Rating Research Services

Executive Comment:

Taiwan's Bond Markets To Maintain Stable New Issuance Volume Amid Modest Economic Growth

Author:
Hwa-Ping Chang, President; Taiwan Ratings Corp.: (886) 2 8722-5898;
hwaping.chang@taiwanratings.com.tw
Contributors:
Patty Wang; (886) 2 8722-5823; patty.wang@taiwanratings.com.tw
Joe Lin; (886) 2 8722-5856; joe.lin@taiwanratings.com.tw

Table Of Contents

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Taiwan Ratings Corp. expects new bond issuance to show little change over the next 12 months compared to 2013. An improving outlook for the island's economy along with stabilizing economic growth in Mainland China and a gradual recovery in the U.S. and euro-zone regions should support fairly stable new issuance volume in the coming year. Our stable outlook for Taiwan's bond market also takes into consideration our expectation that international bond issuances by domestic and foreign entities will grow, particularly for renminbi-denominated bonds--better known as 'Formosa Bonds'. However, we believe the implementation of the Basel III accord is likely to constrain the volume of new financial debenture issuances this year. This is because the accord's tier-one capital definition and capital requirement for banks are likely to motive banks to raise new capital instead of their more traditional use of issuing bank debentures to meet their capital needs.

Our forecast of stable issuance volume this year contrasts with the decline in new bond issuances in 2013. Issuance levels fell in 2013 compared with 2012, because of slower-than-expected economic growth, increasing bond yields amid concerns over the tapering of U.S. quantitative easing (QE) measures, and the substitution of bank debt issuances with new capital-raising measures. In addition, we believe credit spreads (the yield difference between five-year non-Taiwan government and government bonds) are likely to narrow in 2014, because investors become less risk adverse under a more stable economic outlook. However, the narrowing trend could be minor and still far away from the levels before the financial crisis began in 2007. Moreover, we expect the government benchmark rate to climb in conjunction with rising global bond rates, albeit to a lesser extent, leading to a rise in borrowing costs for issuers over the next few quarters.

Overview:

- The volume of new bonds issued is likely to remain flat in 2014, and credit spreads will continue to narrow, albeit only slightly, under a more stable economic outlook.
- Higher-rated issuers will continue to dominate the local bond market, and more and more lower-rated issuers could attempt to tap the market to secure lower borrowing costs.
- The volume of international bonds may rise slightly because corporations might pursue growth overseas under a more stabilized global economy.

Near-Zero Growth In New Domestic Bond Issuances In 2014

We expect the volume of new bond issuances from domestic issuers to remain relatively unchanged year on year in 2014, mainly supported by large corporate funding needs. In addition, Taiwanese corporations are likely to seek funding sources to support their business expansion programs in the coming year to take advantage of an improving economic outlook at home and abroad. Corporates may also choose to lock-in the currently low borrowing costs given the market's expectation of gradually rising interest rates accompanying economic recovery and uncertainties over the pace of the QE tapering. Nonetheless, ample market liquidity in Taiwan and

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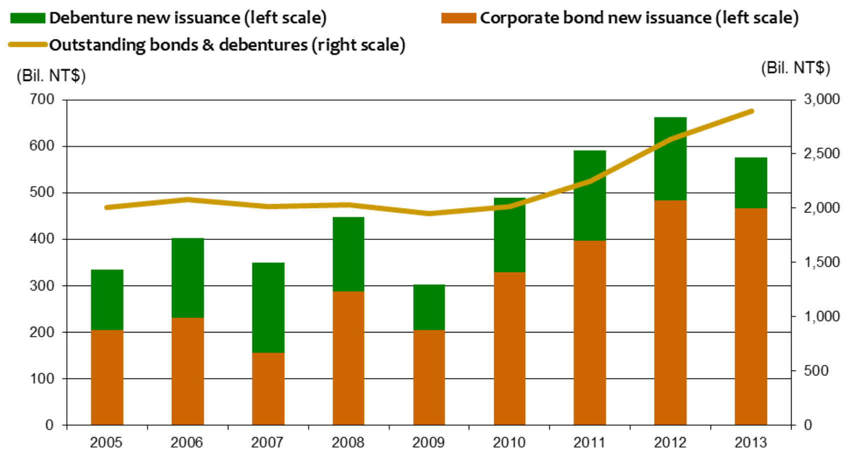
alternative funding from bank borrowings could partly offset growth in new bond issuance.

