Orient Capital Research
Andrew Collier
631-521-1921; 852-9530-4348
andrew@collierchina.com
Shiyi Zhou, Analyst, Shanghai
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Yangzijiang

The Shipbuilding Bank

***Yangzijiang Shipbuilding** is an example of how large firms, state owned and private, are recycling bank loans into the Shadow Banking Market, and earning significant profits from what is essentially regulatory arbitrage.*

In all the discussion of shadow banking in China one of the biggest black holes in the data is the off-balance sheet lending by Chinese corporates. The larger Chinese corporates, both state owned and private, are able to relatively inexpensive bank loans due to their size or state ownership. With this extra capital, they then turn around and lend at much higher rates to capital starved borrowers in the shadow banking market. They are essentially arbitraging the spread between fixed bank interest rates and the demand for capital among Chinese companies.

Yangzijiang Shipbuilding			
Revenue (RMB Million)	**2011**	**2012**	*% Total*
Construction of container ships	2,511.0	6,447.2	*43.6%*
Construction of mutiple purpose cargo	11,084.7	4,891.1	*33.1%*
Construction of train ferry	23.2	-	*NM*
Interest income from advances on contracts	302.8	303.4	*2.1%*
Sale of goods	687.2	1,845.5	*12.5%*
Interest income from microfinance	180.1	215.5	*1.5%*
Interest income from financial assets	916.9	1,096.3	*7.4%*
Total Revenue	**15,705.9**	**14,799.0**	

There are obvious downsides to this type of lending. These corporate shadow banking loans are loosely – if at all -- regulated. The risk profile of loans is entirely up to management, which is not trained to be a bank. If things go sour in the economy – as the two recent liquidity crises and growing system wide debt load suggest they might – many of the larger, "Too Big to Fail" Chinese corporates may suddenly find a mismatch between their bank borrowing and their shadow loans. Such a collapse of loans by hundreds of corporates that have leveraged their balance sheets could cause an economic **and** political crisis; economic, because of the loss employment, and chain reaction among borrowers in the system; political, because many of these large industrial conglomerates, particularly the state firms, have close links with the senior members of the Party Leadership. Thus, these corporate shadow bankers are right in the middle of the shadow banking universe. But getting a handle on how these companies operate in this shadowy world is difficult.

Substantial Profits from Shadow Banking

We found one company whose financials provide a revealing picture of their shadow banking activities. Yangzijiang Shipbuilding is a Singapore listed company that builds container and cargo ships, and ferries. It posted 2012 revenue of $2.6 billion and has a market cap of $3.7 billion. In 2008, when the financial downturn hit the global shipping industry, the company made a strategic decision to invest in non-traditional finance – and become a shadow bank. As the company stated in its annual report:

"Beyond shipbuilding and its related activities, we have developed supplementary income streams from conservatively managed businesses such as low-risk financial investments. We also leveraged on our strong balance sheet to assist ship owners in ship finance and lease vessels for income."

Yangzijiang now manages ***RMB12.0 billion*** in investments and has become an essential part of their profits. Although revenue from financial assets and microfinance was only 8.9% of the total, if we categorize this essentially as interest income from financial assets and microfinance loans– that income totaled RMB1.3 billion**.** Add in ordinary interest income of RMB292 million, plus another RMB326 million in land grants. Combined, this relatively easy profits (risk aside) was **RMB1.9 billion**.

Finance Brings in 50% of Profits

To put that in perspective, the shipbuilder's financial activities, along with the land grants, added up to 50% of the company's 2012 net profit of RMB3.5 billion. How does the financial income compare with operating income from shipbuilding? Financial income ***exceeded*** the company's RMB1.8 billion in cash flow from operations by RMB1 billion. This isn't a shipbuilder with a finance arm – it's a bank with a shipbuilding subsidiary.

Big Bet on the Property Market

So how is the company generating this money? Yangzijiang notes:

"As part of the Group's strategy to optimize returns on robust cash balances and for better cash management, it is our practice to invest in fixed rate instruments offered by trust companies used in financing government-related bodies and corporations in China.

The breakdown by industry makes for good reading. Of the RMB12.0 billion in investments, in 2012 Yangzijiang doubled down on property, which accounted for 44.5% of the total.

