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S&P Global
China Ratings

COVID-19 Impact on Business Growth and Asset Quality has been Moderate for Chinese Auto Finance Companies

A Credit Study on the Auto Finance Industry in China

October 22, 2020

Key Takeaways

- China's auto sales have seen a V-shaped recovery from COVID-19, and we expect the pandemic's impact on business growth in the sector to be moderate and controllable. However, we continue to acknowledge the high degree of uncertainty that remains for the economic recovery from COVID-19 for both China and other countries.
- Auto finance companies' asset quality saw weakening signs in early 2020 due to the pandemic. Following China's robust economic recovery in the second and third quarter, we however expect bad debt pressure in the sector to be controllable. In addition, risk for leading auto finance companies is further mitigated by the strong capitalization, good asset quality and very high reserve buffers in place prior to the pandemic.
- Auto finance companies' business franchise and overall credit profiles are closely linked to the competitiveness of their associated auto manufacturers. Weakening credit quality among global car makers due to COVID-19 may also weigh on their auto finance subsidiaries. We believe the recovery of the domestic car industry can help stabilize domestic car makers' ability to support their auto finance subsidiaries, or at least avoid having a significant negative group influence at this stage.

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About This Article

S&P Ratings (China) Co., Ltd. (S&P China) has conducted a desktop analysis of a selection of major non-bank financial institutions ("NBFI") in China. We have chosen these institutions based on their asset size, representativeness of any specific NBFI subsector and availability of public information. The analysis contained herein has been performed using S&P China Methodologies. S&P China Methodologies and analytical approaches are intended specifically for use in China only and are distinct from that used by S&P Global Ratings. An S&P China opinion must not be equated with or represented as an opinion by S&P Global Ratings or relied upon as an S&P Global Ratings opinion.

This desktop analysis has been conducted using publicly available information only, and is based on S&P China's methodology for financial institutions and our understanding of both the NBFI industry in China as well as our understanding of the institutions themselves. The analysis involves applying our methodology to public information to arrive at a potential view of credit quality across the NBFI sector. It is important to note that the opinions expressed in this report are based on public information and are not based on any interactive rating exercise with any particular institution. The opinions expressed herein are not and should not be represented as a credit rating and should not be taken as an indication of a final credit rating of any particular institution, but are initial insights of potential credit quality based on the analysis conducted. This desktop analysis does not involve any surveillance. The opinions expressed herein are not and should not be viewed as recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security.

We have conducted this desktop analysis on individual institutions and present the results contained herein at an aggregate group level. The different sections of this research show the statistics and performance of different groups of institutions and the market more broadly against the metrics we generally consider most relevant under our methodology.

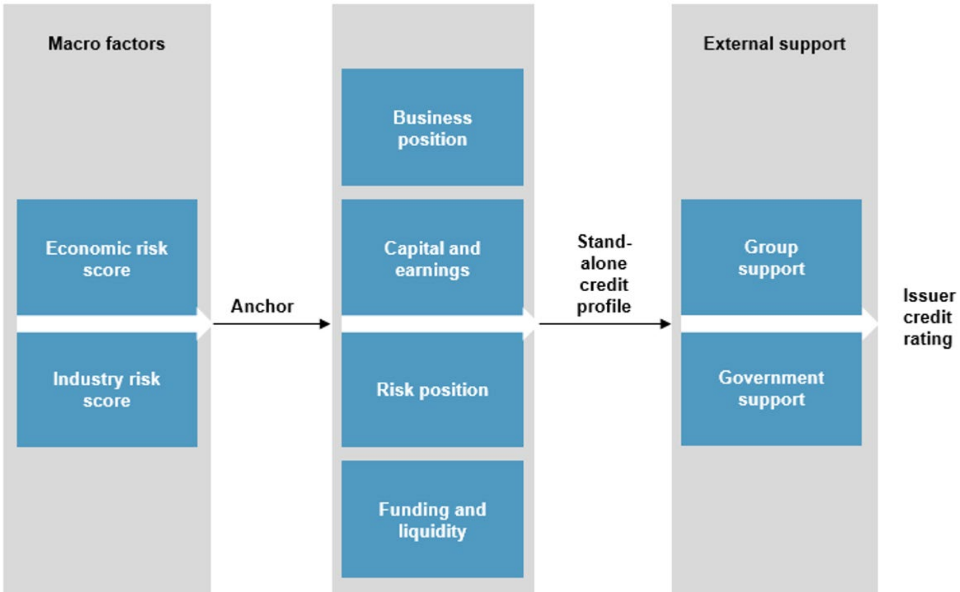
Given the desktop nature of this analysis, and that we have not conducted an interactive review with those institutions, we may have made certain assumptions in lieu of confirmed information and where relevant we may also have attempted to consider any possibility of parent, group, government or other forms of potential support, to inform our view of potential credit quality. S&P China is not responsible for any losses caused by reliance on the content of this desktop analysis.

Overview

This desktop analysis is based on S&P Global (China) Ratings Financial Institutions Methodology. We typically determine the stand-alone credit quality based on our assessment of an institution's anchor, a starting point, and then incorporate its own characteristics compared with the anchor. S&P Global (China) Ratings typically applies an anchor of 'bb+' for non-bank financial institutions ("NBFI"). For NBFIs licensed and regulated by China Banking and Insurance Regulatory Commission ("CBIRC"), we typically adjust their anchor from 'bb+' to 'bbb-' to reflect their robust regulatory environment and access to the inter-bank market. The entity-specific factors that we may use to adjust from the anchor include business position, capital and earnings, risk position, and funding and liquidity. We then determine the issuer credit quality based on the stand-alone credit quality and our assessment of potential group and government influence.

Chart 1

Financial Institution Methodology Framework of S&P Global (China) Ratings



Note: After assessing the issuer's entity-specific factors, a holistic assessment may be applied to evaluate its credit characteristics in aggregate and versus peers before arriving at SACP.

