S&P Global Ratings

RatingsDirect®

The Big Chill In China: Weaker Profitability To Hit Corporate Debt Servicing

January 21, 2019

Key Takeaways

- Weakening demand and external uncertainties will weaken corporate revenue and crimp margins in 2019.
- We expect debt serviceability to decline and deleveraging to stall.
- China's stimulus measures will benefit stronger or larger companies the most, widening credit quality.
- We project a modest increase in default risks, from a low base relative to global averages.
- Our ratings outlook bias is tilted to the negative.

PRIMARY CREDIT ANALYST

Cindy H Huang

Hong Kong

(852) 2533-3543

cindy.huang@spglobal.com

CHINA COUNTRY SPECIALIST

Chang Li

Beijing

+ 86 10 6569 2705

chang.li@spglobal.com

RESEARCH ASSISTANT

Richard Wu

Hong Kong

The economic chill in China is spreading, threatening to weaken profitability across nearly all sectors in corporate China. S&P Global Ratings believes debt-servicing capabilities will decline as demand cools and profit margins contract. And deleveraging will pause or even reverse for some companies.

While policymakers have intentionally steered the country toward a lower and more sustainable growth path, the broadness of the decline in recent months is raising concerns. The central government has responded by loosening monetary conditions and implementing various stimulus support measures. In our opinion, this will likely benefit strong or large companies. Small or overleveraged companies still face high refinancing risks.

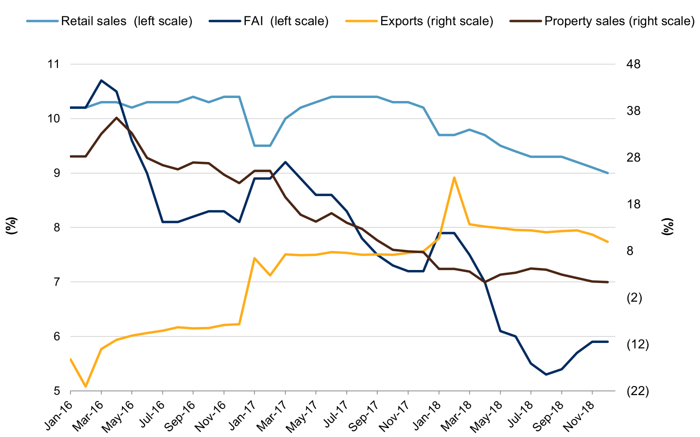
Corporate defaults should continue to increase modestly, in our view. This is driven by rising debt maturities in 2019 and our expectation that financial institutions and investors will remain risk averse against a more fragile economic backdrop. Credit quality will therefore diverge significantly. We expect credit spreads for strong corporates to narrow, but weak companies continue to face higher risk of downgrades and defaults.

Attention Shifts From Refinancing To Corporate Profitability

China has entered a chilly period. Key economic indicators are all showing consecutive monthly declines, including fixed asset investment (FAI), property sales, consumer sentiment, auto sales, and exports. We expect the negative trend in industrial activity and industrial profits to persist throughout 2019, absent of a major government stimulus policy.

Chart 1

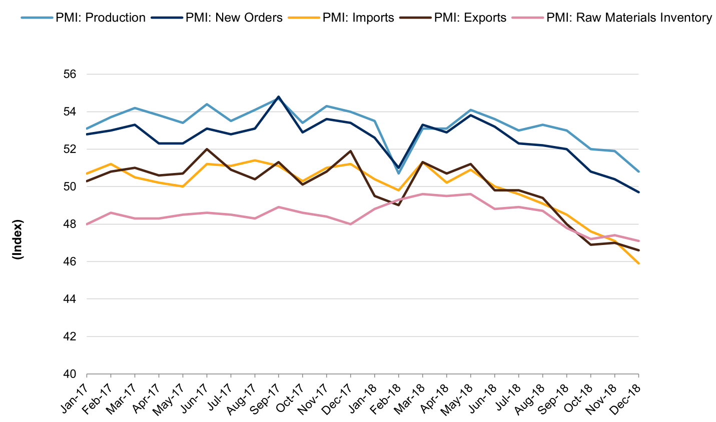
Demand Is Cooling Across Many Segments
Cumulative growth



FAI--Fixed Asset Investment. Source: WIND, S&P Global Ratings

Chart 2

Sluggish PMI Shows Weak Manufacturing Performance



PMI--Purchasing Managers' Index. Reading below 50 indicates contraction. Source: WIND, S&P Global Ratings.

