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IDEA

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Asia Credit Strategy | Asia Pacific

Screening the China HY Property Sector for Alpha

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Credit creation in China has remained selective, driving credit dispersion in China HY. We believe that the China HY property sector offers good alpha opportunities. Using three factors from our PCA analysis and land bank concentration, we screen for defensive China HY property credit.

Credit differentiation will be the key theme for Asia credit: As mentioned in What's Going on in Asia Credit, September 26, 2018, we expect divergence in credit quality and increased dispersion in Asia credit to be important themes going forward. This view is supportive of our more cautious view on Asia credit. That said, we do think that this backdrop provides good alpha opportunities in Asia HY, and China property is the key sector since it drives more than 50% of Asia HY market risk.

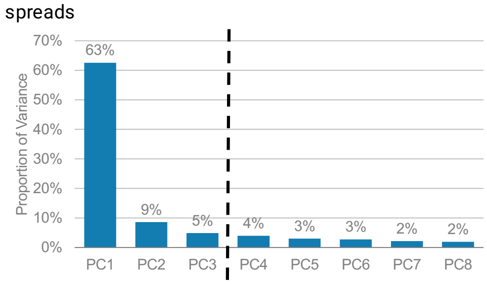
Credit creation in China has remained selective... Despite a strong recovery for China onshore corporate bond net issuance in August, the September number was the weakest since this May. In addition, although we saw an improvement in China's bank loan growth, a lot of this growth is due to bill financing and not medium-to-long-term loans. Hence, it is not clear that corporates (especially small- and medium-sized corporates) are incrementally benefiting from the higher bank loan growth we have witnessed.

...causing even more credit differentiation: Given current tight credit conditions, we are not surprised that defaults continued to pick up strongly in 3Q18. These defaults clearly highlight the importance of credit differentiation, especially for China HY. That said, the good news for investors is that credit dispersion has picked up for China HY sectors compared to the other Asia HY sectors.

Our principal component analysis (PCA) confirms conventional wisdom: Through our PCA, we found that credit quality (63%) is the key driver of China HY property spreads, which makes sense given the idiosyncratic nature of the asset class and sector. Given Asia investors' focus on reducing duration this year, it is no surprise that bond duration (9%) is the second most important factor. Lastly, we believe that trading liquidity (5%) is important due to the backdrop of a higher volatility environment. Putting all three factors together, one would be able to explain close to 77% of the China HY property spread (Exhibit 1).

Screening for defensive China HY property names: Using the three factors from our PCA as a starting point, we can screen for China HY property bonds that fit our more defensive position in Asia credit. On top of these factors, another defensive quality we prefer is China HY property issuers that have high concentration of their land bank in Tier 1 and Tier 2 cities. We started our screen with 31 China HY unique issuers and only four names remain (Exhibit 2).

Exhibit 1: We believe that credit quality, bond duration and market liquidity drive 77% of China HY property spreads



Source: Morgan Stanley Research

Exhibit 2: Screening for defensive China HY property names

No.	ISIN	Company Name	Corp Ticker	Bond Ticker	Ratings	Years to Maturity	Tier 1 & Tier 2 Exposure	Yield to Maturity
1	XS1891434604	Shimao Property Holdings Ltd	SHIMAO	SHIMAO 21	BB-	2.99	61%	6.44%
2	XS1801151371	CIFI Holdings Group Co Ltd	CIFIHG	CIFIHG 21	B+	2.51	76%	8.05%
3	XS1819960136	Yuzhou Properties Co Ltd	YUZHOU	YUZHOU 21	B+	2.56	62%	8.30%
4	XS1811206066	KWG Group Holdings Ltd	KWGPRO	KWGPRO 21	B+	2.81	88%	8.53%

