Credit Research
16 February 2017

#chinadebt

Asia Credit Strategy

Sizing China's external corporate debt

- **China's mounting debt position and rapid credit growth continue to be major concerns, in our view, and are occurring against a backdrop of increasing capital outflows, higher US rates and a stronger USD. We think this raises questions about the sustainability of the growth in China's external corporate debt.**
- **We attempt to identify the various offshore funding channels used by Chinese companies, and then quantify the size of total external corporate debt. We also compare our findings with data reported by SAFE and international agencies. Based on our findings, we believe China's external corporate debt is likely much larger than what has been widely reported.**
- **We estimate total corporate external debt at USD550-650bn (excluding the USD100-120bn due in 2017 and private borrowings), equivalent to19-22% of China's foreign reserves.**
- **If the USD-denominated bond markets are any indication, we estimate that China's external corporate debt could reach USD1trn in the next three to four years. If China's foreign reserves move lower and the CNY weakens over the same period, this would affect borrowers' ability to service debt and, at a macro level, could weaken China's external debt score. We expect this to exert downward pressure on China's sovereign credit ratings; over the next five years we expect these to move at least two notches lower, to A2/A (current: Aa3/AA-).**

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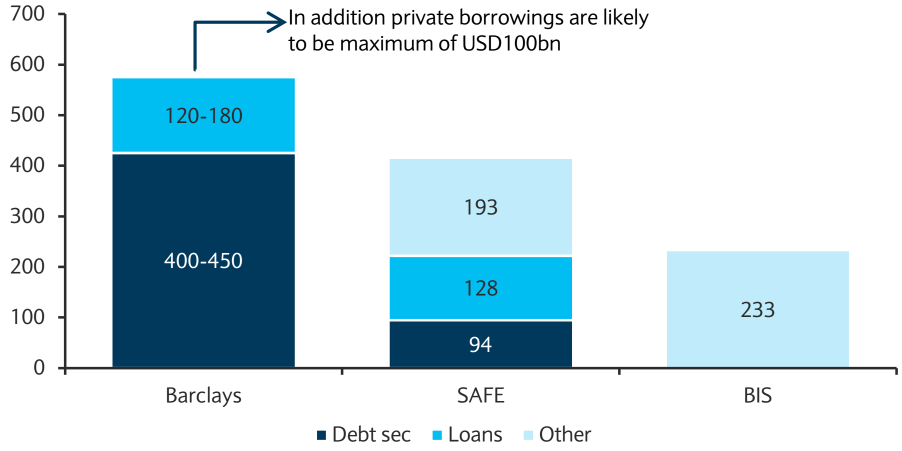
FIGURE 1

Estimates of China's total external corporate borrowings (USD bn, excluding short-term debt)



Note: We exclude short-term borrowings. For SAFE, we include intercompany loans in 'Other' category. BIS does not report the split. Source: SAFE, Bank of International Settlements, Bloomberg, WIND, Dealogic, Barclays Research

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Mounting debt against declining reserves

China's mounting debt load and rapid credit growth are major concerns, in our view. A breakdown of the country's overall debt reveals that the corporate sector has been a key driver of the excessive credit creation (Figure 2). Organisations such as the International Monetary Fund[1] and the Bank of International Settlements[2] have published their findings on China's domestic and corporate debt, including the rate of expansion and absolute size. This rapid credit growth is taking place against a backdrop of increasing capital outflows, higher US rates and a stronger USD, which we think now raises questions about the sustainability of the growth in China's external corporate debt[3].

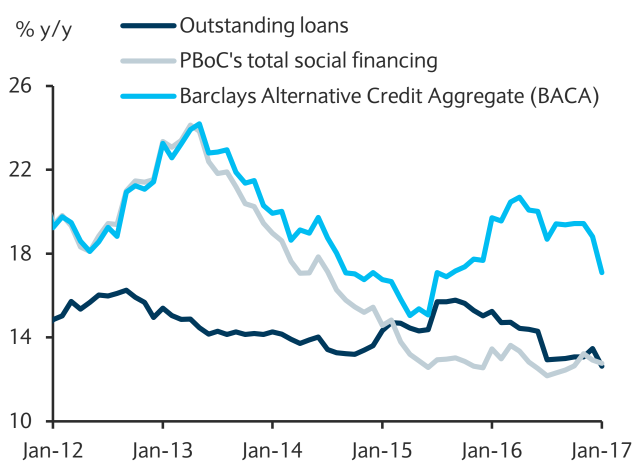
In January 2017, China's FX reserves declined for a seventh consecutive month, to USD2.998bn (Figure 3). However, at a system level, there is limited information on the total size of China's external corporate debt, information that we believe is needed to consider its potential implications, particularly on the country's foreign reserves and FX levels.

