

Economic Watch

China | Corporate deleveraging campaign: from “proactive” to “passive”

Jinyue Dong / Betty Huang

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Chinese authorities’ 2016-2018 corporate deleveraging campaign to tackle the indebtedness of its corporate sector seems to have halted and given way to the escalating China-US tensions in 2019 and the Covid-19 pandemic in 2020. Most notably, the PBoC altered its monetary policy stance from previous tightening during the deleveraging campaign to accommodative during the economic slowdown in the past two years.

However, due to China’s “first-in first-out” of the pandemic and the mesmerizing economic recovery since April 2020, the authorities started to reconsider the financial risks and corporate debt overhang caused by the easing measures during the pandemic time and are willing to begin the policy normalization to curb them. Several recent events pointed to this concern: First, in November 2020, a series of top-profile state owned enterprises (SOEs) defaults has sent shockwaves to financial system through China’s corporate bond market to a large extent, indicating the authorities’ tolerance of SOE default. Second, in January 2021, the authorities promulgated a series of new policies to curb monopolistic behaviour of e-commerce giants and their shadow banking activities. Third, in February 2021, the PBoC withdrew interbank liquidities which led to a significant hike in interbank repo rates, indicating the authorities’ deleveraging intention to curb upcoming financial risks.

Compared with the “proactive” deleveraging in 2016-2018, this round of corporate deleveraging has a significantly “passive” characteristic. In this report, we analyse the ongoing “passive” corporate deleveraging comprehensively from several perspectives: to what extent China’s corporate debt increased due to the stimulus measures in the China-US trade war and pandemic time; why this round of SOE defaults is different compared with 2016-2018; what motivated the authorities to adopt a “passive” deleveraging method instead of a “proactive” one like what they did in 2016-2018; and finally, what is the big picture of bond market defaults and the outlook of deleveraging campaign in 2021.

China’s 2016-2018 deleveraging campaign gave way to the trade war and coronavirus pandemic, leading to debt rising again

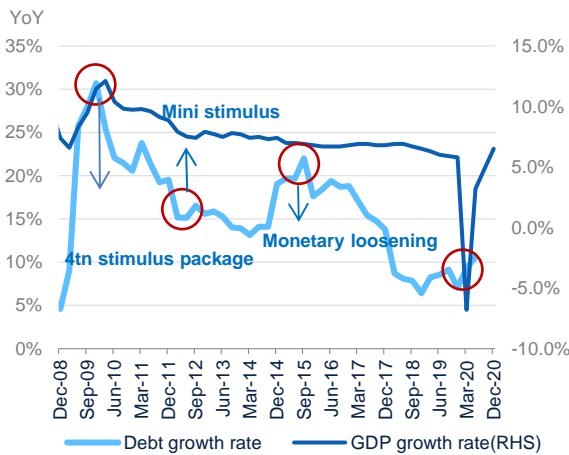
Although authorities’ effort to deleverage China’s corporate sector bore some fruits in 2016-2018, it was shelved a year later, as China eased its monetary policy to offset the economic blow of the trade war with the U.S. in 2019 and the unprecedented Covid-19 pandemic in 2020. In face of intensifying growth headwinds, authorities changed their policy tone from “deleveraging” to “stabilizing firms’ leverage” in 2019.

Based on the historical experience, policy stimulus was always followed by the rise of the country’s debt to GDP ratio. This time is certainly not an exception (Figure 1). The total debt level of China’s corporate sector, gauged by the total credit extended to non-financial corporates as percentage of GDP, stood at 162.5% in the 1H 2020 from 149.4% in 2019, according to the latest BIS data. (Figure 2)

Except for looking at general debt to GDP ratio, we also explore some other indicators to investigate the true debt service capability of the firms in 2018-2020. First, we look at the differences between SOEs and Private-owned enterprises’ (POE) leverage ratio, which is defined as the ratio of total liability to total assets reported by the