Source: Company data, Bloomberg, Morgan Stanley Research

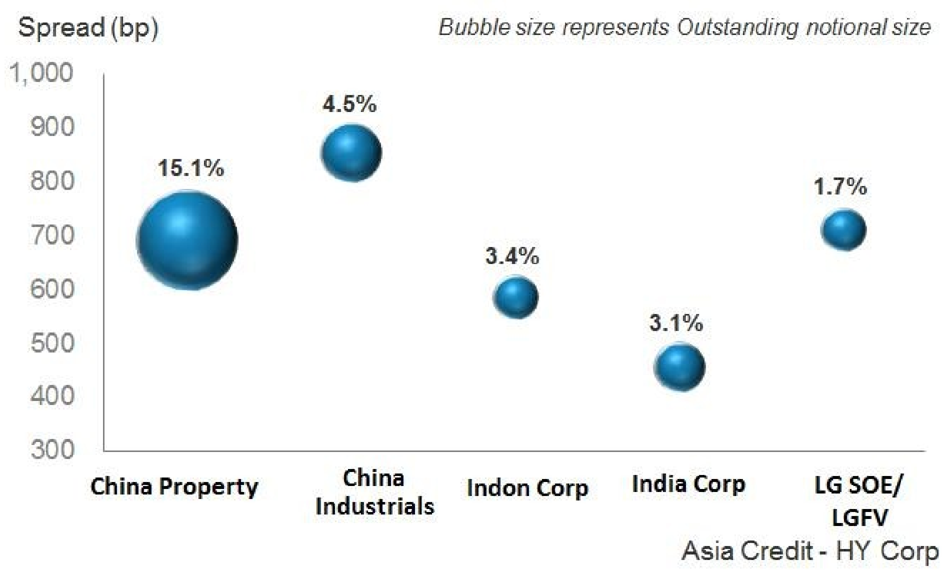
Screening the China HY property sector for alpha

One key theme during our marketing trips in the past month was clients telling us that they are more selective in the credit they are buying. We certainly think that credit differentiation is an important theme, as we wrote in Differentiating on Dispersion, March 14, 2018, warning investors that credit dispersion was going to increase as volatility in Asia credit starts picking up. As mentioned in What's Going on in Asia Credit, September 26, 2018, we expect divergence in credit quality and increased dispersion in Asia credit to be important themes going forward. This view is supportive of our more cautious view on Asia credit (see Not Yet Time to Be Long Asia Credit, August 28, 2018) and our preference to stay up in quality (we prefer Asia IG over Asia HY and China IG over China HY). That said, we do think that this backdrop provides good alpha opportunities in Asia HY that investors can take advantage of, given that credit dispersion is at its most extreme.

It is important to get the China HY property sector right

Since the birth of the Asia HY corporate bond market, China property has been an important sector for Asia HY. The importance of the China HY property sector really took off in 2013 and, five years later, the sector is still the largest driver of Asia HY in terms of market risk (Exhibit 3). We define 'contribution to market risk' as: [notional amount of debt x spread x duration]. The China property sector contributes 15.1% of total Asia credit market risk, which is more than three times that of the second-highest Asia HY corporate sector – China industrials (4.5% of Asia credit market risk).

Exhibit 3: China HY property is currently the largest driver of Asia HY spreads

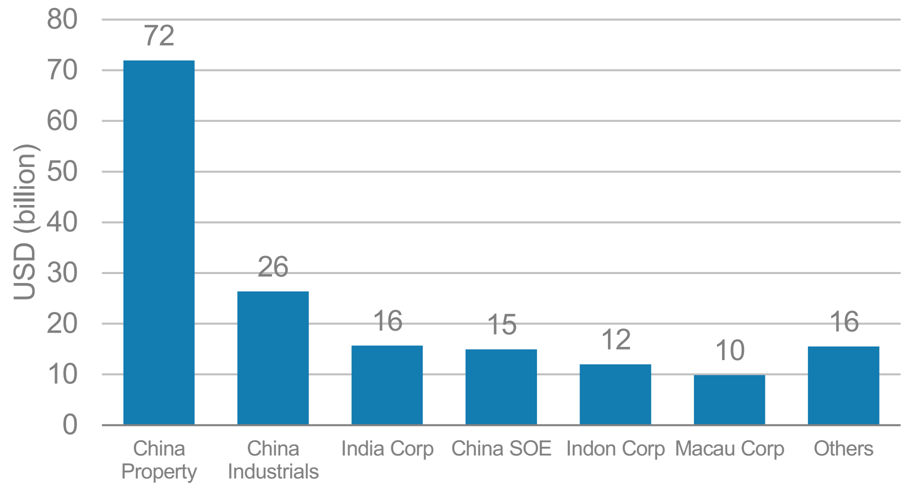


Source: Bloomberg, Morgan Stanley Research

If we compare the current notional outstanding of the China HY property sector versus the other Asia HY corporate sectors, the China HY property sector notional is close to three times that of the second-highest sector. Hence, it is not surprising that the China