We also expect the issuance of financial debentures to end their decline in 2013 given that new issuance volume has been at a low base since 2010. New bond issuances from domestic issuers dipped 13% year on year in 2013, driven mainly by a 39% year-on-year drop in debenture issuances (see chart 1). This differed from the relatively stable debenture issuance due to banks' refinancing needs on their Tier II capital. In 2013, banks enhanced their Tier I ratio directly through new capital issuances, which we expect to continue in 2014. New capital issuance supplemented financial debenture issuances as a funding source for banks and helped to satisfy their Tier I ratio requirement under Basel III, as well as to satisfy the local regulator's requirement for banks' overseas expansion.

Chart 1
Issuance Volume In Taiwan's Straight Bond Market (Corporate Bonds & Debentures)



Note: Excludes the New Taiwan dollar (NT$) & foreign-denominated bonds issued in Taiwan by foreign institutions, and includes the NT$ & foreign currency-denominated bonds issued in Taiwan by domestic banks and local branches of foreign and mainland Chinese banks. Source: Taiwan's central bank.

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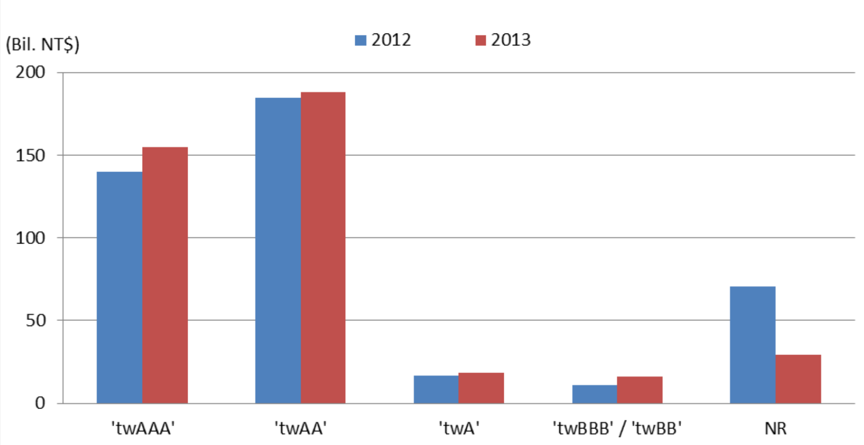
Higher-Rated Issuers Continue To Dominate Corporate Bond Issuances

We expect higher-rated corporations to remain the dominant issuers of bonds in the domestic market in 2014. These large corporates including **Taiwan Semiconductor Manufacturing Co. Ltd.** and **Taiwan Power Co.** have been quite active in bond issuances in the local market to support their re-funding and working capital needs. We assigned ratings at 'twAA-' or higher on about 76% of new corporate bonds and financial debentures in 2013 (see charts 2 & 3).

Chart 2
Corporate Bond Issuances By Rating Category



Note: Data include all publicly offered corporate bonds issued by domestic issuers. NR includes issuances without ratings or not rated by Taiwan Ratings Corp. Source: Market Observation Post System, GreTai Securities Market, Taiwan Ratings Corp.