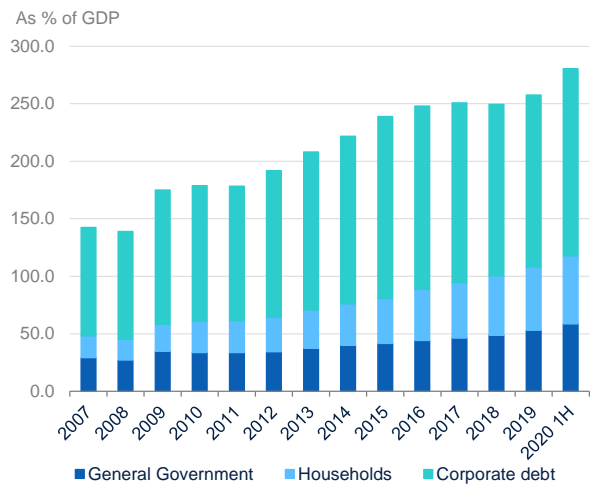
National Statistics Bureau. There are some divergences between the two types of enterprises. In particular, POEs suffered from a rising leverage due to comparatively lack of government support and the authorities' continuously clamp-down of shadow banking activities. By contrast, it is worth noting that the leverage ratio for SOEs has decreased steadily to 56.5% in 2020, accomplishing the government's deleveraging target to lower leverage ratio by 2% by the end of 2020 from the 59.6% at the year-end of 2017.

Figure 1 Historically, policy stimulus always led to debt level rising



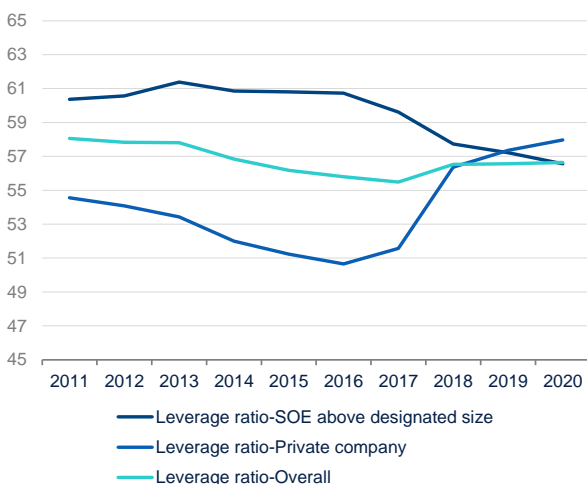
Source: NBS and BBVA Research

Figure 2 China's debt to GDP ratio accelerated in 2020 due to the authorities' stimulus during China-US trade war and pandemic



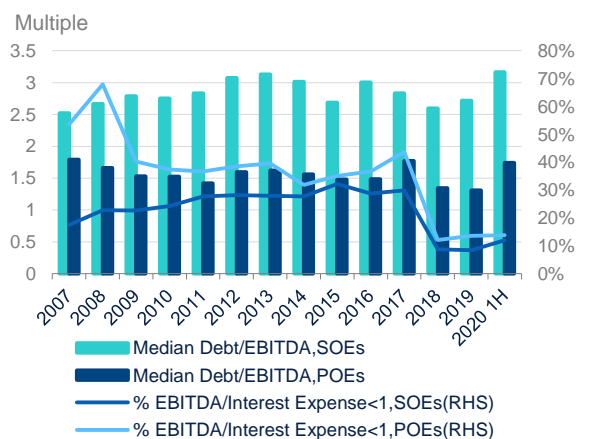
Source: Wind and BBVA Research

Figure 3 SOEs use financial tools to lower total liabilities to assets ratio, thus recording a decelerating leverage ratio



Source: NBS and BBVA Research

Figure 4 However, both listed SOE and POE firms' capacity of debt servicing indeed deteriorated based on our constructed indicators



Source: Wind and BBVA Research (A natural threshold of EBITDA-to-Interest expense is 1. A firm with its ratio of EBITDA-to-Interest expense below this benchmark could have difficulty in servicing its debt.)

