

Show me the money...

...the implications of liquidity constraints for SMEs and Korean banks

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According to the “Annual Report on Small and Medium Enterprises (SMEs)” by the Korean government’s SMBA (Small and Medium Business Administration), the number of SMEs in 2006 was 3 million, hiring 10.9 million employees. This made up 99.9% of the total number of business enterprises and contributed 87.5% to employment in Korea. SMEs’ contribution to employment in Korea is much higher than other countries – Japan 77.8%, Taiwan 76.6% (2005 data), US 50.4% and the UK 58.8%.

GDP contribution by Korea’s SME manufacturers was 40.5% of total 2007 GDP. Thus, deterioration of the business environment in SMEs will have significant impact on Korea’s economy and growth.

On Nov 12, Shinsung Engineering & Construction, established in 1968, that ranks 41st amongst the domestic construction firms with on-going domestic projects of USD1.4bn and overseas of USD520m, filed for a corporate debt reorganization program with the court. According to the Construction Association of Korea, the number of construction firms that filed for bankruptcy in the first 9 months of 2008 was 305 (78 in Q1, 102 in Q2, and 125 in Q3).

The significant contribution by the construction industry (c. 15% of total GDP, according to Merrill Lynch) and the important role in employment by SMEs, are shedding a negative light on the stability of financial institutions as well as a recovery of the economy in the short term.

Government bailout program

The Korean Government’s bailout programs are categorised into three parts - provision of USD liquidity, measures on real estate/construction sector and liquidity provision to SMEs and households. As of Nov 20, USD69bn and KRW22.3tn (USD14.9bn) has been provided or guaranteed by the Government and the BoK (Bank of Korea).

In order to provide sufficient USD into the banking sector, as well as the currency swap of USD30bn between Korea and the US, BoK will (a) guarantee up to USD100bn on external debt that will be issued by Korean banks for three years and (b) provide USD30bn of dollar liquidity into domestic banks, another USD10bn for currency swap, and USD5bn to Korea EXIM (Export-Import).

Measures to stimulate real estate markets and help ailing construction companies include the Korean Housing Guarantee Company (KHGS) purchasing unsold apartment units up to KRW2tn (USD1.4bn) from construction firms, and, together with the Korean Housing Finance Credit Guarantee Fund, KHGC will help construction firms issue Asset Backed Securities (ABS) collateralising the unsold apartment units. Other measures include:

- 👑 easing the tax burden on real estate – transaction tax and holding tax, including comprehensive tax
- 👑 easing restriction on loans; increasing hurdle ratios of LTV (Loan-to-Value) and DTI (Debt-to-Income)
- 👑 boosting housing supplies by abolishing regulations
- 👑 more active/expansionary government spending on social infrastructure (c.KRW10tn [USD6.7bn] in 2009)

A series of rate cuts is very important to avoid a hard landing in the real economy. In a two month period, BoK has cut its base interest rates three times to 4.0% (25bps on Oct 9th, 75bps on Oct 27th and 25bps on Nov 7th) and further rate cuts are implied by the BoK.

One of the problems, in spite of these rate cuts, is that actual interest rates in lending markets and bond markets are remaining at a high level or are heading upwards, which has a negative impact on household consumption as well as the financial burden on corporates.

Bond Markets

Corporate Bonds Issuance – primary market (USD bn)				
2004	2005	2006	2007	9Ms08
31.1	27.9	22.9	22.3	16.0

(Source: "Bonds Market Brief" in Sep '08 by Korea Stock Exchange.)

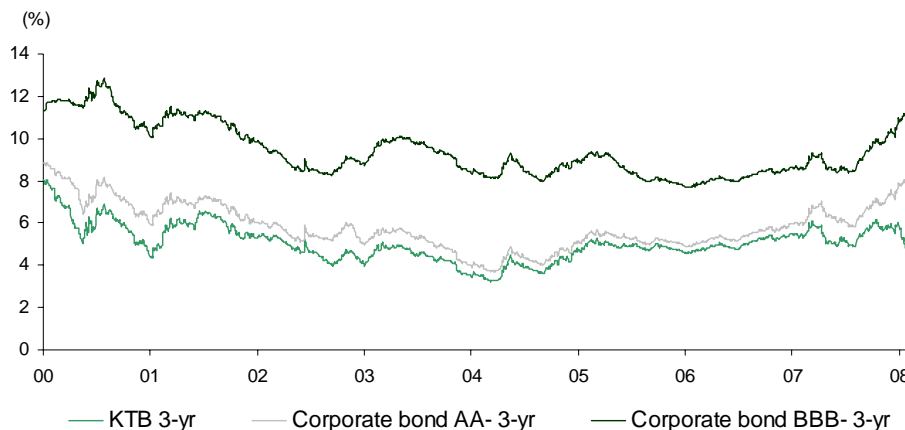
The Treasury bond yield is at 5% or higher these days. Due to the credit crunch and lack of liquidity, financial institutions don't have purchasing power to absorb treasury bonds. The real problem lies in the difficulties of SMEs to gain access to bonds issuance to secure liquidity. Bonds stabilisation funds up to KRW10tn (USD6.7bn) by the government/the BoK were set up for purchasing corporate bonds, banks debentures, primary Collateralised Bond Obligations (CBOs) and asset backed Corporate Papers (CPs).

