

DISTRESS AND DECELERATION IN CHINA

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In a year of volatility in the world's second-largest economy, China posted growth of 6.9% for Q3 2015, slipping below 7% for the first time since 2009 (Figure 1). This deceleration has led to concerns over the country's ability to reach its full-year growth target of 7%, amid skepticism over the accuracy of the official data.

China's ongoing economic slowdown is consistent with government efforts to rein in unbridled growth, much of which was achieved through outlays in infrastructure and heavily leveraged investments. Despite its declining growth profile, China's debt-fueled economy has yet to embark on a process of deleveraging. This has given rise to concerns over a credit bubble and may result in an increase in corporate defaults as companies struggle to repay debt.

Total debt: Rising waters

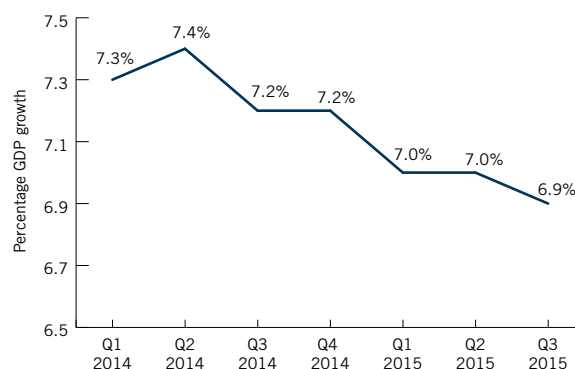
China's total debt has more than quadrupled in the last seven years, accounting for about one-third of global debt growth during the period. As of H1 2014, China's total debt-to-GDP ratio was estimated to exceed 280%, with a debt load of US\$28.2tn, higher than most developed economies, including Australia, Germany and the United States.

At 125% of GDP, China's corporate debt is high by global standards. While its central government does not look overleveraged, local governments and state-owned enterprises have been burdened with repayments stemming from heavy borrowing to stimulate growth (Figure 2). Additionally, it is estimated that there is US\$8.5tn in the shadow banking system, compounding concerns regarding transparency and proper regulatory oversight. Along with the country's slowing growth profile, these high debt levels are creating sector specific concerns, headlined by escalating stress in the commodities and real estate industries.

Real estate: Looming troubles

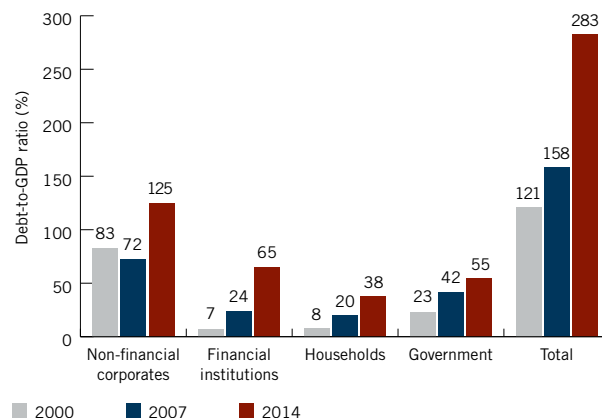
Chinese property developers have been among the hardest hit amid the slowdown. This stems from two distinct trends: rising debt and an oversupply of unsold housing units.

Figure 1: China's quarterly GDP growth (Q1 2014 – Q3 2015)



Source: National Bureau of Statistics of China

Figure 2: China's debt-to-GDP ratio



Note: Numbers may not sum due to rounding.

Source: McKinsey Global Institute

As part of the country's rapid urbanization, developers levered up to finance projects in line with ambitious housing and construction targets. Offshore bond issuance from China's developers grew rapidly during 2013 and 2014, but slipped in 2015 due in part to concerns over devaluation of the RMB and the reopening of the domestic bond market (Figure 3). Nonetheless, property bonds continue to make up a significant part of China's overall offshore bond issuance.