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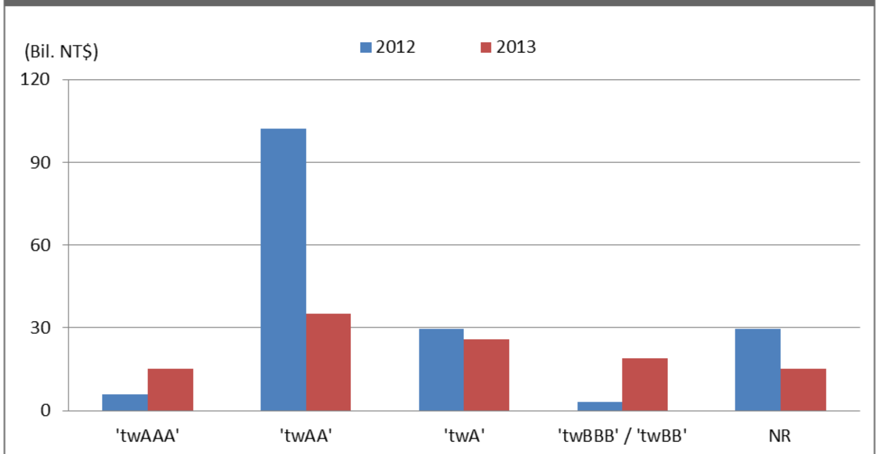
Chart 3
Financial Debenture Issuances By Rating Category



Note: Data include all publicly offered financial debentures issued by domestic issuers. NR includes issuances without ratings or not rated by Taiwan Ratings Corp. Source: Market Observation Post System, GreTai Securities Market, Taiwan Ratings Corp.

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We believe Taiwan's improving economic outlook could encourage more lower-rated bond issuers to tap into the local bond market in 2014, to secure lower borrowing costs before interests begin to rise. The issuance of lower-rated bonds (those rated 'twBBB' and below) grew slightly for corporate bonds and debenture issuances in 2013. Issuers with weaker credit profiles attempted to tap into the market in 2013, either through credit enhancement, such as bank guarantees, or alternatively issuing convertible bonds. This explains the drop in the number of not-rated (NR) bonds during in 2013 (see chart 3).

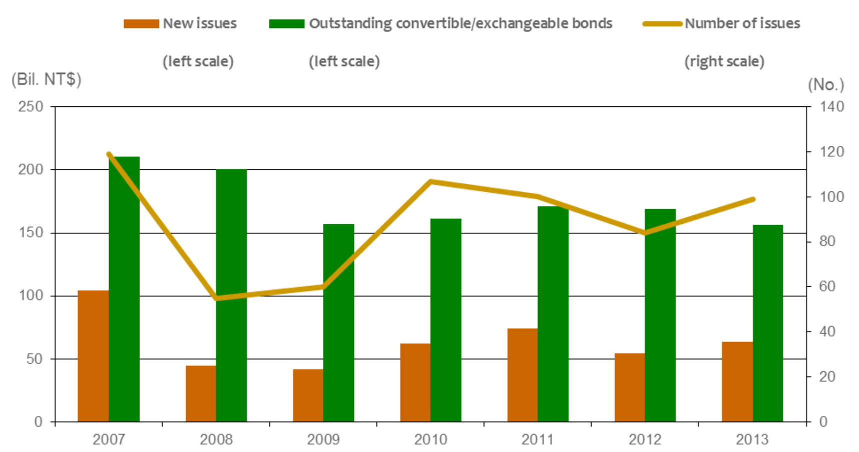
Foreign-Currency Bonds Emerge As An Alternative Fundraising Tool

We expect a growing number of domestic corporations with offshore operations, as well as overseas-based entities to issue foreign-currency denominated bonds (also known as international bonds) in Taiwan. The lower cost of funding in Taiwan is one of the chief incentives for entities to issue international bonds in the local market. The volume of international bond issuances has grown rapidly over the past one year following the deregulation of renminbi (RMB)-funding and given the prolonged access to low interest rates in Taiwan. International bonds grew to represent 10% of total corporate bond and financial debenture issuances in 2013, up from just 1% in 2012. In addition, international bond issuances were 97% denominated in RMB in 2013, with the rest denominated in Japanese-Yen. The start of 2014 has also seen the issuance of US dollar-denominated bonds in the local bond market by **Standard Chartered Bank (Taiwan) Ltd**.

