Orient Capital Research
Andrew Collier, Managing Director
852-9530-4348
andrew@collierchina.com

Juilice Zhou, Analyst, Shanghai
Chris Li, Analyst, Shanghai

Orient Capital Research

November 23, 2016

Notes from China

The Leadership Discovers The Joys of Privatizing Debt

Summary

We just returned from a trip interviewing banks and local lenders in Fujian Province and Shanghai. These local lenders include pawn shops, private families, and small businesses. They provide short and medium-term loans to consumers. Two points jumped out: 1) Consumers are ***leveraging up*** by withdrawing equity from their assets, mainly property and autos. This is a negative indicator for China's economy. 2) Banks and other non-bank are drawing capital from these private individuals to fund government projects. This is a fiscal stimulus ***actively encouraged by the government.***

Rising leverage by individuals at a time when China should be deleveraging is worrisome on its own. But we also believe that the banks are assisting individuals by borrowing from the interbank market and creating products that are sold along with the private creditors. That creates a **systemic linkage** between the formal and informal credit systems. In the words of one PBOC official, China "is transferring leverage from the business to the household sector."

Rising Leverage in the "informal" Economy

Tramping through China's malls and offices speaking to "boiler rooms" and other informal lenders is an enlightening experience. Fuzhou is known for its aggressive capitalism; however, we believe it is similar to other areas of China – just exaggerated. Most important, it was startling to see ***how much leverage ordinary consumers are taking on*** outside of formal channels. These flows are not recorded by the PBOC, which doesn't have much of a sense of the size (confirmed by a PBOC official in Shanghai). What forms does this leverage take? Our interviewers provided the following insights:

- **Pawnshop.** The Diandong pawnshop is managed by a former Bank of China/PBOC official. They take collateral in the form of "liquid durables" such as jewelry, watches, stocks and CDs. The Loan-to-Value is:

  -Gold: 50%
  -Equity: 100%
  -Property: 60%
  -Art, Watches: 50%

The loans generally are 2-2.5% per month for small goods, and 3-3.5% per month for autos and property, which are harder to sell. The lender provides 100% leverage for stocks, obviously a form of margin lending. Interest fell in 4Q 2016 due to increasing competition. This pawnshop used to charge 30-40% per year and now it's down to 18% for annual loans due to increased competition (higher on a monthly basis).

Diandong also is seeking capital for a 500 million Rmb property project that is half-built, with the project providing a 12% return unlevered.

- **1758 Property Lender.** This company, called 1758, said collateralized loans are in demand. "The market is very hot recently. Investors face liquidity pressure and want to cash out," the founder said. Essentially, this business uses private capital to provide a bridge loan to home-owners. It's a form of regulatory arbitrage. Chinese home-owners are not allowed to refinance debt until their existing mortgage is paid. For example, an individual with a 1.5 million Rmb home and a 1 million Rmb mortgage would borrow 1 million from a local lender to pay the bank. Then refinance with a 1.4 million Rmb loan and keep 400,000 in cash. The short-term bridge loan is 12-15% while the new mortgage is 6%.

  The use of proceeds includes: 1) Personal consumption; 2) Debt repayment; 3) Business investment. New property is not the usual target. Oddly enough, this firm works closely with banks, which are eager to increase their loan book.

- **Diaper Business.** This company imports diapers into China and has had a side business providing **loan guarantees.** However, they are switching into what they call "supply side" financing, or short-term informal loans, using their own capital, for individuals withdrawing equity from autos or property. This was another sign of high demand for liquidity among consumers. It's also interesting to note a possible decline in the use of guarantees; this may signal increasing skepticism about the backing behind the guarantors, and a preference for hard cash.

- **China Industrial International Trust.** This is a Trust owned by the Industrial Bank of Fujian. It has 6 billion Rmb on balance-sheet and 4 billion Rmb off-balance sheet – significant leverage as most trusts have limited equity. It is promoting government infrastructure projects under the PPP (Private Public Partnership) banner with a split of 30/30/40 Government/Bank/Private. More important, ***they are looking to high-net worth individuals for investment capital*** for these projects. The borrower would use collateral such as land, consumer goods (alcohol was mentioned), and other collateral to backstop the loans.

