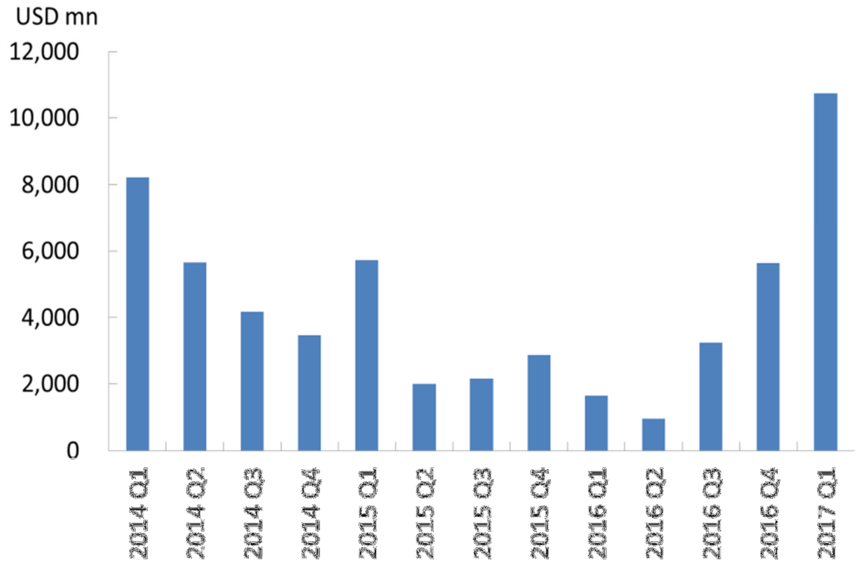
[2] In this study, MPD bonds refer to bonds and notes issued by firms in the real estate sector of Mainland China (as determined by deal nationality). According to Dealogic, the deal nationality of a debt security depends on the nationality of the issuer parent if there is a credit support or guarantee for the issuing subsidiary. For deals without that support or guarantee, the deal nationality refers to the nationality of the issuing subsidiary.

Chart 1. USD denominated credits to non-banks in EMEs



Source: BIS.

Chart 2. USD bonds issued by MPDs



Source: Authors' estimates based on data from Dealogic.

Table 1. New issuance of bonds by MPDs

	Local Currency (in USD mn)				Foreign Currency (in USD mn)					Total (in USD mn)
	CNY	CNH	Sub-total	% of total	USD	HKD	Others	Sub-total	% of total	
2014 Q1	8,562	1,704	10,266	55%	8,215	258	0	8,473	45%	18,738
2014 Q2	18,050	463	18,513	75%	5,646	0	478	6,124	25%	24,637
2014 Q3	12,667	389	13,056	76%	4,170	0	0	4,170	24%	17,226
2014 Q4	11,078	472	11,551	73%	3,465	748	0	4,213	27%	15,763
2014	50,357	3,028	53,385	70%	21,496	1,005	478	22,980	30%	76,365
2015 Q1	7,043	0	7,043	55%	5,717	0	0	5,717	45%	12,760
2015 Q2	14,237	458	14,696	87%	2,000	0	119	2,119	13%	16,814
2015 Q3	31,626	377	32,002	92%	2,150	0	667	2,817	8%	34,819
2015 Q4	38,625	235	38,860	93%	2,850	0	242	3,092	7%	41,952
2015	91,530	1,070	92,600	87%	12,717	0	1,028	13,745	13%	106,345
2016 Q1	54,645	0	54,645	97%	1,640	0	0	1,640	3%	56,285
2016 Q2	40,114	92	40,207	96%	950	471	207	1,628	4%	41,834
2016 Q3	45,061	181	45,242	93%	3,230	0	0	3,230	7%	48,472
2016 Q4	17,482	0	17,482	76%	5,635	0	0	5,635	24%	23,117
2016	157,303	273	157,576	93%	11,455	471	207	12,133	7%	169,708
2017 Q1	10,674	0	10,674	50%	10,760	0	0	10,760	50%	21,434

Note: MPD bonds refer to bonds and notes issued by firms in the real estate sector of Mainland China (as determined by deal nationality)

Source: Authors' estimates based on data from Dealogic.

