

18 December 2017

Asia-Pacific

# China

## How different are the impacts on SOE and POE companies when it comes to default and involuntary changes in management?

### Objective of this study

We look at the impact on Chinese corporates when there are defaults and mandatory replacement of management. We compare the impacts of the two situations on SOEs and POEs.

For default events, we relied on bond data from Bloomberg. We know that there will be more cases in bank lending, but we do not have a reliable sources to dig out the details.

For changes in management, we followed various sources: from government websites to media content.

### Layout of the study

We first look at the universe of bond defaults, then go into details of the trends, industries, whether defaulted SOEs are State-owned Assets Supervision and Administration Commission of the State Council (SASAC), what factors are leading to defaults and what happens after defaults.

We then look at companies that do not have bond defaults but had mandatory change in management. We try to draw some conclusion on factors leading to the management change, and impacts on the SOE and POE.

### Summary of results

We found that China had a smaller bond default rate compared with US and Europe. A number of insolvency cases in China did not lead to massive bond defaults because most of the borrowers had not tapped the bond market.

In terms of impacts, the two situations are very different on state-owned enterprises (SOEs) and private-owned enterprises (POEs) in China because the root causes of the events were different.

Most corporates continued to operate after bond defaults, which were largely the result of overcapacity and overexpansion. Only in a few default cases did the issuers go bankrupt. It is also worth noting that 32% of the defaulted issuers had participated in real estate projects though those were not their core businesses. Instead of bankruptcies, companies have entered long discussions with bond holders. It is likely that SOEs have been waiting for government reforms. POEs have been negotiating with bondholders to restructure repayments.

For involuntary changes in management, all of the cases were related to corruption. Impacts on SOEs and POEs were very different. SOEs have been business "as usual" after their management was replaced by other Party members. But POEs could stop operating or run at a loss or be absorbed by government because their owners disappeared/were detained, etc. The damage depends on the size and business nature of the POE.

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# Section 1

## Impact of defaults on China SOE and POE

In this section, we draw on the lessons of recent SOE and POE defaults, including impacts on the companies.

China had a lower default rate than the US or Europe

First, we would like to find out where China stands on bond default rates compared to major economies. We found that China had the smallest default rate (0.64%) by bond issuers for bonds issued between 2005 and September 2017 compared to the US (1.22%) and Europe (0.78%). However, in terms of amounts defaulted per issuance, Europe had the smallest ratio (0.0299%) followed by China (0.0332%) and the US (0.0473%).<sup>1</sup>

Fig 1 Comparison of bond defaults in the US, Europe and China

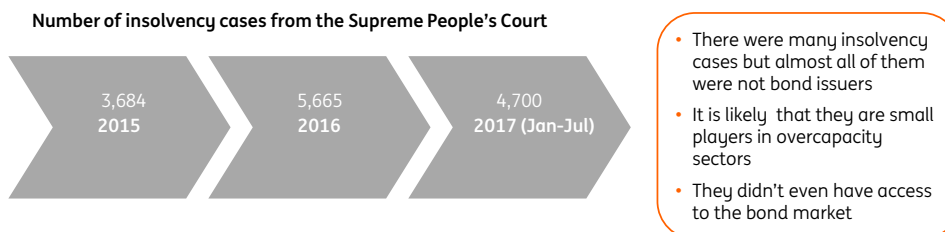
Economy	US	Europe	China
Number of issuers that issued between 2005 and Sep 2017	9,679	12,801	7,599
Amount issued (USD eqv)	146,536bn	98,731bn	36,400bn
Number of issuers defaulted their securities	118 issuers defaulted on 388 securities	100 issuers defaulted on 199 securities	49 issuers defaulted 96 securities
Ratio of issuers that have defaulted their securities	1.22%	0.78%	0.64%
Amount outstanding (USD eqv)	69.3bn	29.5bn	12.1bn
Amount outstanding / Amount issued	0.0473%	0.0299%	0.0332%

Source: Bloomberg, ING

More cases of insolvency than bond issuance. Those insolvency should be smaller companies that do not have access to bond market issuance

Focusing on the Chinese market, we see more cases of insolvency than bond issuance. The number of insolvency cases were 5,665 in 2016 and 4,700 in Jan-Jul 2017. However, these insolvency cases did not lead to significant bond defaults in China because most of these borrowers were too small to gain access to the onshore and offshore bond markets. The increasing number of insolvency cases of small companies is likely to be the result of supply-side reforms to clean up companies in overcapacity sectors, eg, coal, steel, cement, panel glass.

Fig 2 China's universe of insolvency cases



Source: Fitch, ING

<sup>1</sup> Issuers' economy are defined by their country of risk as well as their ultimate parent's country of risks. This include onshore and offshore bonds issuance.

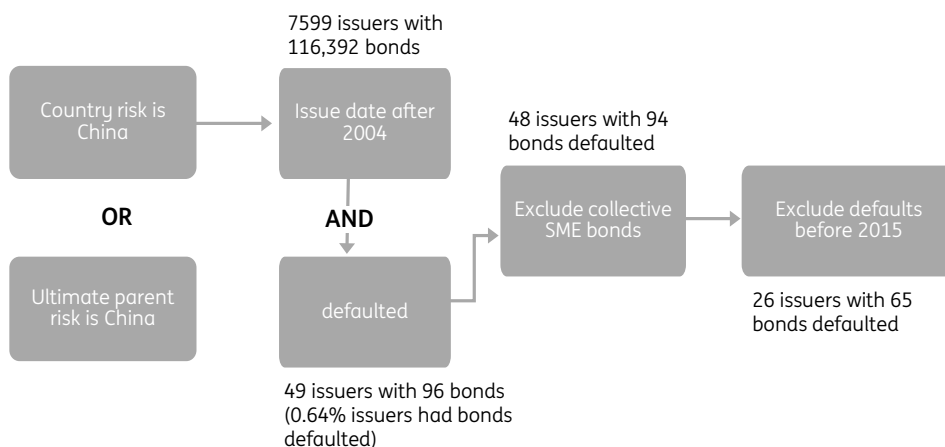
When defining our target group of defaulted issuers in China, we keep in mind the relevance of past cases. Historical defaults that are unrelated to today's economic situation may not be relevant to this consideration, when supply-side reforms only started to yield results in 2015. These reforms have changed the credit quality of many corporates. Therefore, we filter out default cases that took place before 2015.