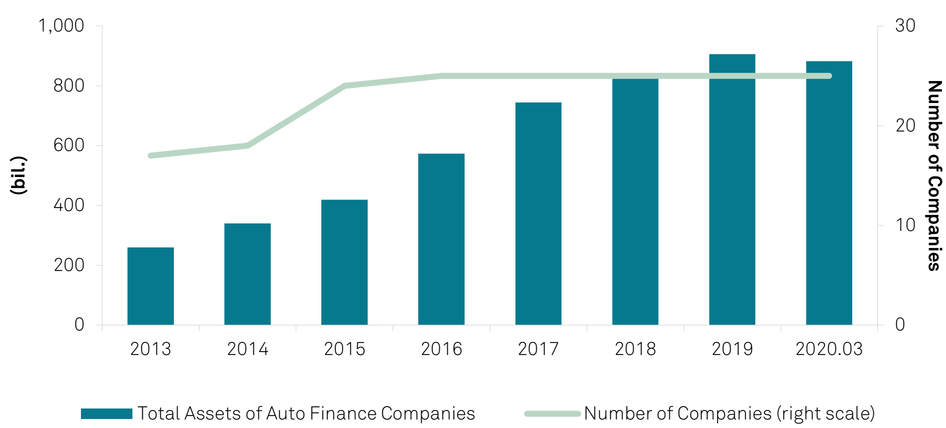
Source: S&P Global (China) Ratings

We typically apply an anchor of 'bb+' to NBFIs and adjust the anchor to 'bbb-' for NBFIs licensed and regulated by CBIRC.

China has 25 auto finance companies licensed and regulated by CBIRC. They are all closely associated with car makers. Before 2003, the regulator allowed only commercial banks to provide auto financing in China. With regulations on auto finance companies announced in 2003, car manufacturers began receiving auto financing licenses the next year. Auto finance is a niche sub-sector of NBFIs. As of the end of 2019, auto finance companies had total assets of 906 billion RMB, representing only 0.3% of China's commercial banking industry.

Chart 2

Total Assets of Auto Finance Companies



Source: CBIRC, collected and adjusted by S&P Global (China) Ratings

Auto finance companies' business growth witnessed a mild slowdown in early 2020 due to the pandemic.

Because auto finance companies are regulated by CBIRC and have access to the inter-bank market for funding, we typically view the average stand-alone credit profile of auto finance companies as better than that of an average NBFI. Therefore, although the typical NBFI anchor is bb+, we adjust auto finance companies' anchor to bbb-.

We have tested the credit quality of ten major auto finance companies which have issued bonds in the domestic market. Thanks to strict regulation by CBIRC, a transparent business model, strong brand names associated with major car makers, strong capital and good asset quality, we view the average stand-alone credit quality of auto finance companies as typically better than an average NBFIs. According to our desktop analysis, the indicative stand-alone credit quality of China's top 10 auto finance companies ranges from [bbb_{spc}] category to [a_{spc}] category, with the median is at [a_{spc}] category. This subsector's standalone credit quality is typically higher than our NBFI anchor of "bb+" and [bbb_{spc}] category median of the 200 banks we tested. Their indicative issuer credit quality typically falls into the range of [BBB_{spc}] category to [AAA_{spc}], also reflecting generally better credit profiles compared with an average NBFI.

We believe COVID-19 has put China's major auto finance companies under pressure from increasing bad debts and a slowdown in business. However, we believe China's effective control over the pandemic and smooth economic recovery have so far mitigated these risks. In addition, leading auto finance companies had good capital and reserve buffers in place before the pandemic. We acknowledge a high degree of uncertainty remains over the economic recovery from the COVID-19 outbreak for both China and other countries. According to the economic forecast made by S&P Global, China is expected to go through a U-shaped recovery in 2020 and 2021. We are using this assumption in assessing the credit implications for the auto finance companies. As the situation evolves, we will update our assumptions and estimates accordingly.

Business Position

Compared with other NBFI subsectors, the auto finance company sector has a relatively high barrier to entry. So far, China has only 25 auto finance companies licensed by CBIRC, and the last license was issued in 2016. One reason is the relatively high concentration of the auto making industry, and all auto finance companies are closely associated with car makers.

However, auto finance companies are not the only institutions providing auto finance services. Commercial banks, financial leasing companies and captive finance companies of car making groups are also in the same market. The auto finance companies are the biggest players with a total market share of about 50%, while banks take another share of about 30%.

Compared with competitors from other sub-sectors, auto finance companies have a distinctive advantage in brand association and synergy with car makers. As institutions founded by car makers, auto finance companies typically have the mandate of promoting car sales in addition to earning an interest income.

Comparison of Various Players in the Auto Finance Market

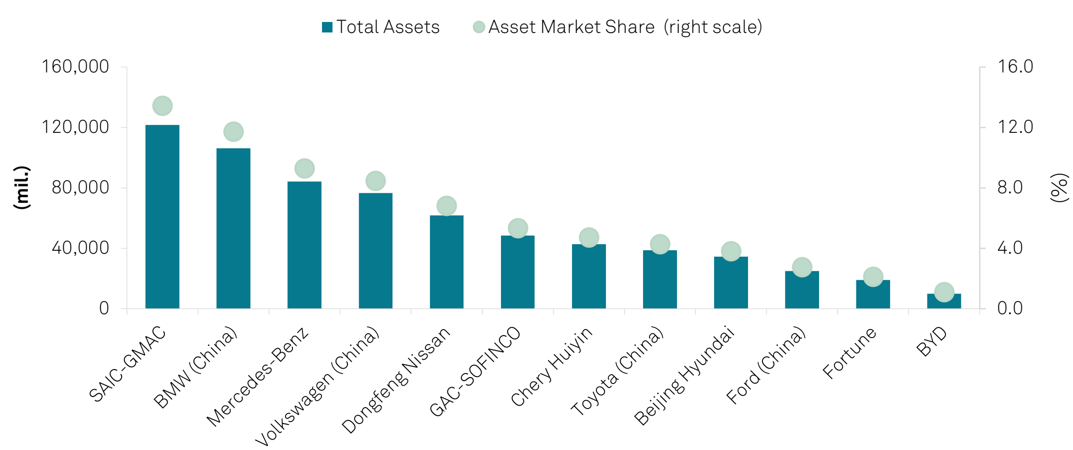
Institution Type	General Characteristics
Auto Finance Company	– Deep knowhow about cars – Close ties with car makers and dealerships – Able to offer borrowers interest discounts given by car makers – Able to bundle credit products with other car-related services – Fast credit review and processing
Commercial Bank	– Very extensive physical business network – Lengthy credit review and processing phase
Financial Leasing Company	– Flexible underwriting standards – Flexible credit product design – Higher interest rates charged to borrowers

Source: S&P Global (China) Ratings

The business franchise of the auto finance companies is closely tied to the brand competitiveness of their associated car makers. The top five auto finance companies (SAIC-GMAC, BMW (China), Mercedes-Benz, Volkswagen (China) and Dongfeng Nissan) represent about half of the auto finance company market, and they are all associated with top car brands in China.

