CHINA'S ECONOMY: "What Goes Up Must Come Down"

Much of the news coming out of China over the last quarter has been dominated by the recent stock market falls. Between June and September 2015 the Shenzhen Component Index fell over 51% from its June peak to 9,290 points, with the Shanghai Index falling by a similar amount.

Although we've started to see some signs of potential stabilisation in the last couple of months, with the Shenzhen Component Index climbing back to 12,495 as at 12 December 2015, China still has a lot on its plate as this short article considers. Whilst recent conditions may have led to consequences for domestic demand (as private retail investors realise their losses on their stock market investments) in our view there are also some far more significant longer-term issues in play which will need to be addressed.

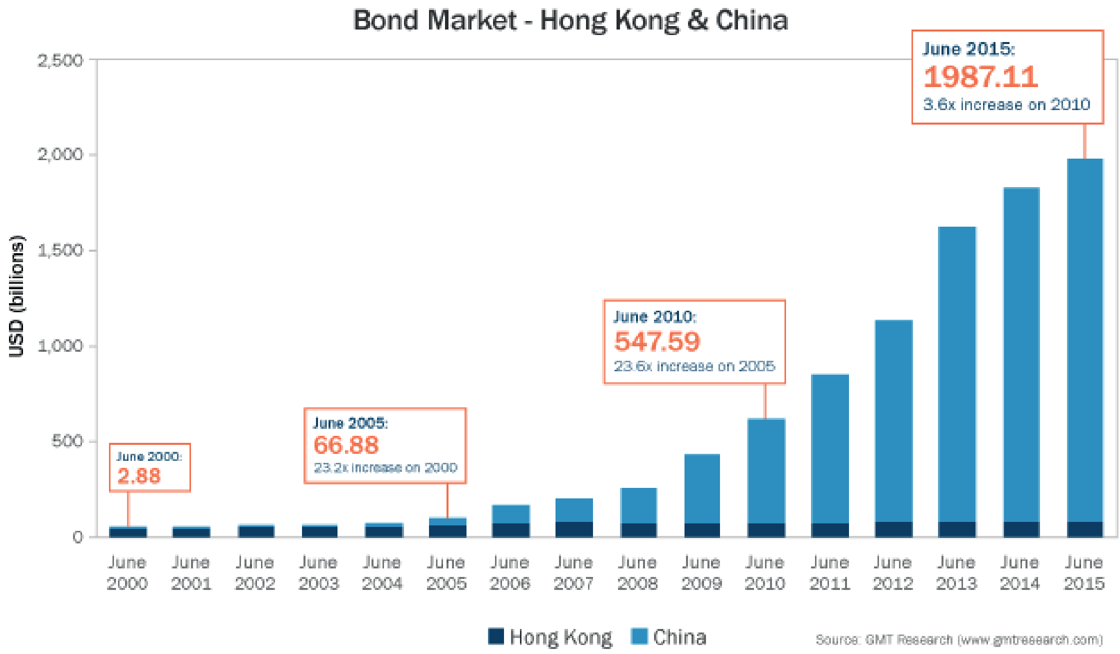
Corporate debt in China continues to grow, and now sits at disturbingly high levels, based on standard leverage metrics –Q3 2015 research from GMT Research suggests corporate debt leverage stands at approximately 7 times gross debt to operating cash flow, about the same level as Spain and more than double the level of advanced industrialised economies (US, Japan, Germany, UK).

> *China will account for 40% of all new global lending through to 2019.*

In fact, as highlighted by GMT, many of the Chinese corporate debt statistics are at the levels experienced in Thailand in the run up to the 1997 Asian Financial Crisis. Whilst we are not suggesting that China will suffer a shock in the same way as Thailand did in 1997 (China has a far more stable currency, vast foreign reserves, and more central levers such as the recent interest rate cuts to pull) it may be possible to draw parallels in terms of capex reductions (and much of the corporate debt pile has gone into financing capital items) and lower corporate profits. Importantly, any soft landing would need the continuation of (relatively) freely available credit, and a general 'pretend and extend' approach from the large onshore Chinese banks.

We have already seen the recent official statistics show a deceleration in the recorded growth rate (down to 6.9% for Q3 2015), but this masks the already evident slow down being experienced in certain sectors – financial services, property, commodities, solar, some manufacturing industries and shipping.

So, the Chinese Government has been facing a dilemma – encourage more and more lending to chase the growth it considers necessary to create jobs for new entrants to the workforce and rural workers transferring to the city; or allow some form of de-leveraging at the cost of all important GDP



growth. So far the signs are that the Chinese Government will continue to push for high levels of lending (Standards & Poors forecasts that China will account for 40% of all new global lending through to 2019), which may help achieve growth targets, but at what cost for the future as the debt problem simply grows.

In the meantime, a number of companies have already defaulted on their bonds, bank Non-Performing Loans and Special Mention Loans are starting to increase and perhaps most notably, increasing levels of new debt issuances are simply being used to refinance existing debt rather than for investment in growth generating activities. Though the economic outlook is now beginning to look less bleak, some corporates may have a weakened position having weathered the decline in conditions since Q2 2015.

For those with exposure (either through direct or indirect investment) to China, we may see an increasing level of emergence of fraud or accounting irregularities, which have a general tendency to come to light as credit conditions tighten, and pressures mount on directors to hit corporate profit targets. The autocratic corporate structures that are prevalent in Asia also make it fertile ground for corporate abuse.

With official results for Q4 2015 looming, there is still a lot that is not known about how the Chinese Government will seek to tackle economic reforms and promote sustainable growth. What is clear from an analysis of corporate debt capacity metrics though is that many corporates have already been weighed down by their debt commitments and a flood of more debt funding less accretive growth investments may still increase the size of the problem. As the Chinese stock markets have shown already, bubbles must ultimately burst.

As a leading global restructuring advisory firm with strong presence and expertise across China and Asia-Pacific, we are gearing up to advise both creditors and corporates as they navigate through these difficult times and consider how to address their debt burden. If you would like to speak to us about the issues raised here, and what they could mean for you or your clients, please get in touch via the details below.

Nick Gronow is a Senior Managing Director based in Hong Kong and has extensive experience advising bank groups, private equity funds, bondholders and corporations throughout the Asia Pacific region. Simon Kirkhope is a Managing Director based in London and has over 15 years of restructuring and insolvency experience in the UK and internationally.

Nick Gronow
Senior Director
Hong Kong
+852 3768 4641
nick.gronow@fticonsulting.com

Simon Kirkhope
Managing Director
London
+44 (0)20 3727 1293
simon.kirkhope@fticonsulting.com

FTI CONSULTING

About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centres throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring.

CRITICAL THINKING AT THE CRITICAL TIME™