II. REASONS BEHIND THE SURGE OF USD BOND ISSUANCE

2.1 *Tightened bond-issuing requirements onshore*

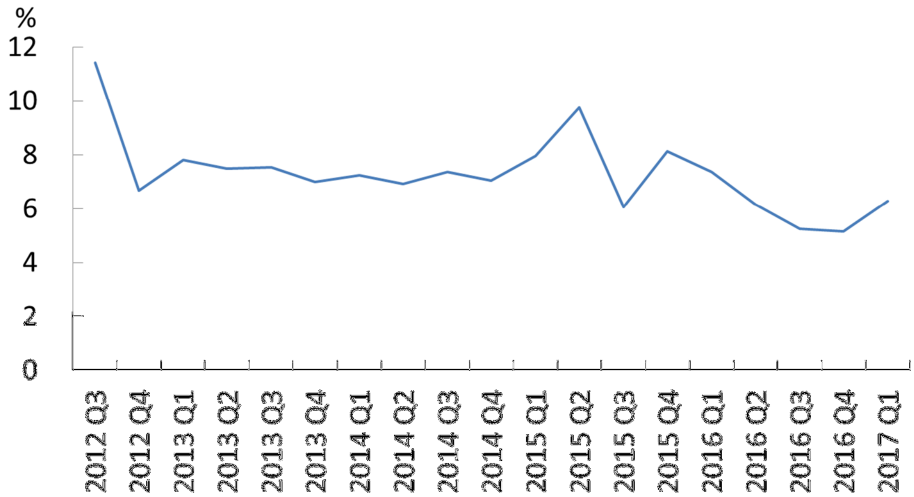
Perhaps, the most obvious reason for the surge of USD bond issuance by MPDs is that they are less able to issue RMB bonds domestically due to stricter regulations. As Mainland property prices continued to surge, Mainland authorities introduced another round of tightening measures to rein in credit in late 2016.[3] The further tightening of credit conditions through stricter rules on MPD bond issuance at the Shanghai Stock Exchange (SSE) has driven more MPDs, especially those with smaller scale and lower profitability, to look outward for financing sources.

[3] Stricter risk assessment processes were introduced in Shanghai Stock Exchange (SSE) to curb property bubble. For details, please refer to http://www.scmp.com/business/money/markets-investing/article/2038317/chinas-bourses-suspend-bond-sales-some-property

2.2 *Refinancing needs and decrease in yield*

A less obvious but more important reason for the surge of USD bond issuance is that MPDs attempt to refinance at a lower cost. When many MPDs first issued their offshore USD bonds back in 2012/13, they were relatively new to foreign investors and it was therefore not uncommon for them to offer double-digit yields. Having built a good track record in the past years, MPDs are now more able to tap the USD bond market, offering coupons (of around 5-7%) at almost half the levels commonly seen in 2012 Q3 (Chart 3). Since 43% of the USD bonds issued by MPDs since 2012 are callable (compared to less than 1% for their RMB bonds issued during the same period), they can call back many of their existing bonds and reissue at lower yields. For example, China Aoyuan Property Group Ltd issued a USD250 million bond in January 2017 at a coupon rate of 6.35%, replacing an 11.45% bond maturing in 2019 but called in February 2017. Table 2 shows that this is not an isolated example. With a substantial portion of MPD bonds issued in the early years becoming mature or callable more recently, the recent sharp increase in USD bond issuance can to a significant extent be explained by an attempt to lower their financing cost. Once we take into account the refinancing needs estimated based on the amounts of bonds matured and called back in each quarter, the recent increase of outstanding MPD USD bonds is much more moderate (Charts 3 & 4).

