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lakyara vol.167

Chinese credit investment opportunities and risks

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30. May. 2013

Nomura Research Institute, Ltd.

Executive Summary

Some funds are starting to pursue relatively high returns by lending money to credit-starved Chinese SMEs. Although the potential returns are attractive, such lending poses practical challenges.

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We recently conducted an interview survey of fund managers who invest mainly in emerging Asia[1]. We learned that some funds are starting to focus on credit investment[2] rather than equity investment opportunities in emerging Asian countries. This report discusses supply and demand trends, investment opportunities and risks in China's domestic credit market[3], a particularly large market of keen interest to Japanese investors.

Overview of credit supply and demand in China

China's credit market has been growing faster than the Chinese economy in recent years. Chinese non-financial corporations' bank loans and bond issuance have grown from RMB1,258.2 billion in 2000 to RMB9,528.5 billion in 2011. This increase equates to a compound annual growth rate of roughly 20%[4], nearly double China's average annual real GDP rate of 10.2%[5] over the same timeframe.

While the supply of credit is thus growing, it is not evenly distributed throughout the Chinese economy. Rather, it flows disproportionately to large corporations. Exhibit 1 provides a simplified overview of the status of credit supply by type of company. From 2007 through 2011, issuance of SME collective bonds, a funding instrument for small and medium-sized enterprises[6] (SMEs), totaled RMB3.8 billion[7], a mere 0.1% of nonfinancial corporate bond issuance over the same timeframe. Of outstanding loans

Exhibit 1: Overview of credit supply in China

Type of borrower	Credit supply			Interest rate level
	Bonds	Loans		
		Bank	Nonbank	
Large companies	○	○	—	Low to moderate
SMEs	×	△	△	High

Note: ○ = sufficient supply; △ = insufficient supply; × = virtually no supply
Source: NRI, based on PBoC, China Bond Information Network, and interview survey data

NOTE

1) We surveyed more than 10 funds between November 2012 and January 2013.

2) Credit investments are defined herein as investments in corporate loans and corporate bonds.

3) Listed equity markets in major emerging Asian countries (China, South Korea, India, Malaysia, Thailand, Singapore, Indonesia, Philippines, and Vietnam) have an aggregate market capitalization of roughly US$7 trillion while their domestic credit markets are collectively valued at some US$20 trillion, of which China accounts for nearly US$14 trillion (as of June 30, 2012; source: Bloomberg, central bank data).

4) Source: PBoC

5) Source: Asian Development Bank (ADB)

6) In China, SMEs are generally defined as companies with up to RMB200–400 million in sales and 1,000–2,000 employees (based on Standards for Classification of Small and Medium-sized Enterprises), although the definition varies by industry.

7) Source: China Bond Information Network

to corporate borrowers, some 80% were funded by banks. The remaining 20% were funded by nonbank lenders[8]. Bank lending, like bond issuance, is skewed toward large companies. Nonbank lenders lend mainly to SMEs (Exhibit 2).

8) As used herein, nonbank lenders include Trust, Pawnshop, Guarantor, Small Bank, Underground Bank, and Wealth Management Product.

One reason that banks do not actively lend to SMEs is interest rate controls. Although signs of deregulation are evident, banks are still guaranteed of earning a respectable net interest margin on loans to large corporations under the deposit and lending rate caps imposed by the Chinese government. The rate caps reduce incentive for Chinese banks to assume the risk of increased lending to SMEs in pursuit of net interest margin.

