STONE MOUNTAIN CAPITAL RESEARCH PERSPECTIVE VOL.35
OCTOBER 2016

China: A Perspective On Risk And Possible Global Contagion

Ashvin Chotai
Senior Advisor Research
Tel.: +44 7740 823049
Email: ashvin.chotai@stonemountain-capital.com

With 2015 GDP of US$10.87 trillion, China is the world's second-biggest economy behind USA. Its banking assets are around three times the size of its GDP while its stock markets, even after last year's crash, were together worth $6.27 trillion in 2015, second only to America's. Its bond market is the third largest behind USA and Japan but growing very rapidly. China is the third largest creditor nation behind Japan and Germany. At the end of September 2016, foreign exchange reserves stood at $3.17 trillion (nearly three times that of Japan, which is in second position globally) but they have been steadily declining since hitting a peak level of nearly US$4 trillion in June 2014.

China's spectacular growth during the last decade has not only made it the "big elephant in the room" on the world stage, but has also created major imbalances in its economy, resulting in a major risk of contagion across the globe.

For example, official estimates for non-performing loans (NPL) stood at close to $300 billion, double the level of 2014. If off-balance sheet and shadow banking loans such as trusts and peer-peer-lending (P2P) were included, NPLs would be much higher. In 2015 alone, investors have lost around $25 billion through financial fraud and nearly $670 billion of capital has left the country while China spent nearly $200 billion to prop up its stock market. These are just a selection of some worrying statistics, which have become a focus of global investors.

In the summer of 2015, a mere 2% devaluation of the Chinese yuan sent global markets tumbling. There were similar China related worries for global markets in early 2016. The slightest of concerns over slowdown in China is having major consequences for commodity exporting countries. So, it is a big understatement to say that the prospect of a China hard landing and the impact on commodity producers and global stock, bond and currency markets would be very severe.

Global investors are currently pre-occupied with issues such as the US Presidential Elections, the nature and timing of Federal Reserve expected tightening and Brexit. China concerns appear to be on the back burner, at least for now. However, they certainly haven't gone away and will continue to remain as one of the major concerns for investors across all asset classes, across the globe.

In this Research Perspective, we review some of the China issues that will continue to remain as major factors in driving global investment decisions across many of asset classes in the coming years.

Link Between Economy And Stock Market Remains Loose

As discussed in our Stone Mountain Capital Research Perspective Vol. 3 China Stock Market: Spectacular Gains Even After A 30% Correction, China's stock market remains fairly underdeveloped with the government by far the biggest investor, maintaining controlling stakes in many large companies, but domestic financial institutions are still relatively minor players. Retail investors and speculators tend to be more active in terms of day-today trading whilst the link between China's economy and its stock market is a pretty loose one when compared to developed countries.

Chinese investors tend to have far larger investments in property, wealth management products (WMPs) and bank deposits than they have in equities.

Global stocks with China exposure will continue to be more responsive to macroeconomic and sector specific news from China than the performance of the Shanghai Exchange.

Growth, Rebalancing And Debt

After spectacular growth over the last two decades, it is now widely recognized that economic growth in China is moderating. Growth is now being driven less by heavy industry and exports and more by services and manufacturing for household consumption than in the past. The current account surplus has come down from its peak of 10 percent of GDP in 2007 to around 2-3 percent in recent years, and the contribution of net exports, formerly a key driver of growth, has been fluctuating around zero. Progress has been good, but this massive rebalancing exercise was never expected to occur overnight nor without periodic hiccups.

While indicators such as PMI, Caixin manufacturing, industrial production, fixed asset investment, FX reserves, export orders etc provide short term progress of the economy, moderation and rebalancing will continue characterize China's economy over the next decade.

A major concern is that in order to meet short-term growth targets and also support sectors like construction and real estate, China has been reverting back to the old model in terms of stimulating growth by monetary policy and credit. Whilst this has stabilized commodity prices, soaring prices of residential real estate and rapid credit expansion in the real estate sector continues to be a cause for concern.