Chart 3

Asset Size and Market Share as of End of 2019



The market shares of auto finance companies are closely linked to the competitiveness of their associated car brands.

Note1: Asset market share = total assets of an institution/total assets of China's auto finance company subsector. Auto finance business of banks and other NBFIs are excluded.

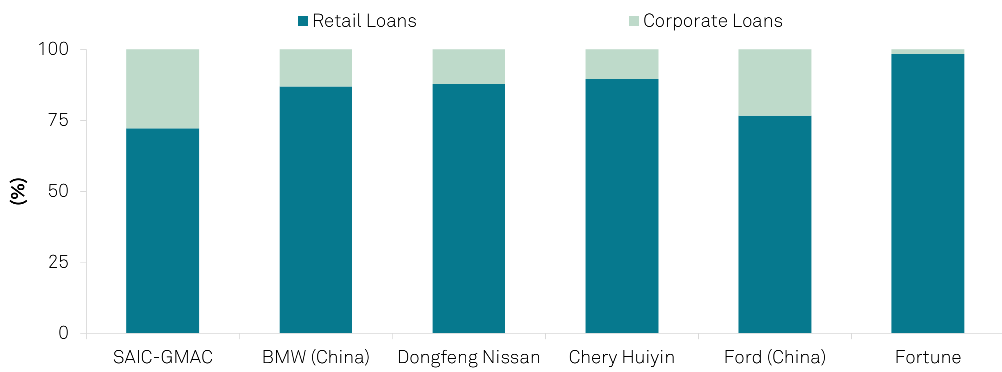
Note2: SAIC-GMAC – SAIC-GMAC Automotive Finance Company Limited, BMW (China) – BMW Automotive Finance(China)Co., Ltd., Mercedes-Benz – Mercedes-Benz Auto Finance Ltd., Volkswagen (China) – Volkswagen Finance (China) Co., Ltd., Dongfeng Nissan – Dongfeng Nissan Auto Finance Co., Ltd., GAC-SOFINCO – GAC-SOFINCO Automobile Finance CO., LTD., Chery Huiyin – Chery Huiyin Motor Finance Service Co.,LTD, Toyota (China) – Toyota Motor Finance (China) Company Limited, Beijing Hyundai – Beijing Hyundai Auto Finance Co.,Ltd., Ford (China) – Ford Automotive Finance (China) Limited, Fortune – Fortune Auto Finance Co., Ltd., BYD - BYD Auto Finance Company Limited.

Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Compared with banks and other NBFIs operating in diversified business sectors, auto finance companies solely focus on auto finance, which leads to good business transparency. Their loan portfolios typically include two parts: a retail portfolio composed of lending to car buyers and a corporate portfolio of lending to car dealerships. Auto finance companies can also conduct auto leasing business, which has more flexibility in terms of product design. But so far, auto leasing is still a marginal part of major auto finance companies' business.

Chart 4

Loan Structures as of End of 2019



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Auto finance companies' loan portfolios are dominated by retail loans to car buyers.

In recent years, the business growth trajectory of auto finance companies has moderated due to a slowdown of car sales in China. In addition, COVID-19 has delivered an acute short-term impact on car sales in the first quarter of 2020, which has further hindered the growth of the auto finance sector in 2020. Passenger car sales began to recover steadily in China in April, and we believe the negative pressure on business growth from the pandemic is controllable.

Chart 5

Sales of Passenger Cars in China

Source: Wind, collected and adjusted by S&P Global (China) Ratings.

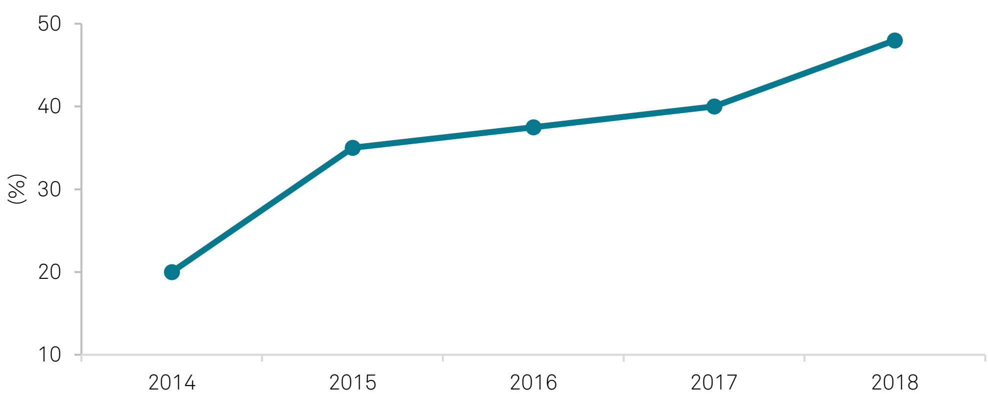
Sales of passenger cars plummeted in early 2020 due to the fallout from COVID-19 but saw a strong recovery in the second and third quarters.

In addition to car sales growth, increased use of leverage by car buyers has been another driving force for the auto finance industry. The use of auto loans witnessed rapid growth in the past few years. China's auto finance penetration rate, or the percentage of new car sales supported by loans, was about 48% in 2018. In comparison, developed countries typically have a rate of around

70%. With slowing car sales in China, we expect higher use of leverage to become more important in driving the sector's business growth.

