Caixin Global Biweekly Briefing

For Client A

June 20 – July 3, 2019

Note: This briefing is prepared for an institutional investor client of Caixin Global Intelligence, and is tailored to the client's area of interest and investment exposure in China.

Executive Summary

Another trade truce was agreed at the G-20 in Japan, with Chinese stock markets, especially tech stocks, rallying at the news. But although further tariffs have been at the very least delayed, the end of this trade war is likely still a long way off. Opening up measures continued, with China unveiling a shortened negative list and an accelerated timetable for removing limits on foreign investment in its financial sector.

Policies to provide liquidity to the market have had some unintended consequences. The central bank is trying to contain the flow of liquidity towards home loans through verbal guidance, while inspectors found that efforts to boost lending to small businesses have prompted larger banks to steal high-quality clients from smaller banks.

Key Updates

POLICY& REGULATION UPDATE

- **Chinese President Xi Jinping and U.S President Donald Trump have agreed to restart trade talks as the U.S. agreed not to impose new tariffs on Chinese exports, the Xinhua News Agency reported on June 29.** China stocks rallied on July 1, the first trading day after the meeting. The benchmark Shanghai Composite Index closed up 2.22%, while the more tech-heavy Shenzhen Component Index closed up 3.84%. Hong Kong's stock market was closed on Monday for a public holiday.

- **The National Development and Reform Commission (NDRC) has released an updated version of the "negative list", the list of sector that foreign investments are restricted or banned,** as the government follows through on pledges to open up to overseas investors. The new negative list released by NDRC has eased foreign access to a range of industries including oil, mining and city gas pipelines. The new rules take effect July 30. The commission said it will also scrap all the restrictions not mentioned in the negative list by the end of this year.

- **During his speech at the G-20 Leaders Summit in Osaka, Japan, on Friday, President Xi Jinping proposed several measures that China will take to further open its market.**

    - **Opening markets**: China will soon release an updated negative list for 2019, which will further open up the agriculture, mining, manufacturing and service sectors. Six new free trade pilot zones will be established, including a new zone in Shanghai. The government will also "speed up the process of exploring the possibility" of building a free trade port in South China's Hainan province.

    - **Expanding imports**: China will further lower tariffs and strive to remove nontariff trade barriers to significantly reduce import costs. China will host a second international expo to promote imports to the country.

    - **Improving business environment:** China will enact a Foreign Investment Law at the beginning of 2020 that will introduce a penalty system for intellectual property infringement. The law will also introduce the universal application of the negative list system.

- **Equal treatment:** China will remove all restrictions for sectors not included on the negative list for foreign investment. Foreign companies that are allowed to do business in China will be treated equally with all other registered companies. A complaint system for foreign businesses will also be established.

- **Trade agreements:** China will push forward regional partnership agreements such as RCEP; accelerate the negotiation of the China-EU investment agreement and the China-Japan-South Korea free trade pact.

- **Chinese banks have increased lending to small and micro enterprises in response to government calls, but concerns remain over the businesses' high bad loan ratios and short life spans,** according to the central bank. Outstanding loans to small and micro businesses rose 21% year-on-year to 10.3 trillion yuan ($1.50 trillion) at the end of May, said Zou Lan, deputy head of the People's Bank of China's financial markets department, in a press briefing on June 24, on the release of a white paper on financial services provided to small firms.

- **China's central bank released draft rules on trading of defaulted matured bonds in the interbank market on June 28,** following a record wave of corporate defaults last year. The short document, released by the People's Bank of China (PBOC) on Friday, sketches out definitions, information disclosure requirements and risk-avoidance measures investors should take. The draft rules are open for comment until July 13.

- **China's policy to boost lending to small businesses has had unintended consequences for small banks.** In an attempt to meet government targets for lending to small enterprises, some big banks in some regions have poached high-quality clients from small and midsize local lenders by offering them lower interest rates, the law-enforcement inspection team of the Standing Committee of the National People's Congress (NPC), China's top legislature, said June 26 in a report. Such clients typically have a low risk of default.

- **The People's Bank of China asked commercial lenders not to lower interest rates on home mortgages from current levels to curb the growth of home loans, according to people familiar with the matter.** The PBOC provided verbal guidance to state-owned banks, joint stock banks and other commercial lenders, the people said, asking not to be identified as they're not authorized to speak publicly. Banks received the guidance early this month, according to two of the people.

- **China's banking regulator plans to tighten rules on so-called cash-management products (CMPs), affecting an estimated $2 trillion of investments.** The China Banking and Insurance Regulatory Commission (CBIRC) aims to treat CMPs similarly to money market funds by imposing stricter rules on pricing and restricting where and for how long the inflows can be invested, the source said, asking not to be identified as the deliberations are private. CMPs are issued by banks and are more liquid than money market funds, which are sold by asset managers.