Structural challenges such as high debt levels and State Owned Enterprise (SOE) reforms are also causes for concern. It is now well accepted that especially since the massive stimulus post the global financial crisis, authorities have not succeeded in reining in credit and debt levels in China's economy have been spiraling at an alarming rate.

© Stone Mountain Capital 2012 – 2016 • info@stonemountain-capital.com

IMF Estimates Non-Performing Loans (NPL) To Be 15.5% Of Total Commercial Loans - Real NPLs Could Be Much Higher

China's total debt-to-GDP, is not out of line by global standards. The level of government or household debt, both at 40% of GDP are also not reasons to be concerned. The problem is in the corporate sector, specifically SOEs and certain sectors like real estate and mining. With corporate debt running at a high 145% of GDP and corporate borrowers' declining profitability, their ability to service the debt in a decelerating economy has reached worrying levels.

Problem loans stand at 5.5% of China's total bank loans, up from 4.4% in 2014, according to official Chinese statistics. However, IMF estimates that 15.5% of total commercial bank loans — or $1.3 trillion — to the corporate sector are "at risk", meaning that companies' earnings (as defined by earnings before interest, taxes, depreciation and amortization, or EBITDA) cannot cover their interest expense. Other independent estimates indicate non-performing loans to be as high as 20% of all corporate loans.

Sectors with worrying level of debts include construction, real estate developers, mining, energy and utilities. These sectors have lowest ability to service debt but sectors such as telecoms, IT, airlines, healthcare are in much healthier situation.

Debtors And Creditor Under Ultimate Control Of The Government

As many large corporations and most of the major banks are state owned, the government ultimately is the owner of both the debtors and creditors and is able to "manage" or muddle through this situation.

China's large state-owned banks are also well capitalized and should be able to withstand some increases in bad loans. They have high level of Tier 1 Capital and significant level of reserves on their books while a high domestic savings rate, loyal deposit base, and support from the government also means that the problem will not get out of control. Capital controls are still tight and risk of significant capital flight is still manageable, although the decline in level of foreign exchange reserve since mid 2014, provide an indication of capital outflow pressures and how much government has been intervening to stabilize the currency.

The long-term challenge is to reform and restructuring of the borrowers, mostly consisting of large SOEs to avoid the problem re-emerging. So far, government approach has focused on mergers and consolidation of SOEs rather than bankruptcies and/or privatization. From an ideological perspective, large-scale privatization can be ruled out while the government also has to tread very carefully in terms of instigating aggressive reforms, which if not handled properly would inevitably lead to high levels of unemployment and social unrest.

Unlike debt crisis in a number of emerging market countries, where foreign currency borrowings were substantial and the banks required bailouts from institutions such as the IMF with the inevitable pressure to reform and restructure aggressively, most of China's debt is denominated in domestic currency and it is able to reform and restructure at its own pace.

The approach likely to be adopted by regulators will consist of transferring bad debts from state-owned banks' balance sheets onto the balance sheets of asset management companies supported by the central government. Some banks would also require significant recapitalization but this is unlikely to present any serious problems for the government.

© Stone Mountain Capital 2012 – 2016 • info@stonemountain-capital.com

Bigger Cause For Concern: Off-Balance Sheet Financing And Shadow Banking

"Shadow banking" is the term used loosely to cover all financial intermediaries that perform bank-like activity but are not regulated as banks. In China, trust companies are the dominant type of non-bank financial institution engaged in shadow lending, often in collaboration with major banks. Major banks, through their off-balance sheet activities, are also active participants in several aspects of shadow banking.

Informal lending has always existed in China's economy and shadow banking has been growing at the impressive rate since 2002. Shadow finance can take variety of forms including entrusted loans (loans made by one non-financial company to another), trust loans (loans made by trust companies), bankers acceptances, interbank entrusted loan payments, financial leasing, guarantee companies, peer-to-peer lending, micro-finance and unofficial lending). A major source of funds for shadow finance is entrusted loans and wealth management products (WMP), which promise higher yields than bank deposits to wealthy investors.