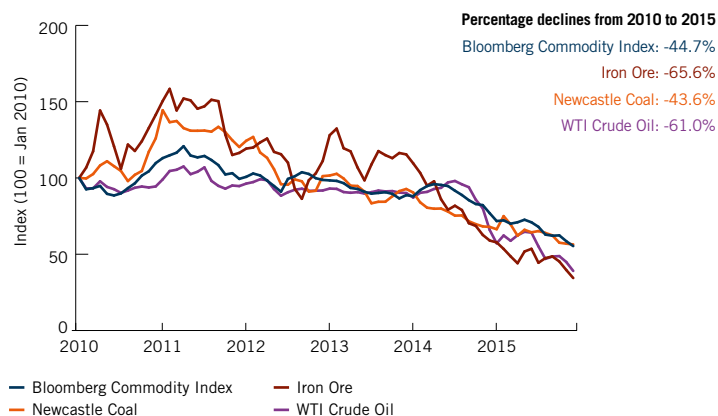
Even as debt levels rise and real estate developers face balance sheet issues, the more immediate challenge of managing an expansive inventory of unsold homes threatens the sector's stability. Property sales have been sluggish this year, contracting after years of torrid growth. According to the Wall Street Journal, China's inventory of unsold homes currently makes up an area of more than six Manhattan islands, which does not include unfinished residential projects which have yet to acquire sales permits. The oversupply is especially apparent in lower-tier cities, a negative outcome for developers that are particularly susceptible to disruption in their business or cash collection cycles.

As initial signs of distress begin to manifest, the pains experienced by property developers are unlikely to remain isolated within the real estate industry. Evidenced by the performance of related industries, China's slowing growth profile, declining spend on infrastructure projects and sluggish sales of residential units in lower-tier cities are impacting other parts of the country's economy.

Commodities: A big hole

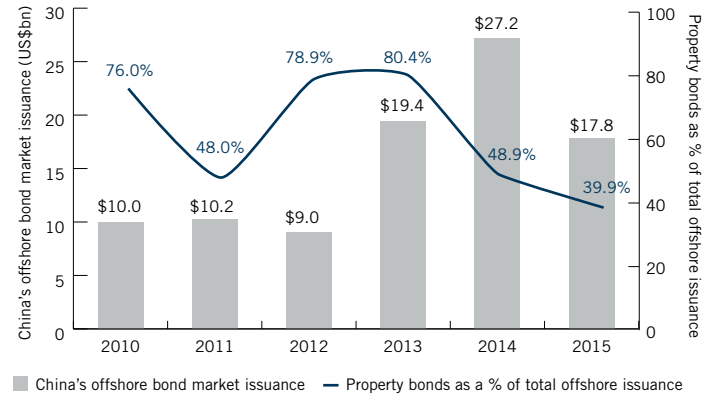
The commodities sector has seen a sharp decline in prices since peak levels in 2011, principally driven by slowing demand from China (Figure 4). This has been compounded by a global surplus of output in many markets. Under the stress of margin compression, many metals and mining companies have been unable to operate at a profit, and lower-quality mines are shuttering operations.

Figure 4: Commodity price declines



Source: Bloomberg

Figure 3: Property bonds as a percentage of China's total offshore issuance



Source: Debtwire

Case study: Kaisa Group Holdings Limited

While historically rare, China has seen a recent surge in corporate defaults and subsequent restructurings, possibly signaling a shift from government bailouts towards market-based solutions, as articulated in China's 12th Five-Year Plan (2011-15). With pre-sale permits rescinded and projects frozen by the government, Kaisa became the first Chinese property developer to default on offshore bonds. Heavily reliant on a short-term cash cycle and presale proceeds for working capital, Kaisa slid into a liquidity crisis under these regulatory sanctions, resulting in an inability to service debt. With nearly US\$11bn in debt, of which US\$2.5bn was due to offshore creditors, Kaisa entered into negotiations to restructure its onshore and offshore obligations.

Simplified timeline

- **Dec '14:** Kaisa shares suspended in Hong Kong after Shenzhen authorities block sale of units at certain projects. Chairman Kwok Ying-Shing resigned along with certain directors and senior management members.
- **End of Jan '15:** Property developer Sunac agreed to purchase a 49% equity stake from the Kwok family.
- **Feb '15:** Kaisa appointed Houlihan Lokey as financial adviser.
- **Apr '15:** Sale restrictions imposed by the Shenzhen government were lifted and Kwok Ying-Shing was reinstated as Chairman.
- **Jun '15:** Kaisa re-engaged with key bondholders and their advisors in relation to restructuring talks.
- **End of May '15:** Proposed Sunac transaction was terminated.
- **Aug '15:** Kaisa's onshore lenders entered into a framework agreement with the Company.
- **Nov '15:** Kaisa announced agreement on debt restructuring terms with a steering committee of offshore bondholders.
- **Jan '16:** Restructuring support agreement released in relation to Kaisa's proposed restructuring with offshore bondholders.

