Watch For COVID Tail Risk In Asia-Pacific, Panelists Say

January 31, 2021

Key Takeaways

- Participants in our recent webcasts pointed to tail risks that could strike this year even amid a post-COVID recovery.
- These include surprise SOE defaults, shifts in government support, and bond-market volatility when interest rates normalize.
- 2021 will likely see more Asia-Pacific corporate and infrastructure issuers lose their investment-grade ratings.

With growth recovering, vaccines arriving, and global monetary policy still accommodative, credit markets are buoyant. Yet a tone of caution, rather than exuberance, prevailed at recent S&P Global Ratings events held to discuss the outlooks for corporate and infrastructure borrowers in Asia-Pacific.

Our panels of senior analysts and veteran credit investors often turned to potential tail risks during the discussion. Why? Because rates are rising, stimulus is receding, credit is tightening, and the Chinese government has made it clear that bailouts are not a given.

True, we expect a solid recovery in Asia-Pacific, with economic growth to reach 6.8% in 2021, led by China. We also anticipate corporate profits to begin reviving this year, helping companies to start working down elevated leverage. Most sectors will not return to pre-COVID credit metrics until 2022, however, and some will take even longer. Meanwhile, we expect defaults to rise, particularly among the region’s state-owned enterprises (SOEs).
Watch For COVID Tail Risk In Asia-Pacific, Panelists Say

Participants In Our Asia-Pacific Corporates And Infrastructure Panels

**Session 1: Shape Of Recovery And Major Shifts To Come**

**Moderator**
Christopher Lee, Head of APAC Corporates, S&P Global Ratings

**Industry panelists**
Haitham Ghattas, Managing Director, Head of Capital Markets, APAC, Deutsche Bank
Freddy Wong, Managing Director - Head of Asia Pacific, Fixed Income, Invesco

**S&P Global Ratings panelists**
Gregg Lemos-Stein, Global Head of Analytics & Research
Richard Langberg, Head, APAC Infrastructure and Utilities Ratings

**Country Lead**
Charles Chang, China Country Lead
Danny Huang, North Asia Commodities Lead Analyst

**Session 2: The Next Chapter For China**

**Moderator**
Charles Chang, Country Lead, S&P Global Ratings

**Industry panelist**
Desmond How, Head of Fixed Income, GaoTeng Global Asset Management

**S&P Global Ratings panelists**
Gloria Lu, Asia Infrastructure Sector Lead
Chang Li, China Country Specialist

**Session 3: South And Southeast Asia’s New Risks?**

**Moderator**
Anthony Flintoff, Head of South and Southeast Asia Corporates, S&P Global Ratings

**Industry panelist**
Vincent Ferraton, Head of Asian Credit Research, Pictet Asset Management

**S&P Global Ratings panelists**
Xavier Jean, South and Southeast Asia (SSEA) Sector Lead
Simon Wong, SSEA Real Estate Lead Analyst

**Lead Analyst**
Minh Hoang, SSEA Commodities Lead Analyst
Andrew Wood, SSEA Sovereign Lead Analyst

**Is There A Divergence Between 'The Real World' And Markets?**

**Gregg Lemos-Stein** started off the plenary session by acknowledging that the many positives—including a vaccine rollout and lower-than-expected defaults—may be raising risks of complacency. Monetary stimulus has been very supportive, but it can’t last forever. “A lot of companies may be masking some solvency issues,” he said.

While Asia has better controlled COVID and as a result suffered fewer downgrades than elsewhere in the world, the struggle is far from over. Globally, ratios of debt to GDP rose 14% in 2020, amid higher borrowing by households, corporates, banks, and governments. In Asia-Pacific, we expect rated corporates and infrastructures companies in Indonesia, Malaysia, and the Philippines will take the longest to recover credit metrics (see chart 1).
Haitham Ghattas of Deutsche Bank observed "some divergence between what's happening in the real world and the markets." In his view, investors are taking a very positive outlook, and are looking beyond the pandemic with some fear of missing out on opportunities ahead. One key factor is the effect of quantitative easing (QE) programs by global central banks. Effective vaccines could unleash pent-up demand and activity, which could boost inflation and lead to rising rates. After strong bond issuance in Asia-Pacific in the first three days of the year, an unexpected jump in U.S. 10-year treasury yields alarmed investors in the region, and sentiment cooled a notch thereafter. Mr. Ghattas expects monetary policy to remain steady for one or two more quarters, and future rate rises to be well-managed. Still, this latest event underscored the risk of market volatility as rates normalize.