- **China's top auditor found that some lenders favor corporate borrowers with deposits at their banks or tie their credit offerings to sales of wealth management products, effectively reducing actual business financing.** The State Council asked the National Audit Office (NAO) to conduct the audit on the enforcement of central government's 2018 budget. In its report issued Wednesday, the NAO said it found five commercial banks that provided a combined 50 billion yuan ($7.3 billion) of credit that was linked to borrowers' deposits and purchase of wealth management products.

- **China has been making slow progress on transferring part of state-owned enterprises' (SOE) equity to bolster the nation's pension funds,** a government policy introduced in 2017 to head off a pension fund shortfall. As of the end of March, 23 state firms administered by the central government had made the transfers with equity worth a total of 113.2 billion yuan ($16.5 billion) to the National Social Security Fund, a fraction of the target. On the local level, only four provincial governments had started the transfer process by March, the auditor said.

- **Prompted by China's cabinet, regulators in Ningbo, a major industrial city in East China, said they are encouraging local banks to accept more intellectual property as collateral for loans in order to ease small businesses' financing woes.** Banks should accept more intangible assets like patents, trademarks — and even permits to drain sewage — as collateral for loans, Ningbo's insurance and banking regulator announced on June 27. The day before, the State Council, China's cabinet, had called for more use of intellectual property (IP) as collateral nationwide.

FINANCE / MACRO UPDATE

- **The Caixin China General Manufacturing Purchasing Managers' Index (PMI) dipped to 49.4 in June from 50.2 in May, indicating a marginal deterioration.** It's the lowest reading since January for the sector, signaling manufacturing contracted in June for the first time in four months as new orders decreased amid reports of trade tensions. The reading indicates continued downward pressure on China's economic growth.

- **The Caixin China General Services Business Activity Index fell to 52 in June from 52.7 the previous month, the lowest reading since February.** China's services sector expanded at the slowest pace in four months in June as weakness in export markets offset stronger domestic new business resulting from supportive government policies and a general improvement in market conditions.

- **China's official manufacturing PMI, released by the National Bureau of Statistics on June 30, stood at 49.4 in June,** unchanged from the month before. **The official non-manufacturing PMI fell by 0.1 point to 54.1,** showing that non-manufacturing business activity expanded marginally slower in June.

- **Profits of China's industrial companies rose in May after a sharp deterioration the previous month.** Industrial firms' profits increased 1.1% in May from a year earlier, the National Bureau of Statistics said in a statement on June 27. Industrial profits declined by 3.7% in April, the worst reading of the data since 2015.

- **China's new Nasdaq-style tech board could become a hotbed for companies to spin off and list units domestically, something that hasn't been much of an option until now.** At least nine companies listed in Hong Kong and mainland China are considering or have decided to spin off parts of their businesses on the freshly launched SSE STAR Market. One of them, Western Metal Materials Co., surged by the 10% limit for two days in a row after disclosing its plans in early April. Lepu Medical Technology Beijing Co. climbed 13% over a similar timeframe.

- **The first company to go public on Shanghai's new high-tech board has just released its initial public offering (IPO) price at a much higher price-to-earnings ratio** than has been seen over the past few years on the Chinese mainland. Suzhou HYC Technology Co. Ltd., a manufacturer of display and touch-testing equipment, has set its IPO price at 24.26 yuan ($3.50) per share. That price values the company at 41 times its 2018 earnings after deduction of nonrecurring gains and losses — much higher than the prevailing price-to-earnings ratio of 23 times earnings on the Chinese mainland stock exchanges.

- Since early 2014, the China Securities Regulatory Commission (CSRC) has unofficially capped IPO prices through informal instructions known as "window guidance". After that, IPO price was unofficially capped by P/E ratio of 23 times earnings.

- **China's securities regulator has allowed mutual funds to indirectly lend company shares to short sellers in an effort to bolster the underdeveloped practice,** which has gained greater flexibility with the creation of the country's new high-tech board. The CSRC published guidelines dated June 14, which allows mutual fund firms to lend securities to China Securities Finance Corp. Ltd. (CSF), a state-owned intermediary that lends shares that it has either bought or borrowed to brokerages. Brokerages can then lend on these shares to other parties engaged in short selling.

MARKET UPDATE

- **E-commerce juggernaut Alibaba Group Holding Ltd. plans to raise $10 billion through a second listing in Hong Kong,** a source close to the deal told Caixin, in what could become the market's largest new offering in almost a decade. A float of that size would mean around 2.3% of the company's shares will be available, based on the company's current valuation of around $430 billion. The deal is being underwritten by Credit Suisse Group AG and China International Capital Corp. (CICC), China's oldest investment bank, sources previously told Caixin.