- **Fujian Province City Easy Credit Company.** This lender is affiliated with the Bank of China to do consumer finance because "there are fewer regulations." (More regulatory arbitrage). "We connect banks with borrowers; we don't ask what they do with the capital," the owner said, although he admitted, "many people are consuming in advance." The 16% returns are quite high because the loans are not collateralized. They look at the borrower's credit history, which can be as little as three months of mortgage payments, at which point the borrower can withdraw equity from the home. Business is good because "the economy is not doing well."

  Although funding comes from the Bank of China, and other banks and insurance companies, it appears that ***the majority comes from private individuals, particularly from the wealthy cities of Beijing and Shanghai***. The property market was strong until October 2016 controls. Now, local residents believe the **market is at a peak** and are cashing out.

- **Lexiangbao P2P.** Another company that lends to customers wishing to withdraw equity from housing and autos. Auto loans are at a 50-70% LTV at rates as high as 36% annually. There is a database of official consumer loans but not for unofficial ones. "I know someone who has borrowed from 30 finance companies."

- **Fund Manager.** He is very concerned about debt levels. "Buying power comes from leveraging. In China, downpayments are coming from Shadow Banks. Leverage is magnifying the boom."

The Banks Contribute to Consumer Leverage

We also conducted interviews with several state-owned and listed joint-stock banks. They are ***contributing to the increase in personal leverage*** because of demand and the desire to grow the loan book and profits.

- **Joint Stock Bank.** "Total Social Financing is under control but there is still a need for liquidity." The general managers and others of this branch said that interbank flows have not been the source of credit. "Interbank lending is declining not because of new rules. There is less demand for interbank lending." This is partly because local government companies (LGFVs) are relying on the new bond swap program for liquidity and are issuing direct bonds, rather than utilizing bank loans. This bank has retreated from buying WMPs issued by small banks due to risks. As a result, profits have fallen 50%.

  Instead, this bank will cooperate with a securities firm to create and invest in a WMP with an LGFV and SOE as additional investors. Much of the remaining capital comes from private sources. ***"In the past it was on-balance sheet lending. Now we're trying to achieve multiple sources of funding. We will create a structured product and sell WMPs with other institutions."*** This bank's total WMP's outstanding has grown by one-third from 1.5 trillion Rmb in 2015 to 2.2 trillion Rmb currently. The bank has shifted its balance sheet from ***loans to asset management products.*** Where does the capital go? Instead of LGFVs, the current trend is to invest in subways and other direct infrastructure projects (probably due to regulatory scrutiny and prohibition against loans to LGFVs.) "In the past, there would be direct funding to a company. Now, there is a *local government guidance fund* which is an equity partner for a 20 billion Rmb investment to build a subway system," a senior official with an SOE bank said.

- **Local SOE Bank Hand-in-Hand with Local Government.** LGFV debt and borrowing is now constrained by the CBRC. The local governments continue to need capital and banks are willing lenders. The alternate route for capital-raising is Private Public Partnerships (PPP). But these require stringent approvals by the Provincial treasury department and fund-raising from private sources. A new investment vehicle, called the Government Purchasing Service, has been created to bypass regulators. "The city level can approve these by themselves but there is a quota." The money is invested in government projects such as highways, airports, and subways. As a result, this branch's assets have doubled in five years to 300 billion Rmb. "I do not believe we can grow as quickly in the next five years," a senior manager told us. Non-bank financials are now 20% of the loan book.

- **Small Bank Loan Book**

Loans	Rmb Bln	
Wholesale	140	46.7%
Individual	100	33.3%
Non-Bank Financials	60	20.0%
Total Loans	**300**	

