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Life after default: why it (sometimes) makes sense to hold on to your distressed bonds

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We highlight three factors that underlie successful debt restructuring and exchange and believe that in the midst of excessive risk aversion, there can be potential opportunities in selected distressed bonds for investors.

To say that 2021 was a challenging year for China's property developers would be an understatement. According to Bloomberg, Chinese borrowers defaulted on a record USD 10.2 billion of offshore bonds in 2021, with real estate firms making up 36% of that total[1]. JP Morgan estimated that 59% of China high-yield (HY) bonds were trading below 70 cents on the dollar (a level that indicates financial distress) and with valuations implying a 40% default rate for the sector[2].

JP Morgan's study also showed that around 42% of China HY bonds were trading below 50, half of which were below 30. To put these numbers into context, the average trailing 12-month global defaulted bond recovery rate for senior unsecured bonds over the five years ending November 2021 was approximately 43%[3].

We believe that in the current market environment where risk aversion appears excessive, there are potentially attractive distressed bond opportunities for investors who have a diversified bond portfolio and who are able to sit through a debt restructuring exercise. In this article, we examine two case studies of successful debt restructuring and distressed exchange in recent years and highlight the key drivers for eventual bondholder recovery. We feel that investors should examine such events on a case-by-case basis and sometimes, it pays to retain defaulted or distressed bonds at deeply discounted prices.

KAISA GROUP HOLDINGS LTD

Kaisa became China's first property developer to default on its USD bonds back in 2015. Negative headlines on the firm started to emerge in December 2014, when government officials blocked the approval of its property sales and new projects in its home city of Shenzhen. The resignation of founder and chairman Kwok Ying Shing in the same month brought forward the maturity of a HKD 400

Source: [1]Bloomberg. As at 7 December 2021. [2]As at 3 December 2021. [3]Moody's. Default Trends - Global November 2021 Default Report Excel Data.

million term loan extended by HSBC. Although Kaisa received a waiver notice from HSBC shortly thereafter and was no longer required to repay the loan immediately, the group's liquidity situation remained tight.

Notably, Kaisa failed to meet the interest payment of USD 23 million due on 8 January 2015 in relation to a USD 500 million senior unsecured bond. Prices of the company's offshore bonds plummeted to below 35 cents on the dollar in the immediate aftermath. See Fig. 1. The group's bank balances at several financial institutions were frozen and investigated into, among other creditor actions that were taken against it. The failure of Kaisa to make good on the abovementioned coupon payment within the 30-day grace period meant that it officially entered into default in February 2015.

Some positive developments transpired in April 2015, when Kaisa announced that the sales stoppage on a majority of its unsold units at eight projects in Shenzhen had been released by the relevant authority. In addition, a subsidiary of Funde Sino Life Insurance Co., Ltd provided a loan of RMB 1,377 million to Kaisa's operating entity in Shenzhen at the interest rate of 12% per annum. Kwok Ying Shing was also unexpectedly reinstated as chairman in the same month.

At the same time, Kaisa continued to engage with the offshore bondholders' steering committee to come up with a consensual restructuring resolution. As an encouraging sign that Kaisa was still able to continue some business operations, the group achieved contracted sales of RMB 5.2 billion in the first ten months of 2015, albeit representing just around 22% of sales in the year-ago period.

Nine months following its interest payment default, Kaisa in November 2015 announced the terms of the proposed restructuring of its offshore debt, which were supported by the bondholder steering committee. The terms in Kaisa's restructuring

Fig. 1: Kaisa bond price performance (8.875% bond due March 2018)

Source: Bloomberg data retrieved 13 December 2021.

agreement went through multiple iterations before it was consented by 53% of offshore bondholders (as measured by the principal amount of their holdings) in January 2016. In March that year, Kaisa managed to garner the support of more than 80% of offshore bondholders for its restructuring proposal, after sweetening the offer by doubling the consent fee to 1% and increasing the coupon rates.

The group's offshore debt at the time consisted of around USD 127 million in loans from HSBC and ICBC, USD 2.22 billion of straight bonds, and USD 232 million of convertible bonds. In summary, offshore creditors were pooled into a single class and given the option to exchange some or all of their claims into any of the following:

- New bonds of various maturities at 1x of claims plus contingent value rights (CVR), equivalent to 7% of the notional value of new bonds received.
- New bonds without CVR, at 1.02598x of claims.
- New mandatory-exchangeable bonds at 1x of claims, subject to a total size cap. These bonds were automatically exchangeable into new convertible bonds once Kaisa's shares resumed trading.

