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Slower Earnings Growth Drags On Deleveraging For Corporate China

August 27, 2018

Key Takeaways

- Our rated portfolio of corporate and infrastructure credits will likely see more neutral to a slightly negative transitions over the next six to 12 months.
- Earnings growth is decelerating; this is a drag on the corporate deleveraging process.
- Tougher funding conditions and the crackdown on local government debt is slowing investment activity.
- The escalating trade friction between China and U.S. is dampening investments and restraining capital spending appetite.
- We project that debt leverage for our rated portfolio of Chinese companies will increase in 2018, reversing the downward trend in 2017.
- Chinese authorities are selectively easing conditions and stimulating activity, but this won't help the riskiest borrowers.

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Corporate China's deleveraging trend is about to pause. This is due mainly to decelerating earnings growth rather than profligate spending or borrowing. S&P Global Ratings believes that underlying corporate spending appetite remains restrained, and that Chinese authorities are committed to deleveraging for state owned enterprises(SOEs).

That said, authorities are fine-tuning their financial-risk reduction measures to support corporate financing. This comes amid rising stress, especially for private enterprises, due to higher funding costs and increased risk aversion by lenders amid slower investment spending and weakening industrial demand. We believe such efforts could take pressure off some companies facing difficulties in refinancing their debt maturities, especially SOEs that rely on new borrowing to pay off old debt. However, in our view, the most vulnerable borrowers, in particular private enterprises, will continue to face higher refinancing and default risk.

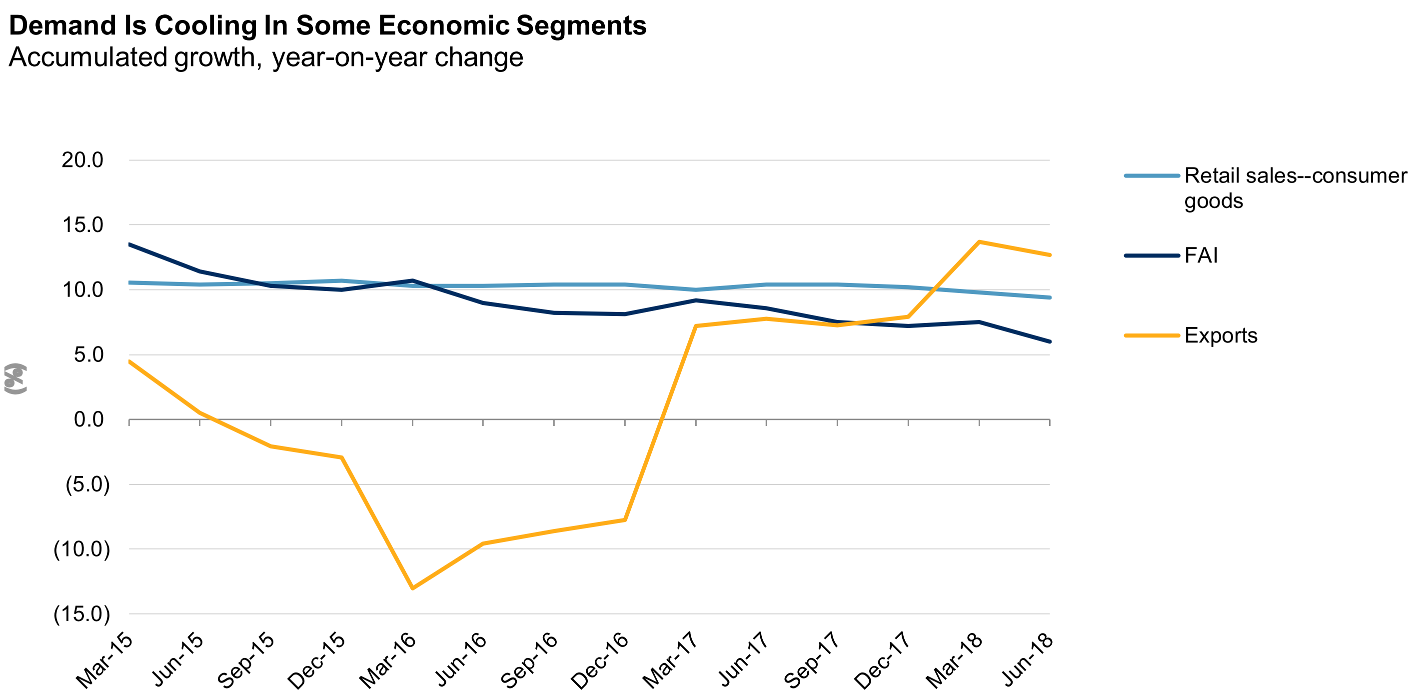
We estimate debt leverage will rise slightly in 2018 for our rated Greater Chinese portfolio, breaking from the deleveraging trend in 2016 and 2017. Overall, we have a modest negative net bias in our portfolio, due to deteriorating liquidity, mostly at the weaker end of the rating spectrum. This holds especially for companies in the capital goods, metals and mining sectors, and local government financing vehicles.

Investment Spending Is Decelerating: But Then So Are Earnings

We expect liquidity conditions will ease in the second half of 2018 to selectively boost economic activity and relieve financial stress. While decelerating investment spending is a necessary component of deleveraging, too sharp a slowdown can knock confidence and earnings momentum.

Despite strong headline 6.8% GDP growth in the first half of 2018, momentum is moderating for fixed asset investment (FAI), consumption (i.e., retail sales), and exports (see chart 1). All these is pointing to slower industrial demand, potentially knocking commodity prices, which contributed to the strong profit recovery of upstream industry sectors in the past two years.

Chart 1



FAI--Fixed asset investments. Source: WIND, S&P Global Ratings.