Financing costs were at the top of the agenda for our participants, who sought feedback on this topic across all three of our sessions. Addressing one of these queries, Xavier Jean, in our session on South and Southeast Asia, noted that Singapore could face associated risks in 2021. The country has been a major beneficiary of global QE, which led to low borrowing costs and hefty issuance even for weaker corporates. Many Singapore corporates went on a debt binge and their debt-servicing capacity worsened during the pandemic. In contrast, markets have already repriced the risk for U.S.-dollar borrowers in Indonesia or Vietnam. Our 2020 analysis on listed companies in Malaysia and Thailand showed they pay high interest rates of 5%-6%; but their median EBITDA to interest coverage is a healthy 5x-6x, so they could absorb even a rapid 100 basis point jump in rates.

Can The High-Yield Market Absorb More "Fallen Angels"

Charles Chang, in our plenary session, noted that the risk is high for "fallen angels" (i.e., ratings that move to speculative grade from investment grade). And despite the recovery, the issuers in the 'BBB' category face significant risks of downgrades in 2021. We have negative outlooks on 43% of rated Asia-Pacific issuers with 'BBB-' ratings, our lowest investment-grade rating (see chart 2), whereas about a third of 'BBB+' ratings, our lowest investment-grade rating (see chart 2), whereas about a third of 'BBB+' rated issuers now carry negative outlooks. Despite the recovery, issuers in the 'BBB-' category face significant risks of
Would more "fallen angels" be destabilizing to markets?

Freddy Wong from Invesco, in general does not expect a spike in defaults or too many borrowers falling into distress, in part because credit growth in China remains healthy and hasn’t responded with a surge in new credit as in the previous economic shock. In terms of 'BBB' category credits falling into speculative grade, Mr. Wong expects many such companies to have a plan to restore their financial positions to maintain an investment-grade rating. Investors will evaluate these plans on a case-by-case basis, and their credit profile trajectory will be reflected in their bond prices.

The Longtail Risk Of Defaults

Christopher Lee observed that in times of economic shock that is mitigated by a huge stimulus, the usual pattern is an upfront spike in defaults and a quick improvement after that. This time, the risk is that defaults have a long tail and defaults could materialize even as economic recovery firmly sets in.
This is particularly the case for SOEs that have taken advantage of liquidity made available by stimulus policies to refinance and help local economies grow their way out of COVID. In some sectors, however, some of these projects may not be able to generate enough cash flows to support themselves, given the lingering impact of the pandemic, or in the case of new outbreaks.

Richard Langberg pointed out that government support becomes essential during times of increased stress. In a country like China, most local governments have large SOE sectors; and these governments are themselves stressed. "They potentially cannot support all troubled SOEs so they are going to have to make decisions," said Mr. Langberg. "Which of these SOEs will they support? The Chinese government hasn't really made any announcements as to which sectors are more important, which they will bail out, which they won't, which they will support. So we may see surprises."

Default fears could limit funding options for weaker SOE issuers.

Gloria Lu named SOE defaults as one of the top risks this year, especially for SOEs owned by local governments. Many SOEs in China have weak liquidity, high leverage, and heavily indebted government owners. These weaker SOEs generally have fairly hefty refinancing needs, and some tapped the market by issuing short-term paper when liquidity was good in 2020. For example, some Chinese renminbi 1 trillion (US$150 billion) in SOE bonds with domestic ratings of 'AA' or below either mature or have exercisable put options this year. However, financing conditions are tightening this year and lenders are veering away from weaker SOEs.
Any unexpected defaults and contagion could close off access for issuers and their peers when they need it the most. We have seen the knock-on effects of a default late last year by state-owned Yongcheng Coal and Electricity Holding Group Co. Ltd. (Yongmei) in Henan province.