We find 26 issuers that have defaulted on 65 bonds, that were issued after 2004.

We filter out defaults before 2015 to draw lessons that are applicable to today's economic situation as supply-side reform escalates

**Fig 3 Bond selection criteria**

- Objective of this exercise is to draw lessons from recent default cases
- We filter out cases before 2015 because reforms have changed credit quality of corporates



Source: ING

We find 26 issuers that defaulted, of which 14 POEs, 11 SOEs and 1 Collective

Among the 26 defaulted issuers, there were more POEs than SOEs. But as SOE issuers tend to issue more than POE issuers, there are more bonds defaulted from SOEs than POEs because when an SOE issuer defaults on one of its bonds, the rest is likely to fall into a technical default. The outstanding amount of the defaulted bonds was CNY48.2bn, 65% of which from SOE issuers.

**Fig 4 Overview of issuers that defaulted on bonds**

26 issuers defaulted 65 bond between 2015 and Sep 2017	Collective	SOE	POE
No. of issuers	1	11	14
No. of bonds defaulted	2	38	25
Repayment after defaults	0	0	3 paper from 2 POE (2 papers from the same issuer were repaid in full)
No. of bankruptcy	0	2	1
Amount outstanding	CNY1.6bn	CNY31.4bn	CNY15.2bn

Source: ING Bank, Bloomberg

SOEs were more likely to have repeated issuance than POEs, a signal of lax financial discipline, in our view

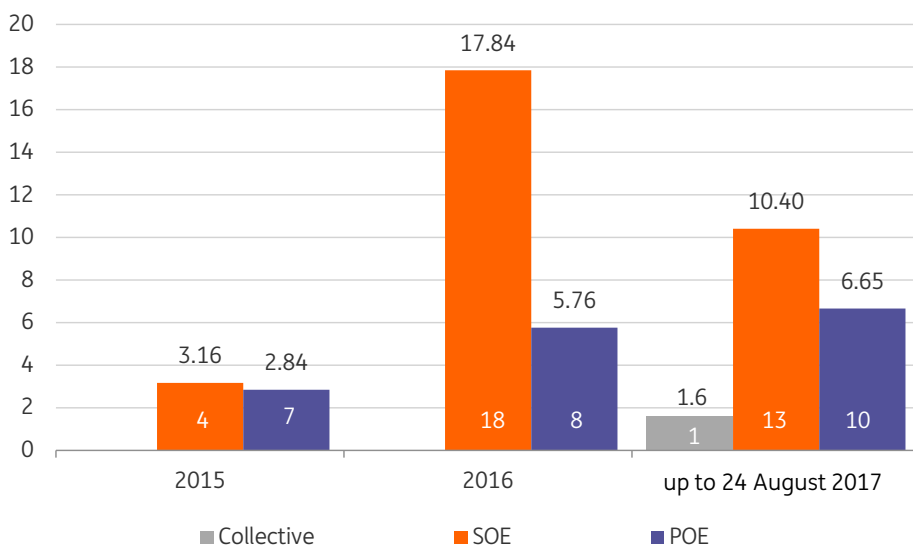
It is worth noting that SOEs had more repeat issuance than POEs. Funds raised by SOEs were, according to prospectuses, usually used for “working capital” or “operation” purposes, where POEs usually had a more specific objective, eg, to fund a project (though it could be beyond a POEs core business into real estate, we will discuss that later). This suggests that SOEs have lower financial discipline. The use of funds could in fact be used to repay bank loans or for projects that could be intended to achieve directions set by the government.

We found that once the bonds defaulted, there was little chance that there would be a repayment. However, this does not mean that the companies were registered as being bankrupt or were restructured, most of them have continued to operate. As we will see, most of the issuers entered into long-term discussions with bondholders.

The number of issuers that defaulted on bonds rose in 2016. Dominated by SOEs, but POEs have been catching up

As the government’s supply-side reforms escalated in 2016 (including setting higher quotas for the numbers of factories to be closed down in overcapacity industries), increasing numbers of SOE bonds defaulted in 2016. POEs have been catching up on this bond default trend in 2017.

**Fig 5 The trend: 11 SOE and 14 POE issuers defaulted 65 bonds between 2015 and August 2017 (CNYbn)**



**The trend:**

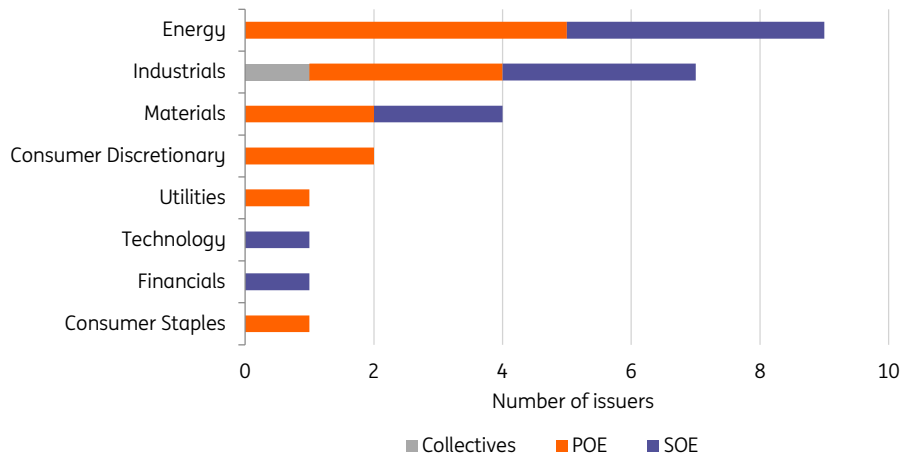
- SOEs default peak could be over as 2016 saw was the clean up of overcapacity.
- Defaults by POE issuers have picked up in 2017

Data indicates the number of issuers that defaulted on bonds  
Source: Bloomberg, ING

Bond defaults directly impacted by central government’s supply-side reform to clean up overcapacity sectors

It is clear to us that bond defaults since 2015 have been driven by the government’s supply-side reforms. Companies in the supply-chain of overcapacity sectors have also been affected in terms of the accumulation of account receivables and, therefore, tight cash flows.

