

# Picking winners: How state guarantees could save some private- sector developers from default

Since August, six private-sector developers have issued onshore bonds guaranteed by China Bond Insurance Co., a state-owned credit enhancement agency.

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## Key takeaways

- The support represents a major shift in Beijing's approach to the property downturn. Until now, it has tolerated defaults by developers, but the depth of the crisis is pushing the central government to do more.
- All private-sector developers – not just those that are overleveraged – have found it increasingly difficult to access funding. The guarantees are an effort to redress that by boosting investors' willingness to buy their bonds.
- RMB 6.8 billion worth of such bonds have been issued so far, but the scope of the program is likely to expand quickly due to the deepening financial distress, with more firms allowed to apply for guarantees and the original six developers likely to issue a second round of bonds.
- Only developers that have not previously defaulted on publicly issued debt have issued guarantee-backed bonds so far.
- We expect that as the program expands, developers that have already defaulted will continue to be excluded.
- The guarantees represent an effort to prevent – or at least limit – defaults by more developers. Five of the six issuers have said that the proceeds of the onshore bond sales will be partly used to repay offshore dollar-denominated debt. Difficulty repaying dollar debt has been a major cause of developer defaults.
- Property companies that issue guarantee-backed bonds will likely find it easier to borrow from banks, many of which have pared back lending to developers deemed overly risky.
- We believe that Beijing's aim is to avoid the turmoil of widespread defaults by allowing reasonably healthy private-sector developers access to funding so that they can survive the property sector upheaval relatively intact. We expect those that aren't able to issue guarantee-backed bonds will either be absorbed by state-owned developers, be liquidated, or, having divested a significant proportion of their assets, become significantly smaller.

Since August, a handful of private-sector developers have issued onshore bonds backed by state guarantees, effectively making the bonds risk-free for investors. The guarantees, provided by China Bond Insurance Co., a state-owned firm that provides credit enhancement services, represent an important shift in Beijing's approach to the property sector downturn. Having been fairly hands-off since rolling out the three-red-lines policy in 2020 to control developers' leverage, authorities are now intervening more directly to prevent – or at least limit – further defaults by developers, focusing particularly on reducing the potential for defaults on offshore bonds.

The guarantees also reinforce a trend we identified in our September 30 report, "[Riding out the storm: The impact of property sector distress on banks](#)." We noted that, despite repeated calls by regulators for banks to increase their support for the property sector, 40% of publicly traded banks reduced their outstanding loans to developers in the first half of 2022, with many saying they had pared back exposure to those deemed overly risky.

We believe that, for the most part, banks will only be willing to increase lending to state-owned developers and a handful of private-sector developers. However, even for China's most robust private builders, ongoing access to adequate bank funding is precarious.

Over the past year, even private developers previously regarded as relatively healthy have found it increasingly difficult to get adequately funded as the crisis in the industry deepened. Funding from presales, traditionally a major source of cash, has plunged in the face of massively reduced demand for new housing. Developers have been effectively shut out of the offshore dollar bond market because of a spate of defaults, the slump in sales, and their deteriorating creditworthiness. This has actually become a drain on funding as companies need to use resources from a dwindling pool of onshore funds to redeem their offshore debt.

Even mainland bond investors – a group mainly comprised of banks, their wealth management divisions, and insurance companies – have grown increasingly wary of buying debt issued by private-sector developers. The few that have issued onshore bonds this year have mostly either needed the backing of some form of credit enhancement or been forced to pay higher coupon rates.

At a minimum, the bond guarantee program is an effort to reopen the onshore bond market to relatively healthy private developers. We expect most – at least, those large enough to issue bonds – that haven't already defaulted on their public debt will eventually be entitled to apply for guarantees from China Bond Insurance. That will help them raise the resources necessary to complete the construction of unfinished housing projects – a government priority – as well as repay maturing debt, and potentially even start new projects.

We believe that the authorities also intend to use the facility as a way to prevent – or at least reduce the likelihood of – more developers defaulting, in particular on their offshore bonds. Almost all of the prospectuses for developers' guarantee-backed bonds state that the proceeds will be partly used to repay or buy back outstanding offshore dollar bonds. Developers have found it particularly difficult finding the resources to service their offshore bonds; the guarantee facility

gives them a channel to raise funds explicitly for that purpose, thereby helping them avoid default.

