INTERNATIONAL MONETARY FUND

Corporate Sector Vulnerabilities in Hong Kong SAR

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SIP/2025/050

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Corporate Sector Vulnerabilities in Hong Kong SAR
Prepared by Phakawa Jeasakul and Hong Xiao

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ABSTRACT: Hong Kong SAR's corporate sector vulnerabilities appear manageable but have increased in recent years. Local non-real estate firms have seen weakening profitability and lower debt-servicing capacity, reflecting pandemic scarring effects and higher funding costs driven by the hiking cycle of U.S. monetary policy. While, on aggregate, their leverage level and liquidity appear manageable, there is high heterogeneity across firms, with smaller listed firms appear to be more vulnerable. As for the local real estate firms, they are exposed to changes in property prices given their sizeable holding of investment properties and inventory. However, their relatively low leverage helps mitigate risks. Mainland Chinese firms listed in Hong Kong SAR show rising financial vulnerabilities, primarily due to weakening profitability and property market adjustment that have adversely affected property developers' balance sheets. Proactive efforts are warranted to ensure effective monitoring and management of financial vulnerabilities in the corporate sector, including ensuring banks' proactive management of nonperforming assets, assessing the impact of the ongoing property market adjustments, and calibrating policies to support small businesses appropriately.

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SELECTED ISSUES PAPERS

Corporate Sector Vulnerabilities in Hong Kong SAR

Hong Kong SAR

Prepared by Phakawa Jeasakul and Hong Xiao

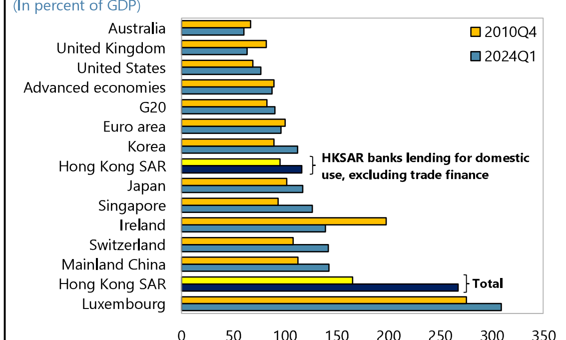
CORPORATE SECTOR VULNERABILITIES IN HONG KONG SAR[1]

Hong Kong SAR's corporate sector vulnerabilities appear manageable but have increased in recent years. Local non-real estate (RE) firms have seen weakening profitability and lower debt-servicing capacity, reflecting pandemic scarring effects and higher funding costs driven by the hiking cycle of U.S. monetary policy. While, on aggregate, their leverage level and liquidity appear manageable, there is high heterogeneity across firms, with smaller listed firms appear to be more vulnerable. As for the local RE firms, they are exposed to changes in property prices given their sizeable holding of investment properties and inventory. However, their relatively low leverage helps mitigate risks. Mainland Chinese firms listed in Hong Kong SAR show rising financial vulnerabilities, primarily due to weakening profitability and property market adjustment that have adversely affected property developers' balance sheets. Proactive efforts are warranted to ensure effective monitoring and management of financial vulnerabilities in the corporate sector, including ensuring banks' proactive management of nonperforming assets, assessing the impact of the ongoing property market adjustments, and calibrating policies to support small businesses appropriately.

A. Introduction

1. **Corporate debt level in Hong Kong SAR is among the highest in the world**. Total corporate debt in Hong Kong SAR grew significantly in 2010s and stood at 268 percent of GDP in 2024Q1, only second to that of Luxemburg (based on BIS statistics). As an important international fund-raising platform (especially for Mainland China), Hong Kong SAR's financial system has provided a significant portion of credit to Mainland Chinese and foreign entities for their operations outside the territory. However, with bank lending for domestic use amounting to 116 percent of GDP and bonds issued by local firms adding another 27 percent of GDP (as of 2024Q1), the debt level of local firms exceeds that of the G20 average and some major advanced economies.

Nonfinancial Corporate Debt
(In percent of GDP)



Sources: Haver Analytics; CEIC; and IMF staff calculations.