FAI growth is likely to decline due to curbs on "shadow banking" since early 2018. But slowing momentum in retail sales, including sharp drops in auto sales, is more surprising given that consumption is a favored growth driver for the economy. We believe poor sentiment, combined with external uncertainties from trade tensions, could spiral into a broad-based decline across sectors.

Debt Serviceability To Weaken Across All Major Sectors

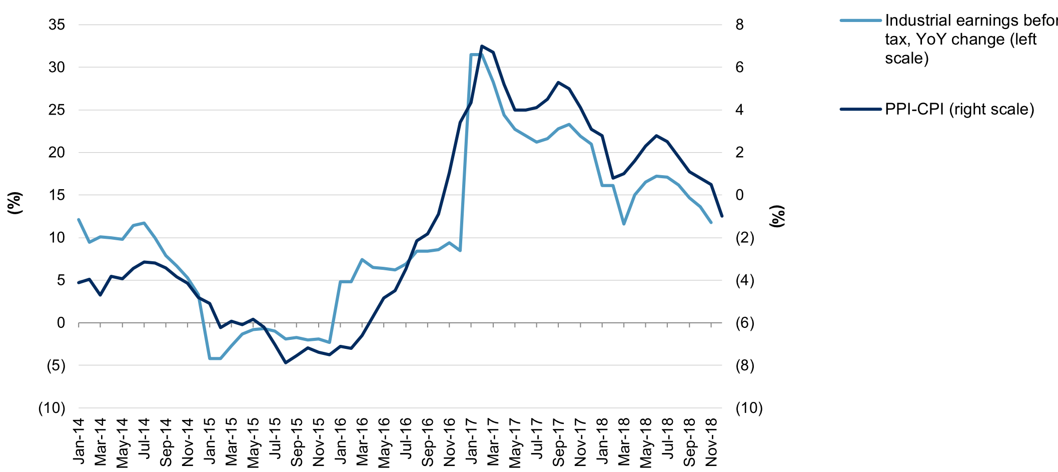
Corporate debt serviceability is set to weaken in 2019. This reverses the trend of financial deleveraging over the past two to three years. We do not anticipate that debt will grow materially, given an already very high corporate debt burden and restrained investment appetite. Rather, revenues and EBITDA are likely to decline, straining companies' ability to cover interest and debt payments.

In our view, upstream sectors will lead the trend, due to weakening commodity prices. Upstream companies have been a major driver of improved corporate earnings in the past one to two years as they benefited from price recovery, China's "supply-side" reforms, and environmental controls. However, these trends should wane in 2019. S&P Global recently lowered our price assumptions for oil and gas and most major metals, due to trade tensions and a slowing global economic expansion.

Midstream and downstream stream companies may not fully benefit from lower raw material costs, due to weak consumer demand, tough competition, and rising labor costs. Critically, falling buyer demand from deteriorating property, auto, and consumer sales is hurting confidence and investment. The difficulties faced by private companies in China is negatively affecting consumer spending, given private companies provide the majority of employment in the country.

Chart 3

Slowing Upstream Performance Is Dragging On Industrial Profits



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

Stimulus Will Be Government-Led But Capacity Is Uncertain

Government stimulus will be key to stabilizing the economy, in our view. Monetary policies have progressively eased since late 2018 and will likely remain supportive in 2019. The government announced tax cuts for small enterprises earlier this month, which should provide savings of Chinese renminbi (RMB) 200 billion (US$29.5 billion) annually over three years for small enterprises.

