Non-Banks Financial Institutions - China

Key takeaways on the Roundtable discussion on China AMCs

Credit Analysis

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Adequate onshore liquidity to ensure low repayment risk

We held a conference call on 2 February with Moody's, China investors, and BofA equity analyst on China Asset Management Companies (AMCs). Overall, our guest speakers believe the AMCs could get adequate low-cost funding from Chinese commercial banks, as well as the bond market in China onshore. The offshore bond repayment risk is very low. Government support is also likely to be strong, and our guest speakers – who are USD bond investors – find it is difficult to differentiate the support level across AMCs. The speakers share the view the that the fundamentals remain challenging in 2024 given the economic downturn. It is still necessary to differentiate AMCs by their fundamentals.

Rating implications of sovereign rating and shareholders

Moody's has downgraded the AMCs because of the weak government support so, from a forward-looking perspective, the sovereign rating may not have direct implication on AMCs' rating now. This is different from the big China banks carrying negative outlooks now. Moody's found it is difficult to discuss the rating implication for potential shareholder change with no official confirmation and no deal details. If the shareholder could provide capital injection and liquidity support, the credit rating would benefit.

Strong government support and supportive funding profile

Our guest speakers from China investment firms believe government support on AMCs remains strong, to prevent systemic risk. This is more important than avoiding the moral hazard during the current economic downturn. On funding profile, our guest speakers believe some of the AMCs' capital-market practices, such as changing brand name and certain accounting treatments, target to meet the lending criteria of China onshore financial institutions. Along with the lower interest rates and a strong demand for yield in China onshore, assuming the major AMCs issue bonds onshore currently, the funding cost could be only 3.5-4.0% at most. In this sense, the offshore perception is less important. Overall, the changes are credit-positive, as the low-cost onshore funding channel could reduce the offshore USD bond repayment risk significantly.

Earnings remain challenging, but repayment risk very low

Our equity analyst gave a brief introduction of the evolvement of AMCs' business model and consensus. From a forward-looking perspective, it is still difficult to be optimistic from an earnings perspective, given the sluggish top-line growth and elevated impairment loss expected. However, the USD repayment risk is still low. The weak profitability may not even impact the capitalization substantially. The USD bonds investors do not need to be concerned too much about the default risk in the coming two to three years.

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Negative outlook driven by fundamentals, not sovereign

Moody's recently downgraded four China AMCs by one notch and set the issuer ratings of China Huarong and Cinda at Ba1 and Baa1 with negative outlook, respectively, and rated the unlisted China Orient and Great Wall at Baa1 and Baa3, with negative outlook and review for downgrade, respectively. The downgrades were mainly triggered by the weaker government support expected. After the downgrades, the support uplift varies across the four AMCs from four to six notches. That said, the weaker government support has already been factored into the downgrades. From a forward-looking perspective, China's sovereign rating with negative outlook is unlikely to have a direct impact on the AMCs' rating. This is different than China's big banks, which have the same rating as the sovereign. The current outlook for the AMCs is driven by the stand-alone ratings amid different macroeconomics, e.g., the downturn of property sector. On the positive side, Moody's also notes that the commercial banks still keep adequate credit lines to AMCs, indicating the low liquidity risk of AMCs. Moody's also discussed the HY rating of China Huarong, and it adjusted off the gain from the equity investment in CITIC Ltd. and found the equity base could fall to negative. Further, Huarong has changed its name to CITIC AMC. This change is not meaningful in Moody's view. So it seems Huarong does not fit the criteria of an IG company.

Shareholder change complex topic, needs more details

Regarding the news on shareholder change at the three AMCs, Moody's found it is difficult to discuss the rating implication. The changes are not confirmed by any official channel. More importantly, for any shareholder change, many other factors could still affect the credit rating. Also, the rating agencies generally do not look only at the shareholders to decide on level of government support uplift, but also need to see the actions followed by the shareholder change. For example, for Huarong to be merged into CITIC Group, the financial consolidation still has not happened. This negatively impacted the government support evaluation. In contrast, if the new shareholder could provide capital injection or similar kind of support, the credit rating outcome could be more supportive. With no details on the deals, it is first difficult to foresee the credit rating implications and, second, it is difficult to compare Huarong and those three AMCs.