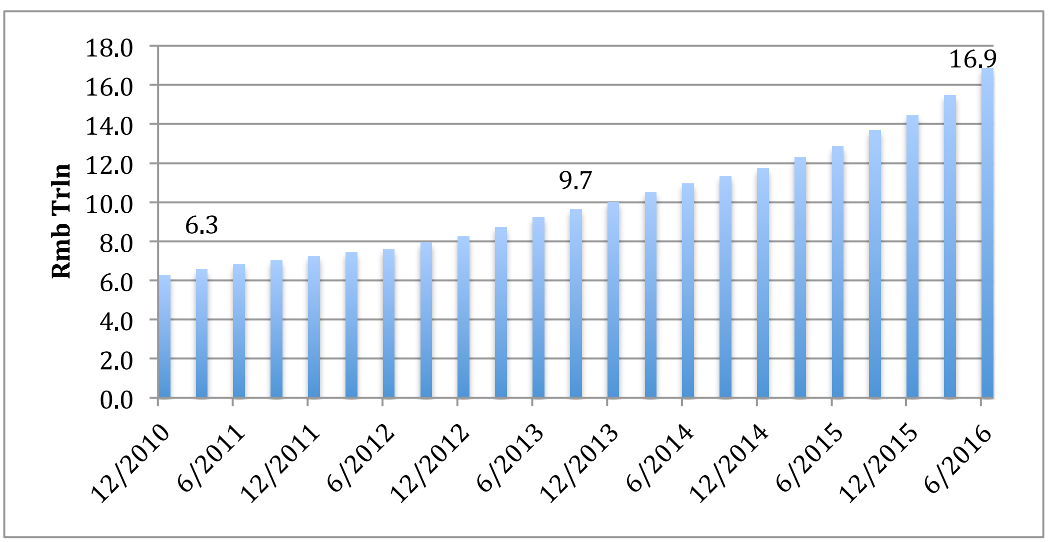
China's Growing Personal Leverage

Data Confirms the Growth Trend

Private Lending and Mortgage Loans

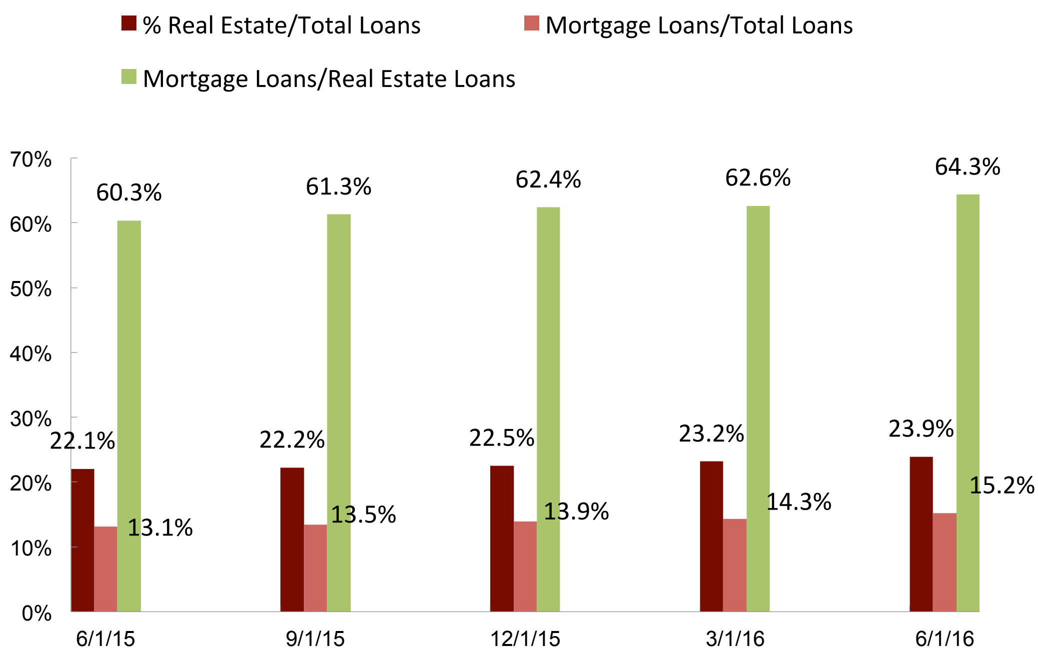
Mortgage loans have climbed continuously for the past six years at a 22% CAGR, from 6.3 trillion Rmb in 2011 to 16.9 trillion Rmb.