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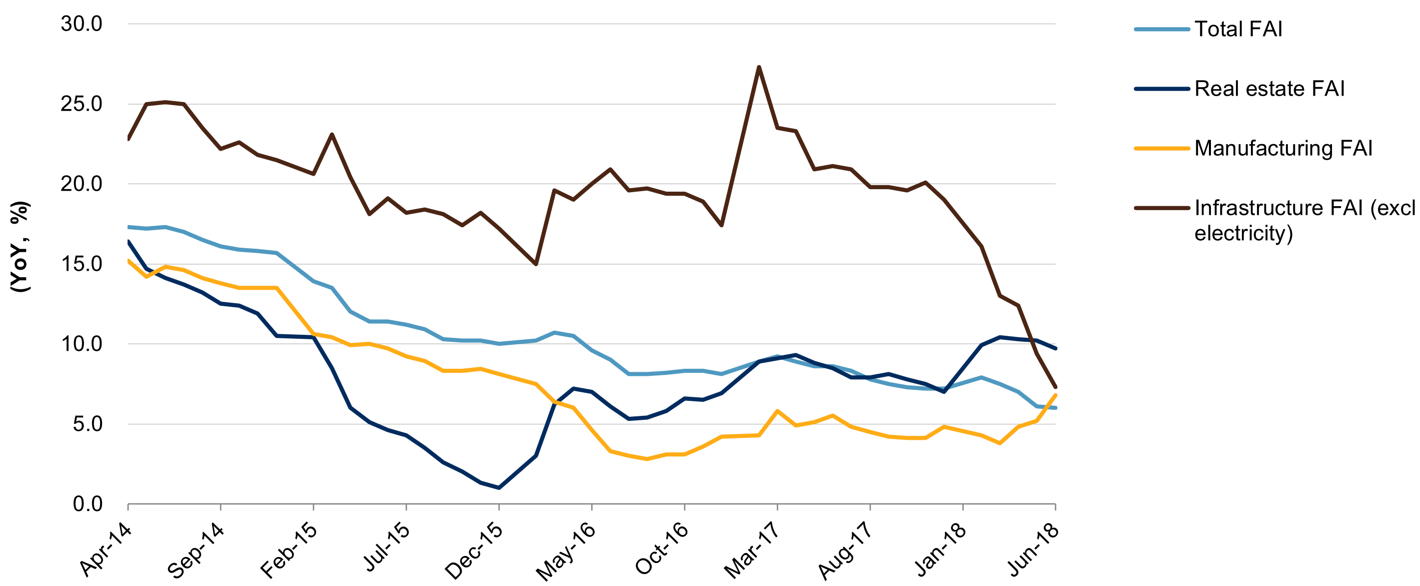
Slower investment spending stems from China's multi-pronged campaign to reduce financial risks in the system, including those caused by local-government development activities. FAI expanded at a more sluggish 6.0% in the first half of 2018, mainly due to weakening infrastructure investment. Infrastructure investments (not including electricity) fell to 7.3% in the year to June 30, 2018, from 21.1% in the same period of last year.

Stricter measures on expansion and borrowing, and tougher implementation of the guidelines by local authorities have restrained spending by local government financing vehicles (LGFVs). At the same time, lenders are constrained by new asset management rules to extend credit through the non-bank channels to LGFVs and property developers. In our view, these factors explain much of the precipitous drop in infrastructure investment (see chart 2). We expect government to encourage a modest increase in infrastructure investment in the second half of 2018, but high leverage in the economy and cautious risk appetite will limit stimulus efforts.

Chart 2

Investment Spending Growth Is On A Downward Trend



FAI -Fixed asset investment. YoY--Year on year. Excl--Excluding. Source: WIND, S&P Global Ratings.
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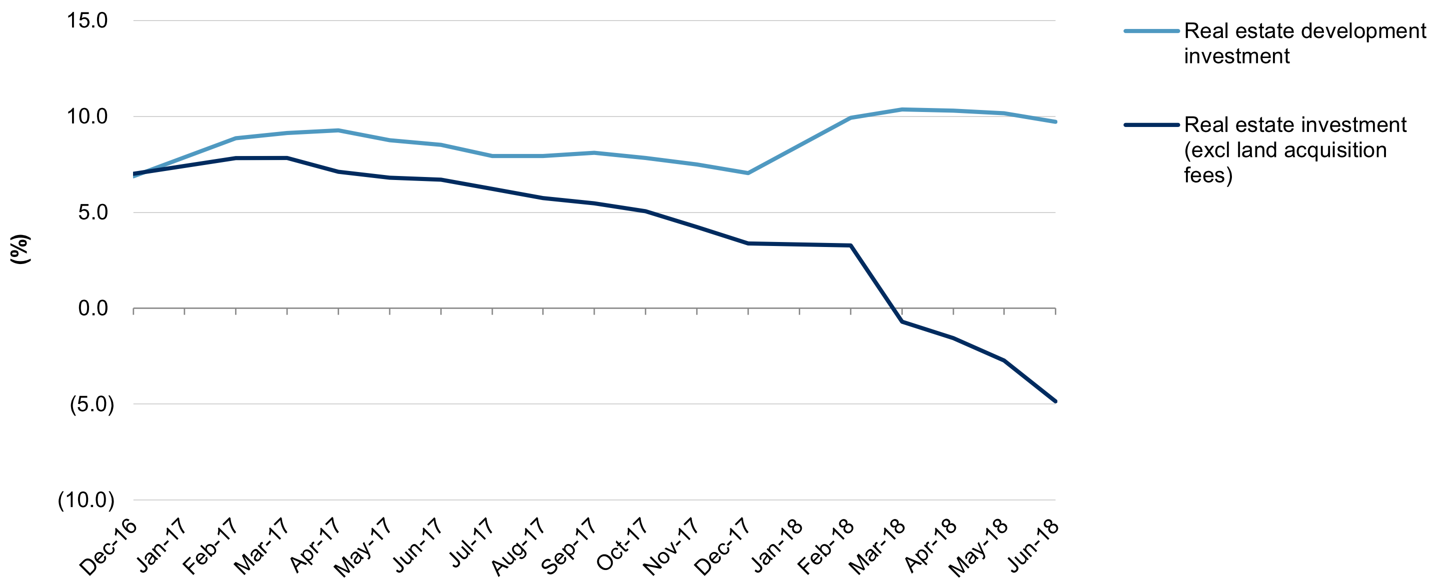
The deceleration in property investments underlines the economic risks attached to deleveraging. Property and related sectors are major pillar of the Chinese economy, constituting 20%-30% of economic output. Since March, property investments excluding land purchases, took a dive (see charts 3 and 4). Tougher credit disbursement is one reason for the drop. Another is slowing sales growth and increasingly tougher policy to control price growth.

In our view, the loosening of monetary conditions will not likely revive investment growth. Liquidity conditions have been easing since the beginning of 2018 and yet FAI continues to fall. The trouble is lenders have turned cautious as the economic outlook moderates, and corporate stress (especially for private enterprises) increased. China is now easing financing conditions, which may spur purchases of financial assets by banks, for example of lower-rated corporate bonds. However, whether that would would reverse falling real asset investments is uncertain.

Chart 3

Land Costs Are Behind The Growth In Real Estate Development Investment



Excl--Excluding. Source: WIND, S&P Global Ratings.