HY property sector is the key driver of Asia HY corporate market risk mentioned above, as the sector has a relatively large nominal amount outstanding.

Exhibit 4: China property sector has the largest amount outstanding in Asia HY

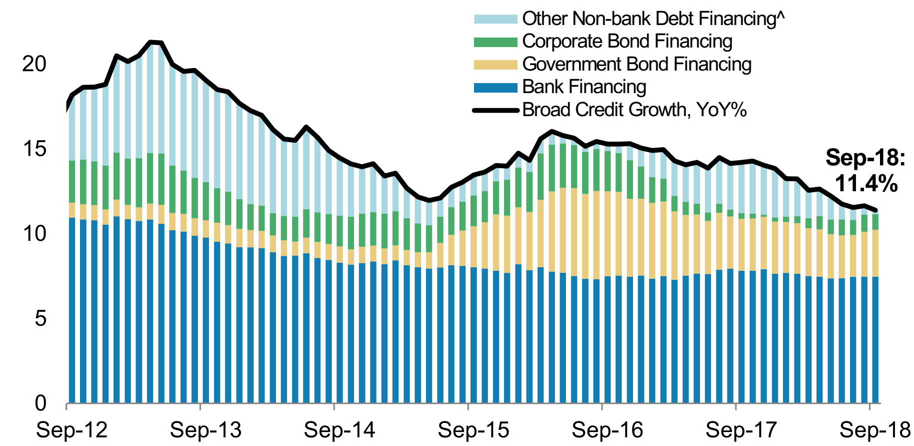


Source: EMDB, Bloomberg, Morgan Stanley Research

China credit dispersion is on the rise

The key driver of dispersion in China HY corporates had been tighter credit conditions in onshore China. Exhibit 5 shows that China's broad credit growth was moderately lower in September at 11.4% (from 11.6% in August) due to tightening policies in shadow banking as well as lower net issuance in the corporate bond market. Our China economists think that the faster pace of issuance in local government special bonds since August could have crowded out corporate bond issuance (see Mild Slowdown in Broad Credit Growth, October 17, 2018). This is a risk we flagged in Not Yet Time to Be Long Asia Credit, August 28, 2018. Hence, we feel that the key risk to watch going forward is credit creation in China.

Exhibit 5: China's broad credit growth remain at a tight level

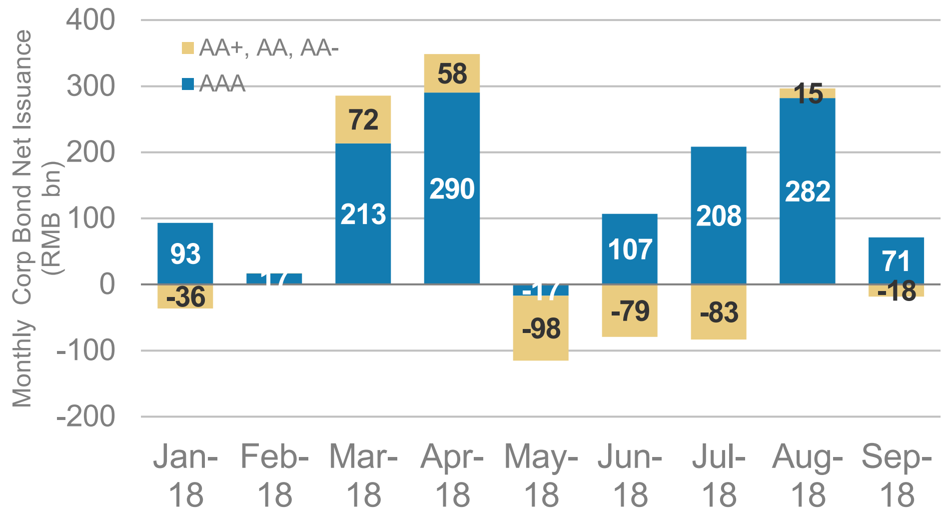


Source: CEIC, Morgan Stanley Research; ^Including entrusted loans, trust loans, bank acceptance, corporate bonds, ABS of depository institutions and loan write-offs.