To prevent systemic risk, gov't support remains strong

Our guest speakers from China investment firms believe the government support on AMCs remains strong. Also, it seems a bit difficult to give a quantitative measure for government support across different AMCs. The fundamentals are different, but the government support could be similar. The investors also believe saving select distressed financial institutions (FIs) could lead a moral hazard, especially when FIs have corporate governance concerns, e.g., alleged corruption. However, if those FIs cannot get timely support and see significant credit events, there could be systemic risk to China's financial sector. Our guest speaker overall believes the systemic risk is more important than moral hazard amid the current economic downturn. So, government support should still be strong for AMCs.

Funding environment could further improve for AMCs

One of the key comfort factors, which is the same as Moody's observed, is that AMCs could get adequate funding from commercial banks in China onshore. Our guest speakers note some accounting treatments are debatable, as well as the perspectives on changing brand name could be different. While those changes are significant for some China onshore FIs as the AMCs could fit better their lending criteria after those changes. As a matter of fact, it is one of the key purposes of AMCs to have certain corporate actions/accounting treatments, to improve the funding profile onshore. Along with the lower interest rates and a strong demand for yield in China onshore, assuming the major AMCs issue bond onshore currently, the funding cost could be only 3.5-4.0% at most. In this sense, the offshore perception is less important. Overall, the changes are credit-positive, as the low-cost onshore funding channel could reduce the offshore USD bond repayment risk significantly.

More fundamental research needed to differentiate AMCs

Our guest speakers believe the valuation of Asia credit is generally not attractive vs. that of developed market (DM). While the AMCs with wider spread have better value than Asia BBB-rated peers. The supply from AMCs should continue to be small, which means the sector will likely be shrinking going forward. However, there could be alternatives with similar ratings and spread levels in the US and Europe. Further, assuming the portfolio size is big, to buy and hold a position of AMCs may not be of much help for the overall performance. While the volatility could be high for AMCs and consuming many in-house resources. Therefore, although the government support could be strong generally, it does not mean the investors could just ignore the fundamentals and just buy anything available based on the expectation of government support. Bottom-up fundamental research is still needed for securities selection.

Challenging outlook for AMCs earnings in 2024…

Our equity analyst gave a brief introduction of the evolvement of business model and consensus view from an equity perspective. Back in 2010, when China Cinda had the initial public offering (IPO), the equity story was well received by investors with many similar distressed asset management (DAM) companies operating in the DM, such as Blackstone. The only question remained is the conflict of the interests between the commercial banks and AMCs, as AMCs buy distressed assets from banks. While it was not difficult to justify, given AMCs' relatively small size and counter-cyclical nature. From 2010 to 2015, the overall revenue growth of the listed AMC was not as strong as the market expected. This put some pressure on other AMC's IPO plans in 2015. From 2015 to 2018, Huarong, which had IPO in 2015, surprised the market by its high growth. In the meantime, the other AMCs were generally cautious and witnessed a slowing expansion. It was difficult to find a clear rationale behind the aggressive strategy back then. In 2018, the previous chairman of Huarong was taken away for investigation, and other AMCs saw further headwinds in the capital market, with some lasting up until now. The growth was also tepid generally due to the constraints of capital and funding. Amid the economic downturn during COVID, it was still difficult to find any AMCs, including the local AMCs, to provide substantial counter-cyclical support for the distressed sectors, mainly because of the AMCs' small asset base vs. the financials resources needed, e.g., the vast funding needs from the Bao Jiao building projects. From a forward-looking perspective, it is still difficult to be optimistic from an earnings perspective, given the sluggish top-line growth and elevated impairment loss expected.

…but repayment risk low, with no liquidity issues

That said, the equity analyst believes the USD repayment risk is still low. The weak profitability may not even impact the capitalization substantially. For any FIs, the key risk for the creditors is liquidity, and not earnings and capital ratios. Sharing the views with other speakers, the analyst believes the USD bonds investors do not need to be concerned too much about the default risk in the coming two to three years.

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