Shadow banking can be regarded as a form of off-balance-sheet bank lending intended to by-pass the loan-to-deposit rules, capital ratios, official interest rate and other regulatory and supervisory constraints while offering investors with more attractive returns commensurate with higher risks. In this sense, shadow banking has been instrumental in providing funding for private companies as the economy transitions from strict state ownership and control to more involvement by private savers and borrowers.

Entrusted loans (loans made by one company to another) forms a major part of shadow banking and are estimated at around 12 trillion yuan in 2016. Entrusted loans are a form of regulatory arbitrage as large companies with access to bank finance lending these funds to other, often small and medium size enterprises (SMEs), who have no access to bank finance. It is quite common for state owned companies operating in low growth / low margin industries, having access to official bank credit and excess cash on their balance sheet to make risky investments in other affiliated or non-affiliated companies in return for higher returns. Real estate developers are amongst the largest recipients of entrusted loans. Generally, practices are highly opaque with very limited disclosure requirements.

Loans by trust companies. Trust companies have a quite flexible charter and combine the role of banks, private equity and asset managers. They are major players in developing WMPs and marketing them directly to wealthy investors or via banks. In recent years, trust companies have attracted greater scrutiny from the regulators meaning tighter constraints on their activities.

Wealth Management Products (WMP) which are opaque structured products offering high returns to investors are a significant funding source at the heart of China's shadow banking system. The estimated value of all outstanding WMPs is estimated at over 23 trillion yuan or 35% of GDP. These are debt or debt-like instruments that pay out higher interest rates to investors. Typically, the underlying investment is a single large loan or a pool of loans but there is often a broad remit with everything from bonds to property included. WMPs are usually purchased by relatively wealthy investors as substitutes for bank deposits, with the benefit of higher yields than banks are allowed to offer on formal deposits. Most of the WMP are not "principal guaranteed" and hence banks can keep the WMPs off their balance sheets. Customers, however, generally expect banks or trust companies to guarantee the principal.

The rapid growth of shadow banking since 2010 has been driven by the popularity of WMPs, combined with the needs of several types of borrowers (e.g. real estate developers, SMEs) who do not have access to bank finance directly, especially since monetary authorities started to reign in bank lending following the 2008-2009 stimulus. More recently, after its crash in 2015, China's stock market has become a no-go area for a lot of retail investors and even more money has flown into WMPs.

© Stone Mountain Capital 2012 – 2016 • info@stonemountain-capital.com

The size of the shadow banking sector has been variously estimated at between two-third and three quarters of China's GDP, considerably smaller than the level in USA, where is estimated at around 150% of GDP. The sector's exposure to high risk borrowers such as real estate developers and other stressed sectors such as coal mining combined with maturity mismatch (most WMPs are short in duration, but loans made tend to be for much longer periods) is a source of significant risk.

A downturn in the real estate market, construction or material/mining sectors could easily trigger a wave of defaults and effect trust companies, WMPs as well as entrusted loans with contagion into the main banking system. The government's ability to control systemic risk to the financial system would be severely tested. On the plus side, while China's shadow-banking system is large it has not yet spawned complex bundled products such as subprime mortgages. The impact will be largely domestic but the risk of indirect global contagion is not insignificant.

Real Estate: Largest Sector Of The Economy - Developers Saddled With High Levels Of Debt

The interconnectivity between the real estate sector and China's overall economy is interesting with involvement of local government, real estate developers, households, investors and of course banks including shadow banks. During the last decade, the very rapid increase in urbanization has supported strong increases in real asset investment across the country. The sector has been a key growth engine for the economy and was a key beneficiary of the 2008/2009 stimulus.

Today, with assets of around $2 trillion, real estate is the largest sector of China's economy and interestingly around two third of it is in private hands. Assets of property developers as percentage of total corporate assets have nearly tripled in the last decade.