We have attempted to identify the various offshore funding channels used by Chinese companies, and quantify the size of China's external corporate debt. We compare our findings with data reported by China's State Administration of Foreign Exchange (SAFE) and international agencies, and conclude that China's external corporate debt is likely much larger than what has been widely reported. We think this may be because some Chinese companies borrow from their offshore arms (such as entities listed in the Cayman Islands or the British Virgin Islands) and then transfer these funds to their onshore entities via equity injections or intercompany loans (Figure 8). In addition, the SAFE and the National Development and Reform Commission (NDRC) do not regulate issuances with Keepwell or Offshore Guarantee structures. We estimate that total corporate external debt currently stands at USD550-650bn (excluding USD100-120bn that is due in 2017), equivalent to 19-22% of China's foreign reserves. This estimate excludes private borrowing given the lack of publicly available data. On our calculations, total external corporate debt is more than USD100bn larger than that reported by SAFE or highlighted in the claims data from BIS.

As such, we expect China's external corporate debt to increase further, especially as the PBoC, NDRC and SAFE have reportedly encouraged local companies to issue more USD

FIGURE 2

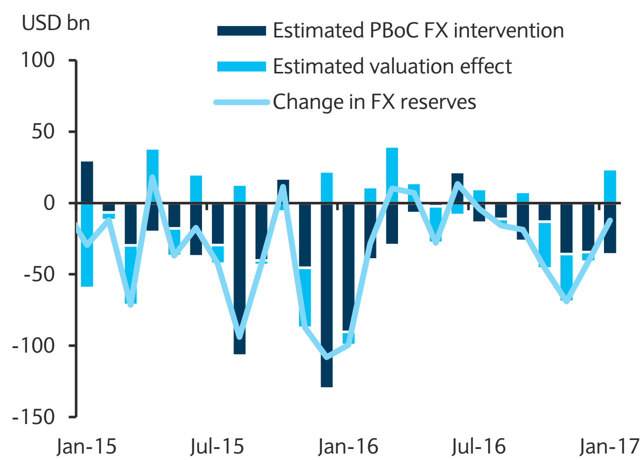
Barclays Alternative Credit Aggregate



Source: Haver Analytics, Barclays Research

FIGURE 3

Change in China's FX reserves



Source: Haver Analytics, Barclays Research

[1] International Monetary Fund, Article IV Consultation, August 2016.
[2] BIS Statistical Bulletin September 2016. "BIS warns China banks risk crisis within 3 years", 19 September 2016.
[3] Refers to debt issued by corporate, SOEs, banks, financial institutions and local government entities.

bonds[4]. If the USD-denominated bond market is any indication (average growth of 24% over the past two years), then we estimate that China's external corporate debt could reach USD1trn in the next three to four years. Over the same period, if foreign reserves move lower and the currency weakens, we think this would affect borrowers' ability to service foreign currency debt and, at a macro level, weaken China's external debt score (especially because much of the corporate debt is issued by state-owned entities, and is treated as contingent liabilities for the sovereign). These factors are likely to continue to exert downward pressure on China's sovereign credit ratings; over the next five years, we expect these to move at least two notches lower, to A2/A (current: Aa3/AA-).

Funding channels in the offshore market

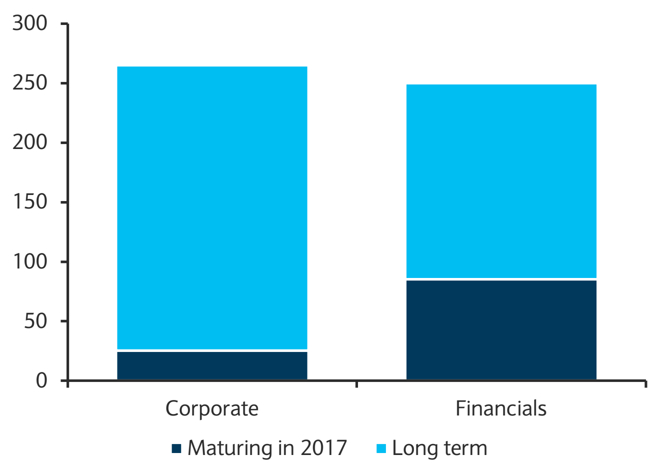
Chinese corporates' presence in the global borrowing markets has expanded rapidly in the past decade. China credit represented only 8.5% of overall Asia credit[5] in 2010, amounting to USD18bn. By end-January 2017, this has grown to USD296bn, representing 46%. Chinese companies raise foreign currency funds through various channels, including the global bond markets[6] (including the 'dim sum' format, certificates of deposit and commercial paper issued by the banks), loan markets[7] (including syndicated loans), and private borrowing. Below, we attempt to quantify the borrowing amounts in these segments, although it is difficult to estimate private borrowings given the lack of publicly available data.