Desmond How, of Gao Teng Global Asset Management, said he does not believe default rates have peaked in China, but he is still constructive on the Asia high-yield market. "The reach-for-yield phenomenon is back in vogue, considering global flooding of liquidity," he said. "Moreover, valuation is compelling. If you look at average yield for Asia high-yield, it’s 7%, versus 4.2% in the U.S. and Europe 3.2%." Mr. How thinks managing credit risk and duration risk is key for this year.

Vincent Ferraton of Pictet Asset Management, said that in assessing the likelihood of support in the state-owned sector, he likes to see evidence of support, not just government ownership. "That’s key," he said. Vincent prefers SOEs that are strategic, or very important to the government. In general, Mr. Ferraton believes state support is generally a credit positive for an issuer. While there is some weakening, he expects state support to remain fairly strong across the region.

How to gauge which SOEs are more likely to default?

For Mr. Wong of Invesco, any signs of lack of confidence in an issuer as indicated by domestic bond pricing or access to the domestic capital market is a key indicator of potential default. A sell-off of an issuer’s bond in the domestic bond market could make it harder for stakeholders, including local governments and banks, to take the risk of providing support. Governance is also critical, Mr. Wong noted. For example, if a company persists with risky expansion plans, even if bond and equity investors object, the risk of default can soar.

Mr. Wong warned against being lured into a false sense of safety because of an SOE’s importance to local development or job creation. He noted that such aims could be met through mergers or other means, while bondholders still suffer stiff haircuts and losses. Mr. Langberg concurred, and noted the same phenomenon with infrastructure SOEs in Indonesia and India. After a debt restructuring, companies would survive and continue to provide crucial services such as electricity distribution. "But the debt investors might be the unfortunate holders of a marked down bond, if you will," he said.

Will a new U.S. administration rescind the tech sanctions on China?

Andy Liu, in addressing this question, pointed out that the sanctions had bipartisan support. So it’s very unlikely for the new administration to come in and quickly peel back the sanctions and remove companies currently on the Entity List in one fell swoop. There may, however, be a review of export licenses and other restrictions to see if they are fulfilling the intended purposes of limiting the outflow of technology to entities associated with the Chinese military. The key question here is whether the Biden administration’s actions will be as punitive to commercial entities.

If the restrictions were eased, we think one beneficiary—among the companies we rate—would be Semiconductor Manufacturing International Corp. (SMIC; BBB-/Negative/—). The chipmaker is dependent on several key U.S. suppliers for equipment and components, but also very importantly, services. Inventory buildup ahead of the anticipated U.S. action has helped SMIC manage so far, but if the sanctions persist, this would be hard on operations and likely would weaken credit quality. Our outlook on the rating is negative.
Watch For COVID Tail Risk In Asia-Pacific, Panelists Say

Related Research

- Semiconductor Manufacturing International Corp. "BBB-" Rating Affirmed With Negative Outlook; Off CreditWatch, Jan. 6, 2021

This report does not constitute a rating action.
Watch For COVID Tail Risk In Asia-Pacific, Panelists Say

Contact List

CHINA COUNTRY LEAD
Charles Chang
Hong Kong
+ 852-2912-3028
charles.chang@spglobal.com

SECONDARY CONTACT
Gregg Lemos-Stein, CFA
New York
+ 212438 1809
gregg.lemos-stein@spglobal.com

SECONDARY CONTACT
Xavier Jean
Singapore
+ 65 6239 6346
xavier.jean@spglobal.com

SECONDARY CONTACT
Christopher Lee
Hong Kong
+ 852 2533 3562
christopher.k.lee@spglobal.com

SECONDARY CONTACT
Richard M Langberg
Hong Kong
+ 852 2533 3516
Richard.Langberg@spglobal.com

SECONDARY CONTACT
Gloria Lu, CFA, FRM
Hong Kong
+ 852 2533 3596
gloria.lu@spglobal.com

SECONDARY CONTACT
Andy Liu, CFA
Hong Kong
+ 852 2533 3554
andy.liu@spglobal.com
Watch For COVID Tail Risk In Asia-Pacific, Panelists Say