Convertible Bond Issuances Are Likely To Grow Slightly In 2014

We expect convertible bond issuances, particularly by small-to-mid size issuers, to grow moderately year on year in 2014, supported by the gradually improving domestic economy. However, issuance volume is unlikely to return to the 2007-level over the medium term. A growing number of issuers tapped into the convertible bond market in 2013, although the issuance amount of each transaction was rather small. As a result, new convertible bond issuances grew 17% year on year in 2013 (see chart 4). We expect supply and demand in the market to grow along with Taiwan's economic recovery.

Chart 4
Taiwan's Convertible And Exchangeable Bond Market



Source: GreTai Securities Market and Market Observation Post System.
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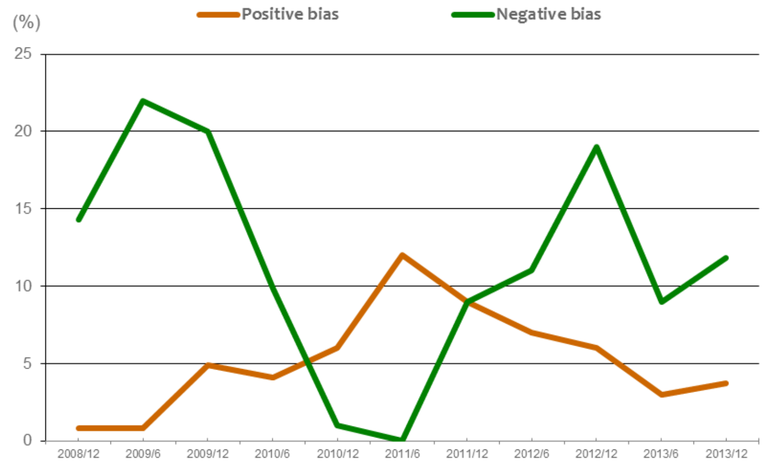
Credit Spreads Are Likely To Narrow But To A Lesser Extent Than In 2013

We expect credit spreads to narrow moderately in the coming year, underpinned by Taiwan's stable economy, signs of stabilization in China's economic growth, as well as the seedlings of recovery in the U.S. and euro-zone. The narrowing of credit spreads goes hand-in-hand with our stable credit outlooks for most industries over the next 12 months and our stable rating outlook on more than 80% of our rated entities. The increase in positive and negative rating bias of our rated pool at the end of 2013 was mainly due to the merger and acquisition plans of financial institutions, with the exception of a weakening in credit profile for one corporate entity (see chart 5).

Chart 5
Rating Bias Of Taiwan Ratings' Issuer Rating Pool



Note: Positive bias refers to the percentage of Taiwan Ratings' issuer ratings with positive outlooks or placed on CreditWatch Positive. Negative bias refers to the percentage of issuer ratings with negative outlooks or placed on CreditWatch Negative. Source: Taiwan Ratings Corp.

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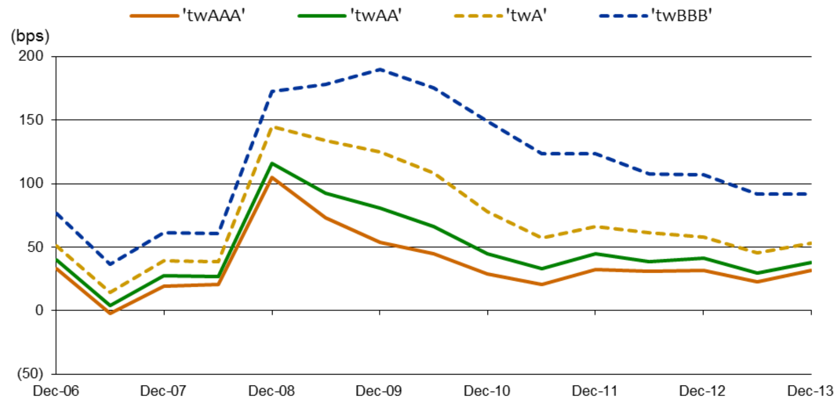
Nonetheless, we expect the pace of narrowing in credit spreads to remain slow in the coming 12 months, which is similar to the trend since 2008 (see chart 6). We don't expect credit spreads for lower-grade bonds to return to the pre-crisis level over the next two to three years. Nonetheless credit spreads are likely to exhibit some volatility in 2014, given market uncertainty over the pace of QE tapering, which has triggered volatility in the global capital market. In addition, local investors are likely to remain risk adverse to lower-grade bonds given the headwinds tempering economic recovery in the U.S. and competition among export markets.

