Jack Rodman

Senior Advisor, Crosswater Realty Advisors

September 20, 2016

CROSSWATER
REALTY ADVISORS

China - The Big Picture

- Slowing economy in manufacturing and overcapacity in materials (steel, cement, coal)
- Number of Chinese companies with more debt than equity rose from 705 to 913 in 2015
- IMF Financial Stability Report: 20% non-financial companies cannot service their current debt
- Increase in # of companies defaulting on bonds; China Bond Guarantee Insurance fund is stressed meeting obligations
- Corporate indebtedness is biggest risk to economic recovery - SOE debt to GDP 115%

Chinese Banks

- Big 4 banks wrote-off 130.3 billion yuan ($19.5 billion) of bad loans in 1/H 2016 to improve future profits by eliminating deteriorating loans
- UBS reported 2013-2015 banking sector got rid of 1.8 trillion yuan ($270 billion) of bad loans
- Banking stocks plunged 20% in FYE 2015 and trade below net book value despite rise in 2016
- In 2016 banks began to cut staff to improve profit margins. Net Interest Margins (NIM) are at all time low
- Issuance of relatively low cost/risk mortgages to prop-up housing produces further downward pressure on NIM

Chinese Banks

- 2016 government promoting bank shares on Shanghai-Hong Kong Connection to raise price to book ratio; 0.8 times at FYE 2015
- UBS estimates an additional 4.5 trillion yuan of bad loans ($700 billion) need to be included in estimates on non-performing loans
- China official NPL ratio of 1.75% understated:
  - IMF estimates NPL ratio at 15%
  - CLSA estimate NPL ratio at 15% to 18%
  - Macquarie/BIS/CEIC estimate NPL ratio is 20%

Chinese Banks

- Special Mention Loans are growing faster than NPLs as banks ignore 90 day delinquency rule
- “Zombie” companies kept alive by extend and pretend practices
- IMF estimates that if NPLs were provisioned at 50% of book bank value, balance sheets could incurr loss of 1 trillion yuan
- Banks cannot raise additional equity capital until their price to book equals 1.0 times by regulation
- As NPL write-offs increase and banks are forced to the capital markets to raise new equity, existing shareholders will be diluted

The NPL Scene in 2016

- Despite mounting pressure from corporate defaults, banks are slow to increase provisions to facilitate write-off of bad debt

- In 2015-1H/2016 only a handful of portfolio sales were open to public bids

- In 2015 the Big Four AMCs bought 80% of the bad loans sold by banks (368 billion yuan) and are considered a preferred buyer

- Recently formed Regional AMCs (27 in total) accounted for only 5% of the NPL purchases because they cannot resolve difficult loans

- Reluctant to hold large NPL portfolio auctions, banks return to "securitization" to get rid of their NPLs sold via the interbank market

The NPL Scene in 2016 - What's In and What's Out

- China will allow domestic banks to issue up to 50 billion yuan ($7.7 billion) of asset-backed securities backed by their NPLs
- Bank of China executes first bad loan securitization since 2008, selling 301 million yuan of bonds backed by 1.25 billion yuan of bad assets
- Once off BoC balance sheet these loans are now classified as “investments” the investor (mostly small banks) book

The NPL Scene in 2016 - What's In and What's Out

- Chinese banks are using "Channel Loans" to shift NPLs off balance sheet to non-bank (shadow banking) financial entities through complex use of intermediary structures

- Mid-sized banks have rapidly grown their balance sheets with these so-called investment products which carry lower provisions and defaults are not deemed NPL

- Banks classify these loans as "debt receivables" not loans. Debt receivables last year grew 63% to 14 trillion yuan ($2.14 trillion)

The NPL Scene in 2016 - What's In and What's Out

- Debt to Equity swaps are back in favor from 1999 when President Zhu Rongji had AMCs acquire debt and convert to equity 601 promising SOE's

- Moody's estimates that SOE's account for liabilities totaling 115% of China's GDP

- 20% to 25% of these SOE's will require a debt restructuring plan, favoring debt to equity swaps

- Bank of Dalian raised approximately 18 billion yuan of new equity by swapping bad debt of 10 billion yuan with China Orient AMC and giving Orient controlling (50.29%) interest in the bank

Policy and Regulatory Changes

- Government is moving to make it more difficult for Chinese entities to move RMB off-shore in complex foreign exchange arbitrage-2015 saw $1 trillion move off-shore
- State Administration of Foreign Exchange (SAFE) eases rules to allow distressed debt investors to repatriate income from their NPL investments
- Purchasers of NPL-backed securities are members of the interbank bond market; foreign institutions can now participate in this market, if properly registered
- New FDI system effective October 1, 2016 will eliminate MOFCOM approval for FIE incorporation unless business is listed on Nationwide Negative List

What to Expect 2H/2016

- Pressures resulting from increase in bad loan provisions and negative impact on net interest margins will force banks to increase NPL disposal and raise new equity

- Banks will continue to use off-balance sheet techniques like Channel Loans and Securitizations over open market loan sales

- Debt to Equity swaps will continue for mid-size banks requiring re-capitalization as well as SOE bond defaults

- Government efforts to increase price to book value will allow banks access to the capital markets to raise equity

- China will continue to "kick the can down the road" despite dire warning of a catastrophic debt bubble by IMF and smart investors like George Soros and Wilbur Ross!!

Mid-Year 2016 Real Estate Summary

- As China's inventory of unsold housing is a national problem; officials are encouraging banks to increase low cost mortgages to soak-up supply
- According to GAVEKAL research firm housing inventories are estimated at 2 years of sales mostly in 3rd to 4th tier cities
- Unsold commercial (retail) and office property will take atleast eight years to digest according to Gavekal
- Commercial inventories at 1 billion square meters (10 billion SF)
- Office inventories at 270 million square meters (almost 3 billion SF)

Retail Property Trends Turn Negative

- Developers built retail into thousands of high-rise residential towers in anticipation of a shift to a consumer driven economy
- Concurrently growth in retail spending shifted to online away from traditional retail channels (brick and mortar)
- Local governments planning on the shift to a consumption driven economy led localities to encourage (via land use policy) more commercial property development outpacing residential
- Mixed-Use "trophy projects" have grown rapidly and Knight Frank estimated in 2014 that by 2016 a total of 1000 projects equal to 430mn sqm will come online
- Slower family formations and demographic changes are not helping the shift to more consumption

CROSSWATER
REALTY ADVISORS

T 213 629 9901
C 206 766 0252
rodman.china@gmail.com
tleary@crosswateradvisors.com