November 7, 2016

China's Corporate Debt

- **Rapidly rising corporate debt is the main risk to the Chinese economy's longer-term outlook.**
- **Debt is centered around state-owned enterprises; the government's resources allow for intervention if near-term financial stability is at risk.**

The Chinese economy is moving onto a slower growth trajectory, which is a natural phenomenon for all countries at a certain stage of economic development. In order to maintain economic and social stability, the Chinese government aims to make this transition as gradual as possible. Authorities' desire to synthetically prop up China's real GDP gains — in order to meet the 2016-2020 output growth target of 6½-7% y/y — is reflected in a continued rapid rise in credit in the Chinese economy. Thanks to loose credit policies, we have seen a stabilization of China's near-term growth prospects; however, existing economic imbalances — a result of inefficient allocation of resources that is endemic for centrally-planned economies — are simultaneously pushed further into the future. Credit-fuelled stimulus leads to funding of potentially nonviable investment projects that have high potential to turn into non-performing loans over the coming years.

CORPORATE DEBT AT THE HEART OF THE PROBLEM

The Chinese economy's total debt reached 255% of GDP in the first quarter of 2016, according to data by the Bank for International Settlements (BIS). When such a debt level is examined in a global context, China does not stand out as a particularly indebted economy (Chart 1). However, it is a noticeable outlier when compared to a more relevant peer group, consisting of other emerging economies that have corresponding (relatively weak) levels of institutional strength and development, governance standards, and insolvency resolution laws. Taking a closer look at the composition of China's total debt burden, it is clear that the issue is centered around corporate debt (Chart 2). China's household debt, at 41% of GDP in the first quarter of 2016, and government debt, at 45% of GDP, are low by global and emerging market standards, while the non-financial corporate debt has skyrocketed to 169% of GDP and is much higher than the emerging markets average (excl. China) of 58% of GDP[1].

RAPID RISE IN DEBT CAN BE INDICATIVE OF TROUBLES AHEAD

The most problematic aspect of China's corporate debt is not the amount per se but its rapid increase in recent years. Credit has risen on average by 18% per year over the past five years and has exceeded the pace of nominal GDP growth of 12% y/y by a wide margin. This trend has created a wide credit gap — the difference between the credit-to-GDP ratio and its long-term trend, in percentage points — of 30 percentage points, according to BIS data. A fresh working paper by the International Monetary Fund (IMF; WB/16/203) refers to research findings indicating that a credit gap above 4 percentage points is a "good predictor" of a forthcoming financial crisis. The same article points out that 38 out of 43 countries where credit-to-GDP ratio rose by over 30 percentage points within a five-year

[1] For further insights regarding China's overall debt, please refer to Scotiabank Economics' Special Report: China's Debt In Context, April 28, 2016.

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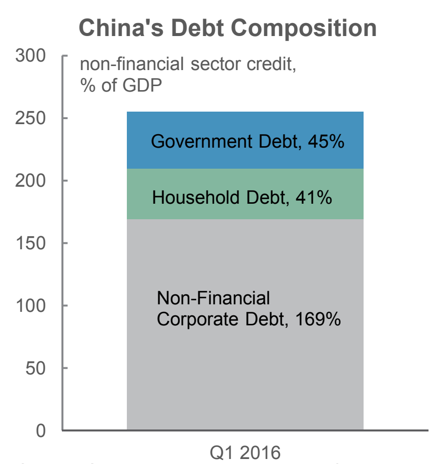
Chart 1

Source: Scotiabank Economics, Bank for International Settlements.

Chart 2



Source: Scotiabank Economics, Bank for International Settlements.

period later suffered from significant turmoil accompanied by an economic downturn, a financial crisis, or both. In China, the credit-to-GDP ratio has increased by 56 percentage points since 2010 to 205%, justifying the increasing global focus on China's financial stability.

CORPORATIONS' DEBT SERVICING ABILITY IS BECOMING QUESTIONABLE

China's credit expanded by 12.9% y/y in the first nine months of 2016. The pace is much faster than China's current nominal GDP gains (7.4% y/y in January-September) and aggregate industrial profit growth (8.4% y/y in the corresponding period), which raises concerns regarding Chinese corporations' financial soundness and future debt servicing ability. Regardless, the growth in industrial profits has picked up when compared with the 6.0% y/y pace recorded in the first half of 2016. While this may ease concerns about the industrial sector's financial strength, more detailed data reveal that the recovery partially reflects smaller declines in the mining & quarrying sector, whose profits were down by 62% y/y in the first nine months of 2016, an improvement from the 84% y/y decline recorded in the first half of the year (Chart 3). Profits in the utilities sector have continued to decline gradually (-3.6% y/y year-to-date) while the manufacturing sector stands out as a solid outperformer, with profits up by 13.5% y/y year-to-date.