Restructuring in Asian markets: Challenges and prognosis



Brandon Gale

The absence of a clear plan at the outset of a restructuring process can easily throw the best of intentions off course. Brandon Gale, Head of Houlihan Lokey's Asia Restructuring Practice, discusses the considerations for both debtors and creditors engaged in restructuring efforts in emerging Asia.

What can we anticipate in terms of corporate debt and distress in China and across the Asia-Pacific region?

China is the engine that drives emerging Asia. Its unprecedented growth and insatiable appetite for commodities over the past decade has led to business plans and capital structures in a number of sectors being underwritten to unrealistic and unsustainable growth, pricing and demand expectations. The clearest example is in the commodities and shipping sectors, which after years of rapid growth are now in cyclical decline as a result of significant supply-demand imbalances, pricing pressure and margin erosion – this has led to quite a bit of restructuring activity both across the region and globally in recent years.

The recent volatility in currencies across emerging Asia following China's devaluation of the RMB in August highlights the importance of companies appropriately managing their foreign currency exposure. Most high-yield issuers in Asia have significant liabilities denominated in USD, but generate cash flows and hold the vast majority of their assets in local currency and don't appropriately hedge against the currency mismatch – which could have widespread implications on credit metrics and available liquidity as issuers look to refinance and/or repay offshore debt as it comes due.

We expect the continuing slow growth in China, coupled with a rising interest rate environment, further currency volatility and a redeployment of capital by global investors into more stable, developed economies to lead to an increase in borrowing costs, reduction in liquidity and increased restructuring activity in the near-to-medium term across the region.

What are the main challenges for offshore bondholders in a restructuring scenario in China?

Given stringent foreign currency and regulatory controls in China, high-yield bonds are typically issued by an offshore holding company or SPV, with proceeds down-streamed to operating companies onshore via intercompany loans or equity contributions. Issuers generally do not have significant offshore assets, which means high-yield bonds are typically unsecured and look to residual equity value (in excess of indebtedness) onshore for recovery. The resulting lack of security and structural subordination to creditors onshore are the primary obstacles bondholders face in restructuring situations in China.

Bondholders do, however, remain senior to equity and for an issuer to maintain its public listing (in the case of listed companies) and equity sponsors retain control and future optionality/upside going forward, a consensual deal with bondholders must be reached.

In our experience, it is important to fully understand the situation onshore and how practical leverage can be used to enhance recoveries. Politics, the significance of the issuer to its local municipality, support from onshore lenders and the importance of social stability in China play a key role in driving outcomes in these restructurings – and a thorough understanding of how these issues are likely to play out, coupled with proper communication with the relevant stakeholders onshore, is critical in crafting a plan to maximize value for creditors offshore.

What are the main differences between restructurings in emerging Asia and in developed markets?

Given the evolution of the leveraged loan and high-yield bond markets, developed markets like the United States and Europe have a longer track record of dealing with complex corporate restructurings. Consequently, legal systems and creditor rights in these markets are more developed and result in quicker, more transparent processes with a narrower range of possible outcomes than what you would typically find in restructuring situations in emerging Asia.

In developed markets, issuers generally initiate a dialog with creditors well in advance of a restructuring catalyst (like a covenant breach or prospective default) to bring awareness to the issue at hand and attempt to find an amicable solution prior to an event of default. This is driven by creditor rights in these jurisdictions and the adverse consequences that could be brought against the issuer by creditors looking to enforce their legal rights and remedies following a default. Given the relatively weak creditor rights in emerging Asia, we find that distressed issuers tend to either try to hide their problems or wait until the last minute and only approach creditors when all other alternatives (asset sales, raising additional capital, etc.) have been exhausted and a default is looming, or in some instances, has already taken place. This naturally leads to a much more contentious dialog with creditors at the outset – who are typically infuriated by the surprise nature of the default and lack of transparency from management. In many circumstances, this can also lead to a lingering sense of distrust which isn't productive to the inevitable restructuring negotiations that need to take place between the parties.