Mortgage Loans



Source: PBOC

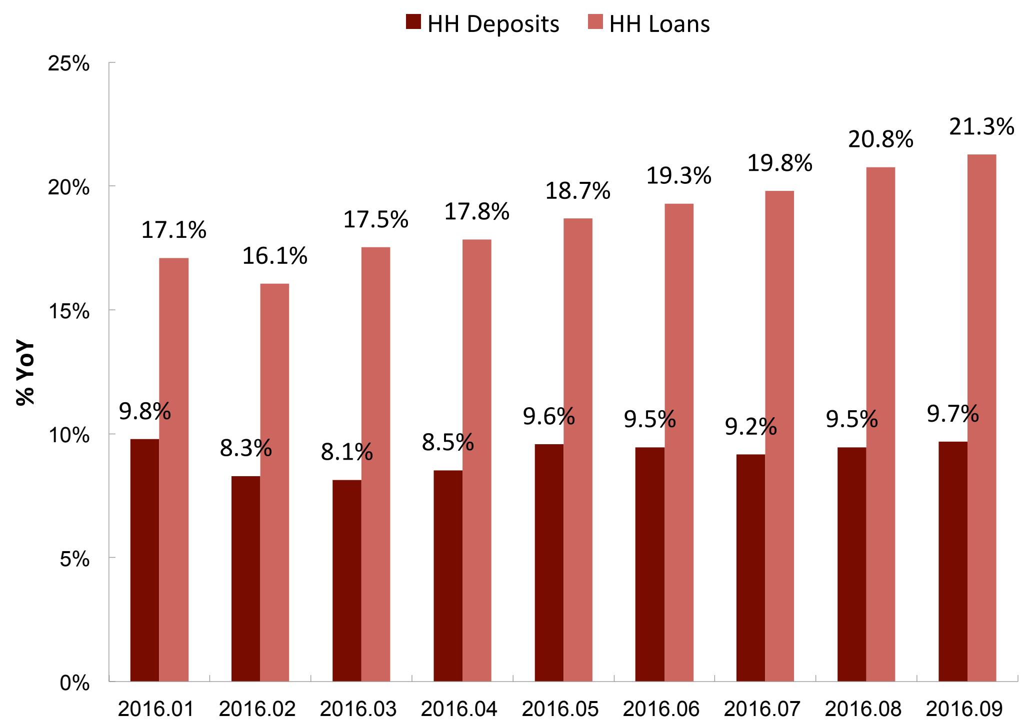
Mortgage loans account for approximately one-quarter of total loans and 65% of real estate loans.



This has generally been interpreted as an indication of strong support for the property market. However, the refinancing data we collected on our trip suggests the opposite may be true: ***homeowners appear to be withdrawing cash from their homes due to concerns about the property market reaching a peak.*** These loans for the most part are not to purchase real estate but for personal consumption, or occasionally, as operating cash for business.

The increase in mortgage loans is occurring despite lower growth in household deposits. Banks are lending out more than they are taking in.

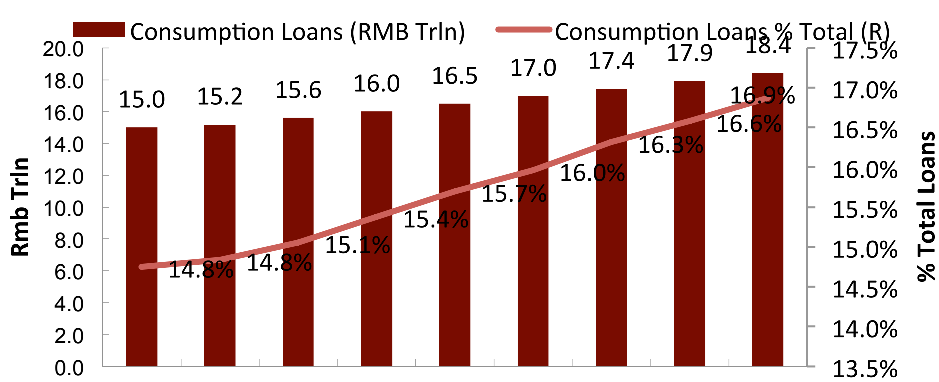
Household Deposits and Household Loans in Chinese Banks (YoY %)



Source: PBOC

Apart from reverse mortgages, personal consumption loans are increasing. Consumption loans have increased from 14.8% of the total in January 2016 to 16.9% in September.