Chart 6

Auto Finance Penetration Rate in China



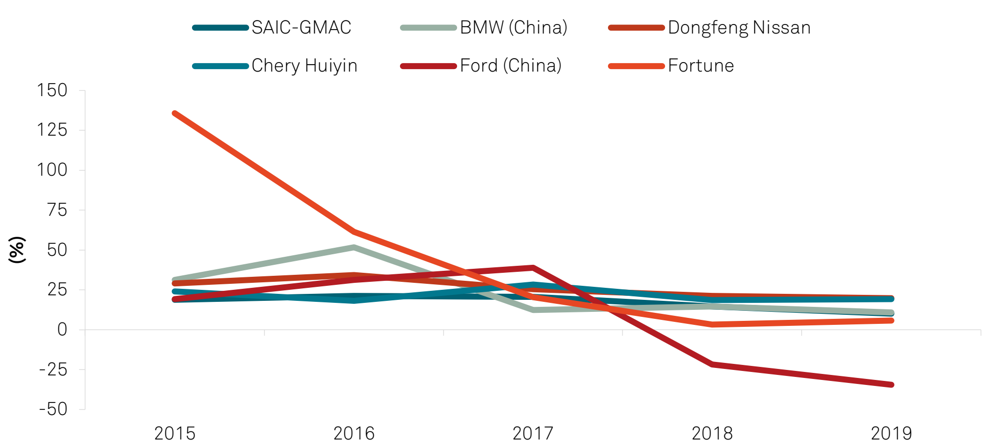
Note: Penetration rate of auto financing represent the percentage of loan funding in new car sales.

Source: *Report on the Development of Chinese Auto Finance Companies* issued by the Auto Finance Committee, collected and adjusted by S&P Global (China) Ratings.

With slowing car sales in China, we expect higher use of leverage to become more important in driving business growth.

Chart 7

YoY Loan Growth Rates



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

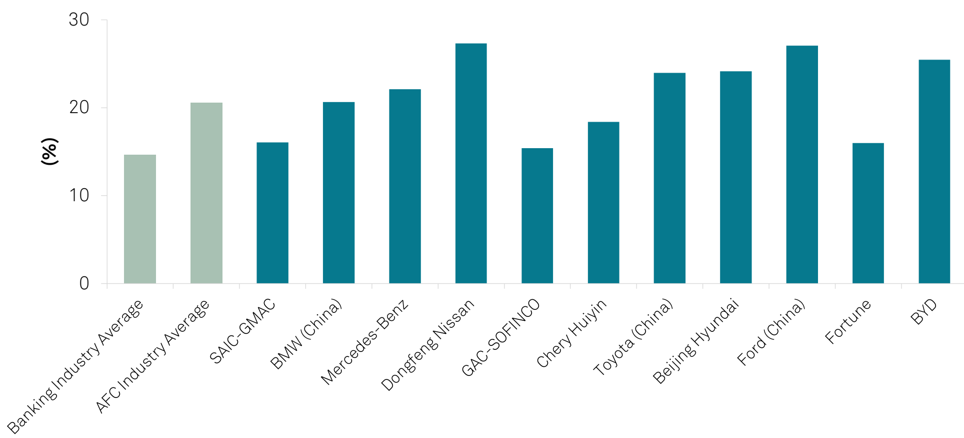
We expect auto finance companies' business growth to be similar to previous years, despite COVID-19.

Capital & Earnings

Major auto finance companies have strong capitalization. Their good capitalization is attributable to strong capital injection from parent groups and good internal capital generation capability. Auto finance companies have a stronger capital position compared with commercial banks. They apply the same standard approach for regulatory capital calculation as banks. Even as a few small banks have come under capital pressure due to mounting bad debts, auto finance companies with a similar size are typically solid in their capital position due to low bad debts and good reserve buffer.

Chart 8

Capital Adequacy Ratio as of End of 2019



Note: AFC – auto finance company.

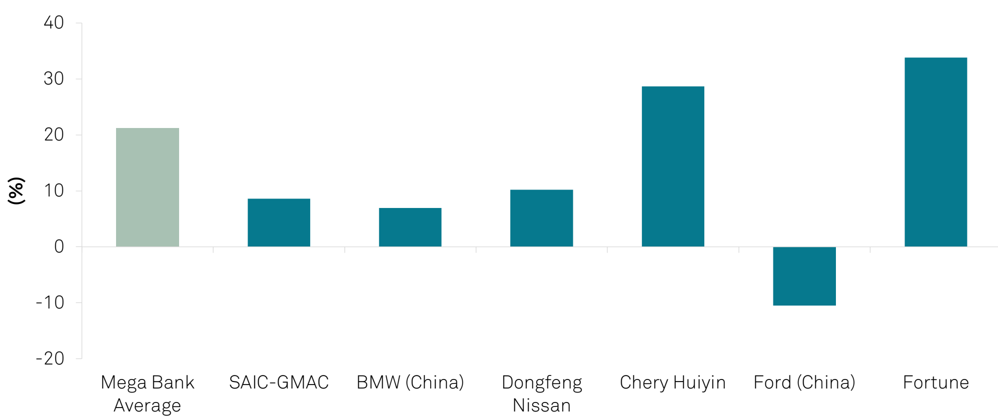
Source: CBIRC, public information of companies, collected and adjusted by S&P Global (China) Ratings.

Thanks to strong capital injection from shareholders, good profitability and sound asset quality, major auto finance companies' capitalization was stronger than the banking sector average.

Because of better asset quality, major auto finance companies typically have lower impairment charges compared with banks. But we expect increasing credit cost because of the COVID-19 pandemic for 2020.

Chart 9

Provisioning/Operating Income in 2019



Note: Ford (China) had a reserve reversal in 2019.

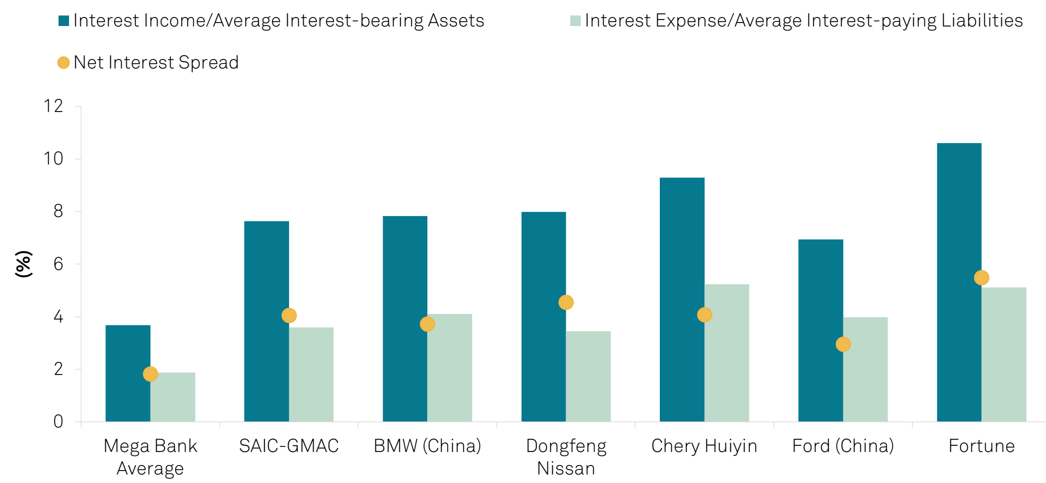
Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Auto finance companies have varying credit cost.