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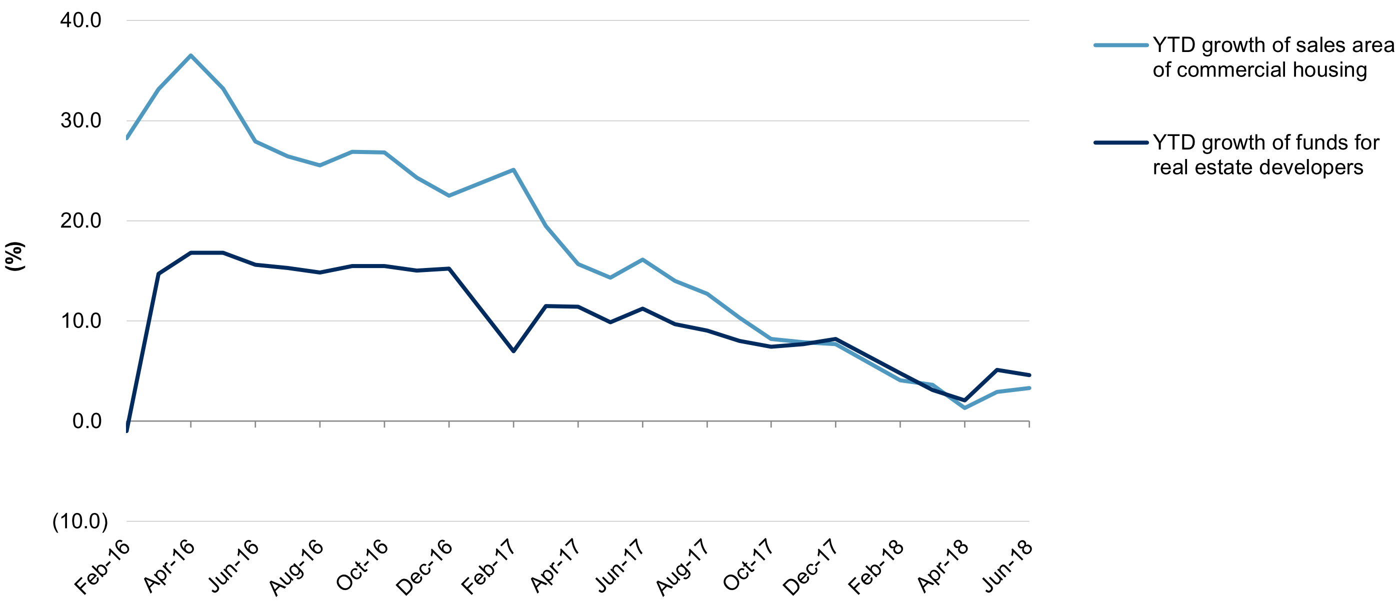
Chart 4

Commercial Housing Sales Growth Is Slowing Amid Tighter Funding, Government Controls



Note: Available funding includes capital, loans, bonds, and advance payments. YTD--Year to date. Source: WIND, S&P Global Ratings.

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Capital Spending And Debt Growth Are Restrained

Corporates have maintained a muted appetite for capital spending under the government policy of deleveraging. In particular, the central government owned SOEs have a mandate to control debt growth and reduce asset leverage target (total liabilities to total assets) by the end of 2020. This mandate remains intact, at least for now, in view of the recent State Council (the Chinese cabinet) pronouncement to support growth and increase credit allocation for infrastructure development.

Aside from the deleveraging policy for SOEs, capacity reduction for industries with excess capacity such as metals and mining, building materials and coal-fired power generation, continued apace under the supply side reform policy. Forced reduction of capacity has also shrunk capital spending in these industries.

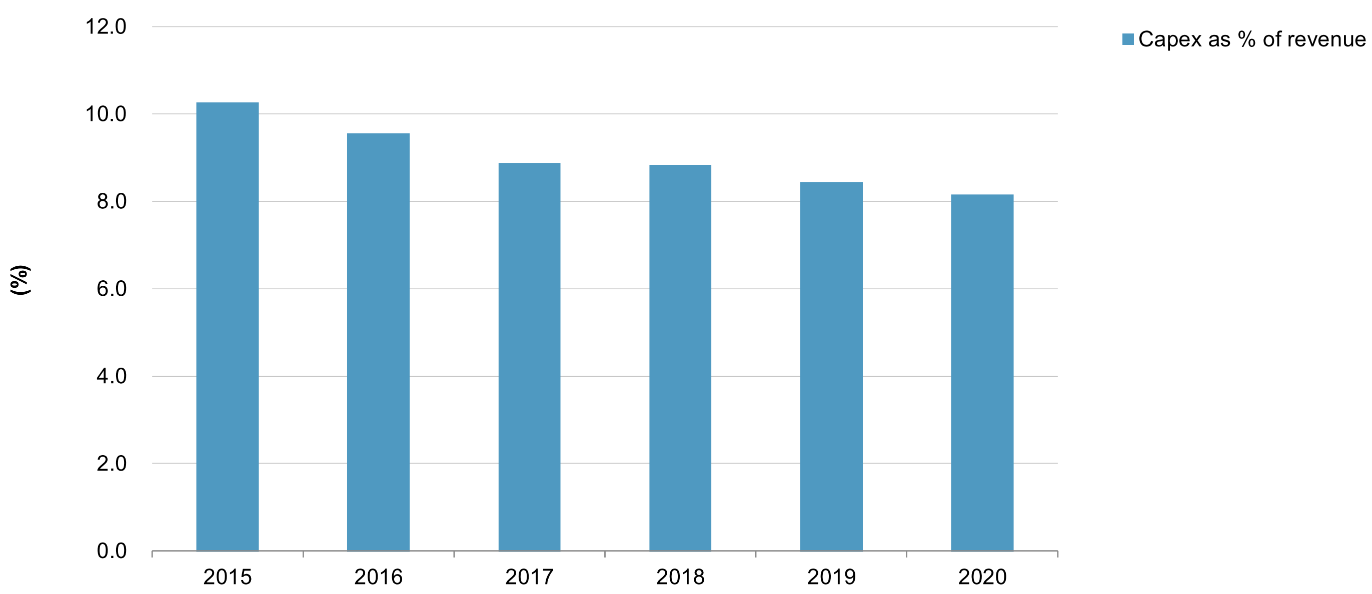
Meanwhile, oil/gas and other commodity producers have kept capital expenditure in line with profits, even with profits recovering strongly. Companies are taking a more cautious approach to expansion with the last boom and bust cycle still fresh in their minds. Commodity producers--typically SOEs--have made limited large overseas acquisitions since the last boom.

Overseas investments have declined, partly because of a less welcoming attitude by host countries in the developed markets, but also because of tightened control and supervision over overseas investments. Regulators are taking a more active role in vetting SOEs' overseas investments, and funding and project feasibility.. Private companies are prohibited from investing in real estate, hotels, and media since mid-2017

These trends have fed through to our rated credits, where spending as a proportion of revenues remains constrained compared with past years (see chart 5).

Chart 5

Capital Discipline Remains Intact For Our Rated Chinese Portfolio



Capex--Capital expenditure. Source: S&P Global Ratings.

