Asia Conference 2023: China Macro

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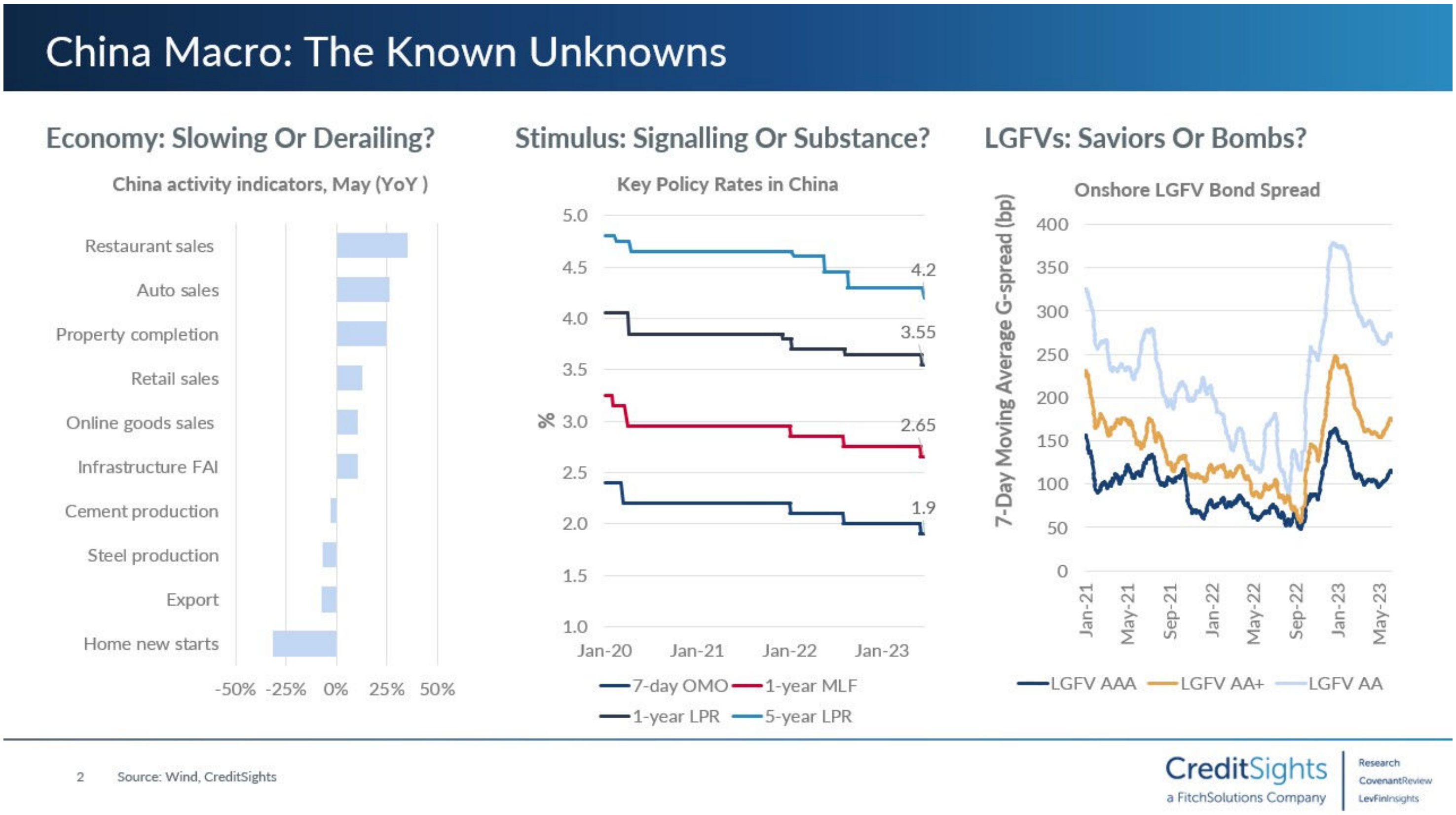
Executive Summary

- **CreditSights held its Asia conferences in Hong Kong and Singapore earlier this month.**
- **This is the transcript for the presentation and panel discussion entitled "China Macro: Navigating the Bumpy Recovery".** We outline our thoughts on the outlook for China's economy, local government financing vehicles, property sector and banks.