**Fig 6 Supply-side reforms have dictated which sectors have experienced defaults**



- Energy/industrials/materials sectors faced oversupply
- Competition drove the bottom line to a loss
- Impact of supply chain hurt downward companies as account receivables built up, cash flow became tight

Source: Bloomberg, ING

SASAC subsidiaries and local SASACs had a higher chance of default than Large Key SOEs under SASAC or Central SASACs

SASAC subsidiaries and local SASACs do not appear to be that safe after all. Among the defaulted SOEs, only one was not in the category of SASAC subsidiaries and local SASACs.

No Central SASACs default cases

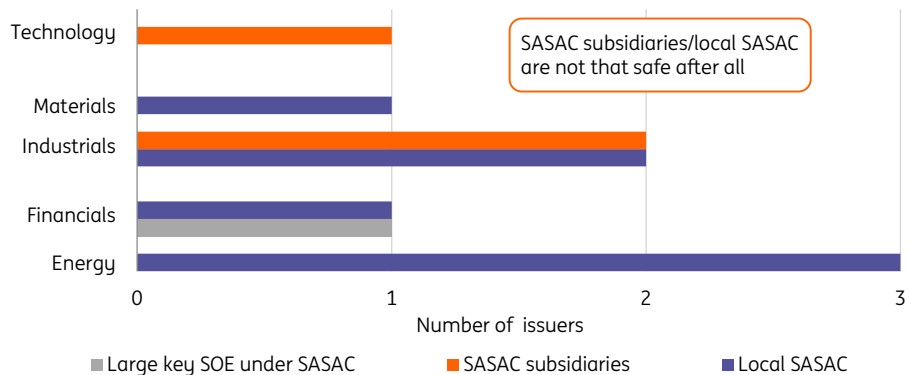
But none of the defaulted issuers fell into the Central SASAC's category, and there was only one issuer under the list of Large Key SOE under SASAC administration.

Size of local SASAC may not be a positive credit quality indicator

Thus, statistically, SASAC subsidiaries and local SASACs had a higher chance of default than Large Key SOE under SASAC or Central SASAC.

Among local SASACs, defaulted issuers tended to be the largest companies in the sector at the local level (provincial or municipal). This might have given investors a sense of security. However, as the largest companies, it could be a result of overleverage.

**Fig 7 Differentiation between Large Key SASAC and local SASAC**



Source: ING Bank, Bloomberg

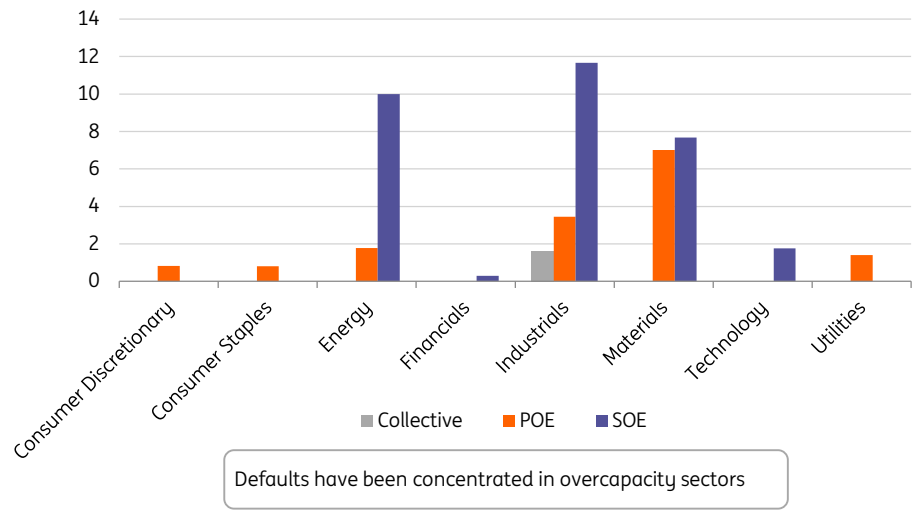
Losses of CNY48.3bn between 2015 and September 2017. Future potential losses (from the same defaulted issuers) would be CNY15.5bn from Sep 2017 to 2022.

In terms of loss from defaults, this totalled CNY48.3bn between 2015 and September 2017. Most of this loss came from the industrial sector (35% of total), followed by materials (30%) and energy (24%). This is a direct outcome of cleaning up overcapacity sectors.

Among the defaulting issuers, 6 of them still had outstanding un-matured bonds. 3 out of the 6 issuers are SOEs. The maximum potential future losses from these outstanding

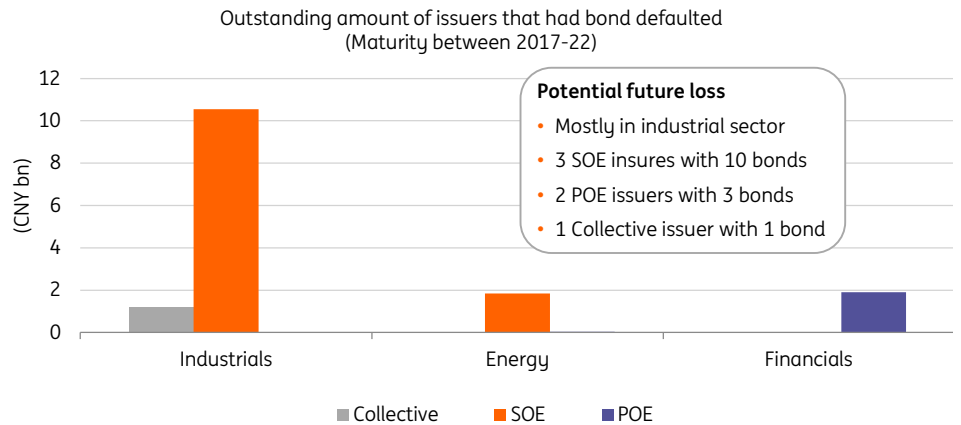
issues would be CNY15.54bn between September 2017 and 2022. Most of these defaults would be in the industrial sector.