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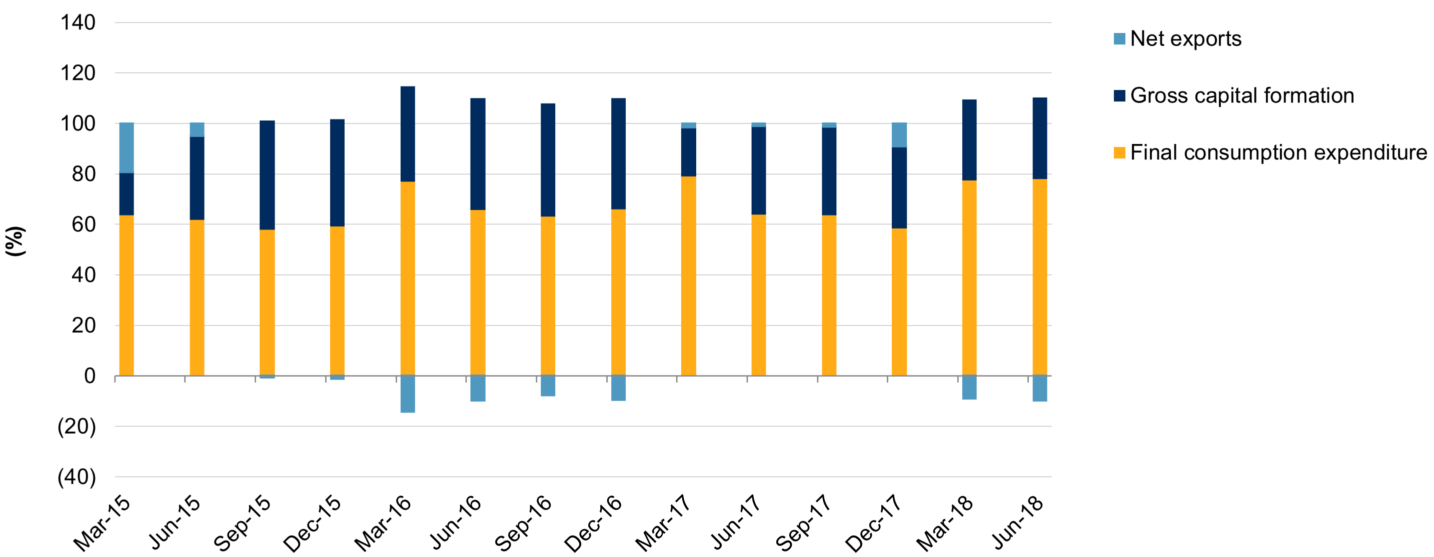
Escalating Trade Frictions Add to Earnings Downside

Further escalations in the U.S.-China trade battle will complicate China's efforts to deleverage its economy. This is because impeded exports would drag down demand for industrial products, slowing corporate revenue growth. Also, higher tariffs for imported raw materials could increase the cost of goods for corporates, harming profit margins and cash flows.

Chart 6

Exports' Contribution To GDP Growth Is Declining
Contribution of net exports to YTD GDP growth



Source: WIND, S&P Global Ratings.
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Rising trade tensions will have a limited direct impact on our rated issuers, for now. Most of these issuers are focused on the domestic market. Real estate, utilities/infrastructure, and LGFVs comprise nearly 50% of the rated portfolio.

As of the end of July 2018, only 4% of our rated companies were directly affected by the first round of tariffs increases of 25%. About 40% of the targeted goods are consumer products. Nevertheless, the expansion of the tariffs to cover an estimated US$200 billion worth of goods (second round) from US$50 billion (first round) worth of Chinese exports will likely have a wider and more meaningful impact on our rated companies. That said, the actual impact can only be confirmed when details of penalties, such as the affected products, are announced.

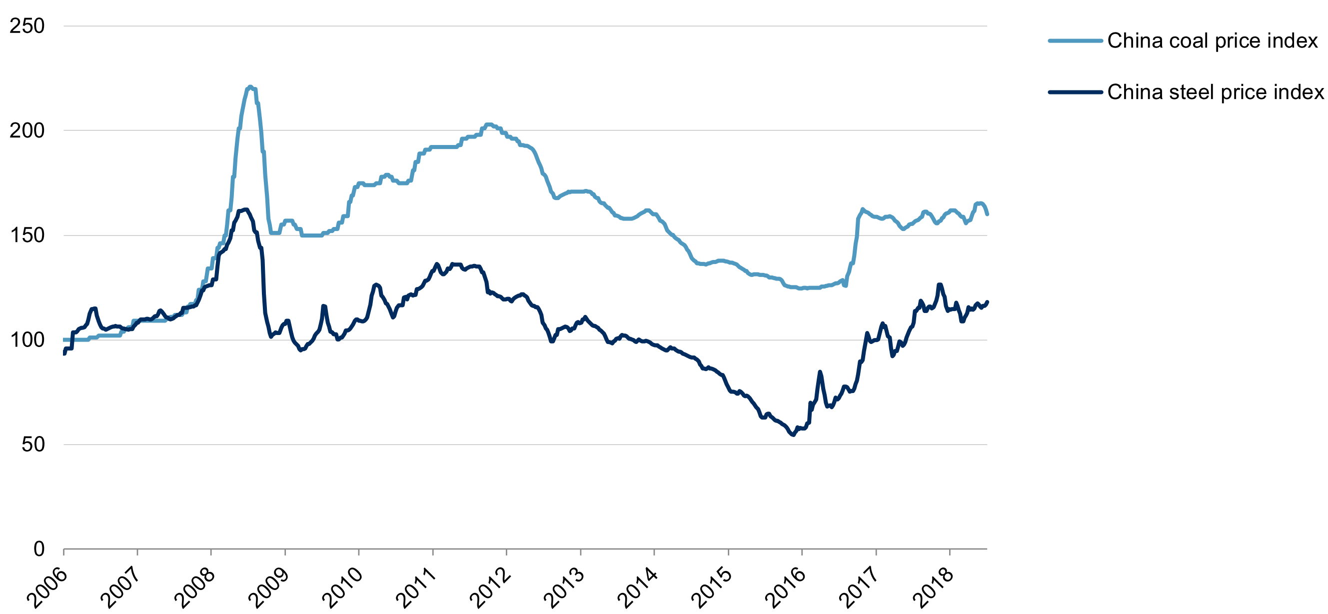
We believe the indirect a impact could be larger. Already, confidence, investment activity, and industrial demand have deteriorated. Exporters often operate on razor-thin margins and may not weather large tariff increases. Potential job losses from a wave of export enterprises' bankruptcy would knock consumption, in particular in coastal provinces where exporters are concentrated.