Global bond markets

Offshore bonds comprise bonds issued by corporates, SOEs, banks, non-bank financial institutions, and local government-linked entities. Most of these bonds are eligible for and included in Asian credit indices – as of end-January 2017, there were USD296bn of Chinese bonds in Asian credit indices. These indices exclude bonds issued in other currencies such as the EUR, those with less than USD150mn of debt outstanding, other domestic jurisdictions such as Malaysia and Singapore, bonds that are deemed 'not liquid' by index providers, and those that are placed privately.

FIGURE 4

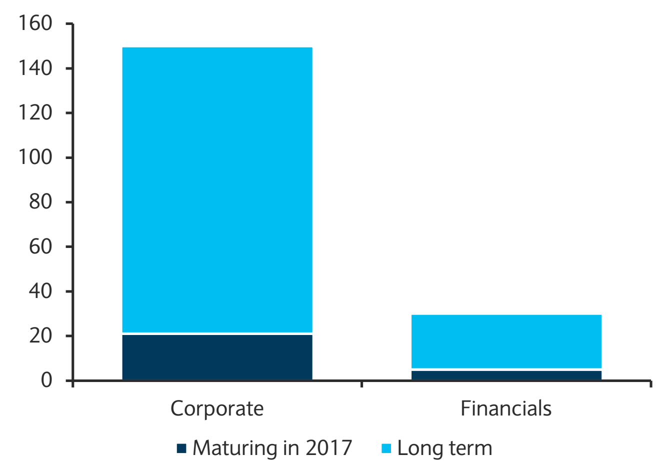
Bonds outstanding of Chinese companies (USD bn)



Source: Bloomberg, Barclays Research

FIGURE 5

Syndicated loans outstanding of Chinese companies (USD bn)



Source: Dealogic, Barclays Research

[4] "PBOC Eases Offshore Borrowing Quotas for Some Companies", Bloomberg, 23 January 2017.
[5] Bloomberg Barclays EM Asia USD Credit Index. Includes only USD-denominated bonds with more than 1y remaining maturity.
[6] Publicly listed issues
[7] Publicly issued loans

Therefore, to better gauge total offshore borrowing through the bond markets, we screen for bond issuances across all currencies (excluding CNY), all bond sizes, all markets of issuance, and all structures (including convertible bonds, perpetual, sinkable), provided that the ultimate country of risk is China. We then exclude certain bonds, such as those issued by Pirelli (even though the company is ultimately owned by China National Chemical Corp [ChemChina]), because we believe such debt is likely to be serviced by the offshore entity. We also adjust for repetition through 144a/RegS structures.

Based on this analysis, we estimate total foreign currency bonds outstanding of Chinese corporates at c.USD500-550bn (as at end-January 2017), comprising USD260-270bn of non-financials, USD245-255bn of financials (mainly banks), and USD7-10bn of CNH structures. Of this amount, close to USD100bn of debt is set to mature in 2017 – 80% of maturities are bank paper including certificates of deposit (CDs).

Chinese banks are active issuers of CDs and commercial paper (CP) in the offshore market. Related to this, Bloomberg[8] reported that Chinese banks (excluding policy and state banks) sold USD145bn of negotiable CDs in January (across all tenors) – this is down 33% from December. However, we think that our USD500-550bn estimate may not capture all CDs as some may not be reported under our criteria. Based on CD syndication data (available on Dealogic and Bloomberg league tables), we understand that USD85bn of CDs across major funding currencies are outstanding (excluding those with less than 1y maturity) – some of these are captured in our USD500-550bn estimate.