**Fig 8 How much loss has been incurred? (CNYbn)**



Source: Bloomberg, ING

**Fig 9 Bonds still to mature issued by defaulting issuers**



Source: ING

Supply-side reform is ongoing. Expect increased numbers of defaults from other overcapacity industries

One real estate developer avoided 'default' record by converting its bond

We should be aware that supply-side reforms are still ongoing. The positive clean-up experience from the coal and steel sectors is likely to be copied to the remaining overcapacity sectors, for example, cement and panel glass, in 2H17.

One property developer (Kaisa) defaulted on its bonds in 2015 by missing a coupon payment. But the bond subsequently became a convertible bond. This shows that 2015, when real estate developers faced difficulties, they could find ways to avoid a 'default' record.

## Case study

### Kaisa from default to removing the default record

It is possible to remove the mark of default in a company's history.

According to Bloomberg, Kaisa became the first Chinese builder to default on dollar bonds in 2015, issuing US\$3.03bn worth of notes on 21st July 2016 in exchange for its debt and loans. It also paid consent fees to creditors before 1st Aug. 2016 for supporting the debt plan in March.

The plan called for Kaisa to issue five series of new high-yield debentures worth US\$2.77bn and US\$259m of mandatory exchangeable bonds to repay note holders and lenders, with maturities between 2019 and 2021.

Creditors would also participate in US\$16.3m worth of so-called contingent value rights, or an incentive plan tied to the builder's market capitalization in the future.

Kaisa's 8.875 percent dollar notes due in 2018, on which it defaulted in April 2015, traded at 82.4 cents on the dollar to yield about 21 percent on 15th July 2016. At the depth of its crisis, the notes slumped below 30 cents on the dollar in January 2015.

However, we do not think that this solution back in 2015 would apply today. The impact on the property market of news of a property bond issuer defaulting, would be too strong a message send to a "bubbly" property market. And we believe that is why the central government allows property developers to look for offshore funding when they need to repay their debts.

During supply-side reform, government allows SOEs to fail if in overcapacity industries

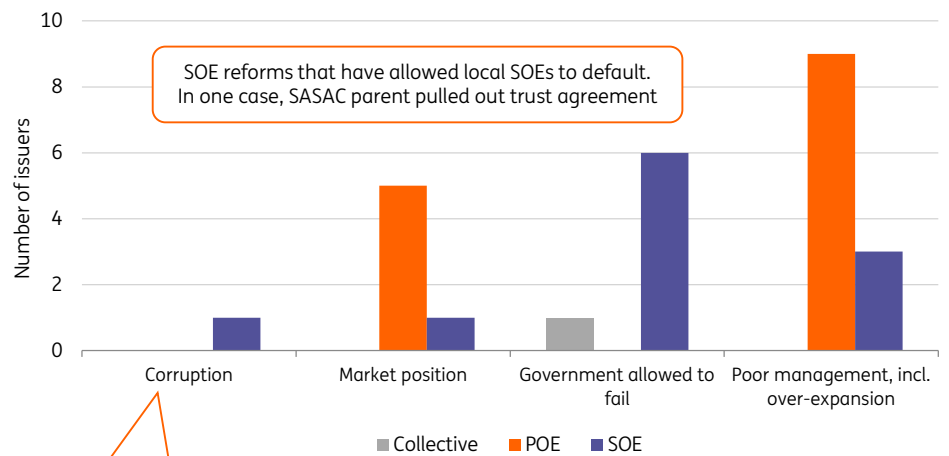
Some POEs entered sectors in uptrend after 2009 stimulus that led to overcapacity

Although there was only one case of a real estate developer defaulting, there have been many more companies entering real estate development even when not part of their core business. Some got hurt. We will come back to this later.

We found that more than half of the SOEs defaulted because governments allowed them to fail, which is a result of SOE reform. For POEs, they were either in overcapacity sectors (when those sectors seemed to have good prospects, especially so following 2009 fiscal stimulus) or overexpanded their business.

Corruption was found to be a rare default reason. We will look into this in the second section.

**Fig 10 Attributes of issuers that had bonds defaulted**



SOE reforms that have allowed local SOEs to default. In one case, SASAC parent pulled out trust agreement

Corruption was a rare default reason on paper... This topic will be discussed in the next session

POEs were more likely to have been positioned in the wrong segment (segments under clean-up reform) and over-expanded businesses to other sectors (tried to become conglomerate), ended up over-leverage with tight cash flows