We expect additional tax cuts and subsidies to be announced in 2019, and higher government spending. Infrastructure spending through government special purpose bonds will likely increase. Higher stimulus could help offset the decline in property and consumer sales for midstream and downstream companies.

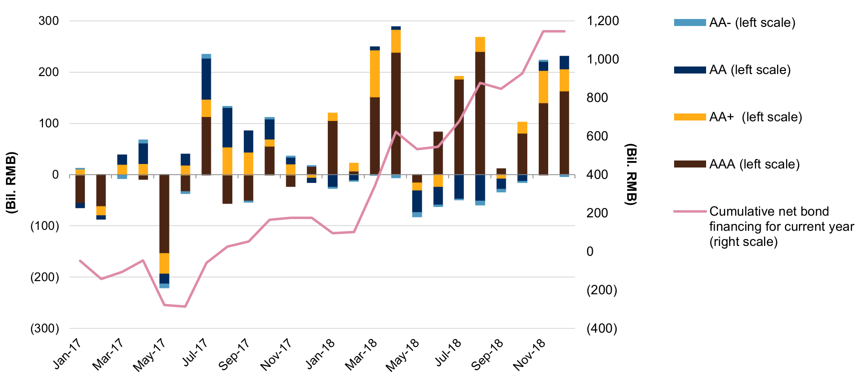
A significant increase in government spending is uncertain, however, given the already high debt burden and fiscal pressure. The government fiscal balance is already in a deficit position, and local and regional government (LRG) debt remains a threat to long-term economic stability. We estimate LRGs' underlying debt was RMB37 trillion (US$5.5 trillion) in 2017, or 45% of GDP (see "Lifting The Lid On China's Local And Regional Government Debt Levels," published on Oct. 16, 2018). In addition, declining land sales will restrict government spending capacity.

Lower Refinancing Risks For Higher-Grade Companies

We expect financing conditions to diverge for Chinese corporates. Central-bank liquidity injections and various government support measures are likely to benefit large companies that have strong market positions in their respective industries. However, small to midsized enterprises (SMEs) and weak companies in fragmented sectors are unlikely to benefit much. The situation is one of abundant interbank liquidity but a lack of strong quality assets; and this will add to divergence in financing conditions for Chinese corporates, in our view.

Chart 4

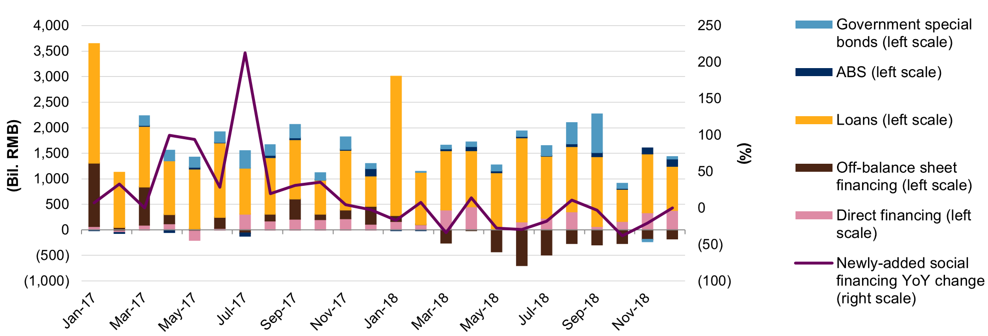
High Rated Bonds Has Dominated Issuance Yet Lower Ratings Are Catching Up



Data based on China domestic rating scale. Bil--Billion. RMB--Chinese renminbi. Source: WIND, S&P Global Ratings