Thanks to high interest rates charged to retail borrowers, auto finance companies typically enjoy a wider net interest spread than the banking sector despite their higher funding cost.

Chart 10

Net Interest Spread in 2019



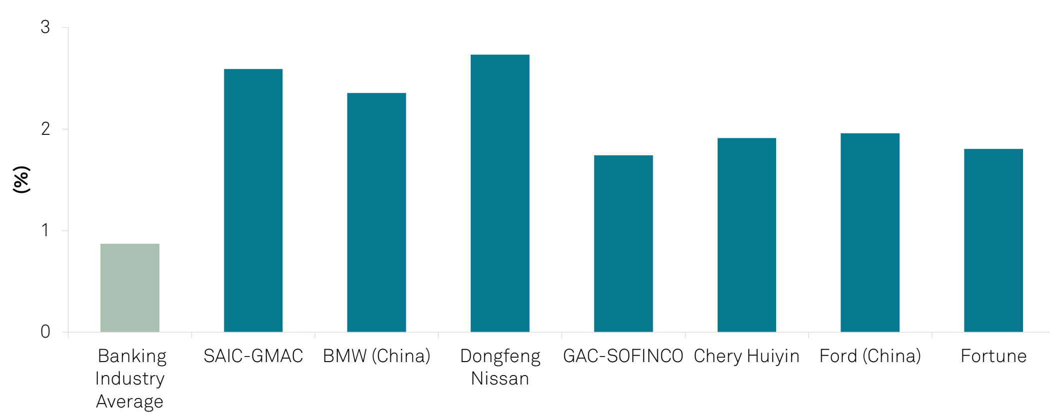
Thanks to good loan yields from retail business, auto finance companies generally have a wider net interest spread compared to the banking sector despite the fact that auto finance companies have higher funding costs.

Note: Net Interest Spread = (interest income/average interest-bearing assets) – (interest expense/average interest-paying liabilities).
Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Thanks to high loan yields and low credit cost, auto finance companies had a profitability level significantly higher than the commercial banking industry. The good profitability typically led to sound internal capital generation capability which further enhance their capitalization.

Chart 11

Return on Average Assets in 2019



Thanks to higher loan yields and lower credit cost, major auto finance companies had better profitability compared to the banking sector.

Note: Return on average assets =net income/ [(total assets at the beginning of the year +total assets at the end of the year)/2].
Sources: CBIRC, public information of companies, collected and adjusted by S&P Global (China) Ratings.

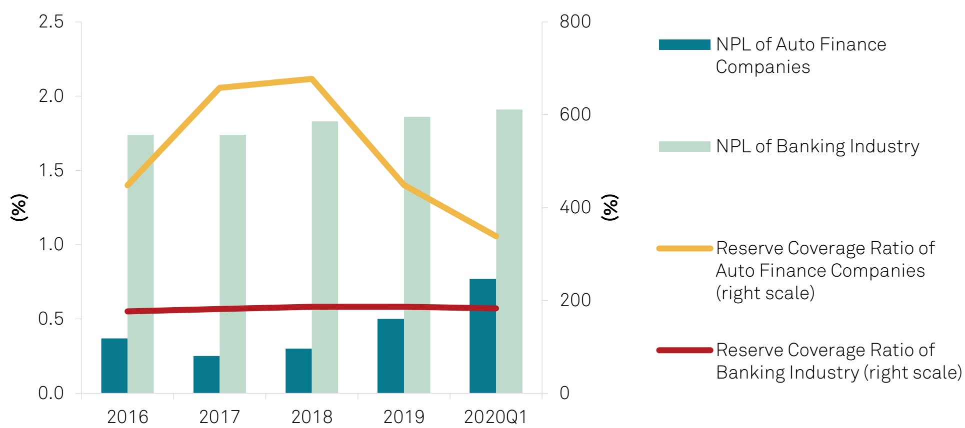
Despite COVID-19's negative impact on profitability, we expect major auto finance companies to be able to meet minimum regulatory capital requirements this year as they typically had good capital and reserve buffers before the pandemic.

Risk Position

Major auto finance companies' granular loan portfolios have had better asset quality performance compared to banks and other NBFIs. Thanks to a transparent business model, deep underwriting expertise in car financing and adequate collateral measures, the auto finance industry has a good track record of asset quality metrics. In addition, auto finance companies typically have prudent provisioning policies and have built up a strong reserve buffer.

Chart 12

Sector Average NPL Ratio and Reserve Coverage Ratio as of End of 2020Q1



Source: CBIRC, public information of companies, collected and adjusted by S&P Global (China) Ratings.