Source: Bloomberg, ING

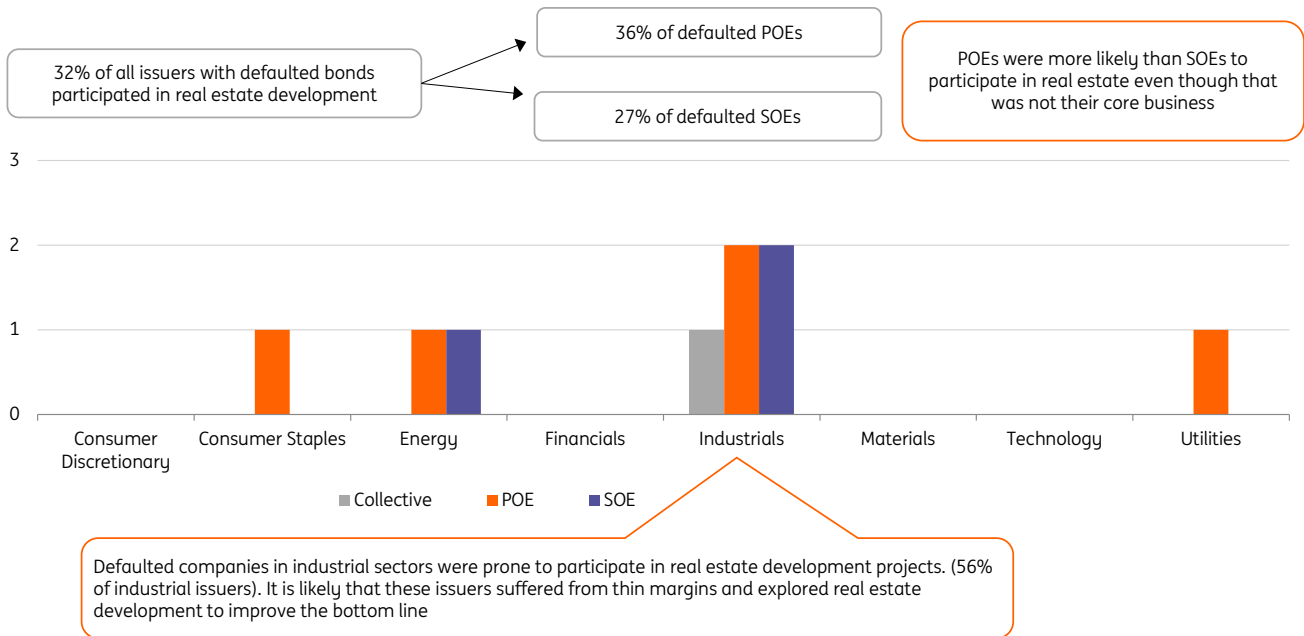
Though few real estate developers among the defaulted issuers, 32% participated in real estate developments, which could have added pressure to default

We were curious that most real estate developers had avoided bond default. So we took a closer look at the defaulted issuers for whom the core business was not real estate. We found that 32% had participated in real estate developments (information sourced from company websites and media).

POEs were more likely than SOEs to get into real estate development projects. Issuers in industrial sectors were more likely than issuers in other sectors to expand to the real estate development sector. This could be due to thin profit margins of their core business.

In early 2013, residential property prices rose, which could have attracted those issuers to expand out of their core business and into real estate development. Then home prices fell throughout 2014-15. This added extra tightness to cash flows for those issuers, especially given the backdrop at the same time as the overcapacity clean-up.

**Fig 11 Participating in real estate could also be reason of default**



Source: ING Bank

Bond defaults usually mean 'business as usual'

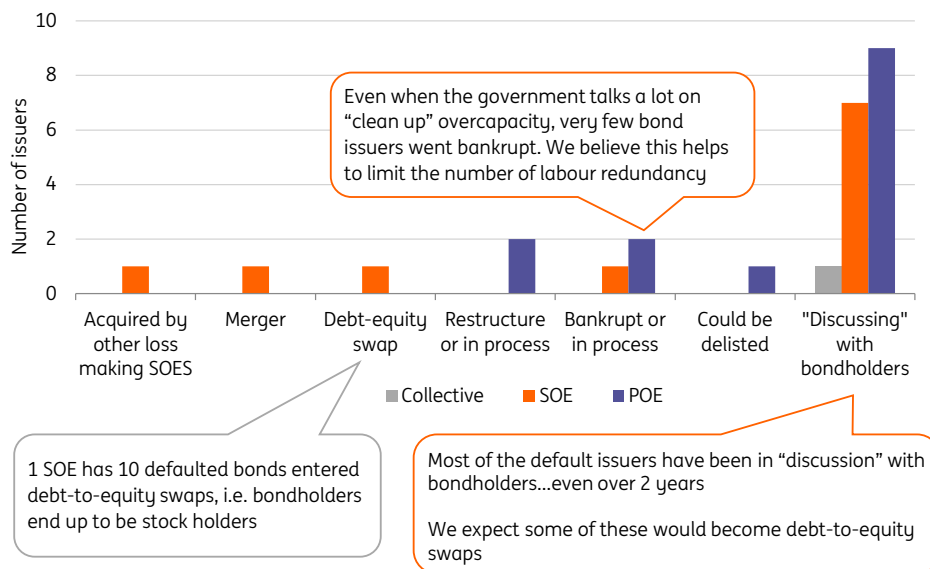
Even if an issuer defaulted, it has not always led to restructuring or being registered as bankrupt. Instead the issuer has often simply entered discussions with bondholders. To date, most have operated 'business as usual'.



SOEs may be waiting for government's arrangement of SOE reform

POEs have tried to negotiate with bondholders but discussions have been long

**Fig 12 After default, restructuring or bankruptcy does not always follow, but debt-equity swaps are more common among defaulted SOE issuers**



Source: Company websites and media, ING

It is likely that SOEs are waiting for further news on the government's arrangements for SOE reform. While POEs have continued to negotiate with bondholders for restructure.

Specifically for SOEs, only one issuer of the 11 defaulting issuers has taken a haircut. Dongbei Special Steel, which is a local SASAC, had one of its bonds haircut by 78%. Bondholders could choose to enter debt-to-equity swap schemes and to become shareholders of the 78% portion.