- **China created a new insurance group to take over the main operations of Anbang Insurance Group Co., the once-acquisitive conglomerate that's under state control.** Beijing-based Dajia Insurance Group, established June 25, has 20.4 billion yuan ($3 billion) of registered capital and will provide insurance services as approved by the China Banking and Insurance Regulatory Commission, according to documents on the website of the National Enterprise Credit Information Publicity System.

- **MINISO Co., a Chinese budget household and consumer goods retailer, is planning an initial public offering that could raise about $1 billion**, according to people with knowledge of the matter. The share sale could take place in Hong Kong or the U.S., while the timeline is yet to be decided, the people said.
    - MINISO, founded by Japanese designer Miyake Junya and Chinese entrepreneur Ye Guofu in 2013, designs its products in Japan and has more than 3,500 stores across 80 countries including China, the U.S., Brazil, the United Arab Emirates and Russia, according to its website. The company posted revenue of 17 billion yuan ($2.5 billion) in 2018.

Key Personnel Changes

- **Vice Finance Minister Zou Jiayi (邹加怡) has been appointed a new member of the PBOC's Monetary Policy Committee.** Zou replaced Liu Wei, the head of the National Social Security Fund.

- **Beijing-based life insurer New China Life Insurance Co. Ltd. nominated a new chief executive officer On June 27 after a five-month vacancy.** The company's board of directors nominated Li Quan (李全) as its new chief executive officer and president. Li was the president and deputy chairman of New China Asset Management Co. Ltd. — the asset management arm of New China Life.

- **Liu Jidong (刘继东), a vice president of property insurance giant PICC Group's investment arm, was put under investigation by the CCDI.** Liu is the second executive of PICC that has been investigated in the past few months. The other is are Liu Hong (刘虹), a former president of PICC's investment arm
    - Wang Yincheng (王银成), a former president of PICC, was sentenced last year to 11 years in prison for bribery
- **Stanley Chen will become head of Google's Greater China business,** having led the tech giant's operations in Taiwan for eight years. His predecessor Scott Beaumont was appointed Google's Asia-Pacific president in March.
- **Tencent dispatched Lai Zhiming (赖智明), one of its vice presidents, to Hong Kong to head Infinium Ltd., its virtual bank there.** Lai will be succeeded in his role as the head of Tencent's fintech business by Lin Haifeng (林海峰).

In-depth Analysis

How Baoshang Takeover Shook Secretive Corner of Bond Market

Nearly a month after China's financial regulators took the rare move of seizing troubled Baoshang Bank in Inner Mongolia, the ripple effects continue to rock the country's financial system.

Beijing-based New China Fund Management recently said it was forced to default on some products after failing to get loans. The mid-size investment house is among a number of nonbank institutions that have felt a funding crunch as contagion fears spread in the wake of the Baoshang takeover. Ironically, the owner of New China Fund Management was previously controlled by the owner of Baoshang.

Although the central bank called Baoshang an isolated case, distrust among counterparties sparked by the incident have pushed up borrowing costs for smaller banks and nonbank institutions.

In China's financial system, funding flows from big state banks to smaller lenders through interbank loans, and small banks then provide financing to nonbank institutions such as funds and brokerages, which in turn invest in corporate bonds. But as the creditworthiness of smaller banks, brokerages and fund managers comes under pressure, the funding chain is clogging up.

Regulators have taken a series of measures to ease market jitters. Days after the takeover, the central bank injected a net 150 billion yuan ($21.7 billion) through open-market operations to beef up interbank liquidity. It also provided credit backing to another troubled small bank, the Bank of Jinzhou, in a 2 billion yuan fundraising through the issuance of interbank certificates of deposit (CDs).

On June 14, the central bank handed out 300 billion yuan in rediscount and standing lending facility (SLF) quotas to support lending by smaller banks. And in the following couple of days, the bank and the top securities regulator summoned big banks and brokerage houses to two meetings, asking them to support smaller peers.

The measures have in part calmed the market, but nonbank institutions still face difficulties in refinancing as it's getting harder for them to use corporate bonds as collateral for repo financing from lenders. A bond trader at a brokerage told Caixin that banks now won't take even AA+ bonds of big state-owned enterprises as collateral.

Structured issuance

The falling dominoes of the Baoshang takeover are now hitting the most secretive corner of China's bond market — the market for so-called structured bonds. Analysts said nonbanks that are distanced by lenders are those that have most often used structured bonds as loan collateral.

Structured bond issuance is known as a creative way for some Chinese companies to secure funding they couldn't otherwise obtain based on their credit ratings. Under this practice, bond issuers buy a portion of their own offerings to inflate issuance sizes and create a better image to attract investors. Structured bond issues aren't technically illegal, though some top regulators this month voiced misgivings.