Industrial Earnings Growth Is Slowing And At Risk Of Declining

Slowing growth in FAI, consumption, and exports will lead to contracting industrial earnings growth. Industrial products prices in China have rebounded a lot from the bottom in 2015 due to the improvement in downstream demand, and also the de-capacity policy (see chart 7). However, weakening investment and exports will hinder future gains.

Chart 7

Industrial Product Prices Are Beginning To Moderate



Note: China coal price index (2006 = 100), China steel price index (1994 = 100). Source: China Coal Industry Association, China Iron & Steel Association, S&P Global Ratings.

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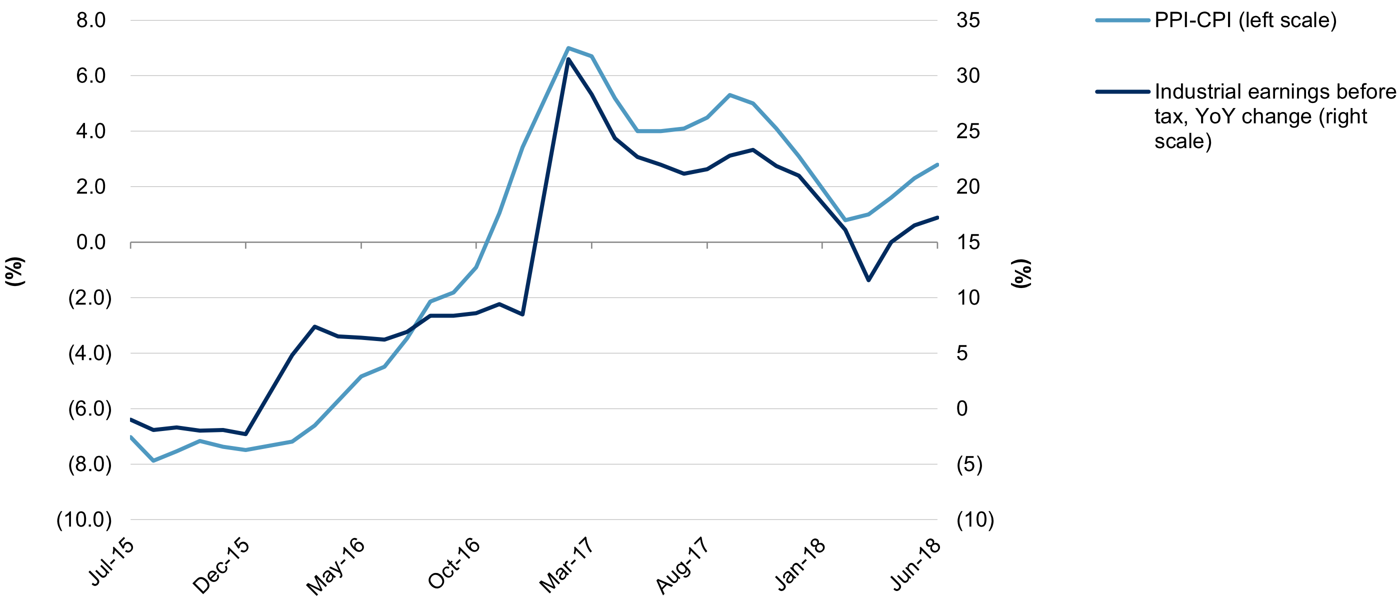
The declining gap between producer and consumer prices (PPI-CPI gap) indicates that earnings growth could slow (see chart 8). This is important because strong industrial earnings growth over the past two years has been a key factor in deleveraging.

Chart 8

Contracting PPI-CPI Gap May Imply Declining Industrial Earning Growth



PPI--Producer price index. CPI--Consumer price index. YoY--Year on year. Source: WIND, S&P Global Ratings.

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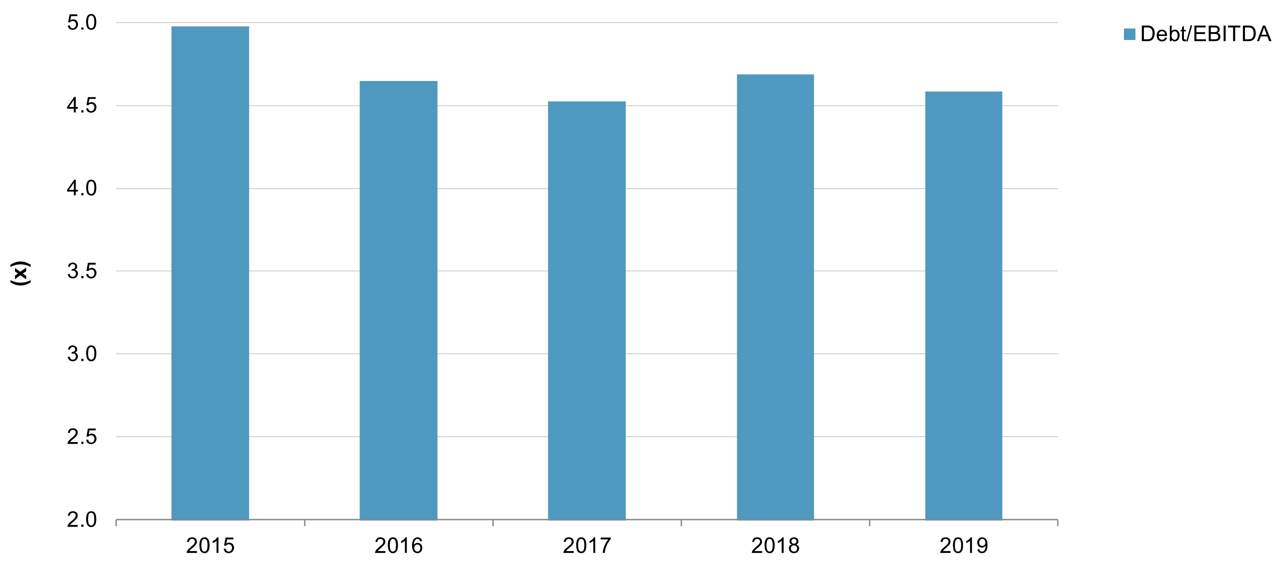
Leverage Improvements Are Over--For Now

We project leverage for our portfolio will increase slightly in 2018, after improving for the two previous years. This is due mainly to declining earnings growth. By our estimates, EBITDA will expand by 10% on average for our rated portfolio this year, down from a heady 25% in 2017. Among large sectors in our portfolio, property and mining drove the earnings recovery in 2017. For example, EBITDA growth was 41% in the property sector and 43% in the mining sector. However, EBITDA growth in these two sectors will shrink to 24% and 2% respectively in 2018.