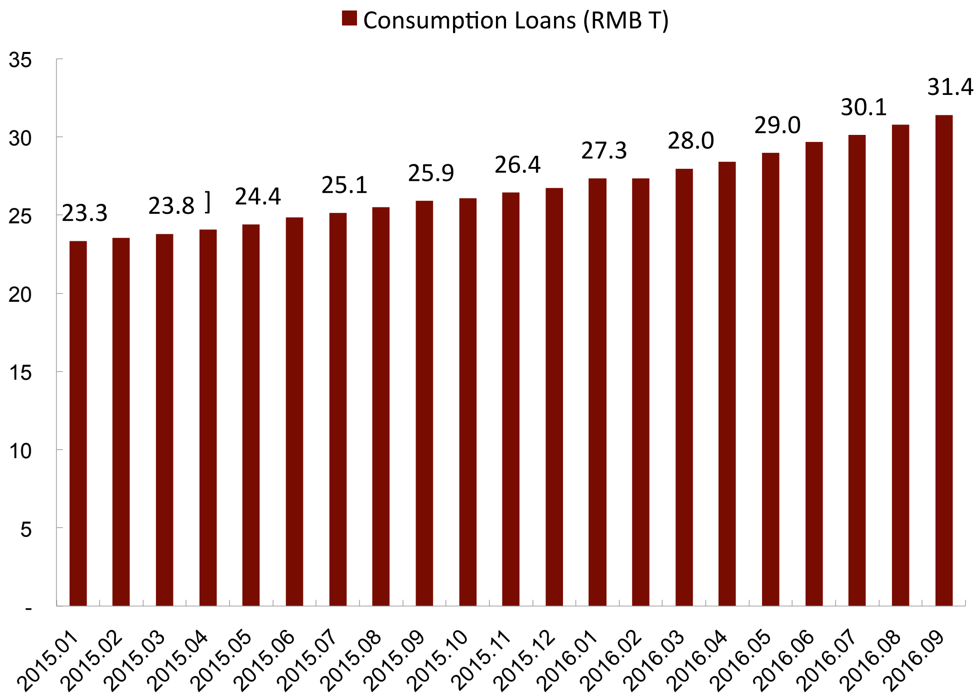
Consumption Loans as Share of Total Loans



Notice the growth of consumption loans – up 34.5% since the beginning of 2015.

Individuals are borrowing both from banks and the Shadow Banking market.

Personal Consumption Loans



Source: PBOC

Estimating Informal Leverage

How can we estimate the size of the personal loan growth within the informal economy? This data is not tracked by the PBOC or any other official sources in China. We can do a back-of-the-envelope analysis. The loan brokers we met with handled volume that ranged anywhere from $2 million per year to the largest, which said they could receive several hundred million USD in investor capital.

Using a conservative estimate of 50 million Rmb per lender in Tier One and Tier Two cities, we arrive at 100 billion Rmb. However, we would argue that there are many other informal loans outside of reverse equity loans that would add to personal leverage, so the figure is most likely much larger. In addition, what is also important is the ***trend – consumers are pulling money out of their assets out of fear of asset deflation.***

Estimate of Local Reverse Equity Loans in China (Rmb Mln)

Number of Tier 1 - 2 Cities	39
Estimate of Local Lenders Per City	50
Capital/Lender (rmb mln)	50
Estimated of Outstanding Collateralized or Reverse Equity Loans	97,500

Source: Orient Capital Research

Official Policy is to Tap Private Credit

The stock market boom and bust in 2015 was the result of an official policy from within Beijing's ruling State Council. That policy called for rising equity prices that the state firms could use to recapitalize. In other words, private capital would be funneled to the state system via the equity markets. Obviously, it did not work.

However, our view is that the leadership has adopted the idea that ***private capital can be utilized for state ends.*** This follows several years of tapping other sources of capital including insurance firms, securities brokerages, and local rural and city banks. The latest iteration of this credit migration is to the largest pocket of savings – private individuals.

We confirmed the new policy focus in our interviews in China this month. According to a Shanghai PBOC official:

> The household sector is not levered up. The government wants to deleverage but knows it's very hard to do. My view is they will transfer leverage from the business to the household sector. The mortgage balance is only one-third of total deposits. The goal is to guide demand in the household sector.