Chart 5

Social Financing Growth Is Slowing
Monthly year-on-year growth

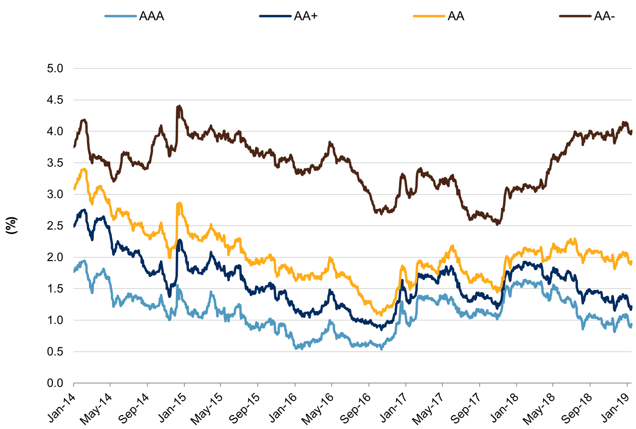


Bil.--Billion. RMB--Chinese renminbi. Note: Direct financing refers to bond financing plus equity financing; loans refers to RMB loans plus foreign currency loans; off-balance sheet financing refers to trust loans, entrusted loans plus bank acceptances. Social financing is China's broad measurement of fundraising. ABS--Asset-backed securities. Source: WIND, S&P Global Ratings.

However, subsiding refinancing risks for large companies will not necessarily translate into improved liquidity. This is because cash generation from business operations is likely to decline with lower sales and margins. In addition, new issuances are increasingly short-dated, meaning companies are vulnerable to a deterioration in credit market conditions. Capital structures in general are trending weaker, in our view.

Chart 6

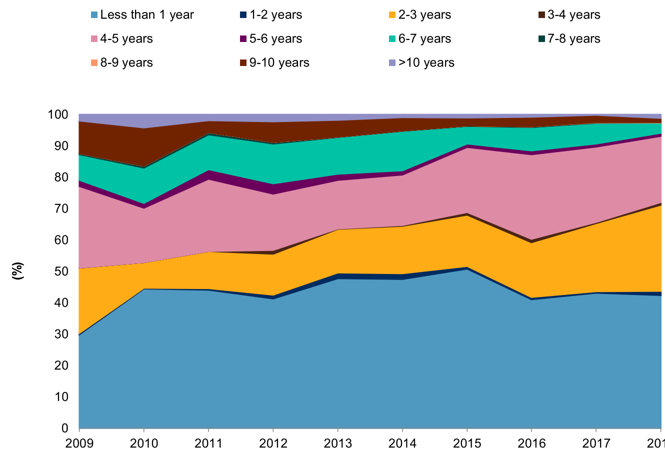
Lower Quality Issuers' Bond Spreads Continue To Widen



Note: Yield spreads are on five-year enterprise bond yield minus government bonds with the same tenor.
Source: WIND, S&P Global Ratings.

Chart 7

Corporate Issuers Have Turned To Shorter Tenor Financing



Note: Data based on Chinese onshore non-financial corporate issuers. Source: WIND, S&P Global Ratings.

Default Rates Will Continue To Rise As Policy Fails To Help Weakest Players

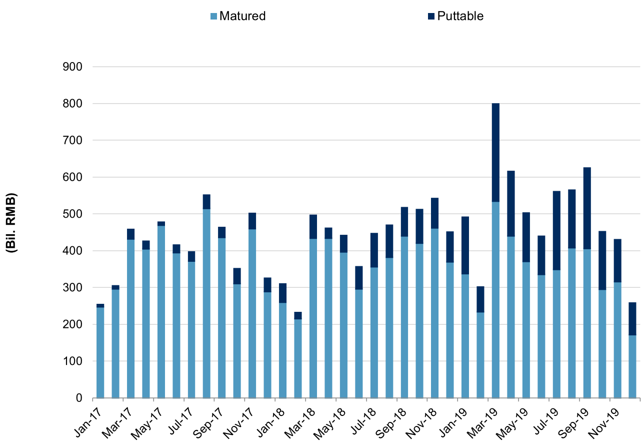
We expect corporate default rates to rise modestly in 2019 due to rising maturities and declining debt serviceability. Monetary easing will not fully offset the risks faced by marginal, over-leveraged companies, in our opinion.