Chart 9

The Improving Leverage Trend Is Set To Pause
Ratio of debt to EBITDA for our rated portfolio



Source: S&P Global Ratings.

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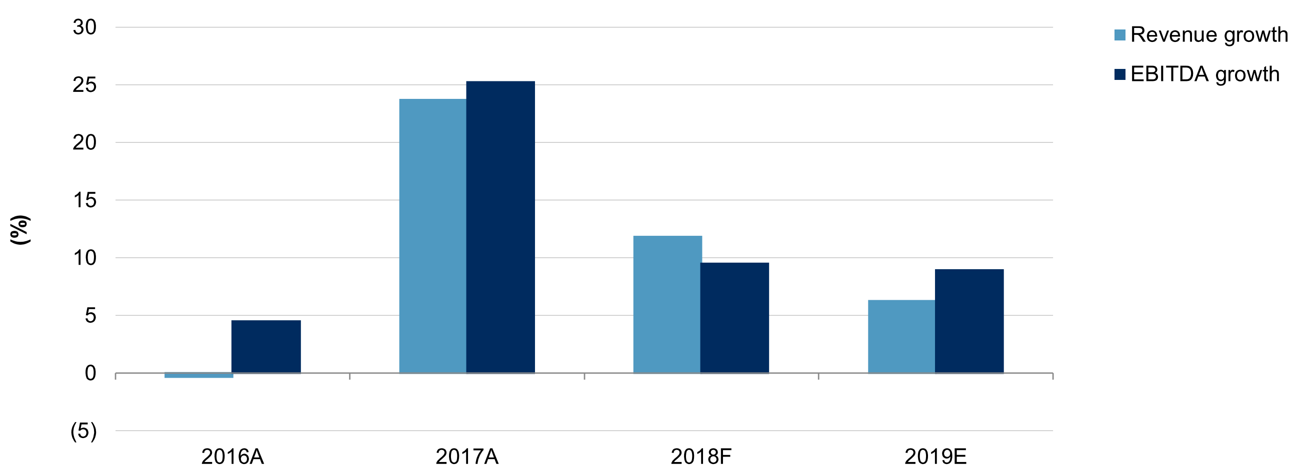
Chart 10

Revenues And Earnings Are Trending Lower For Our Rated Portfolio



A--Actual. E--Estimated. Source: S&P Global Ratings.

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Policy Easing And Stimulus May Not Mitigate Credit Concerns

If trade tensions become more significant, we expect policymakers could try to boost FAI and consumption to make up for the negative contribution of foreign trade. The government has recently relaxed some of regulations on asset management products, encouraged banks' lending, and stimulated infrastructure investment (see table 1). Some sectors, such as infrastructure or property development, may take on more debt as credit conditions ease.

Table 1

Recent Policy Adjustments Are Aimed At Relieving Stress

Date (in 2018)	Policy initiatives
24-Jun	Targeted RRR cut to support "debt-to-equity swap" and the financing of small businesses.
18-Jul	PBOC's “window guidance” required banks to use MLF funds to support credit lending and bond investment.
20-Jul	PBOC moved to soften implementation of tightened regulation of the asset management industry.
23-Jul	The State Council met and requested more active fiscal policy, urged financial institutions to meet reasonable borrowing demands from LGFVs; and effectively ensure funding requirements for projects under construction.
23-Jul	PBOC injected RMB502 billion through a MLF operation.
31-Jul	Politburo meeting concluded with vow to maintain growth despite external troubles, perhaps through: making up shortfall in infrastructure investment and allowing for a fluid "dynamics and pace" of deleveraging; also vowed to curb uncontrolled rise of housing price.
3-Aug	PBOC announced it would impose a 20% deposit requirement for trading currency forwards.
8-Aug	"Key points for reducing corporate leverage in 2018" jointly issued by top plannig body, central bank, finance ministry, banking regulator and state-owned assets administrator, requiring more support for debt-to–equity swap program, more specific timeline, and objective for deleverage of key SOEs, and curbing excessive debt financing by highly indebted enterprises.

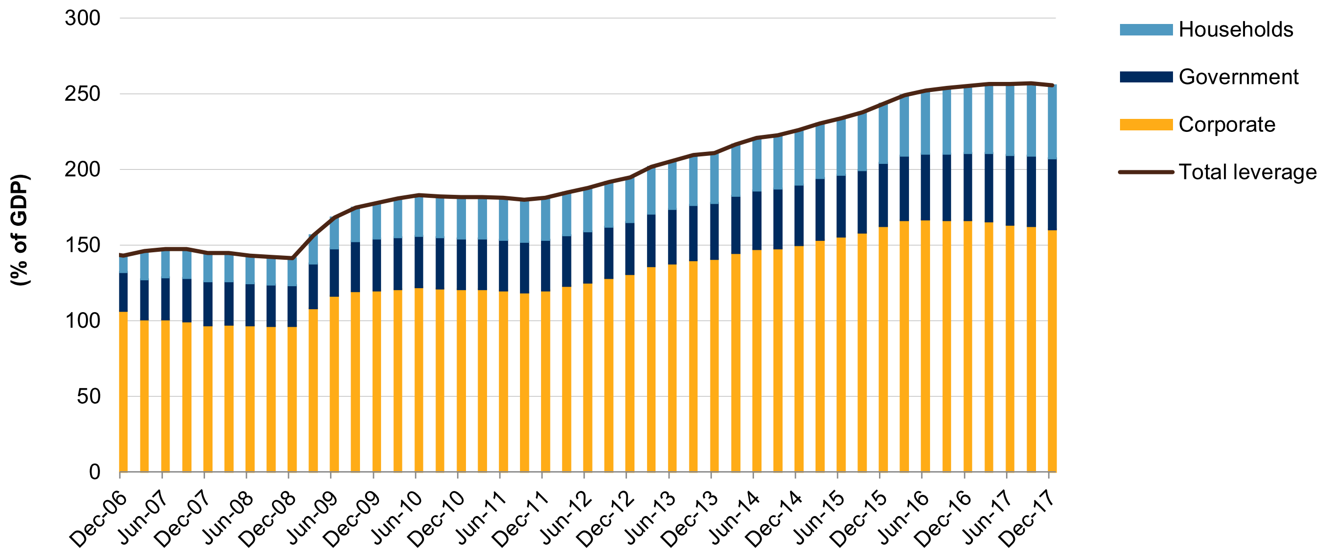
RRR--Required reserve ratio. PBOC--People's Bank of China. MLF---Medium-term lending facility. LGFV--Local-government financing vehicle. SOE--State-owned enterprise.

Still, we believe that deleveraging is a long-term policy. Recent adjustments may not imply a U-turn on the deleveraging campaign. The main reason is that the job is not done. Total leverage in the economy and the corporate sector are still high, although stabilizing. For our rated portfolio, we project a total debt to EBITDA ratio of 4.75.

