CHINA'S WALL OF DEBT v1

The true cost of the debt that China's real estate developers peddled to eager international investors during a five-year property boom is now becoming clear.

Having found themselves shut out of local bond and loan markets seven years ago, a band of developers began looking elsewhere for funds. First an initial public offering, and then a dollar bond sale. It became a well-trodden path. By 2010, a core group of four -- Kaisa Group Holdings Ltd., Fantasia Holdings Group Co., Renhe Commercial Holdings Co., Glorious Property Holdings Ltd. -- raised a total of $5.6 billion. On Monday, Kaisa buckled under $10.5 billion of debt and defaulted.

China’s home builders became the single biggest source of dollar junk debt in Asia amid government measures to prevent a property bubble. They’ve already funneled $78.8 billion from international equity and bond markets into an industry that’s grown to account for one third of the world’s second-biggest economy. Most of the first rush of dollar offerings, in 2010, falls due in the next two years.

“It was an unintended consequence of the Chinese government that property developers are selling equity and debt to offshore investors,” said Ben Sy, a Hong Kong-based managing director in JPMorgan Chase & Co.’s private banking division. “There happened to be huge demand from international investors in the past few years driven by the intense search for yield.”

High Yields

Kaisa was the first to debut in the dollar note market in 2010, selling $650 million of five-year bonds that April. The securities paid a 13.5 percent coupon, more than twice the 6.3 percent average yield for Bank of America Merrill Lynch’s U.S. Real Estate index at the time.

The Shenzhen-based developer was among nine real estate companies that raised $4 billion selling offshore bonds that year, a record at the time and fourfold the previous high. Six of the nine had listed their shares on the Hong Kong stock exchange in the previous 24 months.

Chinese developers’ move into the international capital markets started in earnest in 2007. From January to December, as the rest of the world slid deeper into recession, homebuilders raised $7.2 billion. Since 2008, another $11.5 billion has been raised via IPOs in Hong Kong.
Investor interest was, for the main part, strong. The retail portion of Glorious’s IPO was 51.4 times oversubscribed. Fantasia received orders from individual investors for 160 times the number of the shares it was selling, triggering a claw back mechanism that allowed it to allocate more stock. The retail component of Renhe’s share sale was undersubscribed with investors only applying for 7.25 percent of the shares offered to them, leaving institutional investors to take up the slack.

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Borrowed Money

The shift offshore was precipitated to a large degree by happenings within China. In July 2008, the China Banking Regulatory Commission had issued circular 214 banning the use of borrowed money to buy land in an effort to stem rising property prices. The year prior, the China Securities Regulatory Commission had begun turning down IPO and bond issue requests for the same reason.

Having tapped equity investors, most developers followed up with a dollar bond sale.

Developers weren't "allowed to pay for land purchases with borrowed money from PRC banks," said Cheong Yin Chin, a Singapore-based analyst at independent research firm CreditSights Inc. "They raised money offshore, the proceeds were remitted to China as shareholders' equity to the onshore subsidiaries, so it becomes a form of equity and you can use equity to buy land."

Maturing Debt

2010's roll call included Renhe, which raised $900 million via two dollar bonds, Kaisa, Glorious with $300 million and Fantasia with $120 million. The first of Renhe's notes, a $300 million issue, comes due in May. The $78.7 million of notes still outstanding, sold at 99.08 cents on the dollar, are trading at 95.2 cents. Renhe had 884.5 million yuan ($143 million) of cash on its balance sheet as at the end of December.

Officials in Renhe's investor relations department didn't immediately reply to an e-mail seeking comment. An earlier telephone call was answered by a person who declined to be identified and who requested an e-mail.

Glorious, which was downgraded by Moody's Investors Service by two levels to Ca on Monday, one score above default, has its $300 million of bonds maturing in October. It had cash and cash equivalents, including restricted cash, equivalent to about $226 million as at the end of 2014, its financial accounts show. Auditor PricewaterhouseCoopers LLP issued a disclaimer on April 15 that said they have doubts the company can prepare its results on a going-concern basis.

More Defaults

"Given that most of Glorious's debt is secured, we believe the recovery prospects for offshore bondholders are low and are reflected in its Ca senior unsecured rating," Gerwin Ho, a Moody's senior analyst, said.

Doris Chung, a Glorious investor relations official, didn't immediately reply to an e-mail seeking comment.

Fantasia media relations official Zheng Jingya said the company can pay its offshore debt.

Kaisa, which failed to pay $52 million of interest on two of its dollar bonds after a 30-day grace period expired over the weekend, has said that in a liquidation, overseas creditors may get as little as 2.4 percent of their money back.

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Standard & Poor's said in a report last week that the earnings and profitability of some Chinese property developers may deteriorate further in 2015, and more defaults can't be ruled out.

Record Sales
Still, it's not as if the investors who bought developers' debt have all had a bad run. Kaisa 2018 notes, now trading at 57 cents on the dollar, were as high as 104.7 cents on the dollar in August 2014. Debentures of Country Garden Holdings Co. sold at 99.05 cents on the dollar in August 2010 with a 10.5 percent coupon are at 102 cents.

Investors' insatiable demand for yield also helped fuel sales. Since 2011, offshore bond sales have increased consistently, peaking last year when developers sold $15.7 billion of debt, bringing the total outstanding amount to $41 billion. That's 30 percent of all junk-rated debt in Asia, according to Clement Chong, a senior credit analyst at NN Investment Partners BV, which had 186 billion euros ($200 billion) under management as of Dec. 31.

Creditor Rights
"Issuances from Chinese property companies will continue to dominate U.S. dollar bond supply in the Asian high-yield market given the large investment needs of this sector coupled with the funding limitations onshore," Chong said. "Whilst the government has relaxed onshore funding restrictions for the sector, to date, only a small number of larger property companies have been able to tap the onshore capital markets."

Chong said international investors should understand their rights as creditors in the event of default. "In almost all cases, onshore creditors will get their claims to assets first before offshore creditors, so the position of offshore creditors is deeply subordinated," he said.
Since Kaisa's troubles unspooled, developer bond sales have slowed. Dollar offerings totaled $3.5 billion in the first quarter, half the amount sold in the same period of 2014. Of the seven bonds sold so far this year, only two -- from Evergrande Real Estate Group Ltd. and Times Property Holdings Ltd. -- are rated single B, showing investor appetite for lower-rated junk debt from the sector remains weak.

The yield on Renhe's CCC rated bonds due next month meanwhile has soared 24 percentage points in the past two days. Yields on Agile Property Holdings Ltd.'s perpetual notes rose 3 percentage points in five weeks late last year after its chairman Chen Zhuo Lin was temporarily arrested.

"I think the recent defaults only reflect the risks that have always been there and highlight why investors should demand higher yields in the space," said Benjamin Cryer, a Singapore-based portfolio manager for the Franklin Asia Credit Fund of Franklin Templeton Investments, a unit of Franklin Resources Inc. "Given the amount of leverage in some of these companies, combined with consistently negative free cash flows, a certain level of defaults should be expected."