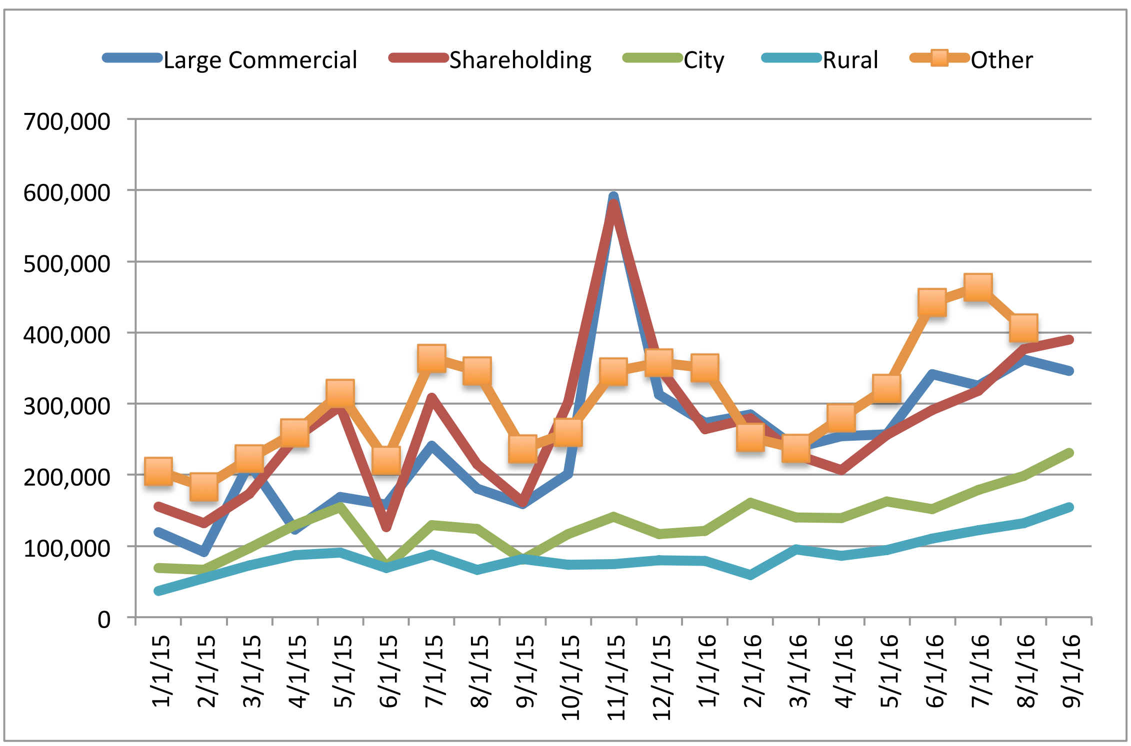
There is a vast pool of wealth within the banks that has with few investment alternatives. Wealth Management Products (WMPs) was directed more at high net worth individuals in the top cities. This program is aimed as much at rural as at top urban residents. Also, the WMPs were funneled primarily into property. Although many of these projects were related to government-backed Local Government Financing Platforms (LGFVs), many of them were simply private residential projects.

In contrast, the current program ***is explicitly designed to support the state sector.*** The most important among these are the Debt-for-Equity Swaps. This is one of Xi Jinping's lynchpin programs. He wishes to reduce borrowing by large SOEs by converting their debt into equity. At first, it was assumed the banks would be the buyers. But recently, it appears the banks have decided they can offload these investments on to private investors with the tacit agreement among regulators. For example, **Yunnan Tin** is swapping 10 billion Rmb of debt into equity. The transaction will be managed by China Construction Bank's Trust, CCB Trust. CCB Bank is also involved in the 24 billion Rmb debt swap for Wuhan Steel. In both cases, a portion of the debt will be sliced into small units and packaged as WMPs for private investors. "***While investors can expect 5% to 15% returns over 5 years, they are taking on risk and would have to absorb any losses***," according to Zhang Minhe, the CCB executive in charge of the swap.

Growth in Wholesale Funding

The story is a bit more complicated, however. Along with the growth in private funding, there is a similar increase in wholesale funding. Interbank loans have risen sharply, particularly among the smaller banks and securities firms.