## Case study

### Dongbei Special Steel restructured via market practice

The process of going from bond default to restructure could be murky. According to *The South China Morning Post*, Dongbei Special Steel failed to repay 10 batches of corporate bonds worth CNY7.1bn (US\$1bn) since March 2016, leading to more than a year's legal battle between the company and 1,911 creditors, including state-owned banks, local lenders and small investors. At the time of the defaults, Dongbei Special Steel refused to release timely financial data to its bond holders, leaving them uninformed. During restructure negotiations, banks, representing the biggest group of creditors, made the key decisions with local government. For example, the profitable assets of Dongbei Special Steel, including its Shanghai-listed Fushun Special Steel unit, were excluded from the restructuring. This made the bond haircut even deeper than reported (78%). Small investors were put aside in the process because banks had agreed with local government on the haircut and restructuring, leaving smaller investors essentially no choice but to vote 'no' to the plan. Debt restructuring is murky but the precondition from local government is that the restructuring should mean 'no lay-offs' of workers. The plant never ceased operations, despite repeated bond defaults.

It is possible we will see further haircut cases because central government has stopped financing loss-making SOEs, especially if they are in the overcapacity sectors. Haircuts combining debt-equity swaps, mean SOEs must face market rules with no government funding to back them up.

Debt-equity swaps could be more common for SOEs that have defaulted on their bonds

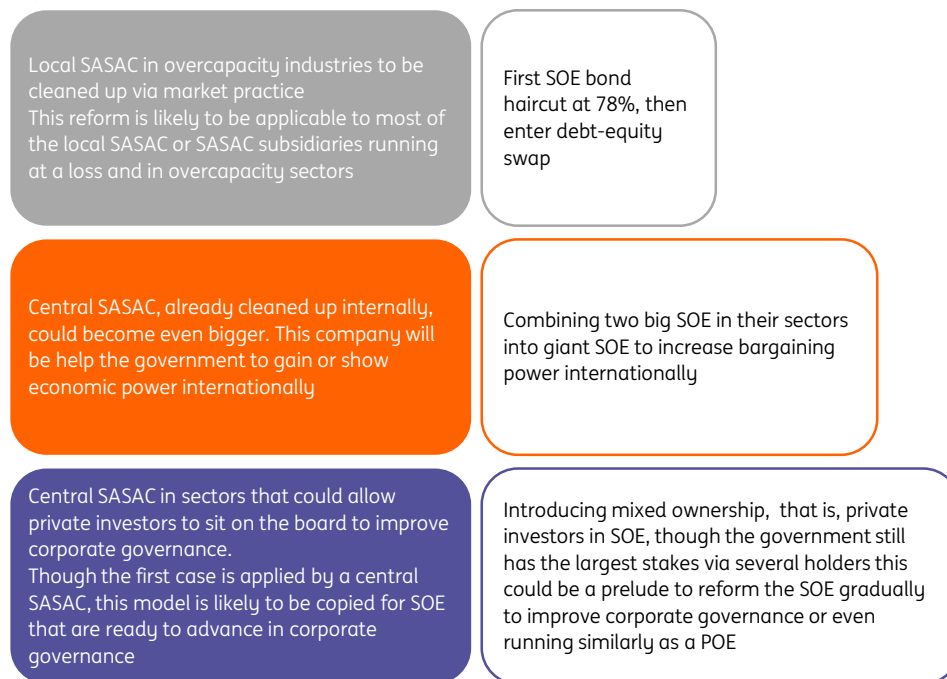
Debt-equity swap schemes usually are dollar for dollar conversions at the inception of the swap. Investors in the swap scheme would benefit if stock price of the issuer rise in the future and vice versa. The swap scheme is usually put into a special investment vehicle, which has other investors, eg, state-owned asset management companies, which we believe provide a final cushion to investors of the swap if many swap cases turn sour in the future.

All in all, investors suffer from a loss of coupon and/or principal when there is bond default. The difference in loss between an SOE issuer and a POE issuer is that SOE issuers can provide an additional solution of debt-equity swaps, though there is no regulation stating that POEs cannot do likewise.

This is one of the three types of SOE reform that we have seen from recent examples.

SOE reforms are creating changes in the structure of companies as well as the credit quality of the companies

**Fig 13 Three major SOE reforms from recent examples**



Source: ING

Another example is combining two big central SASACs into a giant central SASAC. The objective of this is highly likely to increase negotiation power in the international platform. But the clean-up process of the two big central SASACs was done behind closed-doors and we did not see any defaults.

The third type of SOE reform is mixed ownership reform by introducing private shareholders onto the board. This is being trialled to see how it might improve corporate governance and business strategies of the SOE. Though the first case was China Unicom, which is a central SASAC (with the objective of improving business strategies with e-payment platforms operators, including Alibaba and Tencents), we expect smaller SOEs, ie, non-central SASACs, are likely to enter mixed ownership reform. We believe that in the future, smaller SOEs entering such reforms may end up having corporate governance similar to a POE, or even that the government would sell stakes to private investors to offload some of them to POEs if the SOEs are not in national strategic industries.

## Section 2

### Impact on companies when no bond default but mandatory changes in management

Non-event cases therefore no single source of information...

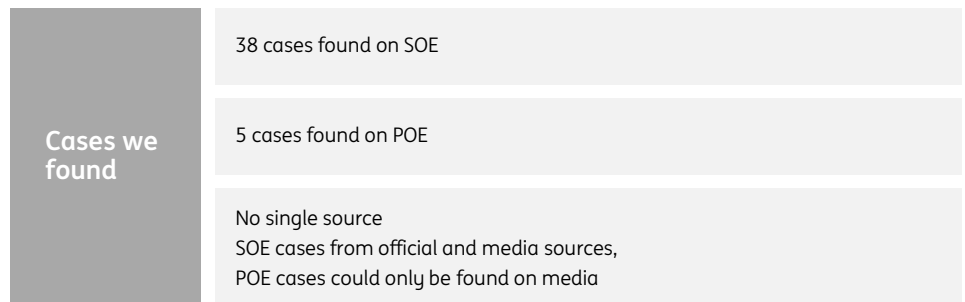
...we rely on government websites and media reports

In this section, we consider companies that have experienced involuntary changes in management. For SOEs, this occurs following direct orders from government. For POEs, the original management, usually the owner, has disappeared or been detained or jailed.