Bond maturities from nonfinancial companies in 2019 will reach about RMB4.2 trillion, not including short-term debt (less than one-year) raised during the year. Including puttable bonds exercisable in 2019, we estimate effective maturities to be around RMB6.06 trillion in 2019, an increase of 15% from 2018.

In terms of sectors, local government finance vehicles (LGFVs) face the highest maturity wall, followed by mining and metals, and real estate.

Chart 8

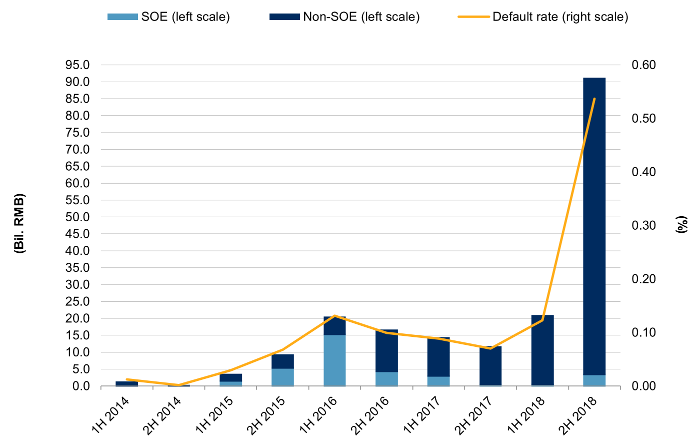
Chinese Issuers Face High Effective Maturities In First Half 2019
Effective maturity includes exercise dates on puttable bonds



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

Chart 9

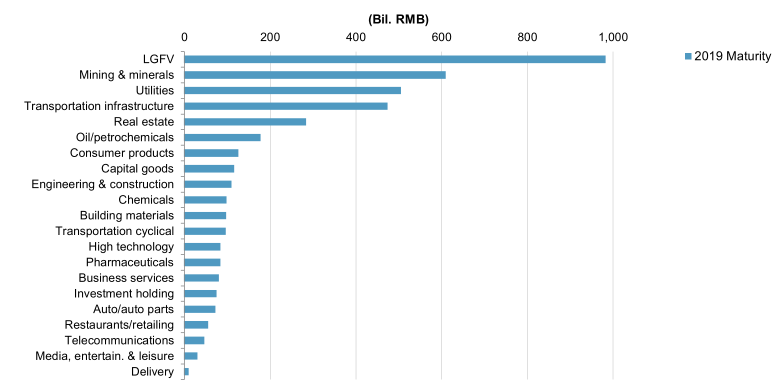
China's Onshore Bond Default Rate Hit A Historical High In 2018



SOE--State-owned enterprise. Bil.--Billions. RMB--Chinese renminbi. 1H--First half. 2H--Second half. Source: WIND, S&P Global Ratings.

Chart 10

LGFVs Dominate Maturities In 2019



Note: Data based on Chinese onshore non-financial corporate issuance. LGFV--Local government financing vehicle. Bil.--Billion. RMB--Chinese renminbi. Source: WIND, S&P Global Ratings.

This largely aligns with the outlook for our rated entities, with a net negating rating bias for the key sectors of real estate, metals and mining, capital goods, machinery and equipment, and utilities. National oil companies and retail are in neutral territory. We have no positive rating bias for any sector that has a material representation within our rated coverage.

Table 1

The Outlook Bias Is Negative For Most Of Our Rated Sectors

Sectors*	Weighting in China universe	Outlook bias§
Auto/Auto parts	3.1%	-10.0%

Table 1

The Outlook Bias Is Negative For Most Of Our Rated Sectors (cont.)