Interbank Loans (Rmb Mln)



Source: PBOC

But the smaller banks are ***joining forces with private lenders to invest in government projects.*** The general manager of a local branch of the China Merchants Bank, one of the most aggressive among the banks, noted in an interview during our trip:

> "We co-invest with securities firms. We serve as intermediaries to flow credit to the real economy in hi-tech and other growing sectors…***securities companies and trusts can serve as financial advisors on WMPs***. They find a company, and a bank to take the senior layer, and we use our own capital or WMPs of funding. The money goes to an LGFV or an SOE. It could be that the SOE is a joint-venture where government is and equity investor."

The banks have been very explicit about this strategy. "In the past we had on-balance sheet lending. We are now trying to achieve multiple sources of lending," the CMB official said. He cited a 3 billion Rmb project in a local subway system involving government, bank and private credit. He also pointed to the bank's total WMP sales, which have skyrocketed from 1.5 trillion Rmb in 2015 to 2. 2 trillion in 2016.

The multiple sources of funding are also occurring in other areas of the Chinese financial system. One is international acquisitions. For example, China National Chemical Corp.'s $45 billion **acquisition of Swiss company Syngenta**, is one of China's largest outbound deals. Two banks, China Citic Bank and Standard Chartered, have said they would provide the capital. However, China Citic said it would turn to external sources for $15 billion -- but they haven't said from where. "Based on the latest documents related to the financing structure, which may be revised, none of the investments will come from ChemChina itself or its subsidiaries," according to an October 9 article by Caixin Magazine. One of the principal sources may be a loan packaged as individual WMPs for purchase by private investors. These would be injected into six offshore special purpose vehicles (SPVs). This is possibly the largest cross-border transaction that has relied on private investors for so much of the acquisition price.

Macroeconomic Impact of these Growing Informal Loans

One outcome of rising personal loans is the potentially damaging effect on consumer wealth and consumer confidence as the result of a rapid deflation of asset bubbles.

Most of the loan brokers we spoke to accept property as collateral at a 20-30% discount. Any declines in the market below this would put investors in negative equity.

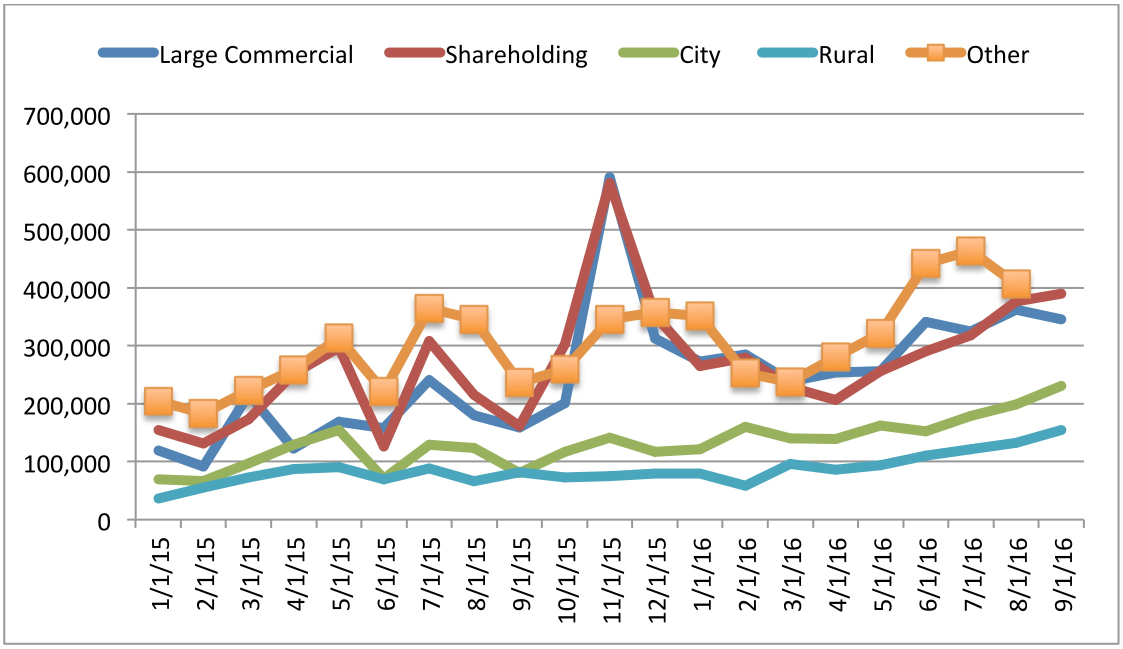
Related Leverage: Interbank Loans

A parallel trend is occurring with a rise in interbank loans, particularly among smaller banks and non-bank financial institutions, such as securities firms. On the surface, this appears unrelated to personal leverage. However, our interviews in China suggest they are related.