Held-to-Maturity Financial Assets by Industry (RMB M)	**2011**	**2012**	***% YoY***	**% Total 2012**
Real Estate	3,946.2	5,355.9	*35.7%*	44.5%
Manufacturing	2,188.2	2,836.0	*29.6%*	23.6%
Trading	-	1,810.0	*NM*	15.0%
Services	-	355.0	*NM*	3.0%
Chemicals	1,500.0	20.0	*-98.7%*	0.2%
Investments	-	63.0	*NM*	0.5%
Textile	-	1,100.0	*NM*	9.1%
Other	2,293.0	1,410.0	*-38.5%*	11.7%
	11,027.4	**12,029.9**	***9.1%***	

Yangzijiang Buys Capital Cheap and Lends High

Where are they getting this capital? Mainly bank loans. In 2012, Yangzijiang had RMB8.5 billion of bank loans and corporate bonds on the balance sheet. Their average interest payment for RMB loans, which comprises the bulk of their borrowing, was 4.9% for current loans and 5.5% for non-current loans.

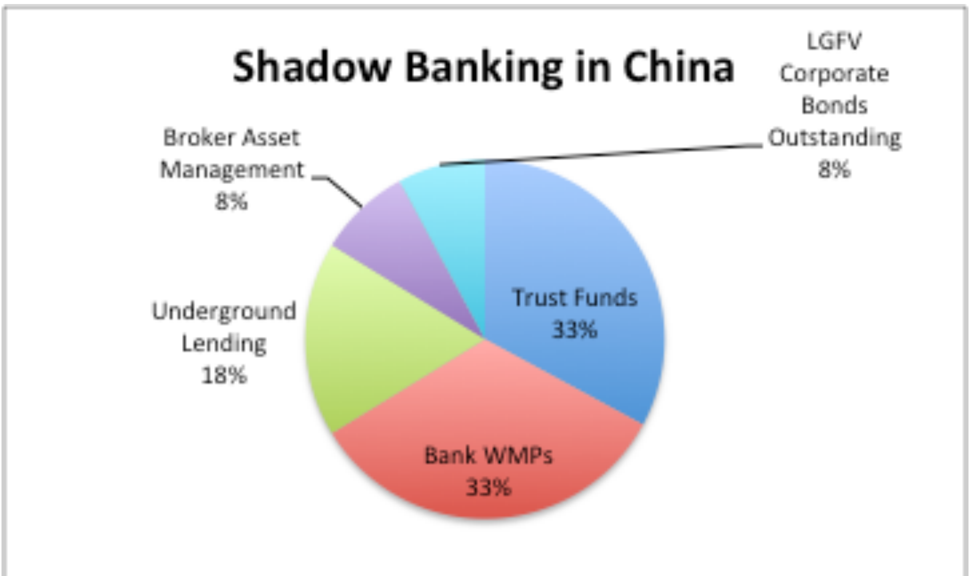
Meanwhile, they are getting very high returns for their loans. Over 40% of their borrowers are paying at least 2x the average 2012 PBOC rate of 6%, while 19% are paying at least 3x.

Interest Rate for Held to Maturity Assets (RMB M)	**2011**	**2012**	***% YoY***	**% Total**
No more than 1x PBOC Rate	300.0	648.0	*116.0%*	5.7%
Between 1x and 2x	3,263.2	4,616.9	*41.5%*	40.6%
Between 2x and 3x	6,799.2	4,590.9	*-32.5%*	40.3%
More than 3x	665.0	2,174.2	*226.9%*	19.1%
	10,727.4	**11,382.0**		

So what we're really seeing is Yangzijiang capitalize on the interest rate spread between its bank loans and what borrowers are willing to pay. That spread averages around a quite high 6 to 12 percentage points.

Significant Macroeconomic Impact of the Failure of Corporate Loans

It's difficult to quantify the extent of shadow banking by corporates in China. One way is to look at Shadow Loans issued by **Trusts**, which is where Yangzijiang invests its bank loans. As the chart below shows, one-third of the RMB22 trillion of shadow loans are issued by Trusts. Trusts are a loosely regulated ill-defined investing group.



Of course, trusts obtain their capital from many sources apart from corporates. We can assume that corporates form a big chunk of the trust business.

But there is a second macroeconomic risk to shadow banking by corporates like Yangzijiang. As Yangzjiang notes in its annual report, "it is our practice to invest in fixed rate instruments offered by trust companies used in financing ***government-related bodies*** and corporations in China. We're talking here about the notorious Local Government Financing Vehicles, who use government land as collateral to get bank loans that are off government balance sheets.

So the maturity mismatch and generally weak risk profile of bank loans could cause big problems in China, not only in the collapse of key corporates, but also by putting great stress on already weak local government finances.

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