These cases have no bond defaults. Since they are 'non-event' cases, we could not rely on a single source to locate them. We rely on government websites and media reports.

We find 43 companies where there has been an involuntary change in management, 38 of which are SOEs and 5 are POEs.

**Fig 14 No single source to locate non-default cases**

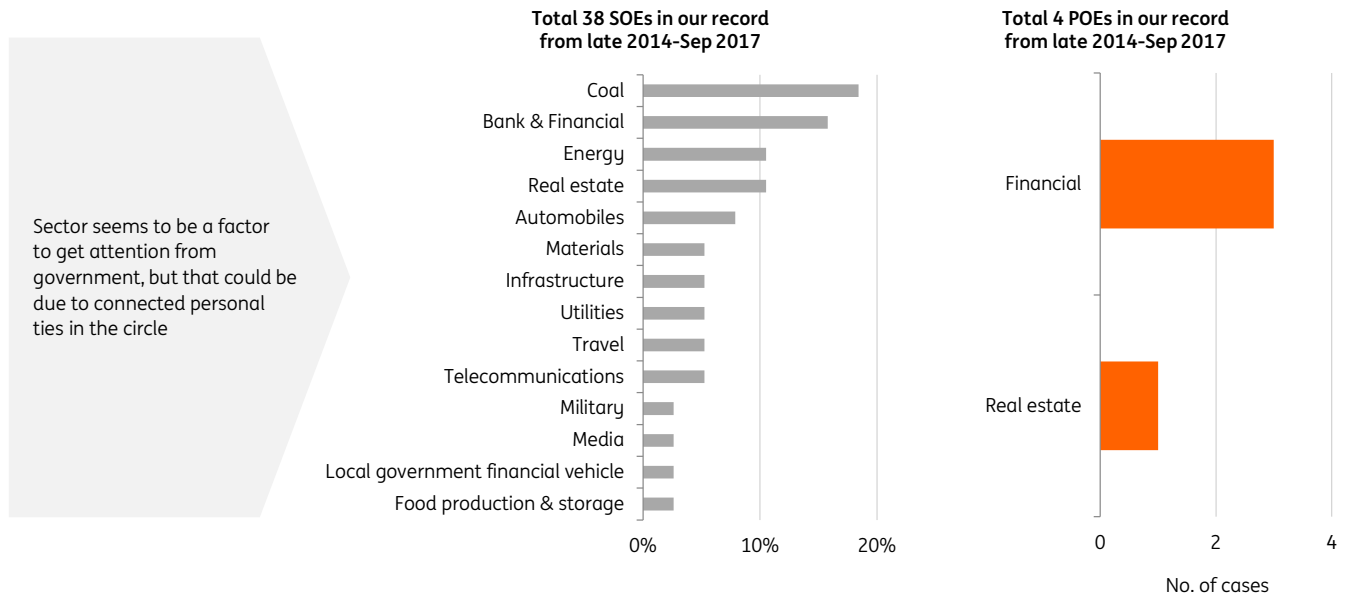


Source: ING

Industry could be a factor in these cases... but we found that personal ties were probably more relevant

By industry, the default case companies are usually in the coal, financial, energy or real estate sectors for SOEs, and financial and real estate sectors for POEs. But the pattern is not as obvious as in the study of bond defaults; we find these cases are more likely to be related to personal ties within the companies.

**Fig 15 Industry may not be the factor**



Source: ING

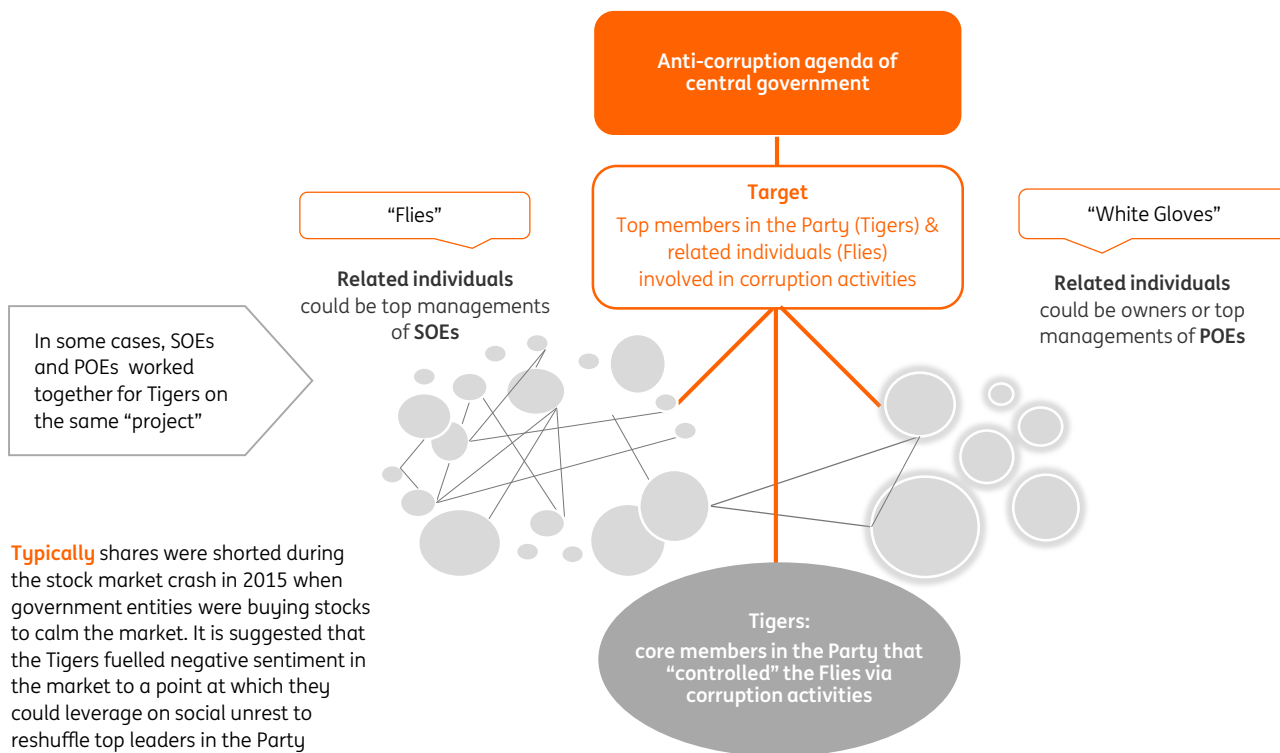
Originating from anti-corruption campaign; personal ties were inter-related among SOEs and POEs