Chart 6
Credit Spread Of Corporate Bonds Over Government Bonds



Source: GreTai Securities Market.
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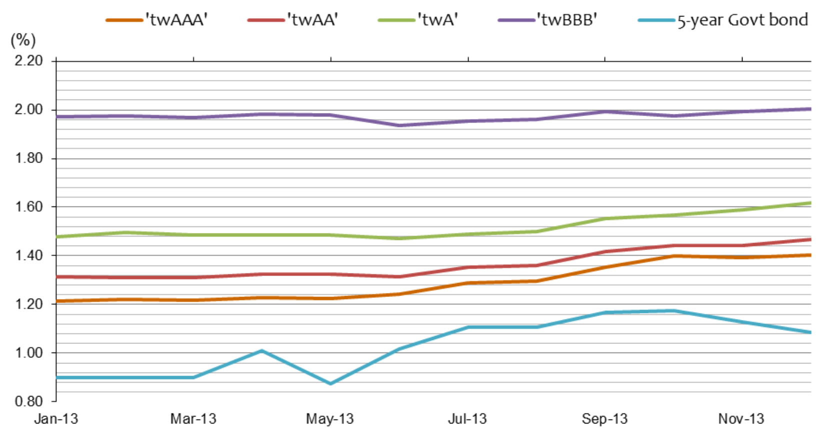
Moreover, we expect the borrowing costs for different rating categories and the five-year government bond rate to rise slowly in line with local interest rates. The upward trend of bond yields in the second half of 2013 was in line with the upward trend in U.S. market rates following the news of QE tapering (see chart 7). In our view, the drop in Taiwan's five-year government bond yield toward the end of the year should be only temporary, because of increased demand for government bonds to digest the ample liquidity in the domestic market. We expect the government bond yield to rise along with corporate bond yields in the coming few quarters, albeit with a lesser degree of volatility that in the global market.

Chart 7
5-Year Corporate Bond Yield Versus Government Bond Yield



Source: GreTai Securities Market.
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Ample Market Liquidity Tempers Most Bond Market Volatility

We believe Taiwan's financial system has ample liquidity to partly offset potential volatility in the bond market over the next one to two years. Borrowing from banks remains an attractive alternative for funding source while interest rates remain low and the banking remains intensely competitive. We also believe the majority of local and international corporations and financial institutions operating in Taiwan to have adequate access to liquidity, which in turn should help them to avoid financial stress over the next 12 months.

Related Criteria And Research

Related Research

- **Executive Comment: Formosa Bond Market Needs More Diversified Issuers And Investors To Reach Its Full Potential**, Feb. 19, 2014
- **2014 Taiwan Credit Outlook: Global Economic Recovery Could Reduce The Negative Rating Bias On Corporate Credits; Other Ratings To Remain Stable,** Jan. 21, 2014
- **Credit Conditions: Asia-Pacific Growth Is Mostly Stable, But Some Lagging Credit Risks Remain For 2014,** Dec. 10, 2013
- **Volatile Global Markets Could Slow Growth In Taiwan Bond Issues,** Aug. 20, 2013
- **Credit FAQ: How A Debt Issue Rating Differs From An Issuer Credit Rating,** July 29, 2013

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