In the first two years after the completion of Kaisa's debt restructuring, the coupon payment of the exchanged bonds was skewed towards additional bonds (pay-in-kind) rather than cash, but after three years, the cash portion of the coupon payment increased. There were additional protections for existing offshore bondholders, such as restrictions on the use of proceeds from issuance of future debt and limitations on the issuance of future subordinated indebtedness or equity.

At the end of February 2016, Kaisa successfully negotiated the restructuring of RMB 33 billion of its onshore liabilities, half of which were owned by CITIC Bank. Kaisa announced a month later that 90% of its onshore liabilities were either successfully restructured or no longer required restructuring. Finally, offshore bondholders approved Kaisa's proposed scheme of arrangement in May 2016, and the scheme was passed by both the Hong Kong and Cayman Islands Courts in June 2016.
Nearly one-and-a-half years after the group first entered into default, Kaisa announced the completion of its scheme of arrangement in July 2016. The indicative prices of Kaisa's bonds implied a high recovery rate of around 86% just before the effective date (21 July 2016) of its debt restructuring. See Fig. 1.

PT ALAM SUTERA REALTY TBK

Alam Sutera is an integrated property developer in Indonesia. Established in November 1993 and listed on the Indonesian Stock Exchange in December 2007, the group focuses on the sale of land lots in accordance with township planning requirements and property development in the residential and commercial areas in Indonesia.

In 2020, Alam Sutera's credit metrics and liquidity weakened significantly as property sales took a hit from the COVID-19 pandemic and land sales to China Fortune Land Development Co., Ltd slowed. The sharp depreciation of the Indonesian Rupiah (IDR) against the USD in 2020 also exacerbated Alam Sutera's refinancing risks. As risk sentiment deteriorated against the backdrop of the global pandemic and refinancing options for the company fell, Alam Sutera's USD bonds plummeted to a low of around 35 cents on the dollar in July 2020.

In early 2020, all three major credit rating agencies took negative rating actions on Alam Sutera, citing heightened refinancing risks among other factors. This weighed further on investor sentiment. The pricing of the company's debt securities continued to languish at deeply distressed levels for most of the year, despite it calling back USD 60 million of its USD 175 million bonds due 2021 earlier, in April 2020. Although Alam Sutera continued to engage in talks with financiers on its refinancing plans, there was limited breakthrough due to the worsening pandemic situation in Indonesia and the country's virus-related curbs.

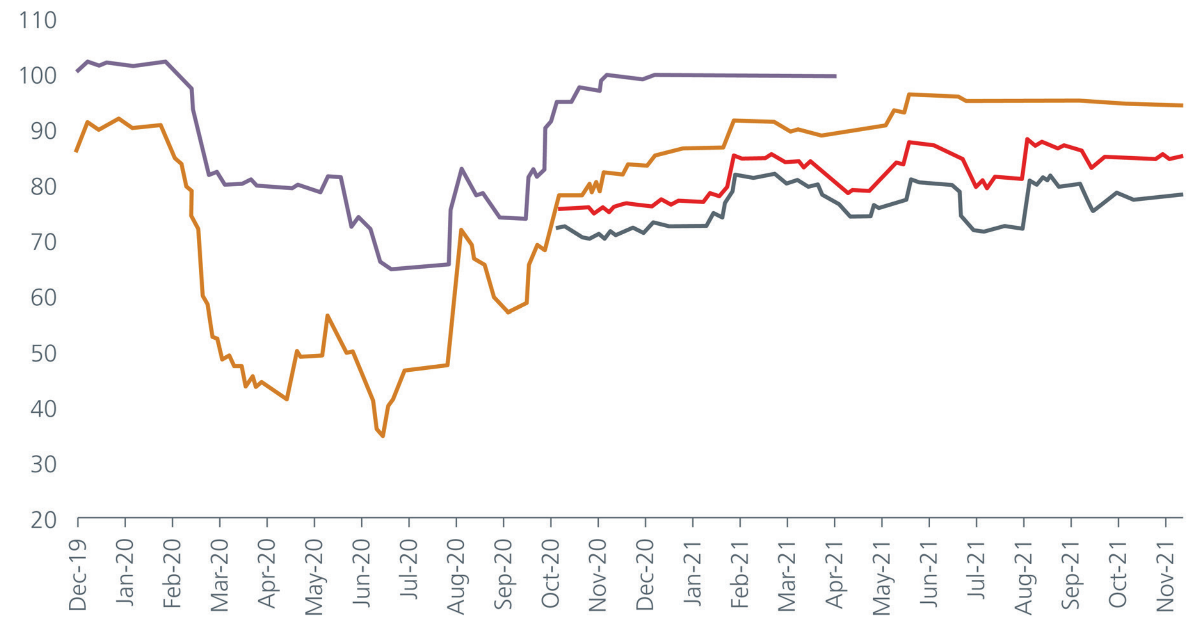
On 29 September 2020, Alam Sutera announced an exchange offer at par value for its USD 115 million 11.5% bonds due April 2021 and USD 370 million 6.625% bonds due April 2022. Alam Sutera's proposal was for all of the 2021 bonds to be exchanged for new 2024 bonds. Meanwhile, 25% of the 2022 bonds would be exchanged for new 2024 bonds and the remaining 75% for new 2025 bonds. The deal provided an upfront early consent fee of 50 bps and would only go through if at least 85% of all bondholders chose to participate.