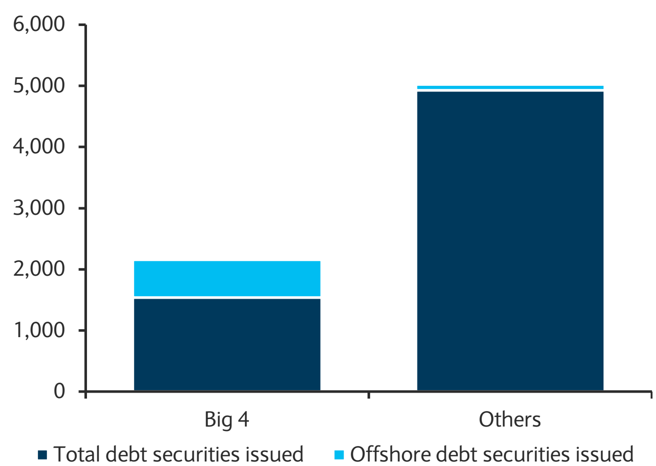
Syndicated loan markets

Offshore loans include direct lending to companies and syndicated loans. In addition, some Chinese companies issue bonds or raise loans from their offshore arms (such as entities listed in the Cayman Islands or the British Virgin Islands), and then transfer these funds to their onshore entities via intercompany loans. The nature of these transactions makes it challenging to get visibility on direct lending (including intercompany).

We screen for syndicated loans made across all currencies (excluding CNY), all sizes, and all structures (including leveraged), provided the borrower is from China. Based on this analysis, we estimate total foreign currency syndicated loans outstanding at c.USD150-

FIGURE 6

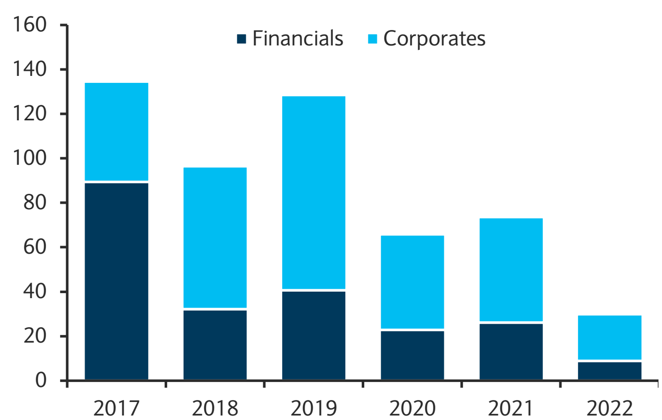
Banks report total offshore debt securities issued (CNY bn)



Source: Company semi-annual reports (1H 16), WIND, Barclays Research

FIGURE 7

Maturity profile of foreign currency China bonds and loans (USD bn)



Source: Bloomberg, Dealogic, Barclays Research

[8] "PBOC Crusade Against Leverage Seen Curbing Bank Debt Spree", Bloomberg, 9 February 2017.

200bn as at end-January 2017 (of which USD25-30bn mature in 2017), mainly comprising non-financials.

Data gaps or discrepancies

Private borrowing

Our estimates exclude private borrowing of loans and bonds. This is due to the lack of disclosures of such transactions. However, we would not expect this component to be significant given that companies tapping this format tend to be of a smaller scale. Our rough estimate, based on our understanding of corporate balance sheets and funding profiles, is that private borrowing could be less than USD100bn.

