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Asian Borrowers Gaining Upper Hand in Bond Sales

Some Investors Willing to Loosen Restrictions in Exchange for Yield

By

Fiona Law

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As investors snap up high-yield junk bonds in Asia, some companies are taking advantage of the strong appetite and loosening strings attached to the debt they sell.

Their ability to do so shows that issuers are gaining the upper hand as they offer relatively high yields, while in exchange for those yields investors are willing to accept less power to enforce restrictions on borrowers.

Still, Asian borrowers globally still have the most prudent covenants--triggers in the bond agreement that could cause a borrower to shore up its financial health--because the region's junk bond market is relatively young, with many countries' bankruptcy procedures largely untested.

"Given this low-rate environment, the bargaining power lies in the hands of issuers and their syndication banks," said Ken Hu, chief investment officer for Asian-Pacific fixed income at Invesco, with $802.4 billion in assets under management. "There's also a rising demand for Asian bonds by private bank investors, who usually pay less attention to covenants."

Chinese developer Kaisa Group Holdings Ltd., for example, issued a $400 million bond in early June with looser restrictions than on other bonds sold in past two years. The company then offered a fee of $3,750 for every US$1 million of bond to investors who agreed to similarly loosen restrictions on the old bonds--including removing restrictions on dividends and other payments. The company won approval from investors.

Kaisa Group didn't respond to a request for comment.

Changes to restrictions can be approved by a majority of investors in the bond. "Many times, investors aren't happy about the changes but have to go along as no one is holding a portion big enough to reject [the changes] and they don't know if other investors would accept or reject the changes," said Dilip Parameswaran, of consultant firm Asia Credit Advisors Ltd. "Many of them are willing to take the additional fee."

Moody's Investors Service says covenants in Asia have gradually weakened in recent years. The region's junk bonds scored an average of 2.67 last quarter, compared to 2.08 in 2011 when the ratings company started a scoring system. A lower number means stronger restrictions.

The scores are measured by six criteria, including restrictions on cash leakage, such as through dividend payments, capping debt levels and accessibility to company assets in case of default. The biggest contributor in Asia to weaker covenants is the increase in the volume of Chinese corporate bonds, which due to capital controls leave offshore investors vulnerable to default risks as they have no direct access to onshore companies' assets.

Bond buyers "have sought yield and have been willing to take a lower level of protection for a higher return," said Laura Acres, associate managing director at Moody's.

"However, should things take a turn for the worse... investors may well find that they have less covenant protection than they originally thought," she said.

Last week alone, $2.6 billion in Asian junk bonds were issued--making it the busiest week for issuance of debt below investment-grade this year, and pushing the total issuance this year to US$17.8 billion, according data provider Dealogic. Issuers last week included Indian energy company Greenko Group PLC and Chinese developer Modern Land (China) Co.

That's in stark contrast to a recent selloff in U.S. junk bonds, as investors reconsider following a rally due to rising geopolitical risks and concerns that eventual interest-rate increases by the Federal Reserve could dent the attraction of fixed-income assets.

To be sure, covenant-lite features are rare in Asia. And while few companies seek to change restrictions part-way through a bond's lifetime, some say looser restrictions benefit borrowers as well as investors.

"These changes we've seen so far give bond issuers more financial flexibility, and they are not unreasonable," said Luke Garner, co-head of high-yield capital markets in Asia ex-Japan at JPMorgan Chase & Co. "As the market continues to stay bullish, you'll continue to see issuers pushing the envelope here, as investors are buying bonds yielding much more than those in the West."

Usually the documents covering covenant changes are complex, and in the case of Chinese developer Evergrande Real Estate Group Ltd. contained more than 100 pages when it paid extra fees and won investors' approval in January to change restrictions on old bonds. Evergrande didn't respond to a request for comment.

MIE Holdings Corp., a Chinese energy producer, changed covenants for a bond in June. Its spokeswoman said the change allows the company to have "operational flexibility" where needed, and was widely accepted by investors who haven't raised any concerns.

Even when investors read the entire documents and understand the changes, they can still find it hard to push back if they don't like them.

"One does need to be cognizant that if the majority of bondholders do agree, you run the risk of missing out on the consent fee and at the same time, seeing covenant changes ultimately going through," said Swee Ching Lim, credit research analyst at Western Asset Management Co., with $468.7 billion assets under management.

Write to Fiona Law at fiona.law@wsj.com