China's recent weak data prints did not come as a surprise to us as we had expected the country's post-COVID recovery to be bumpy and uneven. We had cautioned earlier this year that pent-up consumption could taper off, metals demand still faced challenges, and the property sector was not out of the woods. Our views were supported by our conversations with market participants, business owners, developers, LGFVs, banks, and think tanks in our China and Hong Kong trips during COVID lockdowns and post the reopening.

We expect the Chinese economy to fare better in 2H23, supported by targeted fiscal stimulus in renewables and electric vehicle infrastructure, resilient online retail and auto sales, and to meet the "around 5%" growth target set at the "Two Sessions" meetings in March. However, we do not expect large stimulus due to the budget constraints of local governments; we project more policy rate and bank reserve ratio cuts in 2H22, but credit demand could remain lackluster due to weak consumer and business confidence; and we expect the property sector to continue to drag on growth as doing away with home purchase restrictions is unlikely to trickle down to better demand in lower tier cities, and any additional funding would continue to be prioritized for home deliveries rather than boosting the sector.

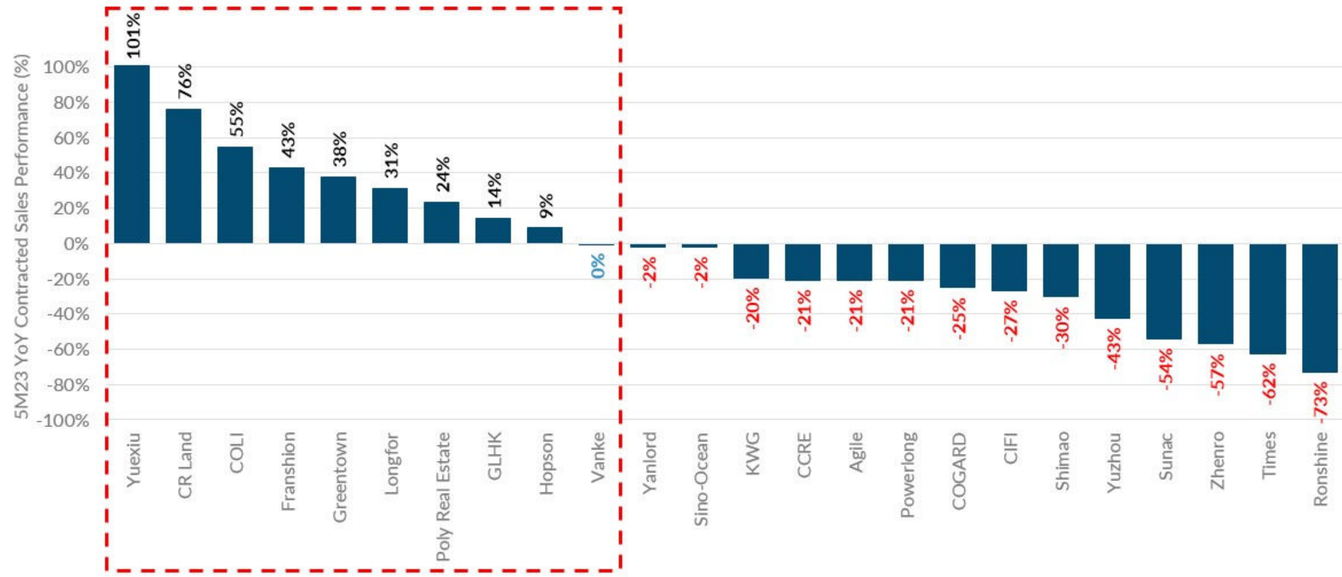
We maintain our view that large-scale and disorderly defaults of LGFV onshore and offshore public bonds are unlikely in 2023. Despite shrinking fiscal wallets amid falling land sales, local governments and their LGFVs continue to repay public bonds on time and in full to limit contagion and reputational risks, albeit while restructuring bank loans, shadow bank debt (e.g., trust loans, wealth management product and bankers acceptance). This is evidenced by the public bond bailouts of weak LGFVs such as Lanzhou Construction, Yunnan Cultural & Tourism, and Chongqing Energy. Onshore LGFV bonds have tightened significantly YTD due to the local governments' high willingness to support and limited bond supply. That said, **we would continue to avoid LGFV onshore and $ bonds of more than 1-2 years in maturity** as the central government could tighten LGFV policies once the Chinese economy picks up and property risk abates, which in turn could result in more difficult funding condition for LGFVs.