2. **However, more recently, corporate credit growth has weakened significantly**. Since 2020Q3, bank lending to corporates has fallen by 70 percent of GDP,[2] mainly driven by the decline in both lending for use outside the territory (41 percent of GDP) and for domestic use (24 percent of GDP). The former largely reflects a challenging economic environment in Mainland China amid the ongoing correction in the property market, while the latter has been underpinned by a slow

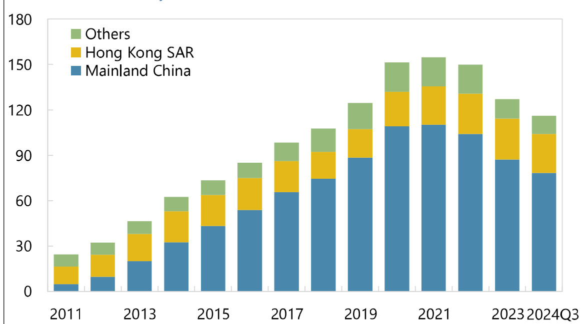
[1] Prepared by Phakawa Jeasakul (MCM) and Hong Xiao (IMF Resident Representative Office in Hong Kong SAR).

[2] The ratio of corporate debt to GDP peaked in 2021Q2 and has declined by 37 percentage points since then.

post-pandemic economic recovery in Hong Kong SAR. The hiking cycle of U.S. monetary policy, which led to higher funding costs and stronger USD and HKD, has also driven Mainland Chinese firms to switch to onshore borrowing in RMB.

Outstanding Corporate Bonds

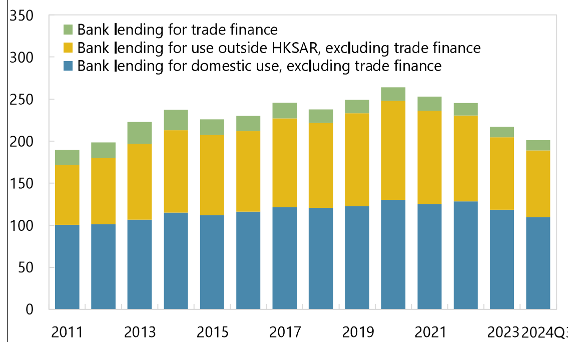
Bonds issued in Hong Kong SAR by firms (in percent of GDP; geographic breakdown is based on the country of risk basis)



Sources: CEIC; Bloomberg; and IMF staff calculations.

Bank Lending to Corporates

(In percent of GDP)



Sources: CEIC; Haver; and IMF staff calculations.

3. **Against this backdrop, the analysis assesses financial vulnerabilities of Hong Kong SAR's corporate sector, using firm-level data of listed firms**. The analysis covers nearly 2,300 companies listed on the HKEX (the stock exchange in Hong Kong SAR), out of which 824 are local Hong Kong firms (10 percent of total assets). The rest of the sample largely comprises of Mainland Chinese firms given Hong Kong SAR's role as an important offshore fund-raising platform for them. The analysis is organized into three sections, comprising an analysis on local firms excluding those in the RE sector, an analysis on local firms in the RE sector, and an analysis on Mainland Chinese firms. A particular focus on local RE firms is warranted given their relative importance to macro-financial stability amid the ongoing property market adjustment. An analysis on Mainland Chinese firms is also relevant as they can affect financial services activity (and thus economic output) and overall investor sentiment.

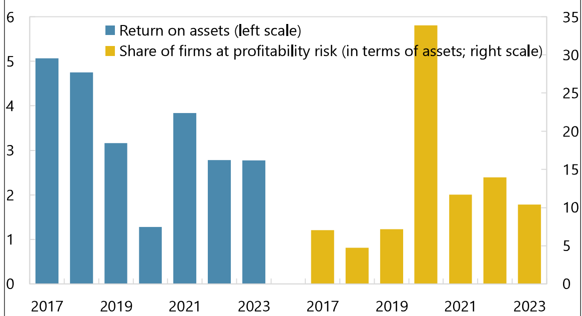
B. Hong Kong SAR's Local Non-RE Firms

4. **Profitability of non-RE firms has been on a falling trend since 2021**. Their return on assets stood at 2.8 percent in 2023, down from 4.7 percent in 2018. At the same time, the share of loss-making firms—although lower than the 2020 peak of nearly 34 percent—stood at 10.4 percent in 2023, above pre-pandemic levels. Weak profitability appears broad-based, reflecting persistent scarring effects from several years of economic contraction. The energy, materials, communication, and consumer discretionary sectors have seen a particularly high share of loss-making firms.

