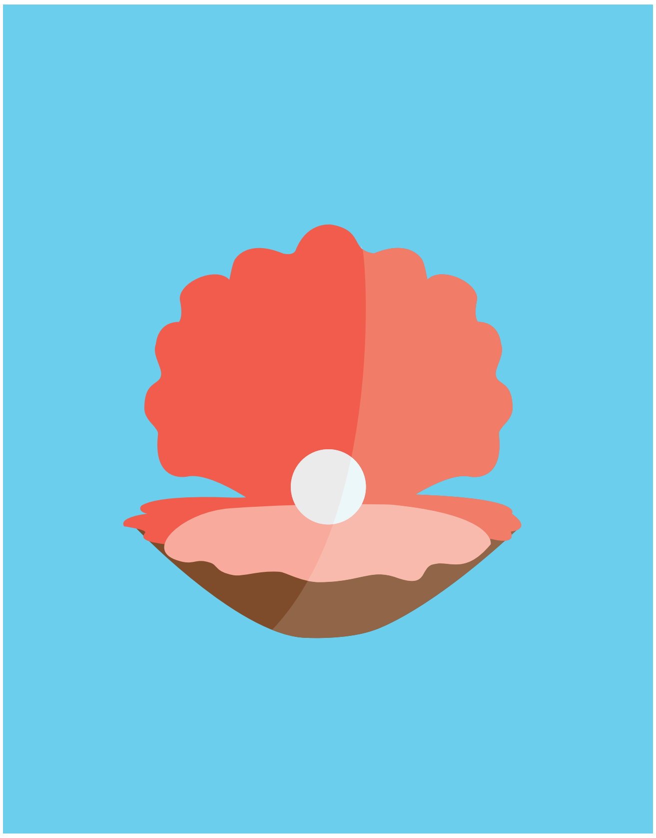
Chinese onshore convertible bonds: the hidden gem?



The Chinese domestic convertible bond market has increased exponentially to become the second largest globally. This happened almost unnoticed. This development deserves a closer look.

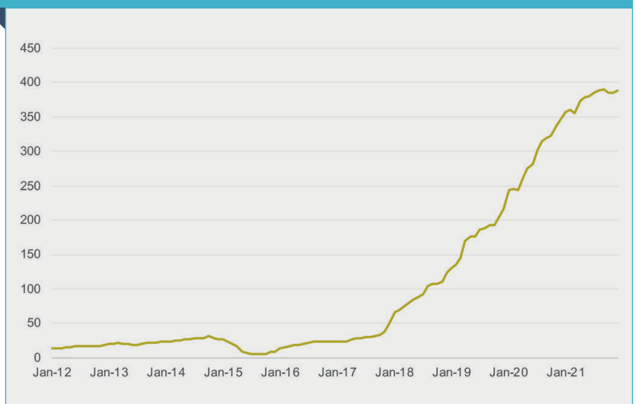
By *Benjamin Barretaud*

Although the very first convertible bond in China was issued thirty years ago, issuance volumes remained minimal until recently. After many credit-led boom-bust cycles, China has engaged in a real disintermediation since the middle of the 2010s, pushing companies to explore its modernizing capital markets. Since then, issuance has been booming, largely surpassing Chinese offshore convertible bonds. From 49 issuers and 140 billion renminbi ($ 21.5 billion) in 2016, it is now close to 400 issuers and 890 billion renminbi ($ 140 billion)[1], as Figure 1 shows. For comparison, the US & European markets are respectively $ 303 billion and $ 98 billion with 252 and 105 issuers. The Asian market (including Japan but ex onshore China) is composed of $ 52 billion and 103 issuers[2].

Notwithstanding a spectacular growth, the popularity of convertible bonds in China seems sustainable. When one thinks about convertible bonds, what comes to mind is typically small-cap and mid-cap companies that do not necessarily have access to traditional debt capital markets, using them to fund their growth in exchange for part of their equity upside. China looks like the perfect place for this hybrid instrument. On the one hand, many investors are eager to embrace the opportunities China has to offer, but may be fearful of the volatility associated with equity investing. On the other hand, many companies need capital to finance their rapid expansion. It is also a more convenient and flexible funding instrument than equities or loans as it is more cost-efficient thanks to relatively low coupons. Furthermore, the regulator's approval to issue convertible bonds is easier and quicker to obtain than for raising capital.