In some sectors, borrowers rely on refinancing to stay afloat, as they have limited ability to repay the debt principal. Most of these companies—some of which are so-called "zombie companies"—remain a significant part of sectors with overcapacity. Also, last year's improvements in leverage ratios were underpinned by volatile commodity prices, and could vanish quickly.

Chart 11

Economic Leverage Has Begun To Stabilize But Remains High
Debt as a percentage of GDP, by sector



Source: Bank of International Settlements, S&P Global Ratings.
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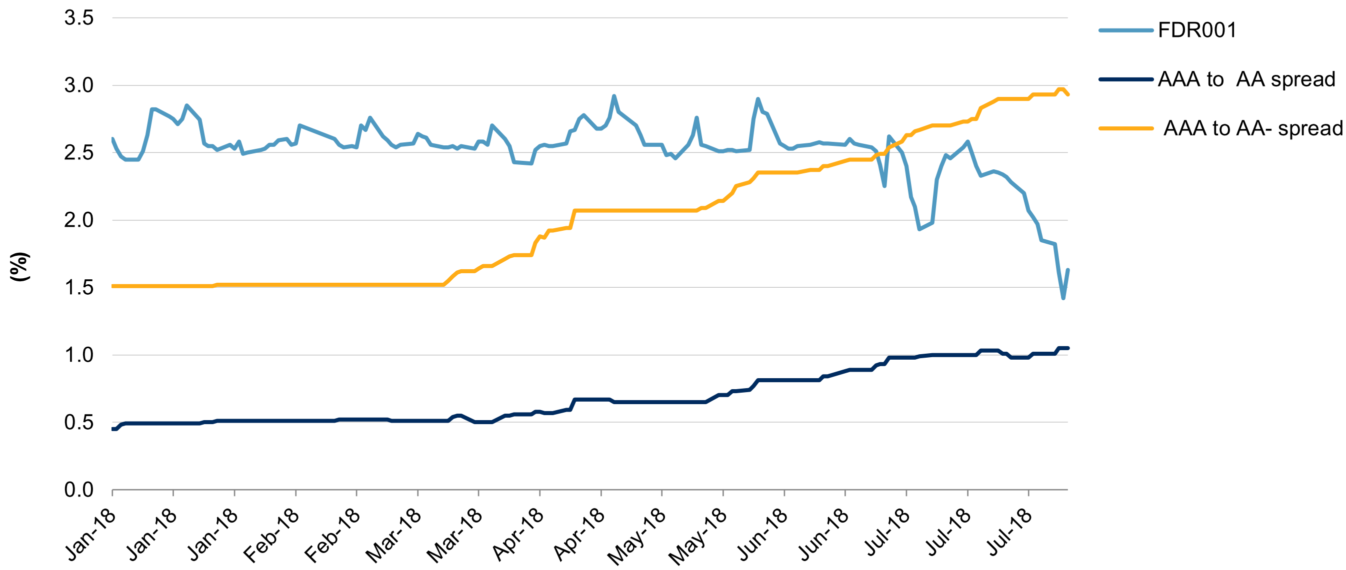
Despite the government's recent efforts to support growth, risk appetite may not improve significantly.

For example, money market rates have been falling since China began easing credit beginning of 2018 (see chart 12). However, bond spreads for weaker borrowers have not budged. Even if yield-chasing banks increase holdings of financial assets, we are not certain this would be channeled into the real economy. Lenders and investors could prefer to increase their exposure to safer investments, such as SOEs or even LGFVs.

Chart 12

Improving Market Liquidity Has Not Revived Risk Appetite
Repo rates vs spreads on enteprise bonds



Note: Spread refers to five-year enterprise bond yield spread. FDR001 is the overnight fixing repo rate between depository institutions. Source: WIND, National Interbank Funding Center, S&P Global Ratings.
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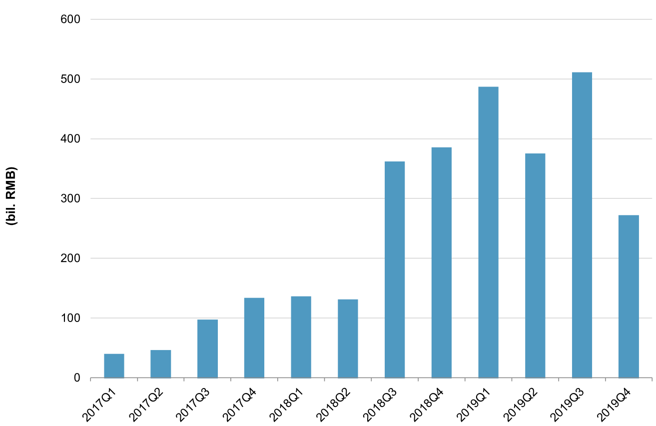
One of the reasons investors and lenders are cautious, is because the onshore bond market will hit a a maturity wall, which could lead to deteriorating liquidity and restrained refinancing conditions for onshore issuers. Including bond puts, the effective maturity amount could rise to Chinese renminbi (RMB) 5.3 trillion yuan this year (assuming all puttable bonds will be exercised at the put date), versus RMB4.9 trillion yuan in 2017.

Chart 13

Bond Puts Are Set To Pile Up In Next Few Months
Exercisable, by quarter



bil.--Billion. RMB--Chinese renminbi. Source: WIND, S&P Global Ratings.
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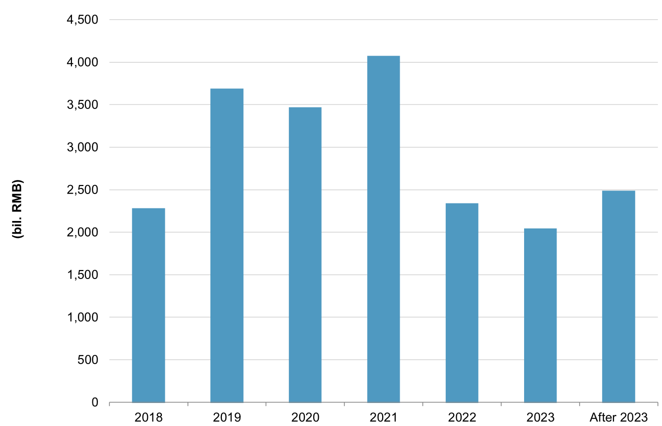
Chart 14

Chinese Borrowers Have A Large Maturity Wall To Climb
Maturities, by year



bil.--Billion. RMB--Chinese renminbi. Source: WIND, S&P Global Ratings.
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Meanwhile, offshore bond issuers meanwhile face currency-related risks, given the recent depreciation of the RMB relative to the U.S. dollar. As China eases policy to reduce stress, the narrowing interest yield spread between China and the U.S. creates new headaches for the RMB (see chart 15). S&P Global economists expect two more U.S. rate hikes in 2018 and three in 2019, which would further compress the yield spreads.