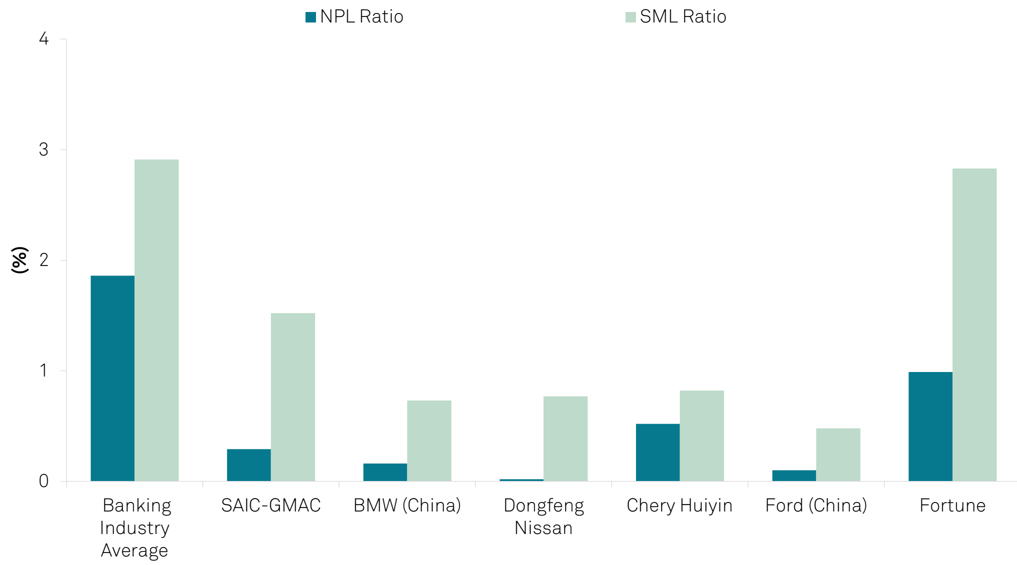
Compared with the much larger banking industry, the niche players in the auto finance sector had better asset quality and higher reserve buffers.

Auto finance companies have extremely high concentration in terms of product types, but we believe the risk of narrow business scope is mitigated by very low single-name concentration and good geographic diversification across China.

Loans underwritten by auto finance companies typically have sound risk mitigation measures. Retail loans typically have cars as collateral and benefit from very good granularity. Asset quality of dealership lending portfolios is typically well protected by multiple risk mitigation measures, such as car inventory as collateral, deposits paid by dealership, and guarantees provided by dealership owners.

Chart 13

NPL and SML Ratios as of End of 2019

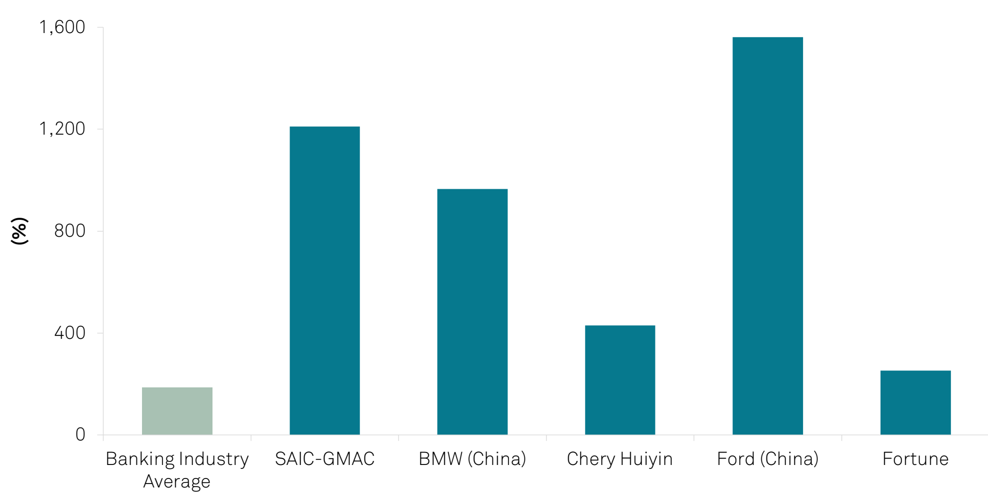


Leading auto finance companies had very low bad debts thanks to their transparent business model, deep expertise in car financing and sound risk mitigation measures.

Source: CBIRC, public information of companies, collected and adjusted by S&P Global (China) Ratings.

Chart 14

Reserve Coverage Ratio as of End of 2019

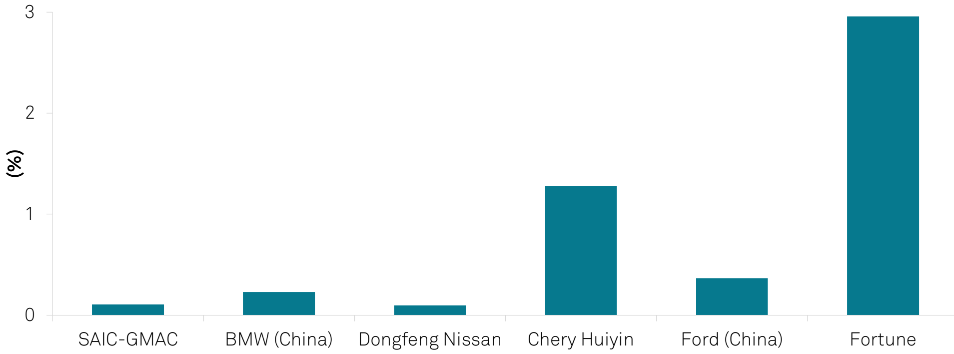


Major auto finance companies' high reserves before COVID-19 have helped them weather through the pandemic.

Note: As of the end of 2019, Dongfeng Nissan's reserve coverage ratio was about 7, 800%.
Source: CBIRC, public information of companies, collected and adjusted by S&P Global (China) Ratings.

Chart 15

Written-off Loans/Average Gross Loans in 2019



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Auto finance companies associated with foreign car brands had very low written-off ratios due to good asset quality.

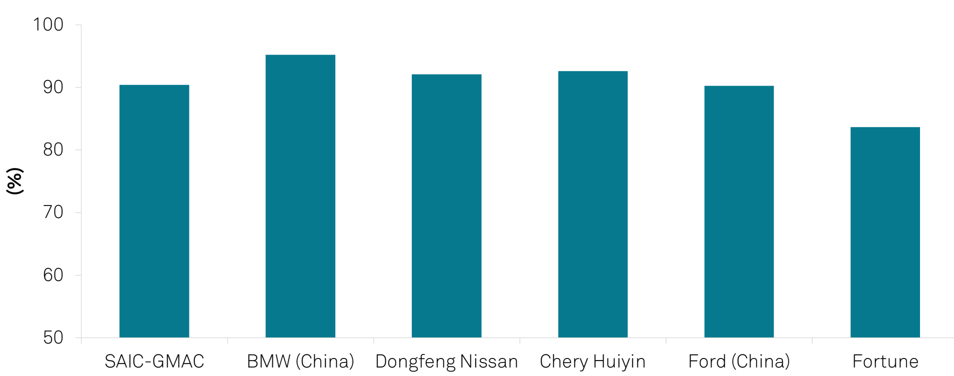
As the pandemic put the wider economy under significant pressure in the first quarter, auto finance companies' asset quality saw weakening signs. At the end of March 2020, the sector wide NPL ratio saw a noticeable increase, but was still below 1% and much lower than the banking industry average of 1.91%., We believe the bad debt pressure on auto finance companies has been mitigated by China's effective control of the pandemic and the steady economic recovery so far. In addition, we believe COVID-related risk is mitigated by the auto finance companies' good asset quality and the high reserve buffers they had in place before the pandemic.