Lower-rated private companies and local government financing vehicles have been the main users of structured issues. One popular method is for the borrower to put up the money for the subordinated tranche — the first to absorb losses — of the asset-management vehicle that buys the bonds.

Funds and brokerages acting as bond managers help issuers structure the bonds and pledge the notes to get bank loans. They provide a channel for corporate bond issuers that are unattractive to bond investors to access financing through the interbank market, while they earn fees from the business.

The tactic began spreading in 2018, especially among private companies, as the world's third-largest bond market was rattled by default fears and as risk aversion grew among investors. In late 2018, Zhou Hao, president of China Chengxin Credit Rating Group, in a public speech said private companies' actual fundraising value was far lower than their bond issuance because a large portion of the issues were bought by the issuers themselves.

There are no official statistics or market consensus on how much of such debt has been issued, but the highest estimate by Citic Securities was that outstanding structured issues reached 1.5 trillion yuan, or about 8% of the total of nongovernment bond issuance.

This practice operated well when market liquidity was abundant, allowing bond manager to use new loans to pay off previous borrowings, analysts said. It also took advantage of the expectation on the interbank market of an implicit government guarantee, so banks tended to overlook the risks related to counterparties. But much of that has changed since the Baoshang takeover.

It is difficult for banks to distinguish which bonds are structured or involve unqualified issuers that may lead to toxic loans, so they just tighten controls altogether, said a fixed-income manager at First Capital Securities. The total amount of toxic assets may not be large, but the contagion effects are terrible, the manager said, citing the 2008 sub-prime crisis as example.

"All of a sudden, the market confidence was gone," the manager said.

Data from the China Foreign Exchange Trade System showed that as of June 10, outstanding bonds pledged for repo financing totaled 6 trillion yuan, including 3.4 trillion yuan from nonbanks. The industry has widely thought that less than 1 trillion yuan of the collateral involves structured bonds.

Some analysts said they expected the risk of structured debts to be exposed, and the Baoshang incident only made that come sooner. They said the incident will help squeeze out bubbles of bond market demand created by the inflated issuance.

“The current credit crunch is temporary, but it will take several months (for the market) to restore the risk-control mechanism,” said a bond manager. “It is a normal process to clear up the market and force out players with dodgy practices.”

Risk exposure

New China Fund Management told clients June 12 that it needed to sell assets after defaulting on several products. The company is among institutions that have actively expanded business involving structured bonds in recent years, sources said.

Until recently, New China Fund’s parent, Hengtai Securities Co. Ltd., was also a subsidiary of Tomorrow Holdings, a sprawling financial conglomerate funded by embattled tycoon Xiao Jianhua, which also controlled Baoshang. Earlier this month, regulators said Tomorrow had shed its stakes in more than 10 financial institutions including Hengtai.

New China Fund didn’t disclosure the size of the defaults, but registration records show that the company currently manages 12 fixed-income products. Caixin learned that New China Fund has started reducing its position in defaulted products.

“Institutions engaged in channeling business involving structured bonds are terrified by the recent market rout,” said a bond market investor. “They are now cleaning up.”

“Bond managers didn’t realize that providing channeling business could be risky,” said a fund manager. “But as lenders cut their funding source due to fears about the quality of collateral, the business exposed them to risks.”

“118 project”

Industry insiders often call structured bond issuance a “118 project,” meaning such arrangements allow bond issuers to leverage 1 yuan to get 1.8 yuan of financing. In practice, the leverage could be even higher if issuers use borrowed money to buy the bonds.

The practice allows companies to access low-cost borrowing from the interbank market, which is often half as much as the cost of bond market financing, analysts said. But the companies have also to pay hefty fees to bond managers.

Some said structured bond issuance is not necessarily a bad thing as it offers a creative way for companies with limit credit access to secure financing, as long as the risks can be properly reflected by the coupon rate.

But opponents said the practice is dodgy as it takes advantage of low risk awareness on the interbank market and creates fake bond demand that distorts market prices. When such assets are used for repo financing, it could easily spread the risks in the interbank market, they said.

Yang Tiecheng, a partner of Beijing-based Han Kun Law Offices, took a tougher stance against structured bond issuance, saying the practice misleads investors.

“If the information is not truly disclosed, issuers and underwriters may contribute to fraud, which is equivalent to fraud in initial public listings,” Yang said.

Chinese regulators have shown anxiety about structured products. Guo Shuqing, the top banking and insurance regulator, on June 13 said in a speech that regulators should resolutely prevent the resurgence of complicated structured products.

“There is a global trend toward easing financial regulation, which may give a new boost to shadow banking business, and we need to pay more attention to that," Guo said.

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