Chart 3. Weighted average yield of USD bonds issued by MPDs



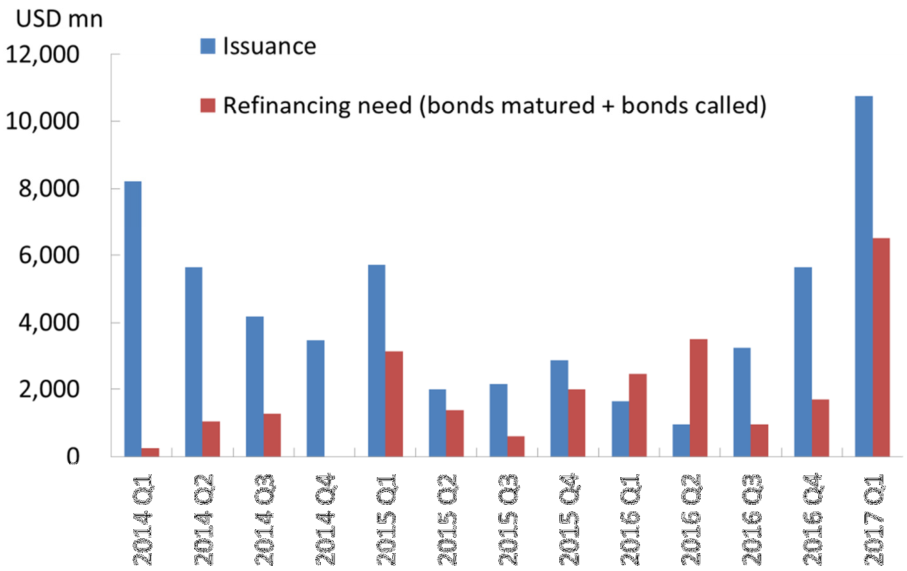
Source: Authors' estimates based on data from Dealogic.

Table 2. Examples of MPDs refinancing

	Bonds Called				New issuance		
Issuer	Amount (USD mn)	Issue Date	Yield (%)	Called Date	Amount (USD mn)	Issue Date	Yield (%)
China Aoyuan Property Group Ltd (中國奧園地產集團股份有限公司)	300	17/01/2014	11.45	28/02/2017	250	11/01/2017	6.35
CIFI Holdings (Group) Co Ltd (旭輝控股（集團）有限公司)	200	27/01/2014	8.99	16/02/2017	285	23/01/2017	5.5
Future Land Development Holdings Ltd (新城發展控股有限公司)	350	21/07/2014	10.5	20/03/2017	350	16/02/2017	5.125
Times Property Holdings Ltd (時代地產控股)	225	21/03/2014	12.825	21/03/2017	375	23/01/2017	6.25
Yuzhou Properties Co Ltd (禹洲地產股份有限公司)	250	24/01/2014	8.625	21/02/2017	350	25/01/2017	6.1

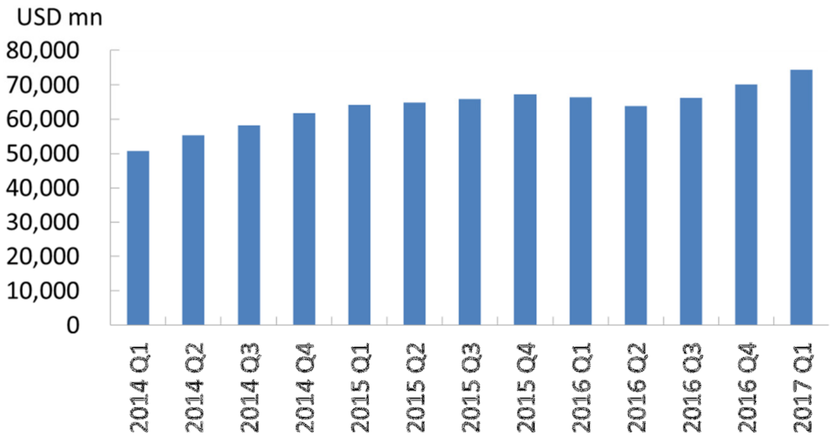
Source: Dealogic.

