China Default Storm Seen as Record Private Bonds Mature

By Bloomberg News - Aug 5, 2014

The small companies that dominate China’s private MARKET for high-yield bonds face rising default risks as their DEBT obligations soar to a record and economic growth slows to the lowest in MORE than two decades.

Privately issued notes totaling 6.2 billion yuan ($1 billion) come due next quarter, the most since authorities first allowed such offerings from small- to medium-sized borrowers in 2012, according to China Merchants Securities Co. The guarantor of debentures sold by Xuzhou Zhongsen Tonghao New Board Co. stepped in to help after the building-materials producer based in the eastern province of Jiangsu missed a COUPON PAYMENT in March. Three other issuers have also faced “payment crises” this year, China Merchants said.

Premier Li Keqiang has sought to expand financing for small companies, which account for 70 percent of China’s economy, as expansion is set to cool to the slowest since 1990 at 7.4 percent this year, according to a Bloomberg survey. The nation’s bond clearing house last month suspended valuation of privately placed securities sold by an AUTO-parts exporter after it failed to clarify media reports regarding a possible default. A polyester maker with similar notes had a bankruptcy application accepted in March.

“The current risks exposed in the private-bond market are probably a prelude to a storm,” said Sun Binbin, a Shanghai-based bond analyst at China Merchants. “There’s been improvement in only some sectors of the economy, not in all.”

Debt Mounts

China started its private junk bond market in June 2012 to give small companies a way of raising FUNDS outside the network of so-called shadow banks. Borrowers sell the notes directly to institutional investors in the market, unlike with publicly auctioned securities. Smaller businesses seeking to sell debt as part of the trial program didn’t have to meet net asset or profit requirements, the Shanghai and Shenzhen STOCK EXCHANGES said the previous month.
The number of Chinese firms whose liabilities are double their equity has surged since the GLOBAL FINANCIAL crisis, suggesting more defaults may come, data compiled by Bloomberg show. Publicly traded non-financial corporates with debt-to-equity ratios exceeding 200 percent have jumped 68 percent since 2007.

Financial Strain

Tianjin Tianlian Binhai Composite Materials Co., which makes polymeric composite materials, couldn’t pay back principal and interest on its notes when INVESTORS exercised their option to sell back the securities July 28, Caixin Online reported July 31, without saying where it got the information. Tianjin Tianlian’s 50 million yuan of bonds are due on Jan. 29, 2015, according to China International Capital Corp. Three calls to the manufacturer went unanswered.

Huzhou Jintai Science and Technology Co. failed to repay the principal and interest on 30 million yuan of its debentures when investors tried to sell them back on July 10, according to a CICC report released on July 25. The report said Zheshang Securities Co., the notes’ lead underwriter, informed the Shanghai Stock Exchange on July 18. Two calls to Huzhou Jintai went unanswered.

A local court accepted an application for bankruptcy by Zhejiang Walters Polymer Technology Co. on March 12, according to a statement on Anji County People’s Court’s website. Investors could sell back 60 million yuan of the company’s bonds on July 23, according to CICC. An official who wouldn’t disclose her name declined to comment on the repayment status yesterday.

Government Help

China’s central bank in June announced a 0.5 percentage point cut in reserve requirements for some lenders as it unveiled policies aimed at supporting smaller companies and agriculture.

“Defaults may make it more difficult for smaller companies to raise financing,” said Xu Hanfei, a bond analyst in Shanghai at Guotai Junan Securities Co., the nation’s third-biggest brokerage. “But the government may provide more financial support to smaller companies to help them survive the tough environment.”

Concern defaults may spread has heightened as data indicate the government’s stimulus measures are failing to gain traction outside of manufacturing. China’s service industries stagnated in July as a private index fell to a record low. Credit-default swaps insuring the nation’s debt against non-payment climbed five basis points this quarter to 82 basis points, according to prices from data provider CMA.
‘High Tolerance’

While borrowing costs have fallen this year as authorities aim to pump more money into the economy to support growth, they remain higher than they were 12 months ago. The yield on AA-rated five-year corporate bonds has climbed 37 basis points in the past year to 6.93 percent. The rate on similar-maturity government securities is 3.98 percent, leaving the spread at 295 basis points, up two basis points in the same period.

There's a high probability more private notes will default in the fourth quarter, according to Li Ning, a bond analyst at Haitong Securities Co., the nation's second-biggest brokerage.

“The government has a high tolerance for defaults in the private bond market because the investors are institutional investors who can tolerate higher risks than individuals,” Shanghai-based Li said. “The government can’t save every single company.”

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