Our job at the outset in these situations (regardless of whether we are representing the issuer or creditors) typically involves (i) educating the issuer with regards the expectations of offshore creditors in the process; (ii) creating a transparent, common information platform that will serve as the basis for restructuring discussions; and (iii) attempting to rebuild trust amongst the parties so a sensible negotiation can take place as to the value maximizing outcome for everyone involved.

Houlihan Lokey is an international investment bank with expertise in financial restructuring, mergers and acquisitions, capital markets and valuation.

The shipping sector, traditionally flourishing on China's status as the world's largest exporter, has also shown signs of significant distress. Services ancillary to the sector, such as docking, warehousing and shipbuilding, have likewise been in decline. Shagang Shipping recently went into liquidation, while China Ocean Shipping Group (Cosco) and China Shipping Group are in the midst of a government-mandated merger. Affected by the slowdown and oversupply, shipyards in China have been discounting containers for sale.

Accounting for about half the world's demand for commodities, China's weakened appetite is rippling through other markets, particularly in Asia-Pacific markets such as Indonesia, Australia, and Mongolia, where China is a key purchaser. A protracted period of low demand for commodities is likely to spur industry consolidation and/or further mine shutdowns with companies turning towards cost control and operational efficiencies, making the commodities sector a continued focal point of potential restructurings in the year ahead.

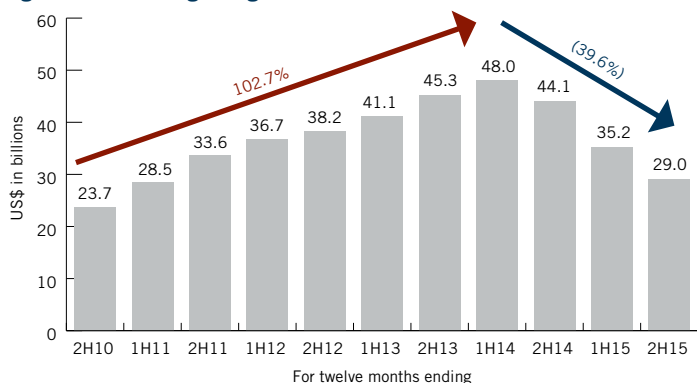
Macau: The wheel of fortune

On top of the shocks being felt across various sectors, political pressure in China has put renewed focus on the government's anti-corruption campaign. This exacerbates key-man risk throughout China and exacts further stress on various industries, as individuals cut back on lavish spending and government officials become more reluctant to approve ambitious development projects.

Historically an enclave of the gaming industry, Macau has been hard-hit by both China's deceleration in growth and the far-reaching repercussions of China's crackdown on corruption, as the flow of funds between Macau and mainland China is being subjected to much closer regulatory scrutiny. Money and visitors have been drying up as the casinos' best customers – high net worth individuals who made their fortunes in property and commodities, high-flying government officials, top personnel from state-owned enterprises – have been vacating the gambling floors in an effort to forestall suspicions of money laundering. This has had a serious impact on casinos in Macau, which are experiencing an unprecedented decline in VIP revenues, putting pressure on their bottom lines and forcing many to reassess future expansion plans. For 2015, Macau's gaming sector recorded US\$29bn in gross gaming revenues, down 34%+ from 2014 (Figure 5).

With the day of VIP high-rollers drawing to a possible close, the central government is encouraging the city to diversify and place greater emphasis on family-friendly tourism and leisure. In October 2015, Macau's newest casino, Melco Crown's Studio City, opened to a lukewarm reception with limited customer appetite for high stakes gambling, while Wynn has delayed the opening of its latest project. Many Macau casino projects have been financed by USD bonds and certain issuers have had to seek covenant amendments to accommodate for the new reality.

Figure 5: Macau's gaming revenue trends



Source: Bloomberg

Outlook: A cold worsens and spreads

As China's economic uncertainties continue, the trend of growing distress is spreading in China and across the Asia-Pacific region, leading to an increasing number of corporate defaults. Companies that have been relying on China's economy as a key driver of their own growth are experiencing a slowdown in sales and earnings. Falling commodity prices and expectations of interest rate increases in the United States, on top of diminishing confidence in the abilities of emerging market corporates to repay their dollar denominated debts, have seen an outflow of foreign investment from China and developing markets. Amid untenable levels of corporate debt, many companies – highlighted by the continued struggles in the shipping, commodities, and oil and gas sectors – will likely continue to face the ripple effect of the slowdown.



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