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Kaisa looms over FA bond event

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The prospect of Chinese developer Kaisa Group defaulting will hover over the proceedings this week at *FinanceAsia*'s sixth annual Borrowers & Investors Forum, to be held on Thursday in Hong Kong.

In previous years the event, which brings together investment bankers, debt capital market specialists, portfolio managers and issuers, has tracked the rapid development of the region's fixed-income markets.

High yield in particular has been an investor favourite, due to its high returns, relatively high credit quality compared to US high yield, and its low default rate; 2014 saw only three deals go into restructuring, amounting to a mere 1.5% of outstanding value in Asian high yield.

Shenzhen-based Kaisa is widely expected to set a new tone for 2015. It started the calendar year by defaulting on a $400 million loan to HSBC, which responded by waiving the breach. That has given Kaisa breathing space but on February 8 it must pay a coupon on its $500 million, 10.25% 2020 bonds.

On Monday, the company announced its CEO, Jin Zhigang, had quit following the resignation of four other executives in December, as well as founder Kwok Ying-shing relinquishing his chairmanship.

It is possible the company can restructure and still meet its coupon payment. For example, it can renegotiate covenants or indentures on the bonds. The Shenzhen government is scrambling to find mainland developers willing to put equity into Kaisa.

Foreign investors, however, are braced for something worse. And that will tarnish the whole of Kaisa's outstanding bonds, totalling about $2.2 billion. That's 2% of the $110 billion in total Asian high-yielding bonds outstanding.

Troubles among Indonesian coal companies and Chinese oil-related names are also likely to increase the ratio of defaulted notionals versus the size of the universe's outstanding issuance. Investors expect Asian high yield default rates this year to be in the 3%-4% range if Kaisa does default.

"Investors bought everything [in recent years] because the day of reckoning seemed far away," said Borrowers & Investors speaker Dilip Parameswaran, CEO at Asia Investment Advisors. "Investors always thought there'd be a lender when it came time to refinance."

There are reasons to remain positive on Asian high yield's ability to generate returns similar to last year's (5.5% for Asia ex-Japan US dollar bonds, according to the JP Morgan Asian Credit Index).

Most issuers were smart and refinanced in 2014 while markets remained open. A modest $6 billion in Asia high yield corporate debt matures in 2015, according to Income Partners.

Moreover, most investors in the asset class are either dedicated Asia managers or come from local private banks, so there's little risk of massive outflows to the US. Maturities average about four years, so there should be little impact from the Federal Reserve raising overnight interest rates by 25 or even 50 basis points.

Indeed, the closing of China's high yield markets to new issuance, until fears about other defaults settle down, probably mean scarcity and attractive spreads will boost valuations at some point this year.

Finally, whatever the issues around specific issuers, Asian fixed income as a whole looks strong within the context of global emerging markets.

"Asian credit is least worst alternative," said Todd Schubert, head of fixed income research at Bank of Singapore and a speaker at last year's Borrowers & Investors event. "Yes it does have some problems but other emerging markets are in far worse shape."

Two questions

Two big questions remain for investors in Asia high yield, however. First, how will bondholders be treated during the expected Kaisa restructuring? The relatively higher credit quality of Asian junk bond issuers compared to the US has traditionally meant lower default rates – but also lower recovery rates.

Only 28% of Asia high yield is rated single-B, versus 56% in the US. The US also has a far greater proportion of triple-C rated bonds. The overall credit quality is superior in Asia, where the proportion of more double-B bonds is greater – and which yield around 150 basis points more than their cohort in the US.

Liquidity and other technicals make Asian high yield more volatile but it is less speculative, and upgrades are more likely than in the US.

But recovery rates in Asia are worse, notes Jim Veneau, Asia fixed income portfolio manager at Axa Investment Managers (one of the speakers at Borrowers & Investors). He notes that cumulative defaults since 1990 have resulted in an average recovery rate of 41 cents in the US, versus only 35 cents in Asia.

"Risk in Asia is not about defaults but low recovery rates," he said.

The second unknown investors and bankers must now ponder: is Kaisa a one-off? The market was totally surprised by its problems; this was seen as a sound, well-managed company with plenty of cash on its balance sheet.

The opacity around its restructuring and the suddenness with which the Shenzhen government froze its local landbank leaves portfolio managers wondering if other surprises await them.

"Not every developer is Kaisa but the restructuring is opaque," said Desmond Soon, co-head of Asian fixed income at Western Asset Management. "There are questions around the recovery level, and that outcome can reprice the entire complex."

Job Campbell, senior portfolio manager at Income Partners, explained Kaisa was a surprise because its fundamentals had appeared strong, yet the company was directly targeted by authorities. "The question then is: is this systemic, and if so, who's at risk?" Campbell's colleague Lachlan Campbell will also be speaking this week at Borrowers & Investors.

Investors speculate that Kaisa has been caught up in China's anti-corruption campaign – but its woes are probably also related to broader weakness in commodity and energy prices. If so, the asset class may see spreads widen.

If that is the case, default rates could well exceed 4% this year – and total returns will suffer. But the asset class should still deliver. A Kaisa default will of course cost bondholders, but in a low-interest rate environment, the asset class still delivers a carry of around 8%. Total returns will depend on spread movements as well as corporate default rates.

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