Sectors*	Weighting in China universe	Outlook bias§
Capital goods/machinery & equipment	10.2%	-24.2%
Chemicals	4.3%	-7.1%
Consumer products	8.7%	-3.6%
High technology	5.0%	-25.0%
LGFV	7.1%	-13.0%
Mining/minerals	10.8%	-8.6%
Oil/Oil petrochemicals	4.0%	0.0%
Real estate	22.6%	-6.8%
Restaurants/retailing	2.5%	0.0%
Transportation infrastructure	5.9%	-5.3%
Utilities	9.3%	-10.0%
Total		-9.3%

*Issuers based in mainland China only. Data as of Dec. 31, 2018. §Calculated by number of positive outlook and CreditWatch with positive implications minus negative outlook and CreditWatch with negative implications, divided by total number of companies in this sector. Source: S&P Global Ratings.

Table 2

Our List Of Potential Fallen Angels And Weakest Links

Potential fallen angels	Rating	Outlook	Sector
Hongkong International (Qingdao) Co. Ltd.	BBB-	Negative	LGFV
Red Star Macalline Group Corp. Ltd.	BBB-	Negative	Real Estate
Xinjiang Goldwind Science & Technology Co. Ltd.	BBB-	Negative	Capital Goods
Weakest Links	**Rating**	**Outlook**	**Sector**
Pactera Technology International Ltd.	CCC+	Negative	High technology
Oceanwide Holdings Co. Ltd.	CCC+	Negative	Real estate
Sunshine 100 China Holdings Ltd.	CCC+	Negative	Real estate
Guorui Properties Ltd.	B-	Watch Neg	Real estate
Yida China Holdings Ltd.	B-	Negative	Real estate
Panda Green Energy Group Ltd.	CCC+	Watch Neg	Utilities
Elion Resources Group Co. Ltd.	B-	Negative	Capital goods
YanAn Bicon Pharmaceutical Listed Co.	CCC	Watch Dev	Consumer products

Note: Weakest links are issuers rated 'B-' or lower with either a negative outlook or the ratings are on CreditWatch with negative implications. Potential fallen angels are issuers rated 'BBB-' with either negative outlooks or the ratings are on CreditWatch with negative implications. LGFV--Local government financing vehicles. Data as of Dec. 31, 2018. Source: S&P Global Ratings.

SOE Reform To Continue And Credit Risk Should Not Be Overlooked

While economic stabilization is now a higher priority, China's state-owned enterprises (SOE) reform will not be derailed, in our view. SOEs will continue to face requirements to improve their competitiveness and capital structures.

In September last year, for example, the general office of the State Council issued its "Guidance on Strengthening the Asset and Liability Constraints of State-Owned Enterprises." This requires SOEs to lower their average asset-liability ratio by 2 percentage points by 2020, compared with the level at the end of 2017. After 2020, SOEs' asset-liability ratio should remain at the industry average level, which is set as the baseline. If an SOE's liability-to-asset ratio exceeds the baseline by 10 percentage points, the company will face special oversight on investment spending, expense disbursements, and time limits for reducing the ratio. The government would also prevent financial institutions from increasing lending to these SOEs.

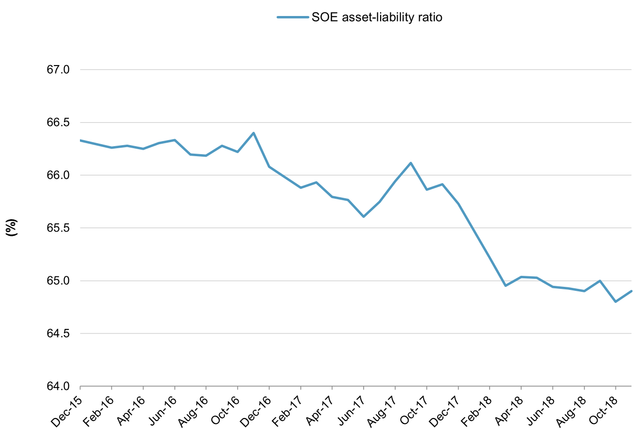
At the same time, "zombie" or loss-making companies face credit and closure risks. In December 2018, 11 ministries and regulators jointly issued the "Notice In Further Promoting The Debt Disposal of 'Zombie Enterprises' and 'De-Capacity Enterprises'," stipulating that SOEs that are continuously lossmaking, or under pressure to reduce capacity, should draw up debt-disposal and related plans and complete them within certain deadlines. In our view, these policy requirements are more explicit than in the past, especially in terms of deadlines. We also expect the central government to announce more specific plans over the next few months.