5. **Firms' weak earnings, together with higher funding costs amid the U.S. rate hiking cycle, have reduced firms' debt-servicing capacity**. 22.3 percent of firms (in terms of debt) were not able to generate sufficient earnings to cover their interest expense in 2023—an increase of 14.9 percentage points from 2018—and the share of firms that had not exhibited the debt-servicing capacity for three consecutive years amounted to 9.9 percent. The latter, which reflects a structurally weak debt-servicing capacity, was particularly evident among firms in the consumer discretionary and communication sectors and may result in additional banks' nonperforming loans especially if

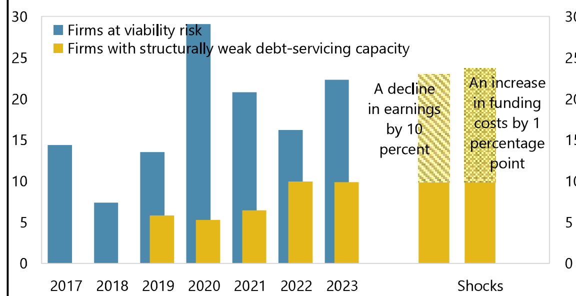
the economy faces sustained challenging macro-financial conditions. Staff estimates suggest that, in an adverse scenario where earnings further fall by 10 percent for three years, the share of firms (in terms of debt) with structurally weak debt-servicing capacity could increase to 23 percent under a static balance sheet assumption[3]. In addition, a further increase in funding costs by 1 percentage point for three years would increase the share of firms with structurally weak debt-service capacity to 23.7 percent.

Local Hong Kong Non-RE Firms: Profitability
(In percent)



Note: Firms are at profitability risk if their profits are negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

Local Hong Kong Non-RE Firms: Debt-Servicing Capacity
Share of risky firms (in percent; in terms of debt)

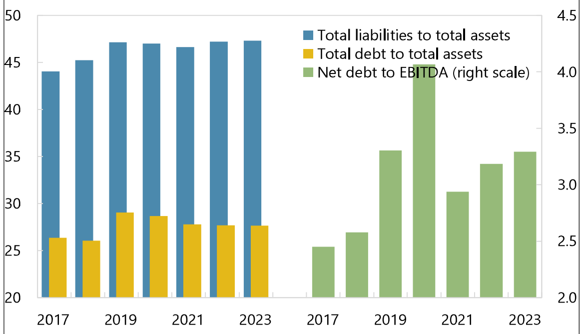


Note: Firms are at viability risk if their EBIT is less than net interest expense. Firms have structurally weak debt-servicing capacity if they are at viability risk for three consecutive years.
Sources: Capital IQ; WIND; and IMF staff estimates.

6. Aggregate leverage level and liquidity risk appear manageable, although there are some pockets of vulnerabilities. Leverage and indebtedness indicators have been relatively stable in recent years albeit at higher levels post-pandemic. The ratio of total liabilities to total assets has fluctuated around 47 percent in recent years, a level that is low compared with Asian peers. Meanwhile, net debt stood at 3.3 times of earnings in 2023, up from 2.6 in 2018, primarily reflecting weaker earnings post-pandemic. Firms in the materials sector have seen a particularly high level of net debt to earnings. Solvency risk also appears low as the share of firms with negative equity was minimal at a level below 1 percent. Overall liquidity risk is limited as firms generally hold sufficient cash to meet short-term obligations and net accounts payable, resulting in a positive adjusted cash position at 1.7 percent of total assets in 2023. Furthermore, their estimated cash position was even more positive at 6.4 percent of total assets as their earnings exceeded interest expense. However, the aggregate liquidity position masks high heterogeneity across firms as 18 percent of them (in terms of assets) exhibited a negative estimated cash position, indicating their vulnerability to refinancing risk.

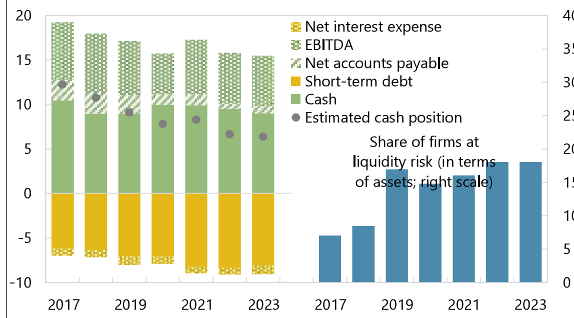
[3] Under this assumption, which is typically used in the IMF surveillance to gauge corporate sector vulnerabilities, firms are not undertaking mitigating actions in response to shocks (e.g., liquidate assets to repay debt).

Local Hong Kong Non-RE Firms: Leverage
(In percent)



Sources: Capital IQ; WIND; and IMF staff estimates.