We are mindful of other medium-to-long term structural challenges faced by China, including the efficiency of an SOE dominated economy, the lack of predictable, transparent and consistent policy making and population aging. Therefore, **we suggest investors not just focus on China's near-term growth but also the amount of long-dated China risk assets, including China credits, that they are willing to carry given the related tail risks could be hard to price and hedge.**

China property is still a rather turbulent sector that has been marred by further liquidity crunches and defaults. The sector still has a long road ahead of itself, and we think any recovery will be a bifurcated one as well.

Homebuyers Still Sticking To Quality Developers

Stronger developers posted YoY-increases in contracted sales for 5M23



4 Source: National Bureau of Statistics, Company data, CreditSights.

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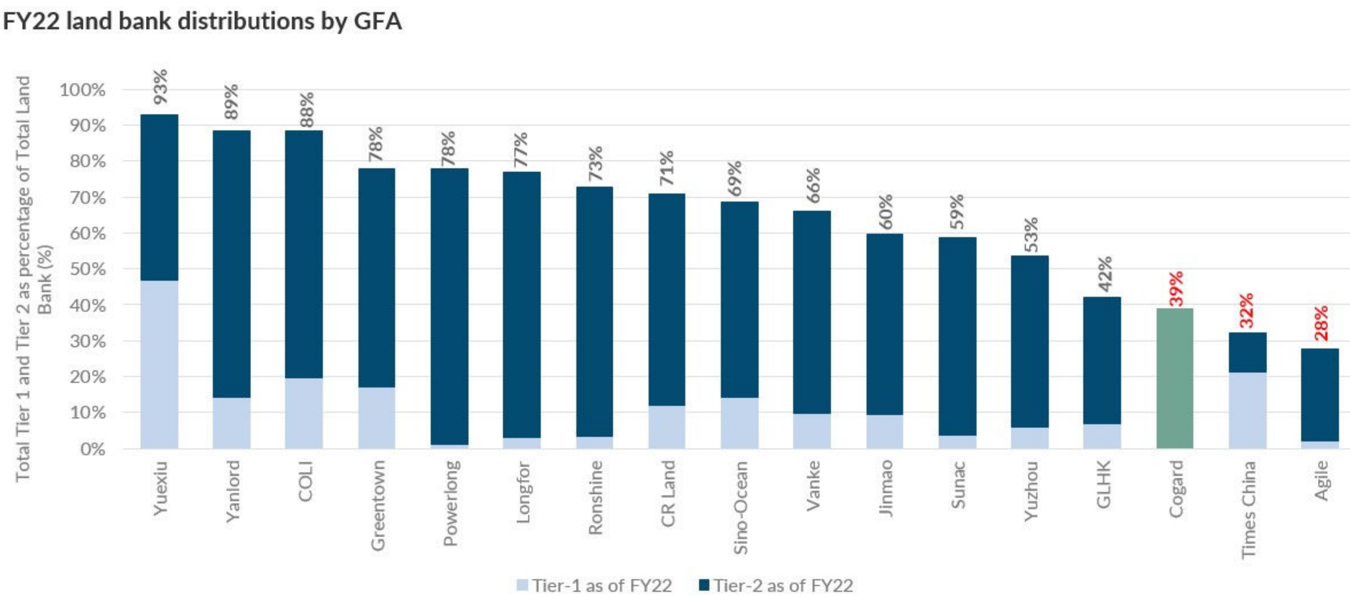
Home sales in China had shown some encouraging signs in the first quarter, though we think this was likely due to a mix of the pent-up demand from end 2022 as well as the low base from last year. Total home sales so far still remain below 2021 levels. We have also noted the MoM price growth for new homes across the various city tiers have been slowing down since March.