2019 should see more cases of debt restructuring, debt-for-equity swaps, liquidations, increased perpetual notes issuance and other means of debt disposal to reduce debt burdens and meet policy targets. Government and SOE parents may not keep supporting some weak subsidiaries, especially perpetual loss-makers. At the same time, the government may choose to punish some SOEs that fail to accomplish the deleveraging plans. For example, the notice on "zombie enterprises and de-capacity enterprises" warned against loan extensions or guarantees for companies that haven't improved their capital structures. Financial institutions will also be punished for providing "illegitimate" support to such companies.

SOEs have made progress in deleveraging in recent years. This was possible mainly due to improved earnings growth, declining capital spending, and, to a lesser extent, the government-led decapacity campaign. We believe SOE spending appetite will remain cautious, due to the slowdown of economic demand. However, declining profit growth will have a negative impact on further deleveraging.

Chart 11

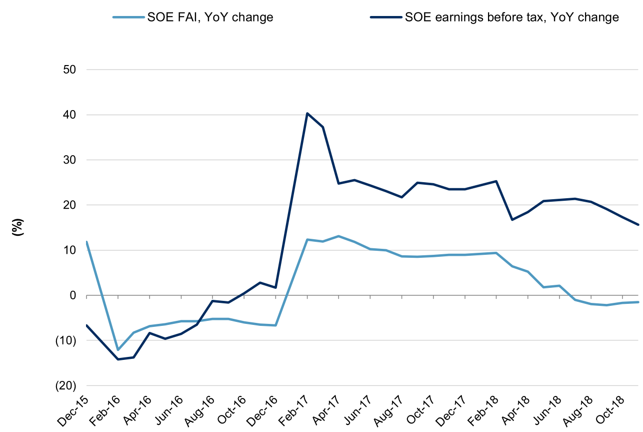
SOE Leverage Has Decreased Modestly



SOE--State-owned enterprise. Source: WIND, S&P Global Ratings.

Chart 12

SOE Leverage Benefitted From Earnings Growth And Prudent Spending



SOE--State-owned enterprise. FAI--Fixed asset investment. YoY--Year on year. Source: WIND, S&P Global Ratings.

Notwithstanding the increase in stimulus, the Chinese government will likely have more tolerance for slowing growth. Our view here takes into consideration China's restrained fiscal capacity, high debt leverage, and determination to change the economic growth model. Therefore, credit risks may remain high, especially for small, over-leveraged companies. We believe divergence between large and small companies will widen even further. SOEs are subject to more strict reform policies, and thus some weak or zombie SOEs will continue have default risks.

Related Research

- How Will China's LGFVs Deal With The Substantial Offshore Refinancing Risk In 2019?, Jan. 9, 2019
- China's Potential RMB3 Trillion Liquidity Boost For Banks Won't Necessarily Spur SME Lending, Jan. 9, 2019
- S&P Global Ratings Lowers Brent And WTI Oil Price Assumptions For 2019 Through 2020; Natural Gas Assumptions Are Unchanged, Jan. 3, 2019
- Lifting The Lid On China's Local And Regional Government Debt Levels, Oct. 16, 2018
- Metal Price Assumptions: S&P Global Ratings Expects Mixed Outlook Amid Trade Tensions And Slowing Economic Expansion, Dec. 13, 2018

This report does not constitute a rating action.