Chart 15

Diverging Monetary Policy May Add To Pressure On Renminbi
U.S.-China 10-year government bond yield spread is narrowing vs exchange rates

RMB--Chinese renminbi. Source: Bloomberg, WIND, S&P Global Ratings.

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Recently, the People's Bank of China (PBOC) announced a 20% deposit requirement for trading currency forwards, to discourage speculative bets against the RMB. Also, the central bank has reapplied a "counter cyclical" factor in its daily currency pricing, to more aggressively manage the RMB. Even so, we believe the narrowing spreads will continue to be a challenge for the central bank to manage capital outflows which add pressure on RMB.

Refinancing Risk Has Put The Brakes On The Positive Ratings Trend

Tighter funding conditions and rising refinancing risk has led us to initiate more negative than positive rating actions so far this year, particularly in the second quarter. This follows a trend of positive rating actions in the previous two years see chart 16 and table 2).

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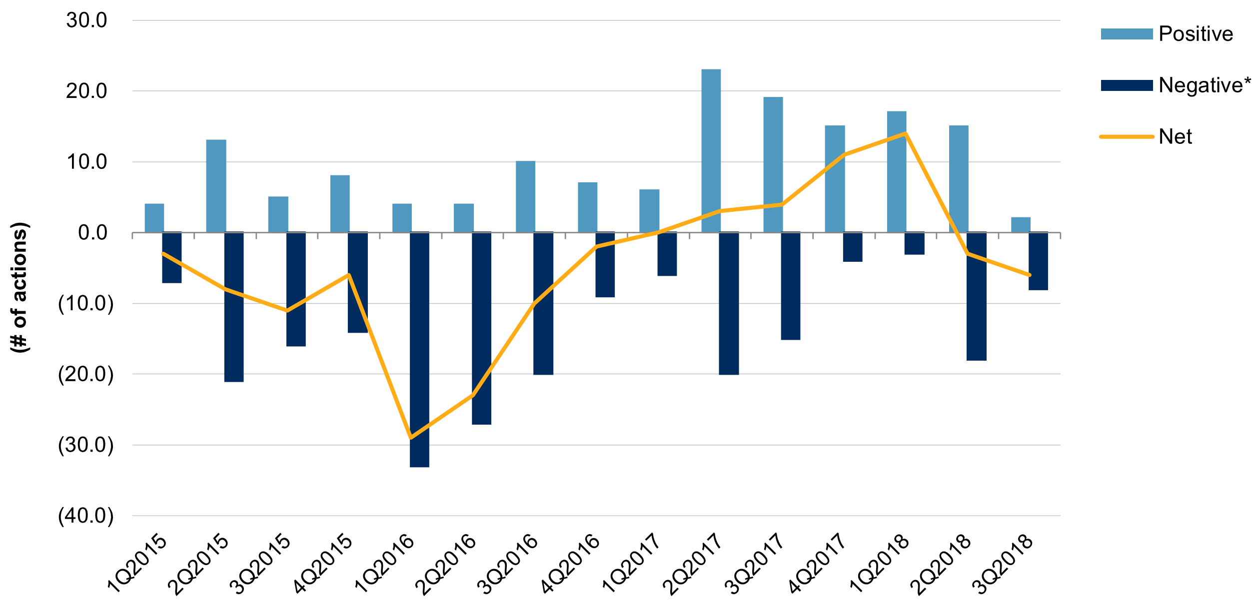
Chart 16

Rating, CreditWatch Or Outlook Actions For Greater China Credit -- Quarterly



Note*: Negative rating actions exclude linked rating actions of China and Hong Kong Downgrades. Source: S&P Global Ratings.

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Table 2

Greater China Credits And Outlook Bias By Sector*

Sectors	Sector weighting	Outlook bias
Auto/auto parts	3.17%	-18%
Capital goods/machinery & equipment	8.93%	-16%
Chemicals	2.88%	0%
Consumer products	6.92%	-4%
Utilities	10.95%	0%
Investment holdings	1.44%	0%
Forest products/building materials/packaging	0.86%	67%
High technology	4.61%	-19%
LGFV	8.36%	-14%
Media, entertainment &leisure	2.59%	0%
Mining/minerals	8.36%	-14%
Oil/oil petrochemicals	4.03%	-7%
Real estate	24.78%	-3%

Table 2

Greater China Credits And Outlook Bias By Sector* (cont.)

Sectors	Sector weighting	Outlook bias
Restaurants/retailing	2.88%	10%
Telecommunications	2.31%	13%
Transportation cyclical	1.15%	0%
Transportation infrastructure	5.76%	5%
Total	100.00%	-5%

*As of July 31, 2018

Overall, our rated portfolio remained in a modest net negative outlook bias at -5%, the same level as the end of 2017. Among the large sectors, the most significant negative outlook bias is in from capital goods, mining, and LGFVs. The main reason for the outlook bias is the liquidity deterioration.

As of July 2018, our list of "weakest links" and "fallen angels" has expanded slightly, to nine companies. Four of these companies are in real estate. This reflects the vulnerability of some developers tightening liquidity and refinancing risk due to highly leveraged operations, large exposure to non-standard funding channels, and large short-term debt maturities.

We expect more negative ratings actions if earnings growth worsens and liquidity conditions do not materially improve.

Table 3

Weakest Links And Fallen Angels*

Weakest Links	Rating	Outlook	Sector
China Automation Group Ltd.	CCC	Negative	Capital goods/machinery & equipment
Maoye International Holdings Limited	B-	Negative	Restaurants/retailing
Pactera Technology International Ltd.	CCC+	Negative	High technology
Oceanwide Holdings Co. Ltd.	CCC	Negative	Real estate
Hydoo International Holding Limited	B-	Negative	Real estate
Sunshine 100 China Holdings Ltd.	CCC+	Negative	Real estate
Potential Fallen Angels	**Rating**	**Outlook**	**Sector**
Red Star Macalline Group Corporation Limited	BBB-	Negative	Real estate
Xinjiang Goldwind Science & Technology Co. Ltd.	BBB-	Negative	Capital goods/machinery & equipment
Hongkong International (Qingdao) Company Limited	BBB-	Negative	LGFV

*Note: Weakest links are issuers rated 'B-' or lower with either a negative outlook or ratings on CreditWatch with negative implications. Potential fallen angels are issuers rated 'BBB-' with either negative outlooks or ratings on CreditWatch with negative implications. LGFV--Local government financing vehicles.

This report does not constitute a rating action.

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