Whilst the 2008/2009 stimulus was necessary, the government has made only token attempts to "roll back" the stimulus from 2010 onwards; local governments have become over-reliant on land sales whilst at national level, policy makers have become over-reliant on this sector to support its economic growth targets. So, loan growth to real estate developers has continued to rise at a relentless pace and there are few signs of deleveraging. The huge problem is the ability or rather inability of many these companies to service debt. Today, real estate developers in China are twice as indebted as their global peers while a third of companies cannot cover interest expense with earning.

Of course, all banks as well as shadow banks have high level of direct and indirect exposure to the real estate debt. While there are currently fewer concerns over the level of real estate loans to households, the level of exposure to real estate developers has already reached alarming levels.

Prices In Bubble Territory But Household Debt Remains Under Control

A boom in property prices, supported by rising incomes and wealth levels, has accompanied rapid increase in urbanization and real asset investment. It is very true that in absence of other reliable investment options, many households / individuals have few options and they have been pumping their savings into the real estate market during the last decade (in a similar manner to global investors in cities such as London, New York and Singapore). This is reflected in the spectacular rise in real estate prices in large cities. In this respect, there are some parallels to Japan's real estate bubble of the late 1980's before the bubble burst in 1989/1990.

China has fairly tight controls over who can purchase real estate (typically only individuals with residency in the city) and how many properties each individual can purchase. For example, large cities such as Shanghai have home purchasing restrictions that limit its residents to only being able to buy one additional house. These restrictions can be varied depending on the state of the real estate market.

© Stone Mountain Capital 2012 – 2016 • info@stonemountain-capital.com

Bank lending for home purchases are tightly controlled at central and municipal levels. Typically, first time buyers are required to make at least a 30% down payment, while second home purchase requires 40-50% upfront, and any additional house beyond this must be paid for in full with equity, as no financing is available. When the government is in tightening mode, higher down payment are often initiated and it would only be in rare circumstances that minimum down payment could drop to 20%. A lot of speculative activity is carried out with cash.

Given China's low level of household debt and high level of savings, foreclosures are still insignificant at household level. In contrast to US sub-prime crisis, it appears unlikely that households would trigger any sort of financial crisis even with a sizeable correction in the real estate market. A major wildcard is the level of loans from "shadow banking" activities, which are tied to the real estate sector.

Central Banks Gives Green Light To Credit Default Swaps

As defaults rise and government reduces (and eventually withdraws) its traditional role as a guarantor of debt to state owned companies and banks, more sophisticated risk management tools and processes are being introduced to manage and price credit risk. Recently, there are strong signs that the People's Banks of China (PBOC) will give green light to credit default swaps (CDS), which will be underwritten by insurers, bank-affiliated asset managers and companies that process bad debts for banks.

Trading is likely to take place in Beijing and Shanghai although lot of details need to be worked out. It currently appears that the regulators will initially monitor how CDS instruments perform in the Chinese environment. Once issuance and usage reaches a satisfactory level, the government will be under less pressure to maintain its role as guarantor of many state owned enterprises. More sophisticated pricing of risk together with higher levels of defaults should result in more rapid restructuring of many state owned companies. It is currently not clear what role foreign risk managers will be allowed to play. However, this is certainly a development to watch as it has significant implications in terms of how China can deal with its corporate debt challenges.

How Could A Crisis Play Out

China's policy makers and regulators are facing multiple challenges to ensure a soft landing for the economy and its financial system. Will a financial crisis play out in the same way as US Subprime crisis and subsequent recession, will China suffer from economic malaise for a decade or so in the same way as Japan or could developments become even more catastrophic? For now, it appears that the government has sufficient control over the economy and its financial system to "muddle through". It has sufficient ammunition at its disposal to restructure, bailout and recapitalize as necessary. One thing appears clear, China is currently in no position to remove capital controls and internationalize its currency. This would just accelerate capital flight and destabilize the global financial system. In future research notes we will revisit some of the issues again.

Ashvin Chotai has been covering developments in China for over 15 years. He is Senior Advisor Research at Stone Mountain Capital and Managing Director at Intelligence Automotive Asia and was previously the Head of Asian Auto Research at Global Insight, now known as "IHS Automotive".