However, the leverage ratio for both listed SOEs and non-SOEs which we believe are more reliable indicators to measure the corporate debt level, showed a significant rise in 2020 according to the Debt/EBITDA ratio and Debt/Interest Expense ratio that we construct. In particular, the ratio of Debt-to-EBITDA is a proxy of a firm's debt level relative to its cash flow while the ratio of EBITDA-to-interest-expense gauges a firm's capacity to service its interest-bearing debt. According to Figure 4, the median of Debt-to-EBITDA ratio among all listed SOEs and non-SOEs rose between 2018 and 2020, suggesting both SOEs and non-SOEs failed to improve their balance sheets as EBITDA declined while debt levels are kept rising to fund capital spending and investment in infrastructure projects. (Figure 4)

Altogether, it is not difficult to reach the conclusion that the debt overhang problem indeed comes back due to the recent stimulus measures during China-US trade war and Covid-19 pandemic during 2019-2020. The discrepancy between the above two kinds of leverage ratios for SOEs lies in the fact that SOEs have stepped up their effort to use financial tools to lower its total liability to assets ratio, such as debt-equity swaps and other hybrid debt-equity instruments. These tools were allowed by Chinese accounting standards to treat as equity, usually have long-dated tenors thus improving the SOE's debt maturity profile. Thus, debt-to-EBITDA ratio for both SOEs and POEs should be more reliable to measure the corporate debt level.

How this round of corporate deleveraging goes? From “proactive” to “passive”

To conduct the corporate deleveraging and solve the debt overhang issue, allowing the zombie enterprises to default seems like a straightforward choice. However, this round of SOE default starting in November 2020 seems like quite a different story compared with what the authorities did in 2016-2017.

First, zombie SOE enterprises are the long-lasting historical burdens of Chinese economy, while the "no growth target" due to the pandemic in 2020 and 2021 gives the authorities a good time window to conduct the "passive deleveraging" on them. Due to the special institutional system in China, the SOE reform has progressed with lots of difficulties in the past decades amid tremendous vested interests and the tight linkage with the government. However, it seems a good opportunity for the authorities to adopt a laissez-faire attitude towards the defaults of these enterprises as there is no growth pressure in the global pandemic time.

Second, unlike the three times of corporate default waves in the past years, this time is quite different. For the past three defaults in March 2014-October 2015, November 2015-December 2016 and 2018-2019, the background was mainly due to the process of overcapacity led by high leveraging amid easing monetary measures, and after that, the tightening monetary policy triggered the corporate default. That means, the historical corporate debt default was mostly business cycle driven. However, this time we do not observe any of the business cycle characters. Particularly, China's monetary policy has remained conservative due to the “first-in, first-out” of the Covid-19 and monetary normalization is the main stance since April 2020. Thus, there are no “leveraging” and “overcapacity” procedures this time. The most likely reason is the local governments cannot bailout these local SOEs due to their shrinking fiscal revenues in the pandemic time.