The chart above shows the 5M23 contracted sales YoY movement for several developers we track. Only a handful were able to record YoY increases, which were mainly the stronger state-linked developers like Yuexiu, CR Land and COLI. This would suggest that homebuyers are still more comfortable sticking to the higher quality developers.

Upper Tier Cities Are The Place To Be



Note 1: Percentage figures for CR Land, Cogard, Longfor, Yanlord, Yuexiu, Greentown, and Powerlong as disclosed by the company.
Note 2: Cogard's figures are based on saleable resources. 39% refer to both Tier-1 and Tier-2 cities.
Note 3: Percentage figures for COLI, Road King ,GLHK, Jinmao, Sino-Ocean, Agile, Times, Yuzhou, Zhenro, Ronshine, and Sunac based on NBS classification of Tier 1 and Tier 2 cities.
Note 4: Tier 1 cities include: Beijing, Shanghai, Shenzhen and Guangzhou. Tier 2 cities include: Changchun, Changsha, Chengdu, Chongqing, Dalian, Fuzhou, Guiyang, Haikou, Hangzhou, Harbin, Hefei, Hohhot, Jinan, Kunming, Lanzhou, Nanchang, Nanjing, Nanning, Ningbo, Qingdao, Shenyang, Shijiazhuang, Taiyuan, Tianjin, Urumqi, Wuhan, Xiamen, Xi'an, Xining, Yinchuan and Zhengzhou.
Source: Company data, CreditSights.

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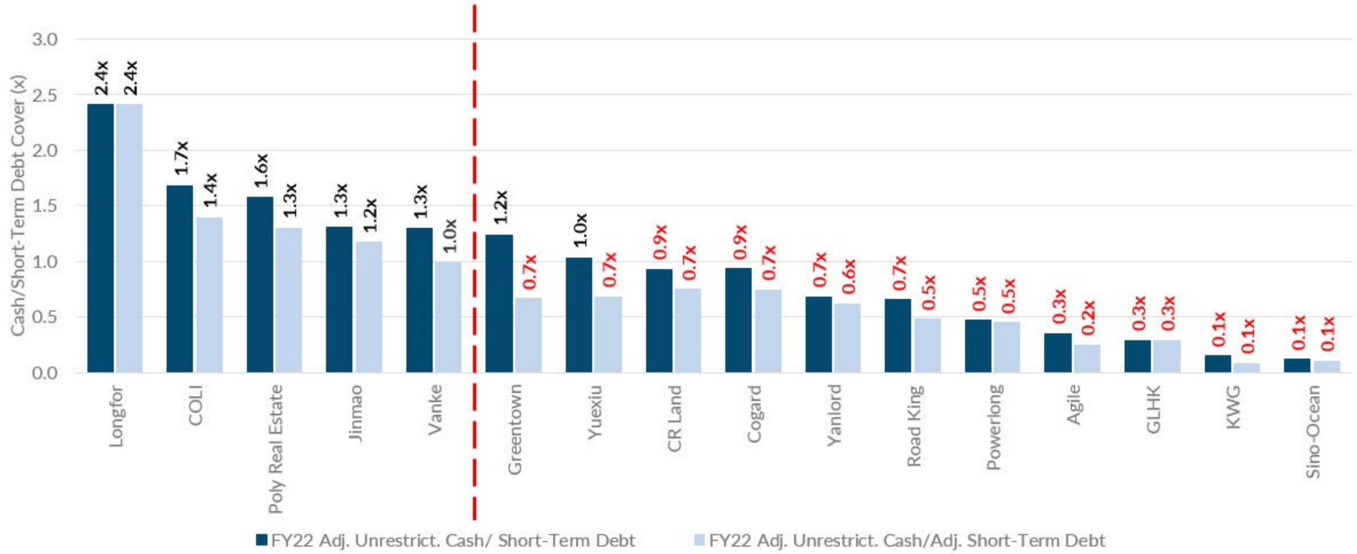
We note that the slight recovery in home demand has also varied across the city tiers, with home prices in Tier-1 and upper Tier-2 cities relatively more resilient than the lower tier cities. The chart above compiles the FY22 land bank distributions for some of the developers that we track.