Chart 4. MPD USD bonds issuance & refinancing need



Source: Authors' estimates based on data from Bloomberg and Dealogic.

Chart 5. Outstanding MPD USD bonds



Note: Amount of bonds outstanding is estimated based on bonds issued by MPDs since 2000.
Source: Authors' estimates based on data from Bloomberg and Dealogic.

2.3 Expectation of a quickened pace of US monetary normalisation

Amid an improving US economic outlook, the Federal Reserve has stepped up the pace of rate hikes. In response, MPDs would like to lock in the prevailing low interest rate by increasing the issuance of USD bonds. While this appears to be unfavorable to bond investors, the market still sees a keen demand for these bonds, which may be attributable to the global shortage of high-yield instruments with reasonable credit quality. For example, the recent issuances of USD250 million three-year notes by China Aoyuan Property at a coupon rate of 6.35% and USD350 million five-year notes by Yuzhou Properties at a coupon rate of 6.1% recorded 10 times and 7 times over-subscription respectively before their closings.[4]

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4 http://www.scmp.com/property/hong-kong-china/article/2064953/chinas-property-developers-flock-us-dollar-bond-market

2.4 Relaxed limit on overseas debt

The National Development and Reform Commission removed the quota approval processes for foreign currency notes with a term of more than one year in late 2015.[5] Under the new policy, Mainland companies are only required to register with the regulator when issuing offshore bonds, compared to the previous requirement of approval on a deal-by-deal basis. The policy has provided Mainland companies with greater flexibility in terms of timing and amount of bonds issued.

III. RISK ANALYSIS

3.1 Currency mismatch

As the bulk of MPD revenues are in RMB, a key concern of the surge of USD bond issuance is exchange rate risk. Given the weakness of the RMB in recent years and a highly uncertain outlook for the currency, MPDs' ability to service foreign debt is raising more eyebrows. Based on their latest annual reports, only a few MPDs that issue USD bonds commit to hedging their foreign exchange exposure while the others only mention that they would closely monitor the movements of exchange rates.[6] While a growing number of MPDs invest in Hong Kong projects, there is still possible currency mismatch in the near term since some of these projects would take years to complete before they could generate dollar-based revenues to match the interest and principal payments of their USD bonds.[7]

That being said, the concern over the currency mismatch is to some extent alleviated once we consider the shift in currency composition of MPDs' other liabilities. While the issuance of offshore bond has seen significant growth, it remained only a minor financing channel for MPDs. Meanwhile, bank loans continue to serve as MPDs' major funding source. Based on the annual reports of the MPDs, we found that an increasing portion of their bank borrowings are

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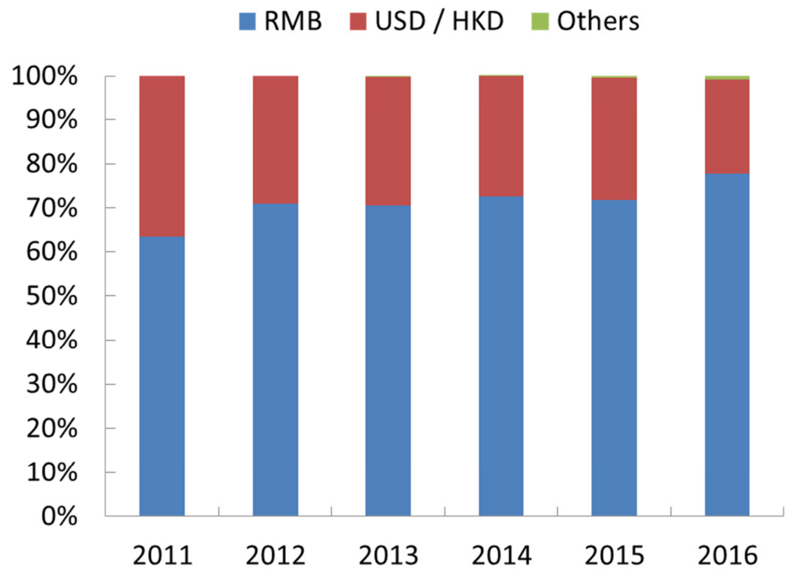
5 For details, refer to the official statement issued by the NDRC: http://www.sdpc.gov.cn/gzdt/201509/t20150915_751047.html .

