COMMENT

# Solving the structural problem in Chinese bonds

The latest twist in the Kaisa saga is putting structural subordination high on the agenda for offshore creditors, says DILIP PARAMESWARAN*

HOLDERS OF KAISA'S offshore bonds face an uncertain future after Sunac abandoned its takeover offer for the troubled Chinese property company. While the negotiations rumble on, investors should be paying close attention to the issue of structural subordination in US dollar bonds from Chinese businesses.

In every jurisdiction, whenever a holding company raises debt, it is structurally subordinated to the operating subsidiary's liabilities. Two of the most important remedies for structural subordination are a guarantee from the operating subsidiary and a charge on the operating company's assets.

But Chinese holding companies are often incorporated outside China, and when they borrow offshore, the onshore operating companies are not allowed to provide guarantees or pledge their assets as security.

From the early days, nearly 15 years ago, investors have accepted structural subordination in offshore Chinese bonds. Many companies have issued – and have successfully refinanced – offshore bonds. Rating agencies notch down the offshore debt if the onshore debt exceeds a certain level (15%–20% of assets, or 2x Ebitda). And life goes on.

SEVERAL PROBLEMS ARISE from this structure. One issue is that the onshore creditors of the operating subsidiaries get priority in a distressed situation. Onshore debt is often substantial, particularly for Chinese property companies, since they take large construction loans from onshore banks by pledging different properties. That is why onshore banks have been able to file suits to freeze Kaisa's assets, while offshore lenders have been left watching powerlessly.

Second, the ability to refinance offshore debt becomes crucial. The offshore issuers are able to pay interest out of dividends from their onshore subsidiaries, but are dependent on refinancing for the repayment of principal.

The third problem is that offshore lenders are exposed to subsequent financing decisions, since companies may be able to raise the share of onshore debt in their capital structure and push the offshore lenders deeper into subordination.

Another structure has emerged to allow China-incorporated companies to raise offshore debt without needing the approval of China's foreign exchange regulator. In this case, the onshore holding company signs a "keepwell" deed, promising to ensure that the offshore SPV that raises the debt will have enough liquidity to service its obligations. It may also sign an equity interest purchase undertaking, effectively promising to transfer enough money offshore to pay back the bonds.

However, the robustness of this structure has yet to be tested in practice. Investors' ability to enforce these agreements is subject to several regulatory approvals from China and hence may fail when the time comes. In any case, claims under these agreements will be subordinated to the onshore company's secured borrowings.

Last year, China opened a window for onshore companies to provide guarantees or pledge security for offshore debt, but this was subject to a restriction that the funds must be used offshore. Perhaps because of this requirement, there has been a very limited take-up of this structure, even though it is more secure for the offshore investors.

The structural problems assume an added importance when we consider China's growing role in Asia's US dollar bond market. In the closely followed JP Morgan Asia Credit Index, China's share has soared in the last four years to 34% of all outstanding bonds. In terms of new issues, China's share used to be 5%–10% between 2005 and 2009, but has since exploded to 55% last year, according to our database. That leaves a large chunk of every investor's portfolio exposed to the structural subordination issue.

DO WE HAVE any practical means of alleviating these concerns? One useful idea would be to incorporate an offshore reserve account with a portion of the bond proceeds, to cover perhaps six months of interest payments. This would enable a stressed company to continue servicing the bonds without triggering a default, giving an opportunity for potential bidders for the business to emerge. In a situation where competing bidders may raise the recovery value for the bondholders, this period may prove invaluable. We have seen such reserves previously in Indonesian deals: why not bring them to China?

**No structure can remedy underlying weakness in the business, but investors should not give up hope for better structures**

Financial covenants could also be tightened. The terms of offshore bonds usually restrict the amount of onshore debt that can be raised by subsidiaries to 15% of total assets, but the definition of debt often excludes bonds, debentures and other capital-market instruments. This exclusion leaves room for large onshore subsidiaries to raise debt from the onshore bond market, raising the level of subordination for offshore creditors.

Other potential areas for tightening could include the maintenance of a company's listing status, and the ability to declare default in case the stock is suspended from trading for a prolonged period.

While no lending structure can remedy underlying weakness in the business or corporate-governance failings, investors should not give up on hope of better structures. As long as we are concerned by the structural subordination problems in China, it is time to think about potential solutions, too.

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