We find that the government's anti-corruption campaign is likely to be the reason behind sudden and forced changes in management at the SOEs and POEs involved. Involuntary replacement of SOE top management, including Chairman, General Manager, CEO, appears to be related to corruption activities in all cases. Management

consisted of Party members that either received monetary benefits or political advancement. They have been labelled as “flies” who worked for “tigers”, who are still at the top of the Communist Party.

POE owners, who had personal ties with government officials, worked for the “tigers” and in some cases, are related to corruption scandals of SOE management. These POE owners have been seen to disappear suddenly, be detained or jailed. They are labelled “white gloves”, or agents for the “tigers” who can thus keep themselves “clean” from corruption cases.

**Fig 16 Forced changes in management likely to be the result of the anti-corruption campaign**



Typically shares were shorted during the stock market crash in 2015 when government entities were buying stocks to calm the market. It is suggested that the Tigers fuelled negative sentiment in the market to a point at which they could leverage on social unrest to reshuffle top leaders in the Party

Source: ING

SOEs and POEs experienced very different consequences as a result of involuntary changes in management.

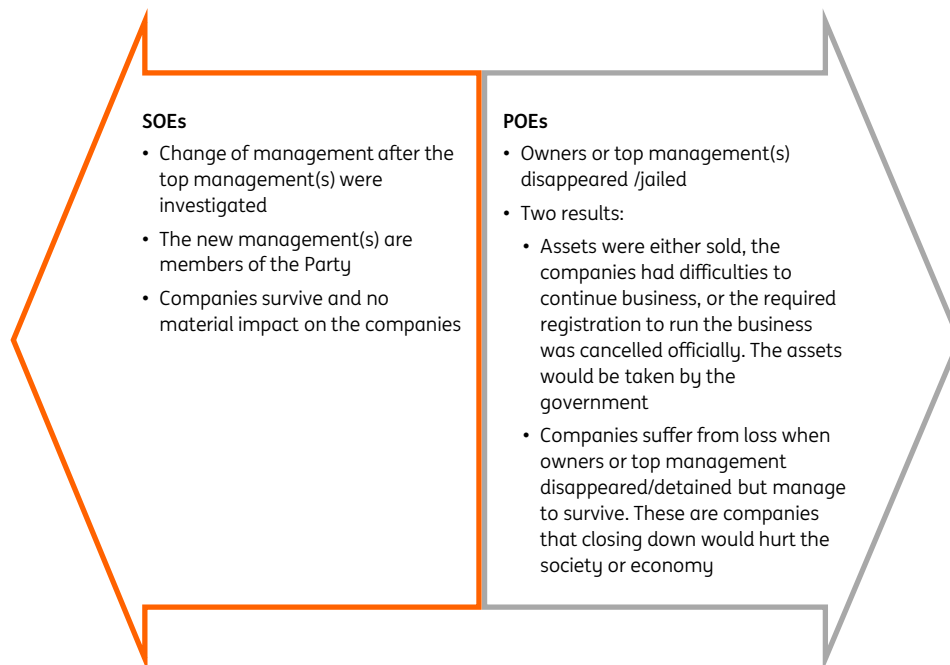
Change in top management has had no material impact on SOE businesses...

SOE businesses have experienced no material change following a change in top management charged with corruption. The Party replaced top management with other Party members, and the SOE businesses have continued as usual. Some of these SOEs might enter reforms (mergers) but we believe this would be more likely to be because this was already within the plan for reforms.

...but POE businesses have been negatively affected; the impact depends on the size of the POE

However, POEs in which “white gloves” have been identified could see their businesses closed, or operating at a loss, or being absorbed by government. Some smaller POE businesses have encountered administrative difficulties. For large POEs, the companies have typically suffered losses when the owners disappeared or were detained but these companies have managed to continue to operate. Owners could be released after several years of “disappearance”. The differing treatment of POEs may be due to the government evaluating that the cost to society (on employment) and the economy (loan defaults) could be too large.

**Fig 17 Impact on companies – big differences between SOEs and POEs**



Source: ING Bank

**Conclusion**

In this study we considered the impact on SOEs and POEs when there were bond defaults or involuntary changes in management.

In the bond default study, we found that there was lower risk of default compared to the US or Europe. There were more POE than SOE defaults. SASAC subsidiaries and local SASACs were at greater risk of default than Large Key SOEs. We found zero default cases of central SASACs in the sample. We note that bond defaults have largely been government reform-driven as supply-side-reform was aimed at cleaning up overcapacity industries. Participation in property development, which was not the core business of the company, would increase the probability of default.

After defaulting on their bonds, SOEs await government decisions on SOE reform, which could be a combination of haircut and debt-equity swap. POEs have entered into long discussions with bondholders for restructuring.

Overall, investors have suffered from a loss of coupon and/or principal when there was a bond default. The loss difference between an SOE issuer and POE issuer is that the SOE issuer could provide the additional solution of debt-equity swaps.

Concerning involuntary changes of management, we find that all cases were related to the anti-corruption campaign. Unsurprisingly, this had very different impacts on SOEs and POEs. SOE businesses usually only had their top management replaced by new Party members assigned by the government. However, POE businesses could encounter administrative difficulties in continuing their business. For large POEs, the companies suffered losses when their owners disappeared or were detained but managed to survive. It could be that closing down such companies was viewed as hurting society or the economy too much.

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