The new 2024 and 2025 bonds would be secured on a first-priority basis by land mortgages over Mall@ Alam Sutera (estimated value of IDR 2.5 trillion) and a piece of commercial lot located next to IKEA in Alam Sutera township (estimated value of IDR 2.4 trillion). There would be a mandatory redemption event with priority given to the new 2024 bonds if these collaterals were to be sold. The 2024 bonds would further benefit from a mandatory redemption event if The Tower office building (estimated value of IDR 1.8 trillion) in Jakarta CBD was sold.

On 27 October 2020, Alam Sutera announced that the exchange offer was successful. 86.1% of 2021 bondholders and 87.4% of 2022 bondholders agreed to exchange their holdings for the new 2024 and 2025 bonds. Upon completion of the exchange offer, Alam Sutera's total outstanding USD bonds comprised of USD 15.99 million bonds due April 2021, USD 46.58 million bonds due April 2022, USD 171.40 million bonds due November 2024, and USD 251.00 million bonds due May 2025.

Alam Sutera redeemed the remaining small amount of 2021 bonds on their maturity date in April 2021. Meanwhile, the indicative pricing of the 2022 bonds is around 94[4], although the bonds are highly illiquid due to the small outstanding amount (USD 24.1 million). The new bonds due 2024 and 2025 have since traded up to the 79 and 85 levels respectively. See Fig. 2.

Fig. 2: Alam Sutera bond prices rebound on easing refinancing risks



Source: Bloomberg data as of 13 December 2021.

Source: [4]As at 13 December 2021.

THREE FACTORS FOR SUCCESSFUL DEBT RESTRUCTURING

The two case studies illustrate three factors that underlie successful debt restructuring and exchange. Firstly, it is crucial for companies that are experiencing a liquidity crunch to be able to maintain normal business operations as much as possible. The eventual recovery rate for creditors and the likelihood of the distressed company returning to financial viability are highly dependent on the performance of its operating assets.

Second, creditors need to work together with the distressed obligor to avoid a disorderly restructuring situation, or worse, liquidation. According to research[5], the recovery rate for China's onshore senior unsecured corporate bond defaults that ended in a liquidation scenario was less than 0.2% in 2019 and 1.1% in 2018. In contrast, the recovery rate for voluntary debt restructuring situations was much higher at around 50-85%.

Third, the importance of maintaining capital market access, or offshore bond funding for Asian dollar debt issuers, also plays a part in influencing the eventual restructuring outcome. Holders of USD-denominated China real estate bonds can take some comfort that offshore funding is an important source of capital for Chinese developers. A company that has better access to offshore debt markets may be viewed as having stronger financial flexibility, which may lead to lower relative funding costs. A company that has access to offshore capital can also tap overseas markets for funding at a time when domestic financial conditions are tight.

In our view, the same factors described above are at work for at least some of the Chinese real estate credits that have already defaulted or are priced as such. For instance, in the case of China Evergrande Group, the government of Guangdong recently said it would dispatch a working group to Evergrande to ensure "normal" operations. Evergrande has also announced the establishment of a risk management committee featuring senior managers from the Guangdong provincial government and mainland state-owned enterprises. The government's hands-on role suggests that Beijing is determined to avoid an uncontrolled collapse of the embattled developer.

THE LIMITS TO NEGATIVISM

When faced with persistently negative headlines and steep bond price declines, it can be immensely challenging for investors to take a step back and consider whether prices are already as low as they can go. The limited reaction in the financial markets when Evergrande was officially labelled as a defaulter in December 2021 suggests that most negative assumptions may have already been discounted in the prices of Chinese high-yield real estate bonds.

A liquidity crunch does not necessarily lead to a liquidation of a company. As the examples of Kaisa and Alam Sutera above illustrate, investors who sold the bonds at their respective troughs, when things looked the bleakest, would not be able to participate in the subsequent recoveries, which were well into double digits in terms of annualised price returns. Furthermore, as and if more cases of successful debt restructuring or credit workout with reasonable recovery materialise, this could also have a positive spillover effect on other bonds that are currently trading at distressed levels. These bonds could in turn rally as their issuers see a significant improvement in market technicals and better access to funding.

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Source: [5]Morgan Stanley. August 2021.

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