This perspective is neither an offer to sell nor a solicitation of an offer to buy an interest in any investment or advisory service by Stone Mountain Capital LTD. For queries please contact Ashvin Chotai under email: ashvin.chotai@stonemountain-capital.com and Tel.: +44 7740 823049. For further information around our research and advisory services please contact Oliver Fochler under Tel.: +44 7922 436360 and email: oliver.fochler@stonemountain-capital.com.

The views expressed in this article are those of the author and do not necessarily represent the views of, and should not be attributed to, Stone Mountain Capital LTD. Readers should refer to the Disclaimer.

SHARE:

STONE MOUNTAIN CAPITAL

Stone Mountain Capital is an advisory boutique since 2012 and we are mandated from 30+ best in class single hedge fund and fund of fund managers across equity, credit, and tactical trading (global macro and CTAs). In private equity and debt, we structure funding vehicles and are mandated with 10+ managers across the sectors real estate, infrastructure, renewable energy/cleantech and financial institutions/regulatory capital relief. As per 29th January 2016, Stone Mountain Capital is mandated on total alternative assets of US$ 44.7 billion. US$ 42.7 billion is mandated in hedge fund and fund of hedge fund AuM and US$ 2 billion in private assets (private equity/private debt) and corporate finance.

Our Team **Our Solutions** **Our Mandates** **Our Research** **Our News**

Contact

We are able to source any specific alternative investment search and maintain relationships with dozens of best-in-class hedge fund managers. We don't pass any costs on to our investors, since our compensation comes from our mandated hedge fund managers. Please contact us, should you require further information about our solutions.

Connect with Stone Mountain Capital:

Stone Mountain Capital LTD (FRN: 729609) is an Appointed Representative of LNG Capital LLP (FRN: 454402), which is authorised and regulated by the Financial Conduct Authority (‘FCA’). Stone Mountain Capital LTD is the Distributor of foreign collective investment schemes distributed to qualified investors in Switzerland. Certain of those foreign collective investment schemes are represented by First Independent Fund Services LTD, which is authorised and regulated by the Swiss Financial Market Supervisory Authority ('FINMA') as Swiss Representative of foreign collective investment schemes pursuant to Art 13 para 2 let. h in the Federal Act on Collective Investment Schemes (CISA). Stone Mountain Capital LTD conducts securities related activities in the U.S. pursuant to a Securities and Exchange Commission ('SEC') Rule 15a-6 Agreement with Crito Capital LLC, a U.S. SEC registered broker-dealer, and member of Financial Industry Regulatory Authority ('FINRA') and Securities Investor Protection Corporation ('SIPC').

Copyright © 2016 Stone Mountain Capital LTD. All rights reserved.

Any business communication, sent by or on behalf of Stone Mountain Capital LTD or one of its affiliated firms or other entities (together "Stone Mountain"), is confidential and may be privileged or otherwise protected. This e-mail message is for information purposes only, it is not a recommendation, advice, offer or solicitation to buy or sell a product or service nor an official confirmation of any transaction. It is directed at persons who are professionals and is not intended for retail customer use. This e-mail message and any attachments are for the sole use of the intended recipient(s). Our LTD accepts no liability for the content of this email, or for the consequences of any actions taken on the basis of the information provided, unless that information is subsequently confirmed in writing. Any views or opinions presented in this email are solely those of the author and do not necessarily represent those of the limited company. Any unauthorised review, use, disclosure or distribution is prohibited. If you are not the intended recipient, please notify the sender by reply e-mail and destroy all copies of the original message and any attachments. By replying to this e-mail, you consent to Stone Mountain monitoring the content of any e-mails you send to or receive from Stone Mountain. Stone Mountain is not liable for any opinions expressed by the sender where this is a non-business e-mail. Emails are not secure and cannot be guaranteed to be error free. Anyone who communicates with us by email is taken to accept these risks. This message is subject to our terms at: www.stonemountain-capital.com/disclaimer.