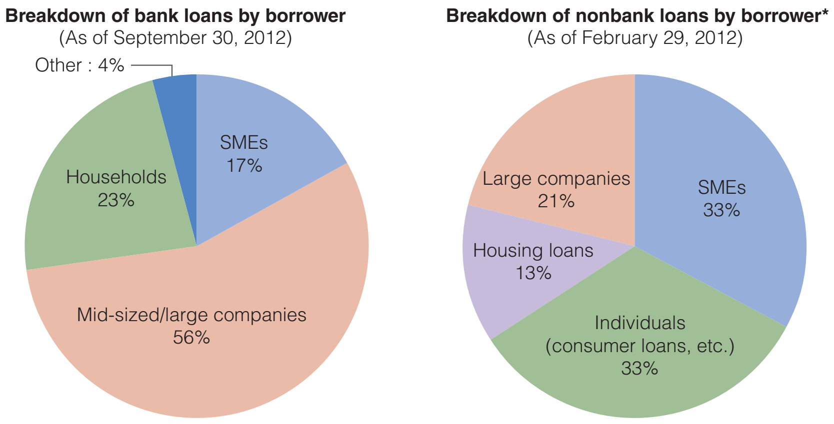
To gauge the adequacy to China's credit supply relative to demand, I compared China to other countries using ratios of corporate debt to nominal GDP as a proxy for credit supply relative to demand for funds. In 2011, China's ratio of corporate debt to nominal GDP was 151%, which is high in comparison to not only emerging Asian countries such as Indonesia (22%) and India (49%) but also developed countries such as Japan (113%) and the US (75%)[9]. While the Chinese economy appears at first blush to be amply supplied with credit, small companies are credit-constrained as noted above. In fact, in Wenzhou, a city with an active nonbank lending market, the average interest rate on aggregate outstanding loans is 20.86%[10], far above banks' one-year base lending rate of 6%[11]. This interest rate differential implies that Wenzhou borrowers, many of which are SMEs, are forced to pay high interest rates because the supply of credit is insufficient to meet SME demand for funds.

9) Source: IMF, ADB and central bank data

10) Source: PBoC (as of December 28, 2012)

11) Source: PBoC (as of December 31, 2012)

Exhibit 2: Breakdown of outstanding loans in China by borrower



*Note: For the breakdown of nonbank loans by borrower, we used data for Wenzhou, a city with an active nonbank lending market.
Source: NRI, based on PBoC and interview survey data

Investment opportunities and risks in China's domestic credit market

Such a supply-demand environment and interest rate levels in China's domestic credit market have prompted some funds to seek to capture income gains by lending directly to Chinese SMEs. Meanwhile, some analysts warn that lending to Chinese SMEs will not yield satisfactory returns on a risk-adjusted basis. Such analysts say that SMEs are deprived of funding because they pose high operational risk and their financial reporting lacks credibility, resulting in low recovery rates on SME loans. Accordingly, lenders that actually lend to SMEs must take steps to protect themselves in the event of default. Such protection usually takes the form of collateral. Secured loans in China are typically collateralized by real estate. Real estate collateral tends to be most readily available when the borrower is a real estate developer. Real estate developers' access to credit from banks has been reduced by tighter restrictions imposed by the People's Bank of China (PBoC) on real estate transactions and real estate purchase money financing since early 2010. Some of the funds that we interviewed are in fact targeting small and medium-sized real estate developers from the standpoint of availability of collateral and demand for financing. Such funds are pursuing relatively high income gains of 15–25% annualized by extending loans secured by real estate valued at two to three times the loan amount.

In the case of such loans, the major risk is whether the collateral practically works as a protection to lenders in the event of default. When extending loans secured by property to real estate developers, lenders must first take into account that the collateral's value may be substantially impaired when the lender needs to protect itself by liquidating the collateral. Periods in which real estate developers experience cash flow problems are likely to coincide with falling real estate prices. Additionally, even if a loan is contractually collateralized, there is a risk that the lender may not be able to foreclose upon the collateral when problems actually arise. Under China's legal system, which is rudimentary in comparison to developed countries', lenders apparently often encounter difficulties in foreclosing on collateral when borrowers default. Dealing with such practical issues is particularly problematic for overseas investors without the requisite network or physical presence in China.

Secured lending to Chinese SMEs offers attractive potential returns, but investors must conduct thorough due diligence on investment opportunities in light of practical challenges such as those discussed above. For Japanese and other foreign investors, finding a partner with the requisite operational capabilities and experience in the Chinese credit market may be a realistic first step.

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