6 Only three of them provide details about how they hedge their foreign exchange exposure in their annual reports.

7 Mainland companies and developers have invested approximately HK$118 billion on office buildings and residential lands in Hong Kong as of May 2017, according to data from major newspapers, such as South China Morning Post (19 Aug 2016), Wen Wei Po (17 Mar 2017) and Ming Pao (17 May 2017).

denominated in RMB (Chart 6). While this helps offset the increase in their exposure to exchange rate risk caused by the surge of USD bond issuance, vigilance is required given that over 20% of their bank borrowings are denominated in USD and HKD.

Chart 6. Currency composition of MPDs' bank borrowings



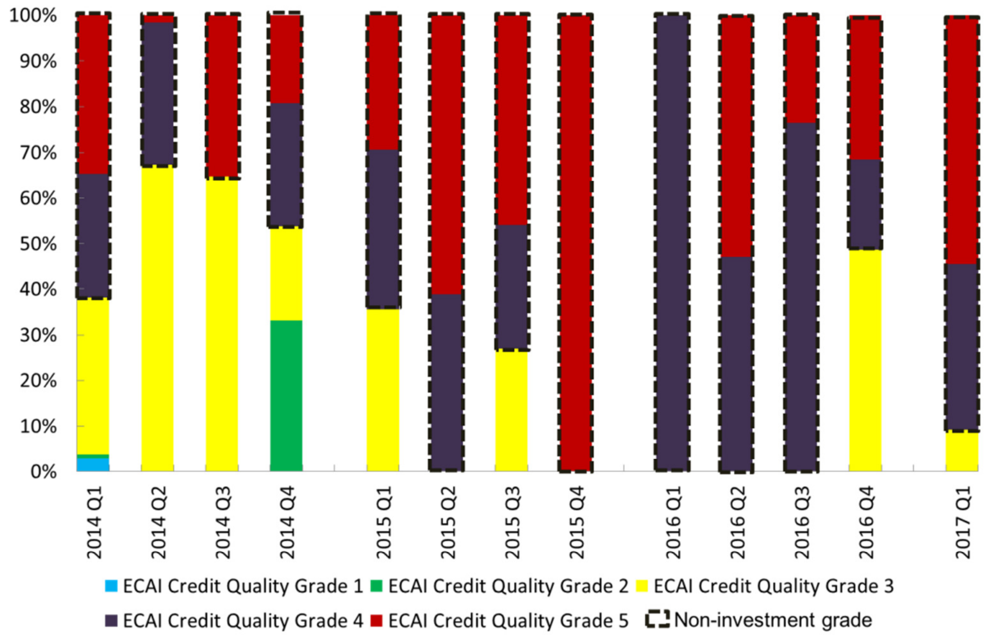
Note: The sample of MPDs includes 43 Hong Kong-listed MPDs with offshore bond issuance in 2010-2017.

Source: Authors' estimates based on data from MPDs' annual reports.

3.2 Credit quality of USD bonds issued by MPDs

In terms of ratings, the credit quality of recently issued MPD USD bonds is worse than those issued three years ago. Chart 7 shows that a predominantly majority issued since late 2015 (except for 2016 Q4) were below investment grade. In comparison, a noticeably higher share (53%) was rated as investment grade in 2014. Furthermore, quite a number of these bonds are not rated by major credit rating agencies. As shown in Chart 8, around 10% of the USD bonds issued by MPDs in the first quarter of 2017 are unrated, and it is much more challenging for bond investors to assess their credit quality. Note that unrated MPDs tend to be smaller and possibly face more regulatory restrictions in issuing bonds onshore. As such, the issuers who tap the offshore market are more likely to be those having inferior credit quality.

