



On 25 November 2019, Tewoo Group, a commodity trading company owned by the Tianjin municipal government, revealed a debt restructuring plan for US\$1.25 billion of bonds<sup>1</sup>. The programme offers bondholders a choice: suffer losses of up to 64% or accept delayed repayments. The announcement marks the first *de facto* default for a Chinese state-owned enterprise (SOEs) in the offshore US dollar bond market since 1998<sup>2</sup>. In this investment note, Fiona Cheung, Head of Credit, Asia, explains the significance of Tewoo's *de facto* default and examines the broader implications for investors in Asian credits.

## China credit watch: First *de facto* offshore default for a Chinese SOE since 1998

In our view, Tewoo's *de facto* default resulted from the interaction of three factors: (1) the company's weak standalone credit profile with high leverage, (2) the lack of strategic importance of Tewoo's commodity-trading business; and (3) the Tianjin municipal government's relatively high level of debt when compared with other tier-one Chinese cities.

The weak standalone credit profile of Tewoo means that the company must rely on bailouts from its state backers to survive. However, the Tianjin municipal government has limited incentive/capacity to provide support given the lack of strategic importance of Tewoo's business and its own high debt level.

### Unsustainably low default rates

Looking at the broader implications, the potential for defaults in China's credit markets remains a hot topic among investors. The onshore default rate for Chinese SOE bonds has remained below 0.3% for the past few years despite high leverage<sup>3</sup>. The depressed rate was mainly due to implicit support claims from the government. Our long-term view is that such levels are not sustainable. Therefore, both central and local government authorities will be

more selective when providing bailouts for financially-troubled SOEs in the future, especially during rough patches of economic growth. As such, our robust credit research process does not take claims of government ownership and implicit support for granted.

Moving forward, we believe that government support will be increasingly selective given the sheer number of SOEs – a decision driven by the associated moral hazard and the authorities' increasing proclivity to allow troubled or unviable companies to fail and let investors take losses.

### Which factors underpin government support for SOEs

When evaluating claims of implicit government support, we assess two principal issues: is the SOE's business strategically important to the economy, and will the default have a systemic impact or lead to potential contagion. We also look at several other aspects relating to the company's overall financial health, as well as the willingness and ability of the central/provincial/local government to offer assistance. Broadly speaking, we prefer SOEs that provide essential or critical services in contrast to those operating in highly competitive industries, a commoditised business line or dealing with financial investments.

<sup>1</sup> Bloomberg, 25 November 2019.

<sup>2</sup> Bloomberg, 26 November 2019.

<sup>3</sup> Goldman Sachs, as of 18 October 2019.

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