One distinguishing specificity of the Chinese offshore convertible bond universe is how underlying companies are different from the ones in broad equity indices such as the CSI 300. As at the end of 2021, 39% of the underlying companies had a market capitalization below $ 1 billion equivalent and 86% below $ 5 billion[3]. Issuers' ownerships and industries are well diversified. Indeed, private-owned enterprises represent 41%, state-owned enterprises 25% and financials 34%[4]. In sector terms[5], when compared with equity indices, the

FIGURE 1: THE FLOURISHING NUMBER OF ONSHORE CONVERTIBLE BONDS



Source: Wind

ILLUSTRATION: SHUTTERSTOCK

convertibles space has larger exposures to financials (34% versus 21%), industrials (17.4% versus 15.1%) and materials (11.8% versus 8.7%) while lower exposures to consumer staples (6% versus 14.9%), IT (11.8% versus 15.9%) and healthcare (3.6% versus 9.6%).

This market shows additional significant singularities compared to other financing instruments in China, as well as convertible bonds in other geographies. Looking at onshore convertible bonds in the Chinese context, they grant companies access to a source of funding dominated by institutional investors (87.7%)[6] looking for diversification from traditional fixed-income, while the equity market is largely retail-driven (47.5%)[7]. Owing to this, unlike in western markets, financials are more frequent issuers.

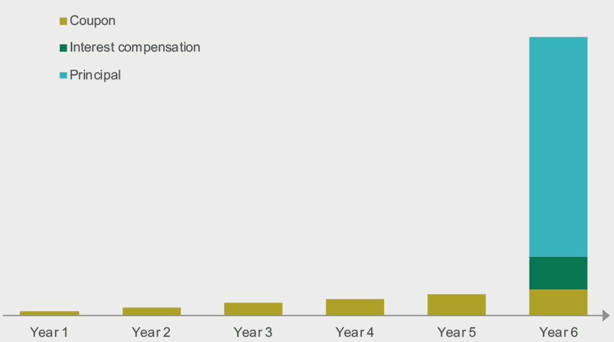
Vis-à-vis international convertible bonds, Chinese domestic convertibles exhibit some unique and appealing clauses benefiting investors:

- Coupons are stepping-up over time, typically starting around 0.2%-0.5% and then attain a range of 1.5-2.5% depending on issuers.
- They are traded on an exchange while global convertible bonds are traded over the counter.
- They are mandatorily rated (mostly by local rating agencies).
- Most issuers have the discretionary right to reset lower the level at which one is allowed to convert its bonds into equities (or conversion price) should they need to reinforce their balance sheet.
- Investors typically have the right to ask for the early redemption of a convertible bond during the last two years before maturity should its share price fall below a predefined level.
- In the case a bond reaches its maturity date (in other words: out of the money and not early redeemed), holders are compensated for the lost opportunity to exercise their conversion option. Therefore, the final redemption price would include the principal, the final coupon and this ‘interest compensation’, as illustrated in Figure 2.

The flexibility the instrument brings to issuers partly explains why we have not seen any default in this market to this day[8]. Thanks to those key characteristics, onshore convertibles have behaved very differently in risk-adjusted terms compared to both Chinese equities and global convertible bonds. The favorable credit-linked clauses underpin the significant downside risk mitigation the asset class has exhibited.

The diversified exposure to smaller companies at an early stage of their growth likely explains the strong behavior of convertible bonds versus equities. Since the end of 2016[9], the CSI Convertible Bond Index had an annualized return and volatility of 6.6% and 10% with a maximum drawdown of -13%. This compares to an annualized return and volatility of 5.2% and 19% with a maximum drawdown of -34% for the CSI 300. This holds true when compared to H-shares or the small-cap focused CSI 500. Interestingly, when compared to global convertible bonds[10], performance and volatility are similar, but the maximum drawdown is much smaller for onshore convertibles (13% vs 22%). As one expects from convertible bonds, convexity in a nutshell! ■

FIGURE 2: CASH-FLOW PROFILE OF AN ONSHORE CONVERTIBLE BOND



Source: UBP

1 Wind, data as of 2021, December 31st.
2 Refinitiv convertible bond indices, data as of 2021, December 31st.
3 Wind, Bloomberg, UBP, FX rate as of 2021, December 31st.
4 Wind, data as of 2021, December 31st.
5 Wind, Bloomberg, using the GICS classification methodology, data as of 2021, December 31st.
6 CICC, CBIRC, SSE, data as of 2021, December 31st.
7 Cf. supra (footnote 3).
8 Wind, UBP.
9 Starting at the end of 2016 when the flow of issuance picked-up meaningfully making the onshore market diversified enough for performance to be representative, through the 16th of May, 2022.
10 Refinitiv Global Convertible Bond Index (USD).

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SUMMARY

The Chinese onshore convertible bond market is booming and already the second largest market globally.

The issuer base offers a diversified exposure in terms of sectors and market capitalizations compared to broad equity indices.

Domestic convertible bonds provide investors with favorable and unique credit-linked clauses.

Therefore, to this date, domestic convertible bonds have experienced a compelling risk-adjusted behavior against onshore equities and global convertible bonds.