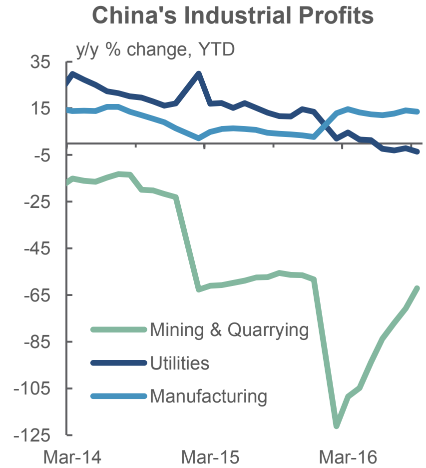
Chinese state-owned enterprises (SOE) are responsible for most of the rise in leverage, having played a key role in channeling the government's stimulus into the real economy (Chart 4). SOEs account for 55% of China's total corporate debt, which is a substantially larger share than their 22% contribution to the nation's economic activity. Stimulus-driven investment has focused on infrastructure and real estate, and supported related industries — such as steel, cement, glass, and coal. Not surprisingly, real estate, mining, steel, and construction are China's most leveraged sectors (as measured by debt/EBITBA). The construction boom has also resulted in a large real estate inventory overhang and severe industrial overcapacity issues; developments in China's real estate sector and a potential price correction pose further risks to the economy's financial stability and banks' balance sheets.

In addition to high leverage, Chinese SOEs are also less profitable than their more efficiently run private sector counterparts. In the first nine months of 2016, industrial profits of SOEs rose by only 2.6% y/y while the corresponding figure for private firms was 7.0% y/y[2]. In terms of an industry breakdown, payables-to-annual sales ratios reveal that real estate, steel, and mining are China's least profitable industries. With such uncertain future debt servicing ability, Chinese corporations may at times face intensified refinancing pressure; according to the IMF, more than half of Chinese corporate debt will come due in less than three years, which is significantly less that in most other emerging market economies.

CONCERNS ABOUT CHINA'S BANKING SECTOR SOUNDNESS ARE RISING

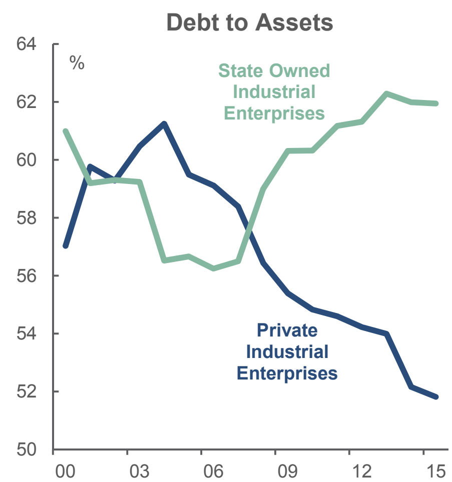
Rising leverage and profitability issues are reflected in weaker credit quality within the Chinese banking sector, which is causing investor unease regarding the unknown risks and potential losses. Official data show that China's non-performing loans ratio was still low at 1.75% in mid-2016; however, this partially reflects the fact that China classifies loans in a different way from the global practice, which would

Chart 3



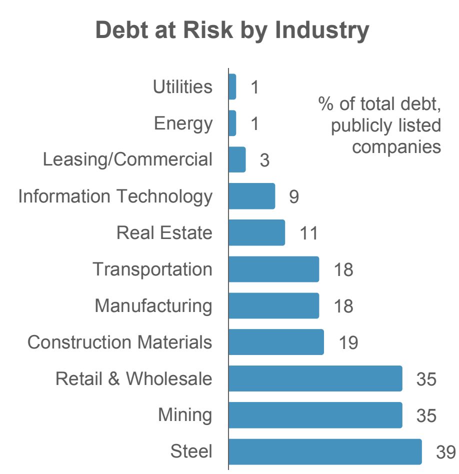
Source: Scotiabank Economics, NBSC.

Chart 4



Source: Haver Analytics, Scotiabank Economics.

Chart 5



Source: Scotiabank Economics, IMF.