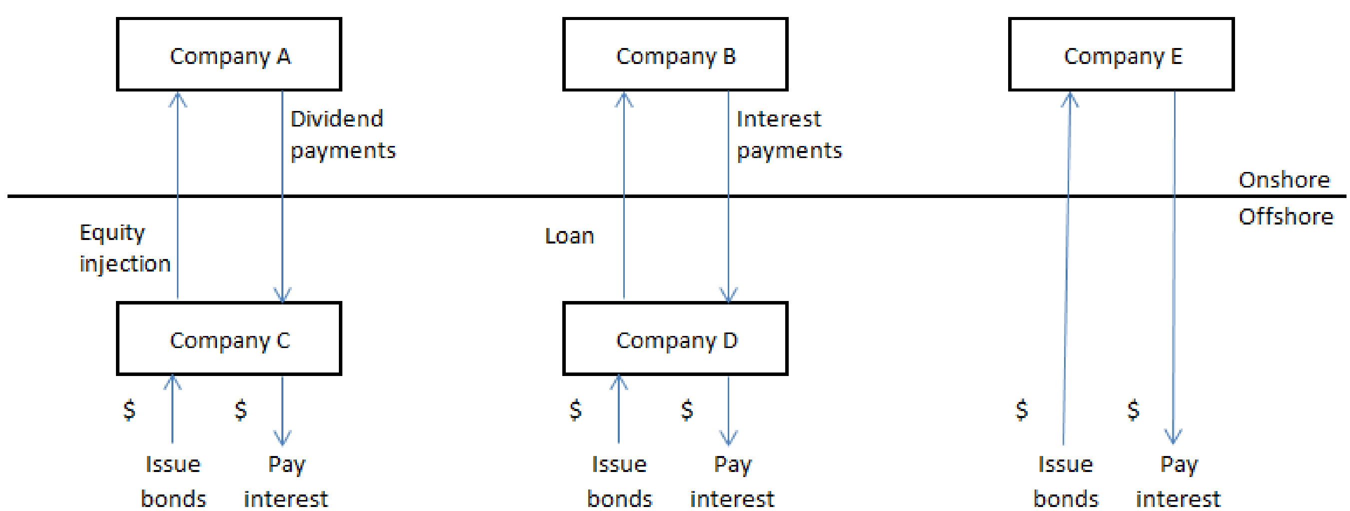
Corporates

As mentioned earlier, some Chinese companies borrow through their offshore entities and then transfer these funds to their onshore entities through intercompany loans or equity injections. The SAFE data suggest that debt transactions between onshore entities and their offshore subsidiaries/branches/joint ventures, including loans, payments and debt, are captured in its reported external data. According to the SAFE's September 2016 data release, this amounts to USD193bn. However, it is not clear to us if this number appropriately reflects the amounts raised and transferred onshore via the intercompany loan channel.

If we assume the bulk of this USD193bn is for corporates, then including long-term borrowings (debt securities and loans) of corporates, the total external corporate borrowing in bond and loan formats would be USD290bn as per SAFE's reported data (Figure 9). This number is smaller than our estimate of USD350-400bn, possibly because the SAFE data does not capture fund transfers in the form of equity injections, or bonds issued under the Keepwell and Offshore Guarantee structures.

FIGURE 8

Typical borrowing structures used by Chinese companies



Source: Barclays Research

Banks

We looked at bank balance sheets to find reported debt numbers and the proportion of offshore debt for the Big 4 banks as well as select mid-sized banks (source: banks' semi-annual reports). Based on this sample set, we found that c.40% and c.2% of debt issued by the Big 4 banks and mid-sized banks, respectively, is foreign currency denominated (mainly USD). We then applied these estimates to the system-wide data available on WIND (Figure 6), and found that of the CNY6.5trn total debt issued by the banks, CNY715bn (equivalent to USD105bn) was foreign currency denominated (as at September 2016). This is slightly lower than our estimate of USD180-200bn, and does not include loans.

Bank of International Settlements – foreign bank claims

We also compared China's external debt with BIS data[9]. According to the BIS data, foreign banks' claims on Chinese entities stood at USD742bn in Q3 16, of which USD509bn was short-dated (up to 1y).

FIGURE 9

SAFE's reported data on China's external debt, September 2016, and our calculations

	Category	USD bn
1	General Government	121
2	Central Bank	67.3
3	Other deposit taking co.	596.9
3.1	S/t	471
3.1.1	Debt securities	44.2
3.1.2	Loan	112.7
3.2	L/t	125.9
3.2.1	Debt securities	76.5
3.2.2	Loan	49.2
4	Other Dept.	404.3
4.1	S/t	292.8
4.1.1	Debt securities	0.2
4.1.2	Loan	28.6
4.2	L/t	111.5
4.2.1	Debt securities	17.8
4.2.2	Loan	78.5
5	Direct Investment: Intercompany loans	242.5
5.1	Debt liabilities of direct investment enterprises to direct investors	193.4
	Total external debt position	**1432**

Most estimates for corporate external debt include (4) and (5). Totalling USD647bn

If we include the bank debt (3) to this number it would be USD1.2tr. Excluding the s/t debt it would be USD430-480bn (based on using (5) or (5.1))

Corporate debt (4.2.1)+(4.2.2)+(5.1) => USD290bn

Financial debt (3.2) => USD126bn

Source: SAFE, Barclays Research

[9] "Consolidated positions on counterparties resident in China", BIS (http://www.bis.org/statistics/b4-CN.pdf)

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