Credit creation in China has remained selective...

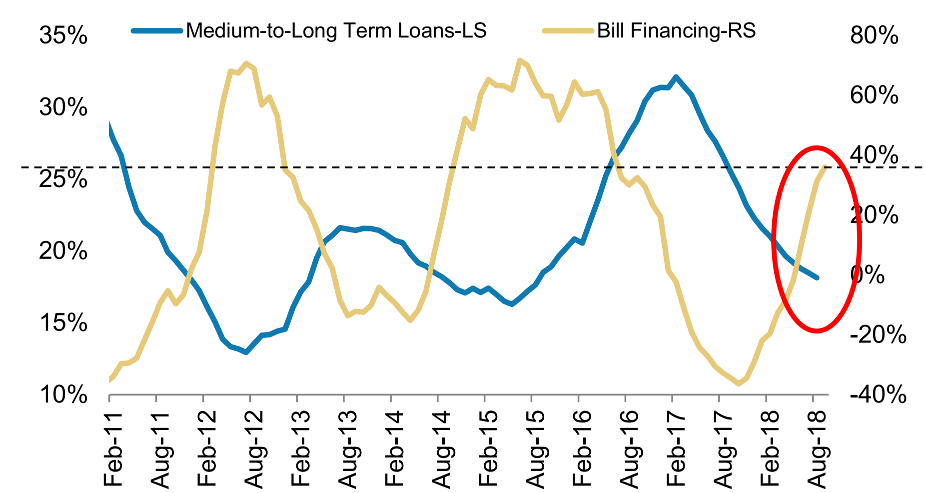
As mentioned in Not Yet Time to Be Long Asia Credit, one of the key data points we have been monitoring closely for signs of tighter financial conditions in China is corporate net issuance. Despite a strong recovery for China onshore corporate bond net issuance in August, the September number was the weakest since this May (Exhibit 6). In addition, although we saw an improvement in China's bank loan growth, a lot of this growth is due to bill financing and not medium-to-long-term loans (Exhibit 7). Hence, it is not clear that corporates (especially small- and medium-sized corporates) are incrementally benefiting from the higher bank loan growth we have witnessed. There seemed to be a lag for bank loan growth to translate into medium-to-long-term loans and the lag had been increasing in every cycle since 2011. The lag has clearly increased as banks seemed to turn more cautious with every easing cycle.

Exhibit 6: September onshore corporate bond net issuance was the weakest since May 2018