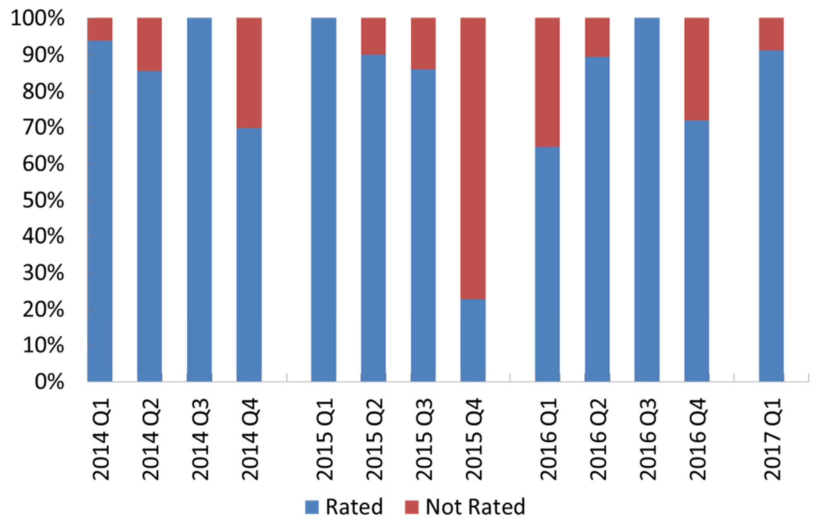
Chart 7. Credit quality of USD bonds issued by Mainland property developers



Note: External Credit Assessment Institutions (ECAI) is a credit assessment system used to evaluate credit quality of assets based on the ratings determined by credit agents such as FitchRatings, Moody's and Standard & Poor's. Bonds with ECAI Credit Quality Grades 4 and 5 are considered non-investment grade.

Source: Authors' estimates based on data from Dealogic.

Chart 8. USD bonds issued by Mainland property developers



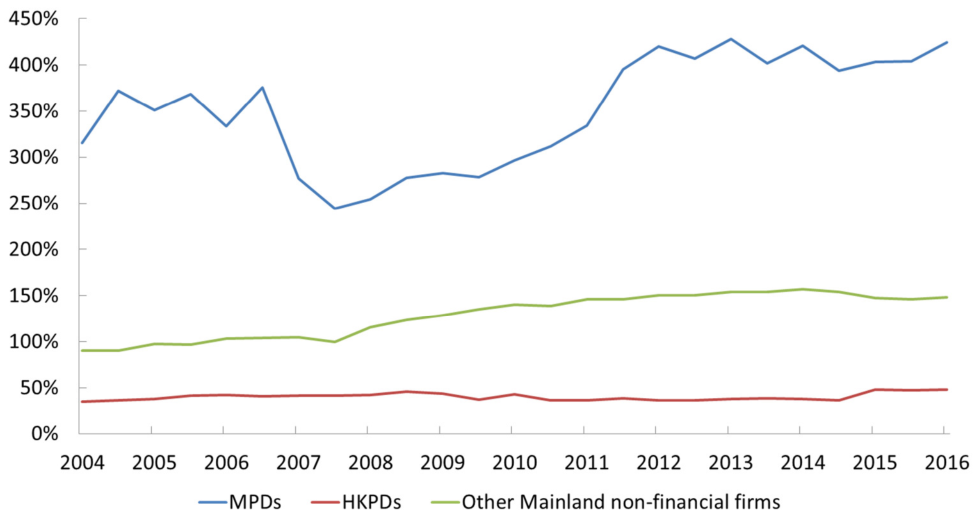
Source: Authors' estimates based on data from Dealogic.