The PBOC data for the third quarter of 2016 shows rising wholesale funding through interbank lending and repo loans. Much of this increase has come from non-bank financial institutions (such as Trusts) and securities firms. For repos, NBFIs share rose from 16.8% in 3Q 2015 to 27.3% in 3Q 2016. Securities firms' share rose from 9.9% to 12.2%.

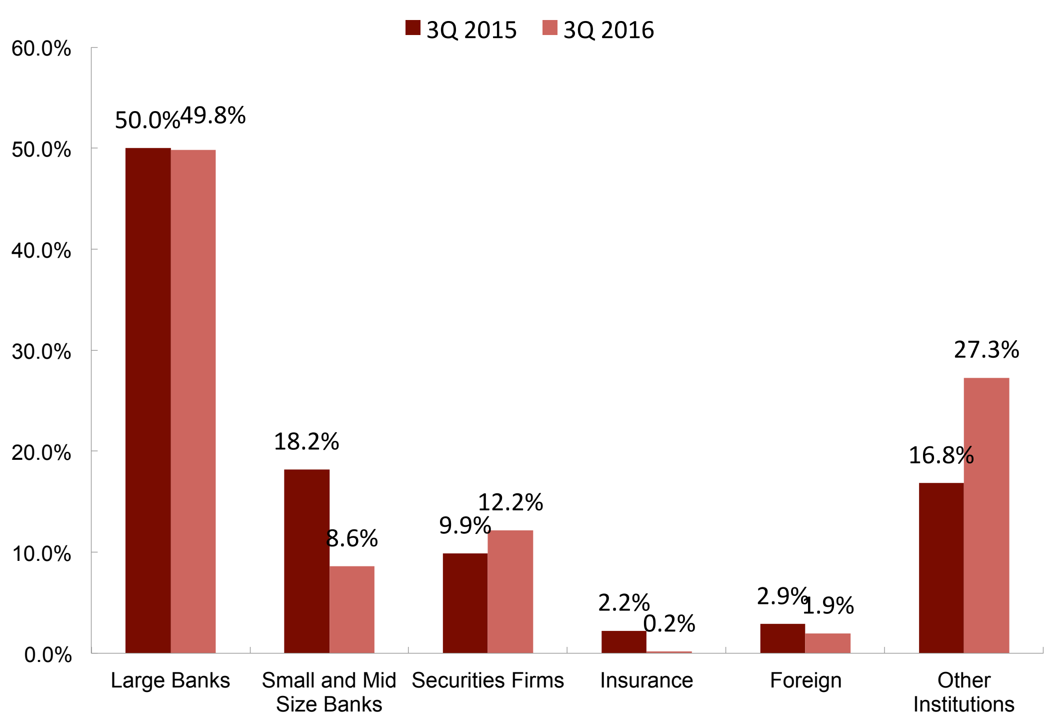
For interbank loans, while large banks had a significant 11.2 percentage point increase, securities firms' share rose 12.8 percentage points. (In this case NBFI's share fell).

Interbank Loans



Source: PBOC

Repo Loans - % Total Loans



Banks with few depositary resources, or who are aggressively seeking to increase profits through ancillary services, are raising funds through two sources: one is the interbank market and the second is from the sale of WMPs. In many cases, ***the banks are assisting private individuals by investing in similar end products.*** As the senior China Merchants banker told us:

"We co-invest with securities companies. We are the intermediaries, flowing to the real economy into growing sectors like hi-tech. The securities companies and trusts can serve as financial advisors on WMPs. They find a company, and a bank to take the senior layer, using their own capital ***or WMPs as funding***."

Conclusion:

The aggressive lending by the smaller banks and non-bank financials, along with private consumers in WMPs, creates a linkage throughout the system that could be damaging in the case of defaults or liquidity mismatch, between short-term funding and longer-term investments.

END