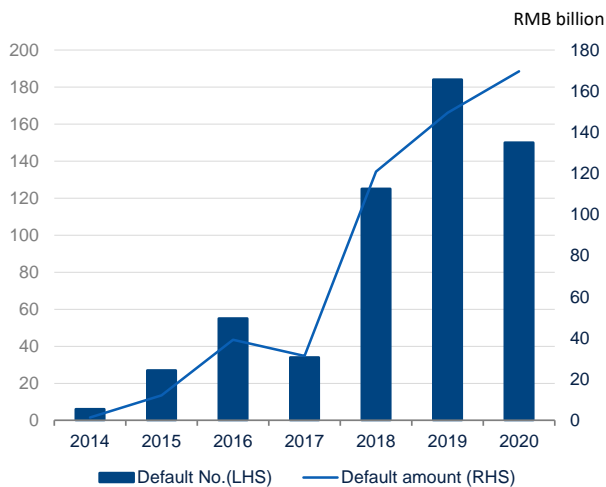
Further peering into the bond defaults

We also found some new patterns in investigating the corporate bond defaults this time. First, both the default number and the default value continued to rise from 2018 to 2020 (Figure 5). The default number surged to 125 in 2018 from merely 6 in 2014, before reaching the peak of 184 in 2019 and then moderated to 150 in 2020. Compared with the default number, the default amount surged all the way to RMB 169.7 billion from RMB 120.9 billion in 2018.

Second, although default cases are most concentrated on POEs, which account for 69.3% of total bond default amount and 71.2% of total bond default number (Figure 6), the number of local state-owned enterprises jumped in 2020 to 59 from 14 in the previous year. The large increase of SOEs default reflects the government's increased

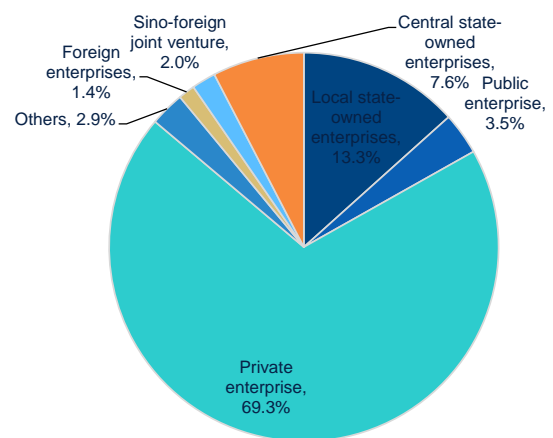
tolerance for isolated defaults in post pandemic time. By contrast, the default number by POEs shrank to 96 in 2020, almost half of 173 registered in 2019. In accordance, the default amount of SOEs jumped to RMB 82.7 billion from RMB 17.2 billion in 2019 while the default amount of POEs shrank to RMB 89.7 billion in 2020 from RMB 123.6 billion in 2019. However, we have to at the same time pay attention that all the defaulted SOEs are at the local government level while Chinese authorities would like to keep those “too big to fail” SOEs safe for the foreseeable future.

Figure 5 Bond default amount and number are rising in China's domestic bond market



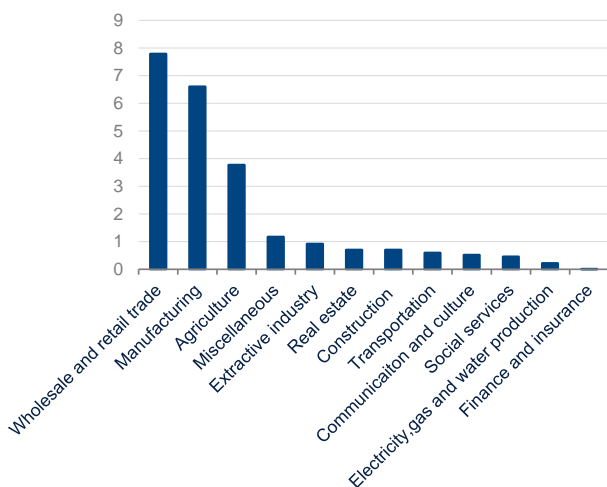
Source: Wind and BBVA Research

Figure 6 The rise of default cases are mainly concentrated on POEs, however, SOEs defaults are on the rise