We also believe that developers who receive bond guarantees will find it easier to borrow from banks who will see the backing as a state endorsement of a developer's viability.

In short, the guarantees are a way to keep relatively healthy and well-managed developers afloat through the property sector's upheaval and allow them to emerge relatively intact on the other side. At least, that's what we believe Beijing is trying to achieve. For the program to serve that purpose, the issuance of guarantee-backed bonds is going to have accelerate quickly and expand to include far more firms.

## The chosen few

In August, local media reported that China Bond Insurance would start providing guarantees for onshore bonds issued by private-sector developers. According to company filings, China Bond Insurance provides a "full, unconditional, and irrevocable" guarantee to make any missed coupon payments and repay outstanding principal in the event of default.

Initially, seven private-sector developers were entitled to guarantees. According to data from China Real Estate Information Corp (CRIC), an independent data provider, all ranked among China's 23 biggest developers by H1 2022 sales revenue. They are:

- Country Garden (China's biggest developer)
- Gemdale (9th biggest)
- Longfor (10th)
- Binjiang Group (12th)
- CIFI Holdings (15th)
- Seazen (16th)
- Midea Real Estate (19th)

What all seven firms initially had in common was that none had as yet defaulted on either their onshore or offshore bonds. Of the other 23 top developers, 13 are state-owned and so (mostly) don't need guarantees. The remaining three – who didn't make the guarantee list – are private-sector companies that have already defaulted: Sunac, Jinke, and Shimao [Fig. 1].

**Fig. 1 – China's top 23 developers by sales in H1 2022**

**Note:** The line between public and private is not always clearly defined. We've categorized Vanke and Greentown as being state owned, as they are widely considered as such even though their major state shareholders hold stakes of only 27.79% and 28.22% respectively. We assume that a large, albeit minority, stake held by large state firms is sufficient guarantee of state aid.

State Owned	Private-sector - entitled to guarantees	Private-sector - in default
China Vanke	Country Garden Holdings	Sunac China Holdings
Poly Real Estate Group	Gemdale Corp	Jinke Property Group
China Overseas Property Group	Longfor Properties	Shimao Group Holdings
Greentown China Holdings	Hangzhou Binjiang Real Estate Group	
China Resources Land	CIFI Holdings (Group)	
China Merchants Shekou Industrial Zone Holdings	Seazen Holdings	
Greenland Holdings Corp	Midea Real Estate Holding	
C&D Real Estate Corp		
China Jinmao Holdings Group		
Yuexiu Property		
Huafa Industrial		
China Railway Construction Corp		
Sino-Ocean Group Holding		

Source: CRIC, Trivium

At the time of writing, six private-sector developers had issued a combined RMB 6.8 billion worth of bonds backed by guarantees – five from the original group. But the program is expanding beyond the original group as shown by the issuance of the most recent bond by Excellence Group, China's 42nd largest developer, on October 12 [Fig. 2]. Local media report that all six firms intend to issue a second round of bonds.

**Fig. 2 – Private-sector developers' bonds guaranteed by China Bond Insurance**

Issuer	Issuance date	Issuance amount (Bln of yuan)	Coupon	Maturity (Years)
<b>CIFI</b>	21-Sep-22	1.2	3.22%	3
<b>Longfor</b>	25-Aug-22	1.5	3.30%	3
<b>Midea</b>	2-Sep-22	1.0	3.33%	3
<b>Seazen</b>	8-Sep-22	1.0	3.28%	3
<b>Country Garden</b>	15-Sep-22	1.5	3.20%	3
<b>Excellence</b>	12-Oct-22	0.6	3.50%	3
<b>Total</b>		6.8		

Source: Company filings, Trivium

Like the other issuers, Excellence hasn't defaulted on any public debt. We expect that as the program expands, developers that have already defaulted will continue to be excluded – although we're less certain what will happen to developers that default after issuing guarantee-backed bonds, an issue we will return to later.