Developers like Yuexiu and COLI have higher exposure to the upper tier cities, and they are also the ones that were able to post YoY-increases in their contracted sales so far this year. Meanwhile, developers with smaller exposure to the upper tier cities, such as Cogard and Agile, may continue facing pressures in their contracted sales generation. Cogard's column is highlighted in a different colour as the company only provided a total figure for Tier 1 and Tier 2 cities.

That said, we think homebuyers' perception of the developers is also important. For example, Ronshine may have a decent exposure to the upper tier cities, but its contracted sales for 5M23 was still down by about 73% YoY.

Only a Handful With Adequate Liquidity

Adjusting for escrow account cash and financial guarantees provided to JVs, associates and third parties



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Note 1: KWG and Sino-Ocean Land did not disclose the exact amount of cash held in escrow accounts but classified that as part of restricted cash.
Note 2: Jinmao, Yuexiu, Powerlong, Agile, GLHK, and Ronshine disclosed their escrow account cash and classified that as part of restricted cash.
Note 3: Longfor does not have any guarantees provided to joint-ventures, associates and third parties for loan facilities.
Source: Company data, CreditSights.

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Given the dampened contracted sales performance for almost all developers last year, and how most have had to repay their debt obligations with internal cash amid a tight funding environment, it is no surprise that **most of their liquidity positions have worsened, with only a handful still possessing adequate liquidity as of FY22.**

In the dark blue column of the chart above, we adjusted their unrestricted cash/short-term debt ratios to exclude any escrow account cash. Cash held in their escrow accounts can only be withdrawn at certain stages of project completion and may not be freely-used for debt repayment purposes. In the light blue column, we adjusted their liquidity ratios for both the escrow account cash, and included any guarantees provided to JVs, associates and third parties in the short-term debt. Only the stronger 'higher quality" developers like Longfor and COLI still possess adequate liquidity.

To summarise, we still remain cautious on the sector, and we think its road to recovery is likely going to be a long and bifurcated one.

Chinese banks are supposed to perform more "national services" to support the real economy in a downturn. However, they are faced with several constraints which have weakened their ability to do so.

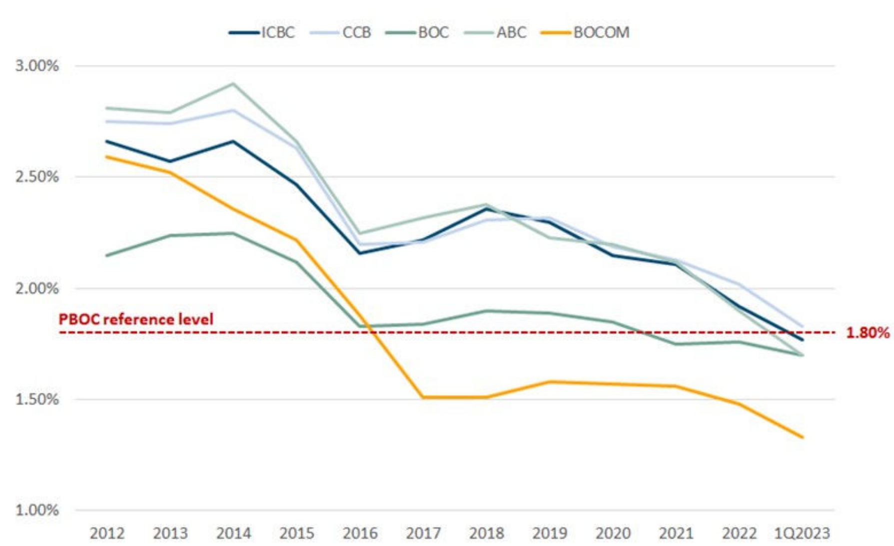
Record Low NIMs Lead to Profit Growth Challenges

Profit growth will be the main challenge for Chinese banks in FY23.