Source: WIND, Morgan Stanley Research

Exhibit 7: Loan lending has not picked up in the current defensive easing cycle

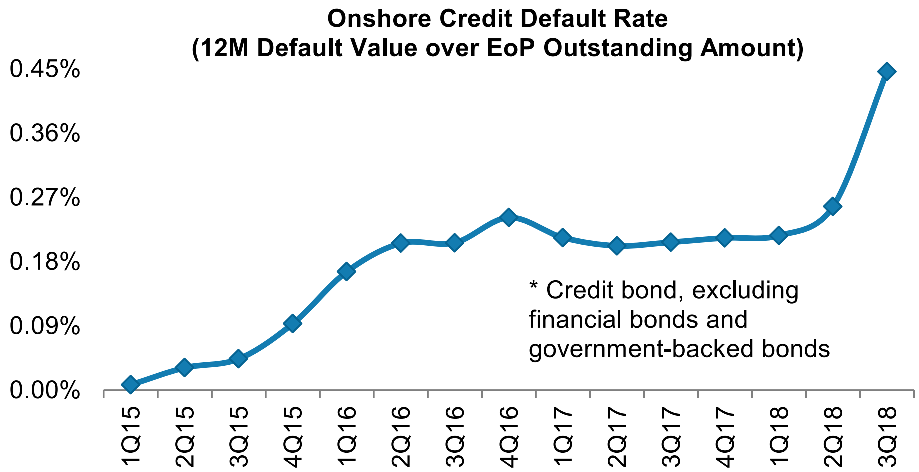


Source: CEIC, Morgan Stanley Research

…causing even more credit differentiation

Hence, given the current tight credit conditions, we are not surprised that defaults continued to pick up strongly in 3Q18. These defaults clearly highlight the importance of credit differentiation, especially for China HY as it is more disproportionately affected by tighter financial conditions compared to China IG. A case in point is the weak period following the mid-autumn festival, where Qinghai Provincial Investment (QHINVG) managed to avoid an offshore USD bond default, thanks to bank funding. At the same time, there were 4-5 defaults in the onshore corporate bond market. This shows that lenders themselves are being selective in who they are providing loans to.

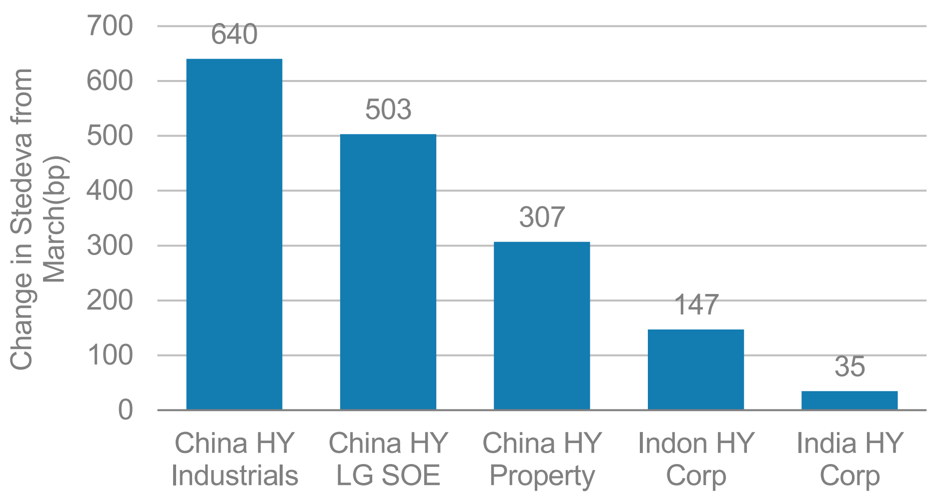
Exhibit 8: Onshore corporate bond default picked up further in 3Q18



Source: WIND, Morgan Stanley Research

That said, the good news for investors is that credit dispersion has picked up for China HY sectors compared to the other Asia HY sectors (Exhibit 9). Among the China HY sectors, China HY industrials saw the largest increase in dispersion, which we think largely reflects its weak fundamentals. China HY LG SOE saw the second-largest increase in dispersion, but we think that the sector is relatively small to screen for alpha. Hence, we are left with the China HY property sector, which we think is an ideal sector to do credit differentiation work as: i) It has a good number of distinctive issuers (31); ii) It is a key driver of Asia HY corporate market risk; and iii) It is the largest sector by notional outstanding in Asia HY.