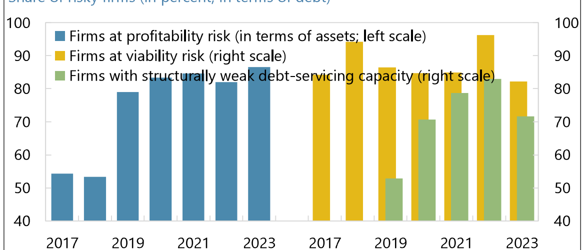
Local Hong Kong Non-RE Firms: Liquidity
(In percent)



Note: Firms are at liquidity risk if their estimated cash position is negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

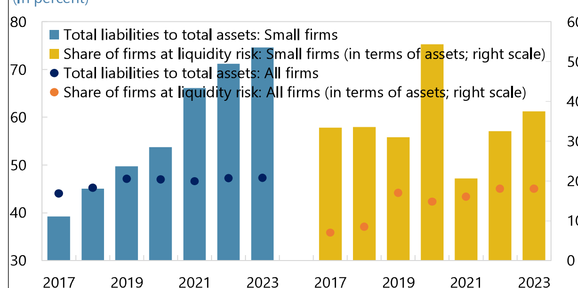
7. Smaller listed firms show notably weaker profitability and debt-servicing capacity. The analysis considers a quintile of smallest listed local non-RE firms in the sample, thus capturing firms with total assets of less than HK$142 million. In 2023, about 87 percent of these small firms in terms of assets were loss-making, and about 72 percent exhibited a structurally weak debt-servicing capacity (i.e., for three years). This finding pointed to the existence of firms with sustained financial weakness among small cap stocks in both the Growth Enterprise Market (GEM) Board and the Main Board.[4,5] Furthermore, smaller listed firms were more leveraged, and they tend to be more exposed to liquidity risk.

Small Local Hong Kong Non-RE Firms: Profitability and Debt-servicing Capacity
Share of risky firms (in percent; in terms of debt)



Note: Firms are at profitability risk if their profits are negative. Firms are at viability risk if their EBIT is less than net interest expense. Firms have structurally weak debt-servicing capacity if they are at viability risk for three consecutive years.
Sources: Capital IQ; WIND; and IMF staff estimates.

Small Local Hong Kong Non-RE Firms: Leverage and Liquidity
(In percent)



Note: Firms are at liquidity risk if their estimated cash position is negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

C. Hong Kong SAR's Local RE Firms

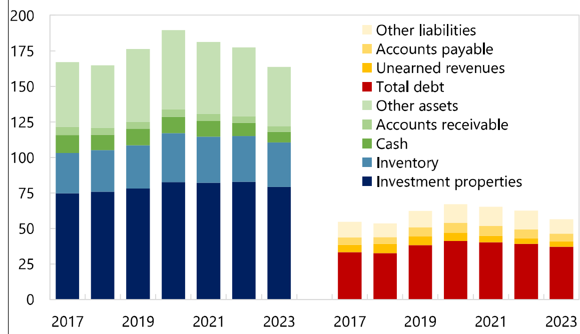
8. The RE sector is very large, and RE firms have sizeable balance sheets holding both investment properties and inventory. RE firms' total assets amounted to about 164 percent of GDP, thus accounting for 44 percent of all local Hong Kong firms' total assets.

[4] The analysis captures about 150 relatively small firms, of which one-third are listed on the Main Board and the remaining are listed on the GEM Board. The findings show that smaller firms on both Boards are financially weak.

[5] The GEM is a specialized board of the HKEX for small and mid-sized firms to raise capital to fund their growth.

Their balance sheets consist of investment properties (48 percent), inventory of unsold properties, property under construction and to--be--developed land, cash and liquid assets, and other assets. With total liabilities to total assets standing at 35 percent in 2023, the balance sheets of RE firms are not significantly leveraged. However, this ratio is highly sensitive to possible changes in property prices given their potential effect on the value of RE firms' assets.

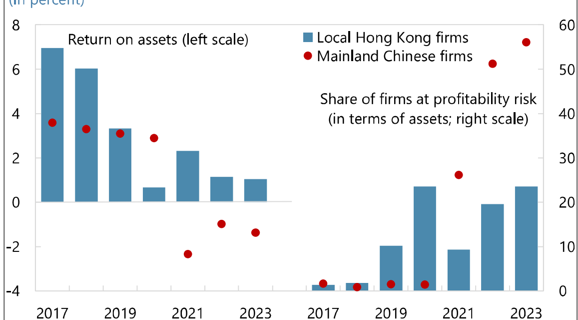
Local Hong Kong RE Firms: Assets and Liabilities
(In percent of GDP)



Sources: Capital IQ; WIND; and IMF staff estimates.