Net interest margin (NIM) compression pressure comes from:

- Loan repricing
- Lower new loan yields/weak loan demand
- Elevated deposit rates – though being targeted down
- Rising funding costs in the Big 5 banks' overseas and onshore foreign currency businesses

Chinese Big 5 Banks: NIM Trend in the Past Ten Years



8 Source: Company data, CreditSights

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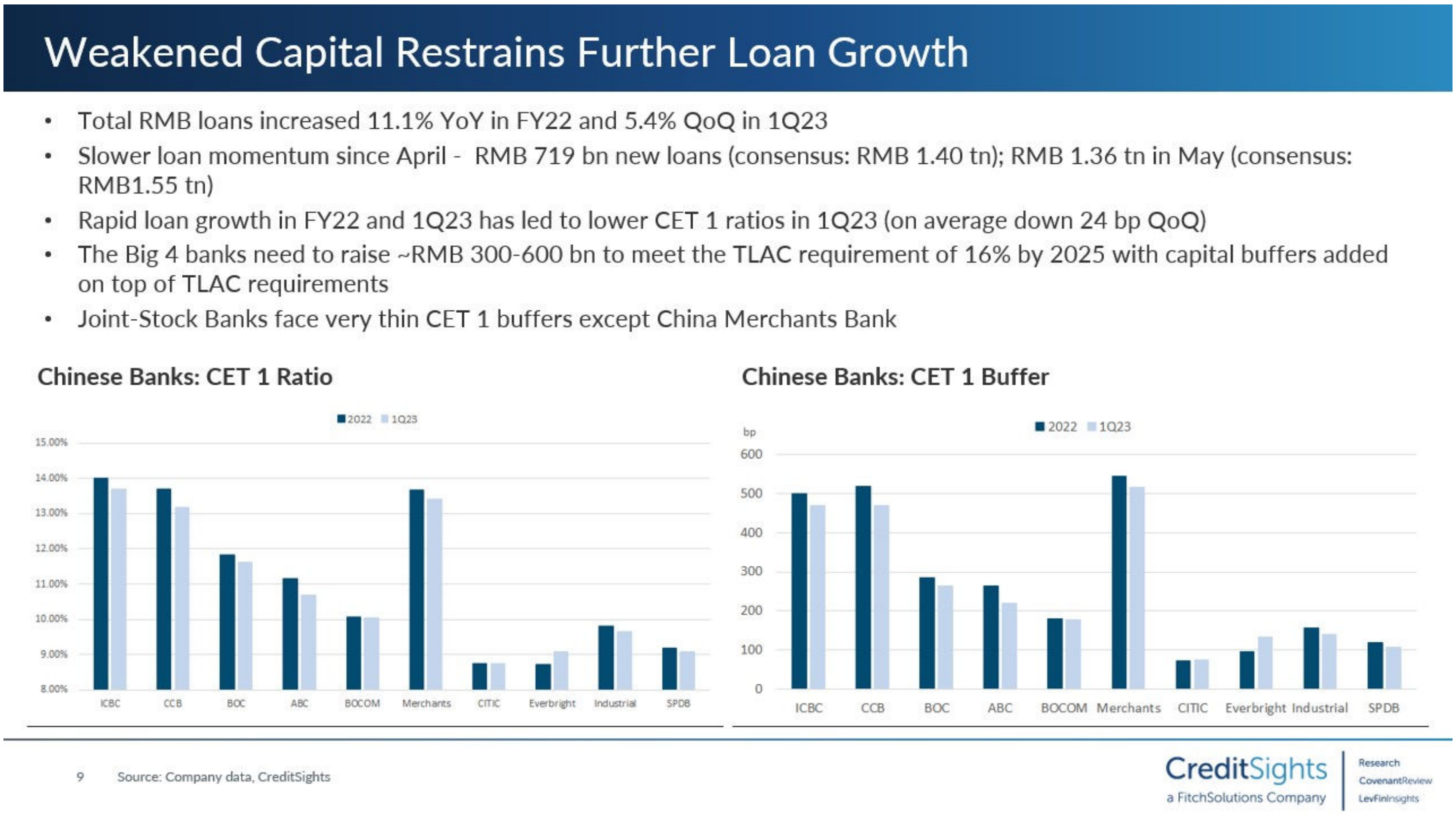
Firstly, profit growth will be the main challenge for many Chinese banks this year, primarily due to NIM compression. As shown in the chart, Chinese banks' NIMs have been on a downward trajectory since 2014, slightly rebounding between 2016 and 2018, but have been declining again. Except CCB, NIMs of all the other Big 5 banks were below 1.8% as of 1Q23 which is the reference level required by the People's Bank of China in its new rating standards for commercial banks.