Exhibit 9: Dispersion for Asia HY has increased significantly since March



Source: Bloomberg, Morgan Stanley Research

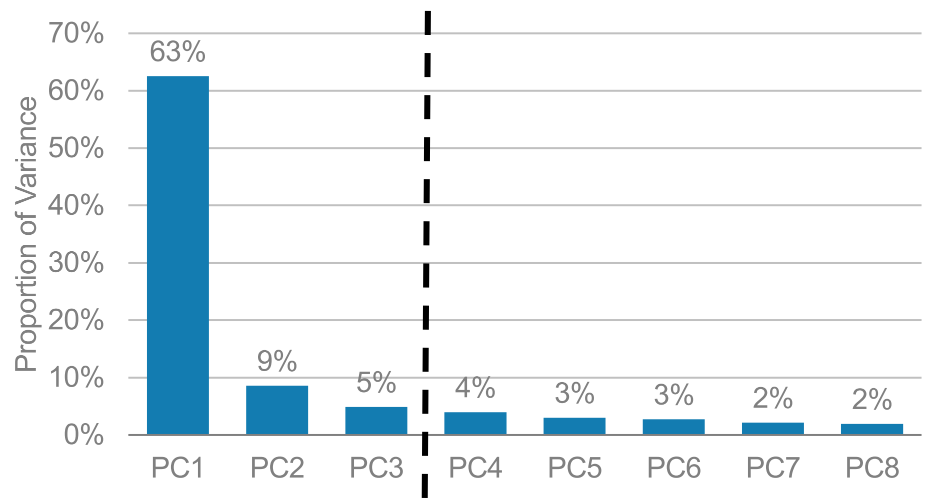
Our principal component analysis (PCA) confirms conventional wisdom

Before we start screening single-name opportunities in the China HY property sector, we need to ask ourselves what the key drivers of the sector spreads are in order for us to make our credit picks. One way to answer this question is through principal component analysis (PCA) and the factor analysis of the principal component.

In order to narrow down the bonds for our PCA analysis, we screen 31 Chinese property issuers for two key criteria: i) Having a relatively liquid benchmark bond; and ii) Having historical bond data that start at least at the beginning of the year (i.e., since January 1, 2018). Given these two conditions, we end up with 17 China HY property issuers bonds for our PCA.

After running our PCA analysis we find that the first principal component (PC1) explains 63% of the change in China HY property spreads, followed by 9% for PC2, 5% for PC3, and so on (Exhibit 10).

Exhibit 10: The first three factors drive close to 77% of China HY property spreads based on our PCA analysis

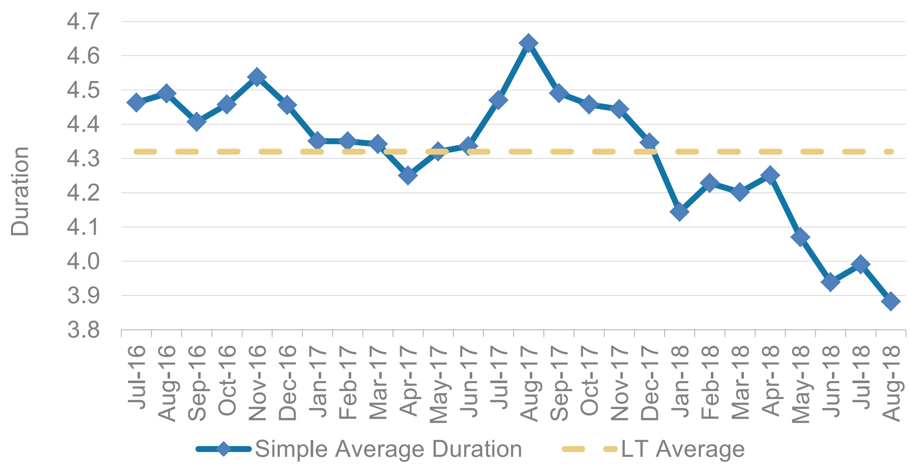


Source: Bloomberg, Morgan Stanley Research

We focus our factor analysis on the first three principal components because, by figuring out these three components, we are already able to explain 77% of the change in China HY property spreads. There is clearly a trade-off in spending too much time and yielding limited results if we try to do factor analysis on all the principal components as the factors get too idiosyncratic as we move down from PC4 to PC17.

Our factor analysis confirms that credit quality is the largest driver of China HY property spreads, which is not surprising given the idiosyncratic nature of the asset class (HY corp) and sector (31 unique issuers). Given that Asia investors had been focused on reducing duration in the past 10 months (Exhibit 11), it is also makes sense to us that duration ended up being the second-largest driver of China HY property spreads. Lastly, we have market liquidity as the third most important driver of China property spreads as we feel that trading liquidity is very important against the current backdrop of higher volatility.