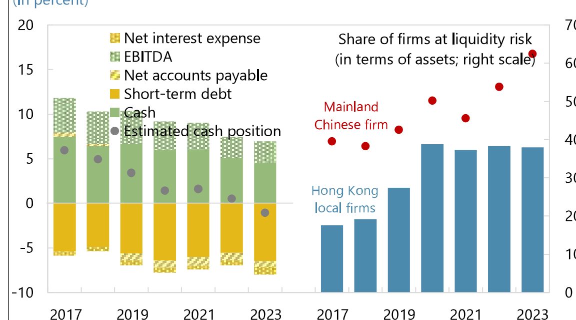
9. RE firms suffered from weakening profitability post-pandemic, while their liquidity risk has increased. In terms of profitability, their return on assets has declined notably to 1.0 percent in 2023 from 6.0 percent in 2018, reflecting the impact of the pandemic and the ongoing property market adjustment. About 23.5 percent of RE firms in terms of assets were loss-making in 2023, a sharp increase from 1.8 percent in 2018. Together with higher funding costs, weak earnings have reduced their debt-servicing capacity. About 20 percent of RE firms in terms of debt were not able to generate sufficient earnings to cover interest expense in 2023, and the share of firms with structurally weak debt-servicing capacity has crept up to 10.7 percent. Regarding liquidity risk, more RE firms have become exposed to refinancing risk as 38 percent of them in terms of assets exhibited a negative estimated cash position, mainly driven by a decline in cash holding and an increase in short-term debt.

Local Hong Kong RE Firms: Profitability
(In percent)



Note: Firms are at profitability risk if their profits are negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

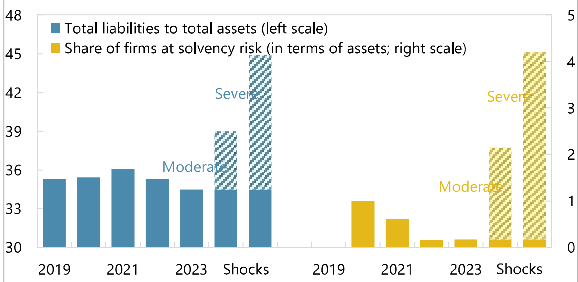
Local Hong Kong RE Firms: Liquidity
(In percent)



Note: Firms are at liquidity risk if their estimated cash position is negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

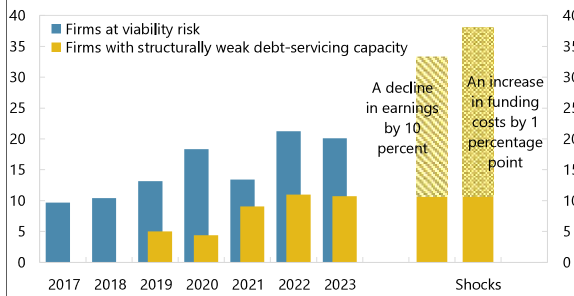
10. Several macro-financial headwinds could exacerbate financial vulnerabilities of RE firms. Amid the ongoing property market adjustment, the leverage of RE firms could increase by 5 percentage points to 39 percent if inventory valuation falls by 10 percent and commercial RE prices drops by 20 percent. Under the same scenario, the share of debt belonging to firms with negative equity would increase but remain low at 2.1 percent. Meanwhile, the share of debt belonging to firms with structurally weak debt-servicing capacity could increase to 33.3 percent in the case that earnings fall by 10 percent for three years and to 38.1 percent in the case that funding costs increase by 1 percentage point for three years.

Local Hong Kong RE Firms: Leverage and Solvency
(In percent)



Note: Firms are at solvency risk if their common equity is negative. Moderate and severe shocks assume a decline in inventory valuation by 10 and 20 percent, and a decline in commercial real estate prices by 20 and 40 percent, respectively.
Sources: Capital IQ; WIND; and IMF staff estimates.

Local Hong Kong RE Firms: Debt-servicing Capacity
Share of risky firms (in percent; in terms of debt)



Note: Firms are at viability risk if their EBIT is less than net interest expense. Firms have structurally weak debt-servicing capacity if they are at viability risk for three consecutive years.
Sources: Capital IQ; WIND; and IMF staff estimates.