3.3 Leverage-related risks

As a significant share of the USD bonds recently issued by MPDs is for refinancing (Chart 4), their leverage has not increased as much as suggested by the surge in the USD bond issuance. In fact, the total bond issuance of MPDs has fallen considerably as the decline of RMB bond issuance is more than enough to offset the increase in USD bond issuance (Table 1). The increase in USD bond issuance appears to be rapid mainly because it was compared to a very low base.

While MPDs still have a much higher debt-to-equity ratio than major property developers in Hong Kong (HKPDs) and other Mainland non-financial firms, this ratio has clearly stabilised in recent years (Chart 9). The other two commonly used indicators of default risk, namely Altman's Z-score and the interest coverage ratio, also suggest a similar picture (Charts 9 & 10). In particular, both indicators are at similar levels as two years ago. Therefore, although the high leverage level of MPDs remains a potential threat to financial stability, the situation has not deteriorated in recent years.

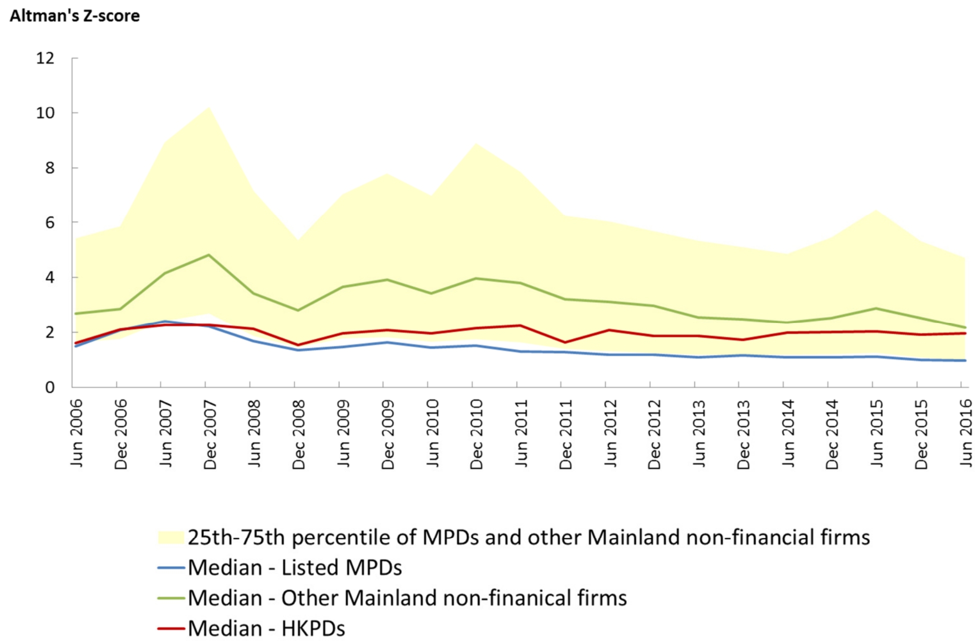
Chart 9. Average debt-to-equity ratio of listed MPDs with offshore bond issuance



Notes:
1. Debt-to-equity ratio is defined as the ratio of total liabilities to shareholders' equity. A higher value indicates higher leverage.
2. The sample of MPDs includes 63 listed MPDs (regardless of their listing jurisdiction) with offshore bond issuance during the period from 2010 to 2017.
3. Other Mainland non-financial firms refer to the non-financial and non-MPD constituents of the Shanghai Shenzhen CSI 300 Index.
4. The sample of HKPDs includes 40 Hong Kong property developers listed in Hong Kong.

Source: Authors' estimates based on data from Bloomberg.