Corporate Bonds Issuance (by credit rating) (USDbn)				
	2006	2007	8Ms08	Sep'08
A- rated and above	7.0	11.4	9.5	1.2
Weight %	62.1%	77.4%	83.6%	94.7%
BBB+ rated and below	4.3	3.3	1.9	0.7
Weight %	37.9%	22.6%	16.4%	5.3%
Total	11.3	14.7	11.4	1.9

(Source: Financial Supervisory Services)

According to the public release by the FSS (Financial Supervisory Services) on "Bonds Issuance in September 2008", bonds issuances by "A- rated and above" were 77.4% of total issuance in '07, and have increased more than 94% in the first 9 months this year. To the contrary, bonds issuance with BBB+ rating and below, have become relatively smaller.

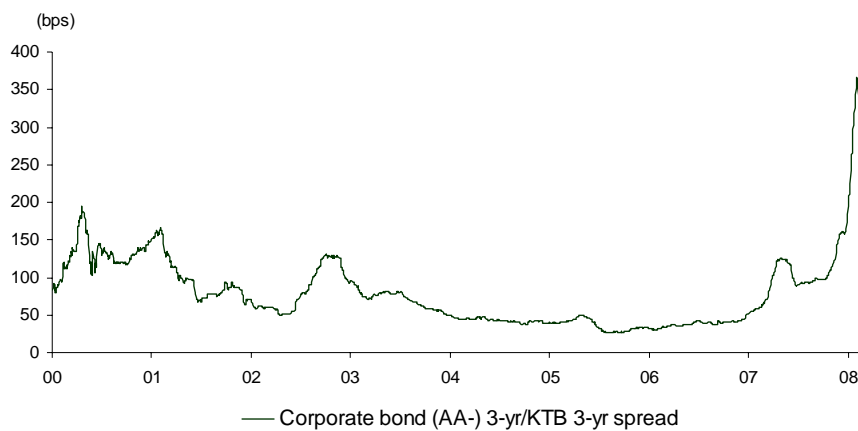
Yield on corporate AA-/BBB- 3 yr and Treasury bond



(Source: Samsung Sec)

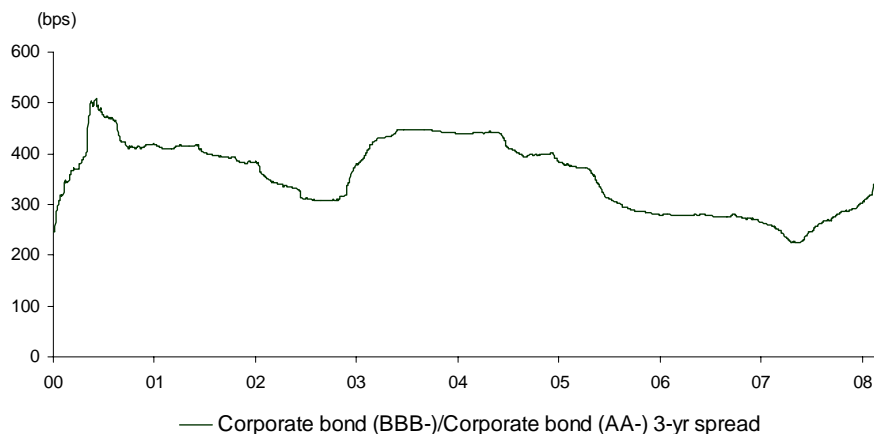
It is true that most bonds issuances are made by large corporations. The relatively small proportion by lower credit rated companies implies that SMEs, that have more restriction on the access to bond markets, are having a more serious credit crunch experience. Furthermore, the credit crunch situation has made the entire bonds primary market shrink. According to FSS on Nov 21, bonds issuance in Oct was KRW2.3tn (USD1.5bn, -43.6% YoY), amongst which SMEs have not issued any corporate bonds. This compares with KRW9.8bn (USD6.5m) in Sep and KRW223.8bn (USD149m) in the 10 months to end October '08. No issuance with BBB and below was made in Oct.

Spread between corporate AA- 3 yr vs. Treasury bond



(Source: Samsung Sec)

Spread between corporate BBB- 3 yr vs. Treasury bond



(Source: Samsung Sec)

Construction sector in SMEs

There were 90k SME construction firms in 2006, however, some of these must have gone under by now. Recent data says that out of 321 bankrupt companies in October 2008, 65 were construction companies, which is the highest figure in 43 months.