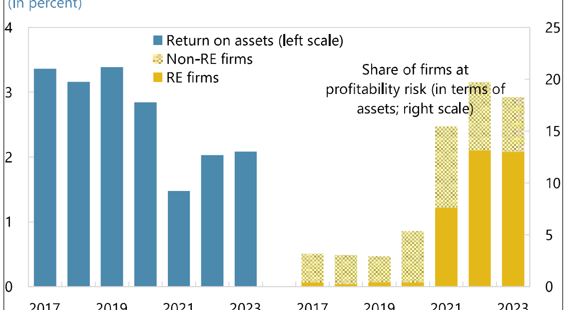
D. Mainland Chinese Firms Listed in Hong Kong SAR

11. Financial vulnerabilities of Mainland Chinese firms listed in Hong Kong SAR have increased in recent years.[6] These vulnerabilities are largely driven by overall weakening profitability since the onset of the pandemic and increased weaknesses of property developers.

- *Overall weakening profitability*. The return on assets of Mainland Chinese firms fell to 2.1 percent in 2023 from 3.4 percent in 2019, and the share of loss-making firms in terms of assets increased to 18.3 percent. The decline in profitability has also reduced firms' debt-servicing capacity. The share of debt belonging to firms with structurally weak debt-servicing capacity increased by 13.5 percentage points to 19 percent, largely driven by property developers.

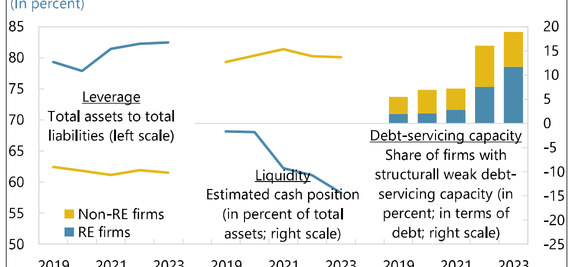
- *Property developers' weak balance sheets*. The ongoing property sector adjustment in Mainland China has significantly hit property developers' balance sheets. Mainland Chinese property developers are facing falling profitability (return on assets at -1.4 percent in 2023), elevated leverage (total liabilities to total assets at 83 percent), and a negative estimated cash position (14.4 percent of total assets). Furthermore, there is a significant tail of financially weak property developers that are loss-making and maintain structurally weak debt-servicing capacity, negative equity, and negative estimated cash position.

Mainland Chinese Firms: Profitability
(In percent)



Note: Firms are at profitability risk if their profits are negative.
Sources: Capital IQ; WIND; and IMF staff estimates.

Mainland Chinese Firms: Leverage, Liquidity and Debt-servicing Capacity
(In percent)



Note: Firms have structurally weak debt-servicing capacity if their EBIT is less than net interest expense for three consecutive years.
Sources: Capital IQ; WIND; and IMF staff estimates.

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[6] See Selected Issue Paper on "Assessing Vulnerabilities of China's Corporate Sector" that accompanies China's 2024 Article IV.

12. Given their dominance in Hong Kong SAR's stock exchange, financial weaknesses of Mainland Chinese firms have likely affected Hong Kong SAR's financial services activity and investor sentiment. Weak earnings and profitability of Hong Kong SAR-listed Mainland firms has contributed to their lower share prices, likely resulting in weaker incentives of both local and Mainland Chinese firms to raise equity financing in the territory. Meanwhile, concerns about firms' repayment ability could affect investors' appetite to invest in corporate bonds. This has not only affected the local financial services sector, which was a key driver of past growth, but may have also undermined investor sentiment with possible effects on private consumption and investment.

E. Policies to Promote Macro-Financial Stability

13. Proactive efforts are warranted to ensure effective monitoring and management of financial vulnerabilities in the corporate sector. Key actions should include:

- **Ensuring that banks remain proactive in managing nonperforming assets**. Given the notable pandemic scarring effects, Mainland China's ongoing property sector adjustment, and potential macro-financial headwinds, it is important that banks continue recognizing nonperforming assets and making appropriate provisions.

- **Effectively monitoring the impact of the ongoing property market adjustments in Hong Kong SAR**. While financial vulnerabilities of local Hong Kong RE firms appear manageable, it is important to remain vigilant given the importance of the property market to the economy and the size of RE firms' balance sheets.

- **Carefully calibrating policy support to small businesses**. Policy support to small businesses, including the existing credit guarantee schemes, should be well calibrated to strike a proper balance between providing necessary support and facilitating an orderly exit of non-viable firms. Expanded use of the Commercial Data Interchange could also help overcome information asymmetry problems and improve financing access for small viable businesses.