NIMs have been under pressure due to many factors - loan repricing as a result of several rounds of LPR cuts, lower new loan yields to support the economy, elevated deposit rates which are currently being targeted down by Chinese authorities, and rising funding costs in the Big 5 banks' overseas and onshore foreign currency businesses.



The second constraint comes from banks' weakened capital which restrains further loan growth. The loan growth momentum was very strong in FY22 and 1Q23. However, credit growth significantly slowed down in April and May, partially due to the accelerated front loading of lending in 1Q, while we believe capital constraint is also a likely factor.

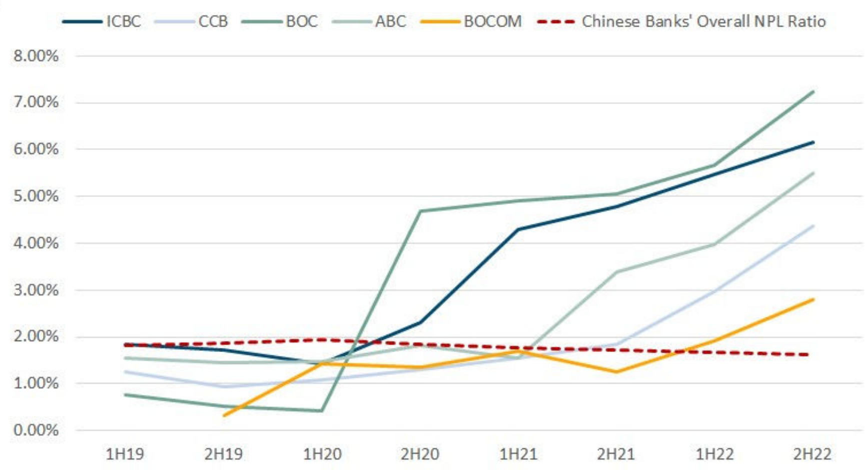
Rapid loan growth, combined with weaker profit growth, has put Chinese banks' capital under pressure. The CET 1 ratio of the whole banking sector fell 24 bp QoQ in 1Q23 and the Total CAR dropped 31 bp QoQ.

The CET 1 buffers are very tight at the non-Merchants joint stock banks. While the Big 4 banks have a comfortable CET 1 buffer, they also face great pressure to meet TLAC requirements and need to raise RMB 300-600 bn per bank before 2025. Separately, several city and rural level commercial banks have decided not to redeem their onshore Tier 2 bonds this year, as their capital ratios would fall below required levels if they redeemed.

Property Asset Risk Continues

- Gross NPL ratios of Chinese banks seem to have stabilized, but the property sector NPL ratios have not yet shown positive signs
- The rising ratios have not reflected property loans that have been extended
- Banks are told to further extend the loans post the original one-year extension
- Harder to dispose of property sector NPLs

Chinese Big 5 Banks: Real Estate Sector NPL Ratio



10 Source: Company data, CBIRC, CreditSights

Finally, we cannot underestimate property asset risk. Although the gross NPL ratios of the banking sector seem to have stabilized, the property sector NPL ratios have not yet shown positive signs. The real property NPL ratios could be even higher as they have not reflected property loans that have been extended, which are mostly classified as special mention loans on the banks' balance sheets.

Chinese banks were encouraged to extend property loans due within 6 months by one year in Nov-22, and as banks are seeking regulatory guidance on how to handle the loans post the extension, recent onshore news has said that the banks have been told to further extend the loans by another 12 months. These extended loans will remain an overhang for Chinese banks until the property market sees a meaningful recovery.

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