China Bond Insurance's own internal requirements will likely exclude defaulters – and potentially some developers that haven't defaulted. The company demands "counter-guarantees" from any issuer it backs. That means it is only willing to underwrite developers that have enough unencumbered assets to use as collateral – which over-leveraged developers tend to lack – or can provide a guarantee from a third party.

Local media have reported that Longfor and Seazen posted land as collateral while Midea Real Estate provided a third-party guarantee from its parent, Midea Group.

In late October, PBoC Deputy Governor Pan Gongsheng called on China Bond Insurance to increase its support for private-sector developers. However, the company's "counter-guarantee" requirements could potentially limit the number of developers able to tap its services.

## The benefits of state backing

The guarantees make funding raised in the onshore bond market possible, and they bring down developers' cost of funding, as we can see from three bonds issued in September.

Seazen's three-year bond carried a coupon rate of 3.28%, almost half the 6.0% rate it paid on a three-year bond issued in June 2021. Country Garden sold a bond at 3.2%, down from 6.3% on a four-year redeemable bond issued in December 2021, while CIFI also saw its interest rate decline to 3.22% from the 5.5% it paid on a four-year bond issued three months earlier.

The real cost to developers is a little higher, though. According to NAFMII, China Bond Insurance charges an annual fee equivalent to about 0.8% of the amount raised from the bond sale. That's a preferential rate. NAFMII says that China Bond Insurance usually charges about twice that for guaranteeing bonds.

While all six developers said they intend to use the proceeds to complete existing projects, five said that the funds will also be used to repay or buy back outstanding offshore dollar-denominated bonds. Only Midea didn't cite that as a reason for issuance.

This is a fairly radical development. China's developers have struggled to repay their offshore dollar bonds. Yields have spiked to a level that not only makes it unfeasible for developers to increase their offshore debt, but also makes it impossible for them to issue new offshore bonds to replace those maturing. As a result, they have to raise debt elsewhere and the guarantee scheme allows them to tap the onshore bond market.

However, the program isn't a magic bullet. In mid-October, CIFI failed to pay the coupon on an offshore dollar-denominated bond. At the time, the company brushed off the missed payment, saying it was the result of delays in remitting funds from onshore during the weeklong National Day public holiday immediately before the scheduled payment.

But on November 1, CIFI announced it had halted repayment of all interest and principal on its offshore debt, which amounts to USD 6.85 billion. In a statement to the Hong Kong stock exchange, it said that since the beginning of 2022 it had paid USD 1.5 billion in principal and interest on offshore debt, but had only been able to raise USD 500 million in new funding.

The difference was paid using cash transfers from the mainland – including, presumably, some of the proceeds from the guarantee-backed onshore bond it issued on September 12 – but the company said:

***“Such remittances have become increasingly difficult in light of the deteriorating financing and operational environment faced by the real estate industry.”***

Local media has reported that CIFI intends to issue a second guarantee-backed bond which could potentially help it meet its offshore obligations. However, now that it’s defaulted, the guarantee and the proposed issue may be in jeopardy.

## Expanding the winners’ circle

Local media have reported that other developers are considering applying for guarantees from China Bond Insurance. They are:

- China SCE Group (China’s 26th biggest developer)
- Agile Group (31st)
- Radiance Holdings (37th)
- KWG Group (43th)

If the reports are true, KWG, which has struggled to meet its offshore debt obligations, will be an interesting test case of the outer limit of what China Bond Insurance is willing to guarantee. Technically, KWG hasn’t defaulted, but that’s only because in September it convinced investors to accept a 16-month extension on the repayment of dollar-denominated bonds maturing that month. The agreement explicitly said that KWG’s failure to make the September bond payment wouldn’t trigger a default.

We believe that authorities will balk at granting guarantee facilities to defaulters as this creates a disincentive for investors to approve debt restructuring plans. Why would they agree to a restructuring if there’s a possibility that the bond in default might be repaid from the proceeds of a guarantee-backed bond?

Just where authorities – and China Bond Insurance – will draw the line is unclear. Will firms like KWG be lumped in with the defaulters, or will they be thrown a lifeline?