[2] These figures average less than the aggregate industrial profit growth of 8.4% y/y YTD due to omission of certain classifications, such as foreign-funded enterprises that have recorded strong profit growth of 10.2% y/y YTD.

categorize a loan as non-performing if it is more than 90 days past due. By Chinese standards, a loan is non-performing only if it is more than 90 days past due and if the lender bank assesses that it would suffer losses after selling the collateral. Given use of judgment in classifying debt, comparisons of Chinese NPL ratios with their international counterparts can be misleading. The portion of loans that is 90 days past due but that banks still consider "performing" is typically classified as a "Special Mention" loan. Combining the official NPL and Special Mention loan ratios provides us with an alternative indicator of China's problem loans; this ratio reached 5.8% of total loans in mid-2016. Nonetheless, wide differences persist among estimates; Fitch Ratings assesses that the actual NPL is 15-21%. China's under-reporting of non-performing loans is accompanied by the issue of under-reporting of total debt. A large share of credit products fall into the less-regulated and riskier shadow banking category. Due to lack of transparency, banks' exposure to corporations through off-balance sheet products as well as associated risks are very difficult to assess.

The IMF has expressed concerns regarding the health of the Chinese banking system. It estimates that "debt-at-risk" accounts for 15.5% of the total corporate loan portfolio. Debt-at-risk is defined as the debt of corporations that do not generate enough earnings to cover their interest costs[3]. The corresponding figure for only publicly listed companies is 14% (Chart 5). While the large numbers are deeply concerning and deserve deeper scrutiny, it is worth pointing out that this metric takes into account a company's earnings at a certain 12-month period, omitting the possibility of a rough patch in the company's otherwise potentially sound outlook. Therefore, it is important to keep in mind that all debt-at-risk will not inevitably turn into NPLs and bank losses. The debt-at-risk ratio is the largest in the steel industry where 39% of total debt is problematic. The mining and retail & wholesale industries follow close behind. The real estate industry's debt-at-risk ratio is "only" 11%; however, given that it is one of the largest sectors and also the most leveraged, its troubled debt burden is the biggest in nominal terms and poses a sizeable risk to China's future economic stability. The IMF estimates that assuming a 60% loss ratio, potential bank losses on total at-risk loans could be equivalent to 7% of GDP. Potential losses would likely be even more substantial if the analysis included shadow banking products.

GOVERNMENT RESOURCES ALLEVIATE NEAR-TERM RISKS; PROGRESS NEEDED IN TACKLING LONGER-TERM RISKS

In addition to the looming debt problems, the Chinese financial system's fragility in the medium term is further exacerbated by the fact that the banking sector is in the process of being liberalized. With the sector lacking strong governance and risk management frameworks, newly-introduced competition may prompt intensified distress among its weakest members. Accordingly, we point out that lack of progress by Chinese authorities in recognizing losses within the banking sector and implementing necessary corporate restructurings may trigger a significant correction in the economy later on.

While we consider China's corporate debt to pose one of the biggest risks to the country's outlook over the coming years, we do not expect it to be a near-term threat to the economy. Weaker profitability and asset quality issues may be reflected in the banking sector's existing buffers over the coming quarters, yet capital adequacy of the Chinese banking system remains sound. The Tier 1 Capital ratio at 11.1% in mid-2016 indicates that banks are well-capitalized. Moreover, China has low external debt (13% of GDP) thanks to persistent current account surpluses and a high household savings rate; the reliance on domestic funding allows for more effective government involvement, if needed. In addition, the debt burden is concentrated on the SOEs; it is worth noting that the Chinese SOEs — both banks and industrial firms — are considered to carry implicit government guarantees and would likely receive financial assistance from the government should they face such serious troubles that they would undermine China's economic stability. Indeed, the Chinese administration enjoys vast financial resources and has the ability to intervene efficiently due to the centrally-planned economic system. While net debt statistics are not available, it is worth noting that China's foreign reserves alone account for 30% of GDP, comparing favourably in a global context.

The Chinese government remains committed to resolving the debt problem. Excess industrial capacity is being reduced, so called "zombie" companies are being identified, and a SOE reform has been announced. While progress so far has been rather slow, it is vital for Chinese and global financial stability. Indeed, we expect China's corporate debt issue to continue to draw investor attention for many more years to come.

[3] Debt-at-risk is defined as the debt of corporates with interest coverage ratio of below 1. Interest coverage ratio is EBITDA/interest expense of the corporate. EBITDA = earnings before interest, taxes, depreciation, and amortization.

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