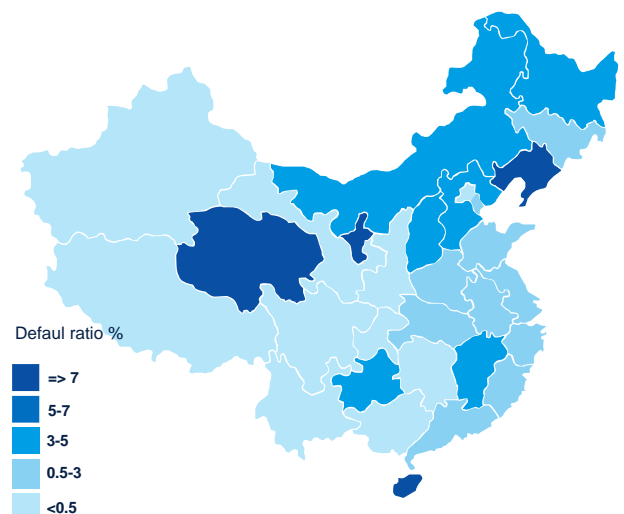
Source: Wind and BBVA Research

Figure 7 The uneven default ratios across sectors



Source: Wind and BBVA Research

Figure 8 Bond default ratios by province



Source: Wind and BBVA Research

Third, the leverage ratios are quite uneven across sectors. Wholesale and retail trade as well as manufacturing industry saw the highest default ratio. (Figure 7) By components of these industries, procyclical industries such as the household appliances and electrical equipment industry behaved comparatively well, while the traditional and overcapacity industries such as mining, steel production manufacturing, extractive industries and traditional auto-making suffered more. The default companies are most concentrated in the high leverage sector.

Last but not least, the bond default ratio is related to the economic environment in each province. In developed areas such as the eastern coastal areas, despite of a high bond default amount, the much higher bond issuing amount largely diluted its effect. However, in less developed provinces, companies would be more vulnerable to restructuring. For example, in northeast of China such as Liaoning province, both the bond default amount and the default amount ratio ranked high. Moreover, due to the continuing negative impact of the debt level of Hainan Airline Group, Hainan province suffered from the highest bond default ratio and issuer default ratio, which reached 14.91% and 40.9% respectively.

“Passive” deleveraging is set to continue in 2021, but more comprehensive structural reform is needed

China’s authorities have promulgated a series of stimulus measures to deal with the coronavirus shock in 1H of the last year, but the better-than-expected economic rebound has propelled the central bank to reconsider the corporate deleveraging issue and other related rising financial risks. However, in 2021, a neutral but accommodative policy support will still be needed to foster economic recovery given the global uncertainties. Thus, we anticipate that authorities will postpone the start of a real tightening cycle and “proactive deleveraging” to a later stage. That means, “passive” deleveraging will still be the main policy tone throughout 2021.

Under this circumstance, with the possible monetary tightening later this year, more companies may face refinancing pressure. Thus, corporate defaults are likely to top last year’s record as comparatively more tightening monetary stance will squeeze out borrowers. Financially weak POEs will account for the majority of the default as these companies are more vulnerable to economic slowdown, government’s crackdown on the shadow banking and investors’ risk aversion. On the other hand, the rising of SOEs default cases will become more eye-catching. For SOEs in financial distress, the government will be more tolerated for isolated default at the local government level and the possible provision of support from the authorities will depend on the SOEs’ strategic importance. That means, the defaulted SOEs will still be at the local government level while Chinese authorities would like to keep those “too big to fail” SOEs safe for the foreseeable future.

The most recent PBoC’s move to withdraw interbank liquidities further indicates the authorities’ intention to curb rising financial risks and press ahead deleveraging campaign. Together with the “passive” deleveraging by having more tolerance of corporate default, a more stringent financial regulation will also be implemented in 2021. Altogether, the PBoC should take the historical lesson that withdrawing interbank liquidity cannot ultimately solve the debt overhang problem and financial risks, a comprehensive structural reform should be the ultimate way to deal with all these issues. That means, how to balance between maintaining growth momentum in the post-pandemic time and conducting corporate deleveraging is still quite challenging for the authorities going forward.

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CONTACT DETAILS:

BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 30 25
bbvaresearch@bbva.com www.bbvaresearch.com