Funding & Liquidity

Typically, we view major auto finance companies as having an average funding and liquidity profile compared with other NBFIs regulated by CBIRC. Auto finance companies generally rely on wholesale funding and there is typically a maturity mismatch between their assets and liabilities. Meanwhile, they have access to the inter-bank market and thanks to their good credit quality, major auto finance companies have stable access to the capital market and bank credit. Therefore, we typically view their funding and liquidity risk as controllable.

Chart 16

Net Loans/Total Assets as of End of 2019



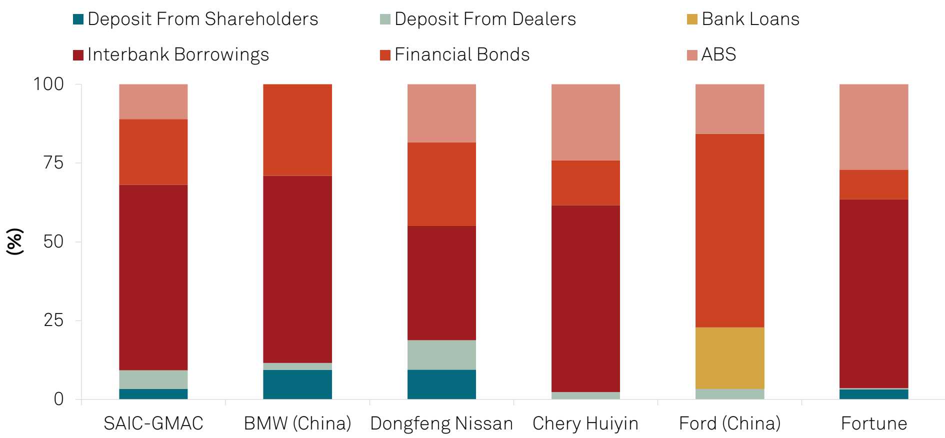
Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Auto finance companies' assets are dominated by auto loan portfolios.

China's major auto finance companies have diversified funding sources composed of bank loans, inter-bank market borrowing, bond market and asset-backed securities ("ABS") market. In particular, ABS issuance is becoming an important funding source.

Chart 17

Funding Structure as of End of 2019

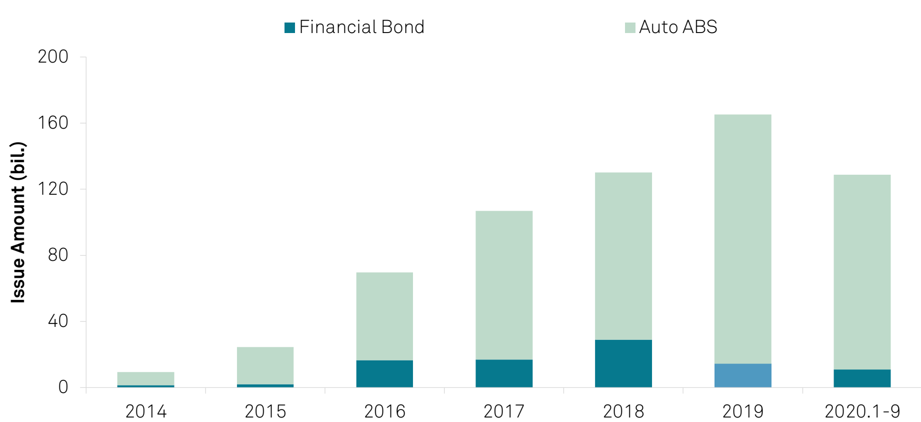


Note: Deposit from shareholders include the deposits from shareholders and other subsidiaries in the same group.
Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

Auto finance companies have reasonably diversified funding sources.

Chart 18

Bonds and ABS Issued by Auto Finance Companies



Source: Wind, collected and adjusted by S&P Global (China) Ratings.

ABS issuance is becoming an important funding source for auto finance companies.

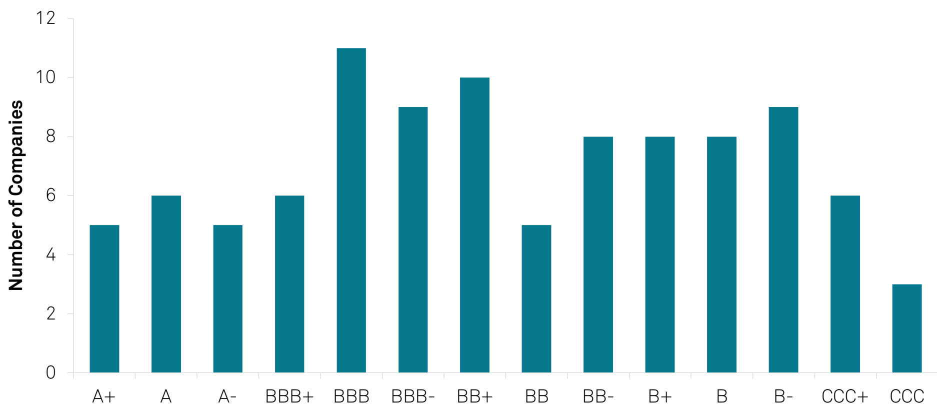
Group Influence

Auto finance companies are of great importance to the business development of their car making parents. We typically view them as highly important to their parents, and group influence is typically an important part of our analysis to decide their overall issuer credit quality.

We believe group influence can be positive or negative for auto finance companies. Car makers typically have varying creditworthiness, leading to different levels of capability to support their auto finance subsidiaries in times of need. In some cases, car makers may have weaker credit profiles than their auto finance subsidiaries from a standalone perspective. In such situations, we believe there is a possibility of the parent having a negative influence on the subsidiary.