It’s also interesting to note local media reports that Sino-Ocean Group – a state firm indirectly controlled by the central government – was among the first batch of developers approved to receive backing from China Bond Insurance. As yet it hasn’t issued a guarantee-backed bond. More recently, the local press has reported that Greenland Holdings – a state-owned developer managed by the

Shanghai municipality's state-owned enterprises regulator (SASAC) – is considering applying for a guarantee. Both companies have had trouble repaying their bonds. On October 31, Greenland said that it couldn't repay USD 370 million of offshore bonds due November 13 and is seeking to extend the repayment of those and other bonds with later maturity dates by up to two years.

#### **China Bond Insurance Co.**

In 2009, the interbank bond market regulator (NAFMII) and six state-owned entities – a group that includes PetroChina and steel producer Shougang – established China Bond Insurance Co. as the country's first credit enhancement institution.

Today, more than 50 financial institutions provide guarantees for onshore bonds, but China Bond Insurance is the biggest. In 2021, it provided guarantees on RMB 79.3 billion worth of bonds. In second and third place were guarantee institutions set up by the governments of Jiangsu province and Chongqing municipality which have guaranteed RMB 77.8 billion and RMB 73.5 billion worth of bonds respectively.

China Bond Insurance mainly provides guarantees for bonds issued by local government financing vehicles.

## **Whither the losers**

The outlook for private-sector developers that aren't able to obtain guarantees for their bonds is grim. They'll find it increasingly difficult to raise new funding which will force them to restructure their debts and sell assets to raise cash as they try to survive until a recovery in housing demand improves their fortunes.

However, while the central government undoubtedly doesn't want to see a wholesale collapse of troubled developers – the Party prioritizes stability above almost all else, and it typically intervenes to prevent the unmanaged unravelling of any large firm – it also probably doesn't want them to fully recover either.

Beijing can see the changing dynamics of the market and doesn't want housing construction to return to the levels of the boom years when developers produced vast quantities of homes that were sold to people who kept them empty and held them as financial assets for capital gain. The result was inflated prices that made owning a home unaffordable for vast swathes of the Chinese population. It also led to a significant amount of household savings sitting idle in unproductive housing assets.

Structural changes in the economy and demographics mean the property market cannot sustain this kind of growth. With China's population rapidly aging, and probably already shrinking, it's likely that many empty investment properties may never be occupied and demand for new homes will decline. Prices in towns and cities across the country are likely to fall, erasing big chunks of household wealth

that could have been more productively deployed in China's bond and stocks markets.

When China's economy emerges from its current funk, the residential property development sector will be a shadow of its former self. That will either manifest itself through fewer but bigger developers, a large number of smaller developers, or a mixture of both. Once the property sector returns to some semblance of normality, we expect that weaker private developers denied bond guarantees will have shrunk in number – either as a result of selling assets, takeover by state-owned developers, or liquidation.

On an individual corporate level, key questions remain about their prospects. What happens to big developers such as CIFI that default after being granted a guarantee – will they continue to be able to issue bonds with China Bond Insurance's backing? And what about companies like KWG, which is reportedly seeking a guarantee after having restructured its offshore bonds.

## Conclusion

The bond guarantee scheme was only introduced in August and with so many variables, it's difficult to predict how effective it will be, how it will develop, and how generous China Bond Insurance will be with its guarantees.

However, the program underscores Beijing's concern that bond defaults among China's private-sector developers will increase unless it provides a safety net. If no support is forthcoming, then the fallout from the property sector's woes will begin to be felt more acutely in other parts of the economy. Most notably, the impact will be seen among banks that will have to deal with more nonperforming loans, and among local governments that will need to deploy their own resources to bail out local construction firms and finish housing projects to appease angry homebuyers.

The program is only a temporary fix. It will keep the stronger private-sector developers afloat, provided they can issue guarantee-backed bonds in sufficient volume, and assuming banks are then willing to increase lending to developers that have bond guarantees. However, only a recovery in housing demand will put developers back onto a sustainable footing. A solution to that conundrum continues to elude regulators.