Chart 10. Altman's Z-score of listed MPDs with offshore bond issuance

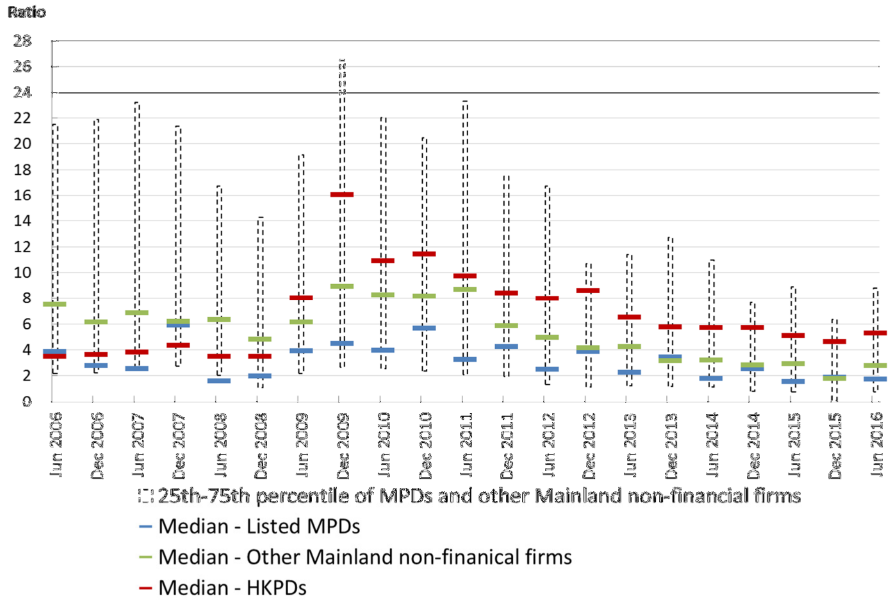


Notes:

1. A lower Z-score indicates a higher likelihood of a company default.
2. The sample of MPDs includes 63 listed MPDs (regardless of their listing jurisdictions) with offshore bond issuance in 2010-2017.
3. Other Mainland non-financial firms refer to the non-financial and non-MPD constituents of the Shanghai Shenzhen CSI 300 Index.
4. The sample of HKPDs includes 40 Hong Kong property developers listed in Hong Kong.

Source: Authors' estimates based on data from Bloomberg.

Chart 11. Interest coverage ratio of listed MPDs with offshore bond issuance



Notes:
1. Interest coverage ratio is defined as the ratio of earnings before interest and taxes to interest expense.
2. The sample of MPDs includes 63 listed MPDs (regardless of their listing jurisdictions) with offshore bond issuance during the period from 2010 to 2017.
3. Other Mainland non-financial firms refer to the non-financial and non-MPD constituents of the Shanghai Shenzhen CSI 300 Index.
4. The sample of HKPDs includes 40 Hong Kong property developers listed in Hong Kong.

Source: Authors' estimates based on data from Bloomberg.

IV. CONCLUSION

The USD bonds issued by MPDs have increased markedly since mid-2016, fuelling concerns about their vulnerability to further weakness of the RMB. We find that the major driver behind the recent surge is actually refinancing. In particular, as a significant share of the high-yield bonds issued by MPDs in earlier years has matured or become callable more recently, certain MPDs refinanced their redemptions by issuing new USD bonds with substantially lower yields. Other drivers (such as expectations of a quickened pace of US monetary tightening and eased limit on overseas debt for Mainland corporates) have also added impetus to the surge.

As the phenomenon is mainly attributable to an increase in refinancing activities, the overall debt burden of MPDs has not increased as much as one might expect when focusing on the recent USD bond issuance figures. Commonly used measures of default risks show that while the high leverage level of MPDs remains a potential threat to financial stability, there is no sign of further deterioration of the situation lately. More importantly, bank loans remain the predominant source of their financing and we find that foreign currency bank loans have accounted for a declining proportion of the total in recent years. Nonetheless, since the majority of the MPDs' revenues are RMB-denominated and only a few of them adopt a hedging policy for their foreign exchange exposure, the currency mismatch problem will still be a concern in the event of a further significant weakening of the RMB and therefore the situation should be monitored closely.