Exhibit 11: Asia credit funds duration is at a two-year low



Source: Individual Funds Fact Sheet, Morgan Stanley Research

#1 factor: Credit quality

We believe that the first factor (PC1) is credit quality, which explains 63% of the change in China HY property spreads. Exhibit 12 shows that as credit ratings of the China HY property issuers improve, the loading factor of the bonds decreases. Fundamentally, we believe that credit quality, as the first factor, makes a lot of sense as HY sectors tend to be more idiosyncratic-driven than, say, IG sectors that are driven more by macro factors. We feel that credit rating is a good proxy for credit quality of these China HY property issuers as it incorporates both quantitative and qualitative credit assessments of each issuer. In addition, we find that credit quality is strongly correlated with beta of the China HY property bonds. Lower-rated issuers such as EVEERE have the highest market beta, while BB rated names such as COGARD have beta in the bottom five.

Exhibit 12: Our first factor lines up nicely with the credit rating and beta of the China property issuers

China HY Prop Bond	PC1	Market Beta	Ratings
EVERRE 20	0.41	1.05	B-
SUNAC 20	0.30	0.73	B-
CAPG 20	0.29	0.65	B
CHINSC 22	0.27	0.57	B
LOGPH 23	0.26	0.61	B+
YUZHOU 22	0.25	0.58	B+
TPHL 20	0.24	0.55	B
GZRFPR 22	0.24	0.54	B+
FTLNHD 22	0.23	0.54	BB
CENCHI 21	0.22	0.53	B+
AGILE 22	0.21	0.51	BB-
PWRLNG 21	0.20	0.44	B
SHIMAO 22	0.20	0.45	BB
COGARD 22	0.19	0.45	BB
KWGPRO 22	0.18	0.40	BB-
YLLGSP 22	0.18	0.37	BB-
ROADKG 21	0.13	0.29	B+

Source: Bloomberg, Morgan Stanley Research; Note: Credit rating is the lowest rating among S&P/Moody's/Fitch.

#2 factor: Bond duration

We think that the second factor (PC2), which explains 9% of the change in China HY property spreads, is bond duration. Exhibit 13 shows that the higher-duration bonds (i.e., more than two years) have positive loading factors for PC2, while bonds with a lower duration (less than two years) have negative loading factors. We think that this is because in a sell-off in the China property sector, the short-dated bonds are viewed more defensively and investors might want to switch out of high-duration bonds into low-duration bonds to de-risk. The opposite is true in a rally – investors who want to pick up risk typically sell low-duration bonds in exchange for high-duration bonds.

Exhibit 13: Short-duration bonds tend to be negatively correlated with the change in China HY property sector spread

China HY Prop Bond	PC2	Years to Maturity
AGILE 22	0.51	3.84
PWRLNG 21	0.20	2.92
CHINSC 22	0.14	3.41
SHIMAO 22	0.13	3.72
GZRFPR 22	0.12	3.25
ROADKG 21	0.12	2.90
YLLGSP 22	0.12	3.28
LOGPH 23	0.11	4.36
YUZHOU 22	0.11	3.29
KWGPRO 22	0.11	3.94
FTLNHD 22	0.08	3.82
CENCHI 21	0.03	2.28
CAPG 20	-0.02	1.25
TPHL 20	-0.03	1.28
COGARD 22	-0.04	3.78
SUNAC 20	-0.20	1.82
EVERRE 20	-0.73	1.44

Source: Bloomberg, Morgan Stanley Research

#3 factor: Trading liquidity

Unlike the first two factors, which were relatively easy for us to quantify, this is not the case for the third factor (PC3). This is the trading liquidity of the bond of the China property issuer. We acknowledge that trading liquidity is very hard to measure as there are no centralised dealing data for the China HY property bonds. That said, based on our conversation with our China HY trader, we are comfortable in saying that bonds that have a negative load factor for PC3 are benchmark bonds for the China property sector. It would not be a surprise to investors if we say that bonds of SHIMAO, COGARD and EVERRE are benchmark bonds for the China HY property sector. In contrast, issuers such as CAPG and TPHL are relatively less liquid than the benchmark. Why are benchmark bonds negatively correlated? We think that in a recovery from a sell-off, the benchmark names will start to rally first due to the liquid nature of the benchmark bonds. The opposite is true in a situation of a rally turning into a sell-off – the benchmark bonds will be the first to be sold by investors.