The sluggish real estate market situation is shown in the increased number of unsold apartments, which is estimated (informally) c. 300K units, according to Merrill Lynch (many construction companies are reluctant to release the number of unsold apartment units data). In money terms, this represents c. W75tn (USD50bn), equivalent to 7% of Korea's nominal GDP in 2008. The big six leading construction companies are taking c. 11% of the total unsold apartments, which implies there are many SME construction companies suffering from the liquidity crunch due to disappointing pre-sales results. Furthermore, many unsold apartments are located in provincial areas where it's harder to expect a quick recovery.

One of the major reasons for this sluggish pre-sale of apartments is that construction companies have set their selling prices very high, riding on asset price bubbles in the past, which in turn has a boomerang effect to the construction companies.

Other relevant data are the outstanding PF (Project Financing) loans that are guaranteed by construction companies. According to FSS, PF loan provision to construction firms by banks at 1H08 end was KRW47.9tn [USD31.9bn] (KRW 25.9bn [USD17.3bn] at 2006 end) with a default rate of 0.68% (0.23% in 2006). PF loans by mutual savings banks to construction companies was W12.2tn [USD8.1bn] (W11.3tn [USD7.5bn] at 2006-end) with default rates of 14.3% at 1H08 and 17.0% at 3Q08 (10.3% in 2006). Samsung Sec measures W20.5tn (USD13.7bn) of PF loans in the 25 leading construction companies.

PF loans are an off balance item, not shown in balance sheet figures. The increasing trend of default rates both in banks and mutual savings banks is threatening the stability of those financial institutions, which in turn provokes tighter loan control over SME construction companies. This is basically similar to the US sub-prime situation. One big difference is that there are no derivatives involved.

Implication to banks

As shown in the table below, loan to deposit ratios by Korean banks have continuously increased from 109.0% at the end of 2006 to 124.2% by 3Q08. In order to fill the gap of over-demand, Korean banks had to depend upon more issuances of Certificates of Deposit (CDs) and debentures. However, the current credit crunch doesn't allow the banks to issue CDs and debentures at favourable conditions.

Loan to deposit ratio							
(Wtn)	Loan [A]	Funding			Loan/Deposit Ratio		
		Deposit [B]	CD[C]	Debenture [D]	A/B	A/(B+C)	A/(B+C+D)
End 2006	508.6	466.6	65.4	95.3	109.0	95.6	81.1
End 2007	583.0	470.6	88.0	121.2	123.9	104.4	85.8
1H08	632.0	499.5	107.3	127.8	126.5	104.2	86.0
3Q08	649.2	522.7	106.3	134.6	124.2	103.2	85.0

(Source: A press release in Oct by FSS about "Loan to Deposit ratio")

Furthermore, extreme difficulty in funding in USD-denominated debenture is another big burden for the entire banking sector. Despite the fact that there is a high demand for loans from SMEs, the banks are not in a position to increase loan growth. Instead, they need to monitor and control any default and the increase of non-performing loans from SMEs at the same time. Possible defaults from construction SMEs are becoming seriously burdensome.

In general, corporate loans in KRW from banks account for 50-55% of loans, and households account for c. 40-45%. Of total corporate loans, SME loans account for c. 90% and the remaining are filled with large corporate loans. In November 07, construction loans made up 10.3% of total SME loans, an increase from 8.4% in 2005. More exposure to SME construction loans, including PF loans, explain the higher delinquency ratio in banks as shown below.

The Net Interest Margin (NIM) trend of the aggregate banks has been heading south for the last couple of quarters; from 2.77% in 1Q07, to 2.6% in 1Q08, to 2.57% in 2Q08. Recently, deterioration of NIM is becoming more severe.

SME loan delinquency ratio (banks)



(Source: Samsung Sec)

Possible increase of NPLs (Non-Performing Loans) from SMEs and deterioration of NIMs, have led most of the banks to issue sub-ordinate bonds to enhance their BIS (Bank for International Settlements) capital adequacy ratios; Woori Financial are issuing KRW1tn (USD667m), KB Financial KRW 700bn (USD467m), Shinhan Financial W700bn (USD467m), and Hana Financial KRW500bn (USD333m).

When to buy banks?

The Korean government's policy gets more specific, focusing more on the construction industry, small shipbuilders and financial institutions as well. One of the examples is to launch a program called "Construction Companies – Creditor Coalition" that will select 100 or more viable construction companies (before default) and provide them with more liquidity in exchange for restructuring and more control over management.

Similar programs will be also applied to small and medium shipbuilders with decent order backlogs, but no refund guarantees provided by banks. Once they are selected by banks, refund guarantee will be supported so that they can meet any delivery schedules. Of course, the losers from the program will be scrapped at fast speed. Specific policies aiming at SMEs imply that there must be some negative legacy affecting banks balance sheets going forward.

Given the huge impact of SMEs to the entire GDP and the contribution to employment, restructuring in SMEs is a must to avoid any further negatives to the economy. Despite this, more time is required to observe further progress in the restructuring of SMEs and banks, however, starting to lay all the bad things on the table may shorten the window of opportunity in investing in Korean banks.

Narrowing the spread between corporate bonds and treasury bonds or stabilisation/appreciation of KRW, will be a key signal for investment in Korean banks.