Chart 19

S&P Global Ratings' Issuer Credit Ratings of Companies Worldwide in the Automobiles and Components Industry



The global car making industry has wide credit divergence, resulting in varying capacity to support auto finance subsidiaries.

Note: This chart includes 99 entities across different countries rated by S&P Global Ratings as of October 9, 2020.
Source: S&P Global Ratings, collected by S&P Global (China) Ratings.

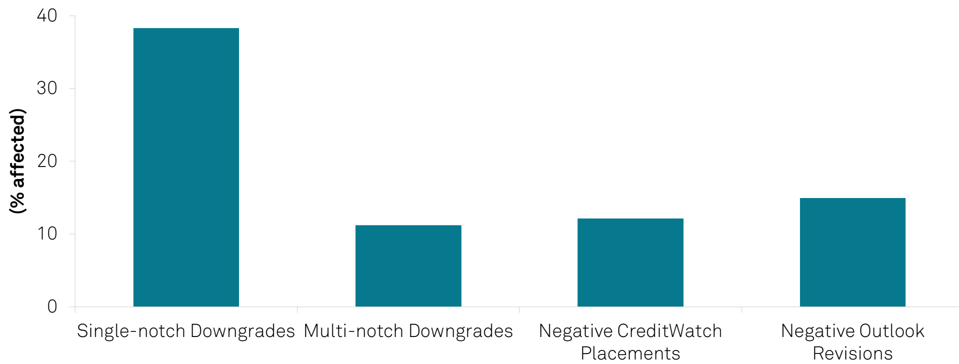
Car makers were hit hard by the pandemic, leading to frequent negative rating actions by S&P Global Ratings. According to a research paper published by S&P Global Ratings in September 2020, global light vehicles sales will fall 20% this year compared with 2019 following the disruption to sales and production caused by COVID-19. Signs of improvement began to emerge in China during the second quarter, and S&P Global Ratings saw some return to stability in Europe and North America in July and August. S&P Global Ratings continues to believe that the Chinese market has the potential to return to moderate long-term growth, and expects it to be the only region to see sales recover to 2019 volumes by the end of 2022.

Therefore, although the international auto industry will continue to come under credit pressure in the foreseeable future, we believe the recovery of China's car industry can help stabilize domestic car makers' capacity to support their auto finance subsidiaries, or at least avoid having a negative group influence at this stage.

Chart 20

Downgrades by Number of Notches in the Automotive Sector Amid COVID-19 And Falling Oil Prices by S&P Global Ratings, as of Oct 5, 2020

Car makers were hit hard by the pandemic, leading to frequent negative rating actions by S&P Global Ratings.



Source: S&P Global Ratings Research, collected by S&P Global (China) Ratings.

Indicative Issuer Credit Quality

Due to the good asset quality and strong capital of China's major auto finance companies before the outbreak, we believe that auto finance industry will maintain a stable credit outlook under the assumption of a U-shaped economic recovery in China in 2020 and 2021. The impacts of COVID-19 on auto finance companies are not only on their stand-alone credit quality, but also on the capabilities of their parent companies to support them.

Credit Outlook of Major Auto Finance Companies for the Next 12 Months

Rating Factor	Outlook	Key Comments
Business Position	Stable	– Business franchise is closely tied to the competitiveness of associated car makers. – COVID-19's impact on business has turned out to be moderate as car sales in China experienced a V-shaped recovery. – Looking beyond the pandemic, with slower car sales in China, we expect higher use of leverage to be an important driving force for future business growth.
Capital & Earnings	Stable	– They are subject to the same regulatory capital adequacy framework as banks, and average capitalization of auto finance companies is stronger than the banking sector thanks to strong shareholder capital injection, good profitability and good asset quality. – Better profitability compared to the banking industry thanks to better loan yields and lower impairment charges. – COVID-19 is likely to have a negative impact on profitability in 2020, but we expect sound earnings for 2021 as long as the pandemic continues to remain under control in China. – Despite earning uncertainty due to the pandemic, we expect the capitalization of the sector to remain strong.
Risk Position	Stable	– Thanks to a transparent business model, deep underwriting expertise in car financing and sound collateral measures, major auto finance companies have had very good asset quality metrics. – As the pandemic put the wider economy under significant pressure in the first quarter, auto finance companies' asset quality saw

Rating Factor	Outlook	Key Comments
		weakening signs. At the end of March 2020, the sector-wide NPL ratio saw a noticeable increase but was still below 1%, and much lower than the banking industry average of 1.91%. – As China's economy steadily recovers from COVID-19, we believe asset quality pressure has been reduced compared to the toughest period in the first quarter of 2020. We expect the overdue loan ratio of the sector to improve in 2021 as long as the pandemic remains under control in China. – We acknowledge a high degree of uncertainty remains over the extent of the economic recovery from COVID-19 for both China and other countries, and will continue to monitor the situation. – Asset quality risk for major auto finance companies is also mitigated to some extent by good asset quality and high reserve buffer before the pandemic.
Funding & Liquidity	Stable	– We expect the central bank's monetary policy operations to return to normal, but we don't expect such changes to affect the liquidity profile of major auto finance companies. – As institutions with high credit quality, we expect major auto finance companies to maintain stable funding and liquidity profiles.
Standalone Credit Quality	Stable	– The good financial health before the pandemic and robust pickup in auto sales and wider economic recovery up to now have helped the companies maintain stable standalone credit profiles.
Group Influence	Stable with downward pressure	– Car makers typically have varying creditworthiness, leading to different levels of capability to support their auto finance subsidiaries in times of need. – Although the international auto industry will continue to come under credit pressure in the foreseeable future, we believe the recovery of China's car industry can help stabilize domestic car makers' capacity to support their auto finance subsidiaries, or at least avoid negative group influence at this stage.
Issuer Credit Quality	Stable with downward pressure	– We believe that auto finance industry will maintain a stable credit outlook in 2021 under the assumption of a U-shaped economic recovery in China.

Source: S&P Global (China) Ratings

This report does not constitute a rating action.

Appendix: Related Methodologies & Research

- S&P Global (China) Ratings Financial Institutions Methodology, January 31, 2019.
- Auto Finance Companies Face Bad Debt Pressure and Business Slowdown in 2020——A Credit Study on the Auto Finance Industry in China, May 25, 2020.