Exhibit 14: Bonds that are negatively correlated with the PC3 tend to be benchmark bonds for the China HY property sector

China HY Prop Bond	PC3
CAPG 20	0.50
TPHL 20	0.23
CENCHI 21	0.18
PWRLNG 21	0.11
YUZHOU 22	0.10
LOGPH 23	0.08
GZRFPR 22	0.06
FTLNHD 22	0.06
CHINSC 22	0.04
ROADKG 21	0.04
SUNAC 20	0.01
KWGPRO 22	0.00
SHIMAO 22	-0.03
YLLGSP 22	-0.11
COGARD 22	-0.12
EVERRE 20	-0.40
AGILE 22	-0.66

Source: Bloomberg, Morgan Stanley Research

Screening for defensive China HY property names

We can use the three factors mentioned above as a starting point to screen for China HY property bonds that fit our more defensive position in Asia credit. On top of these factors, we think we can add another factor to increase the defensive nature of the screen by looking at the land bank breakdown. Below are the steps that we have set up to screen for defensive single names in the China property sector:

Step 1: We screen for China HY property issuers that are rated B+ and above (we use the lowest rating among S&P/Moody's/Fitch).

Step 2: We screen out China HY property issuers that don't have at least one bond that is equal to or below three years' maturity.

Step 3: We screen out China HY property issuers' bonds that are illiquid.

Step 4: We screen out China HY property issuers that have lower than 30% of their land bank in Tier 1 and Tier 2 cities.

We started our screen with a full list of 31 distinctive Chinese HY property issuers, and after step 1 we were left with only slightly less than half of the issuers. Step 2 saw minimal names drop off as most Chinese property issuers have bonds that meet the duration requirements. Close to half of the remaining names in step 2 managed to survive the liquidity test in step 3. The last step saw only three names drop off and we arrive at a list of four issuers in the China HY property sector (Exhibit 15).

Of the four, SHIMAO 21 has the highest ratings and the bond's duration is highest too. In terms of asset size, SHIMAO has the largest total asset size (Rmb 333 billion), while YUZHOU has the smallest asset size (Rmb 103 billion). Looking at Tier 1 and Tier 2 cities' concentration, the lowest concentration is relatively high at 61%, which is SHIMAO, so most of the names we screen out have a pretty defensive land bank.

Lastly, in terms of fundamentals, these names are defensive versus the sector. The average cash/short-term debt of the four is 2.31x, versus the overall China HY property sector average of 1.2x. If we look at leverage in terms of net gearing (net debt/equity), the average net gearing for the four is 73%, which is significantly lower than the sector average of 126%.

Risks include a large fall in physical property prices in Tier 1 and Tier 2 cities in China, triggering low contracted sales, or credit conditions in China tightening significantly from here, which would increase the liquidity risk of the China HY property sector.

Exhibit 15: Screening for defensive China HY property names

No.	ISIN	Company Name	Corp Ticker	Bond Ticker	Ratings	Years to Maturity	Tier 1 & Tier 2 Exposure	Yield to Maturity
1	XS1891434604	Shimao Property Holdings Ltd	SHIMAO	SHIMAO 21	BB-	2.99	61%	6.44%
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Source: Company data, Bloomberg, Morgan Stanley Research

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(as of September 30, 2018)

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Overweight/Buy	**1178**	**37%**	**308**	**42%**	**26%**	**562**	**40%**
Equal-weight/Hold	**1378**	**44%**	**343**	**46%**	**25%**	**625**	**44%**
Not-Rated/Hold	**49**	**2%**	**5**	**1%**	**10%**	**7**	**0%**
Underweight/Sell	**554**	**18%**	**83**	**11%**	**15%**	**224**	**16%**
TOTAL	**3,159**		**739**			**1418**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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