Conditions in China's Corporate Sector

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Abstract

Revenue and profit growth have slowed in China's corporate sector in recent years, alongside a broader moderation in China's economic momentum. The slowdown has been most severe for labour-intensive private companies, particularly export-oriented manufacturing firms. The government has responded by announcing a range of measures aimed at easing financial conditions faced by the private sector. Earlier efforts by the Chinese authorities to reduce risks in China's financial system appear to have been successful in stabilising leverage in the state-owned sector, but the financial position of private sector firms is more fragile, and risks remain elevated in the real estate industry.

Introduction

Conditions in China's corporate sector are important for Chinese economic growth and financial stability, and have significant implications for China's major trading partners, including Australia. Chinese business investment has been an important source of economic growth, and driven demand for resource commodities. However, by the same token, the corporate sector has been the largest contributor to non-financial sector leverage, and corporate debt remains very high by international standards. Analysis of the activities and financial health of China's companies is also helpful for forming assessments about the broader trajectory of the Chinese economy and the effectiveness of government policies affecting businesses.

A range of previous studies has examined conditions in China's corporate sector.[1] These analyses have documented the decline in corporate profitability and rise in leverage since 2008–09, which stemmed from the rapid increase in debt-funded investment that formed part of the Chinese Government's stimulus response to the Global Financial Crisis (GFC).

This article provides an update on recent developments by drawing upon official industrial survey data. However, the official survey data only cover a limited number of industries and are restricted to companies above a certain size.[2] Therefore, for more detailed sector-level analysis, this article uses alternative data derived from the financial statements of listed companies. As at the end of 2018, more than 3,300 non-financial companies were listed on the Shanghai and Shenzhen stock exchanges, with a combined value of CNY58 trillion in assets.[3] Listed companies represent a relatively small but growing share of China's broader corporate sector: these firms accounted for around 10 per cent of non-financial enterprise assets in 2016 and around 10 per cent of non-financial corporate debt in 2018.

Revenue and Profit Growth Has Weakened, Driven by the Private Sector

A range of indicators suggests that growth in revenue and profits of Chinese firms has slowed noticeably in the past few years. The profitability of industrial firms captured in the official industrial survey had been trending lower following the 2008–09 stimulus. In large part, this downward trend reflected the fact that returns to new large capital outlays declined following the extremely large boost to investment that occurred during the period of stimulus. Profitability rebounded in 2016 and 2017 following government efforts to reduce overcapacity, leverage and the cost of doing business, under the policy framework of 'Supply-side Structural Reform' (see Boulter 2018). However, in the past two years, growth in revenue and profits has moderated again, and the return on equity has trended sharply lower (Graph 1).

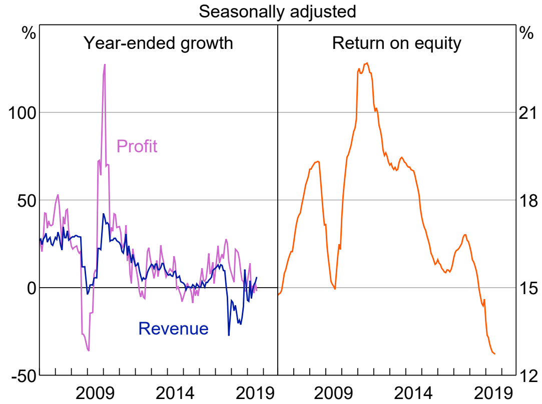
A similar pattern has been apparent for listed companies (Graph 2). The recent slowdown in operating revenue and profit growth reported by both listed and unlisted companies suggests that, in aggregate, supply-side policies were only temporarily able to limit the downward pressure on business profits. Moreover, the slowdown appears to have been exacerbated by efforts by Chinese regulators to reduce risks in the financial system; these efforts have resulted in a squeeze on less-regulated sources of credit, which private firms are more reliant on. The deterioration in profitability is also likely to be related to a broader slowdown in global manufacturing and trade that has weakened the cash flow of export-oriented firms.

The more granular ownership and industry-level data reported by listed companies allow us to analyse the drivers of the slowing in corporate sector profitability in more detail. The data suggest that the slowing since 2017 has been driven by private companies (Graph 3).[4] By contrast, the profitability of state-owned enterprises (SOEs) has been trending higher. It is likely that the profitability of SOEs has continued to be supported by the government's implementation of supply-side policies, since the high leverage and excess capacity characterising these firms made them the primary target of these policies. SOEs have responded by reducing their investment expenditure and have reduced excess capacity, particularly in the mining

Graph 1

China – Industrial Sector Financial Indicators*

Seasonally adjusted

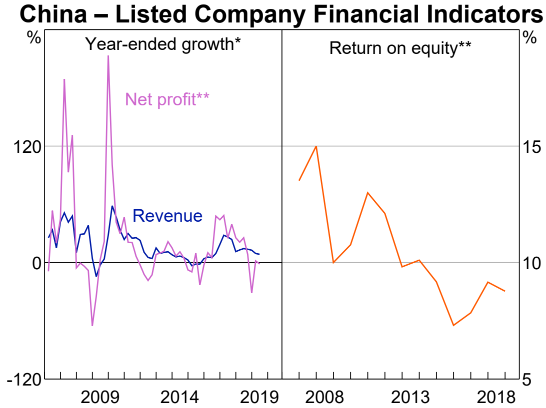


* December observations removed.

Sources: CEIC Data; RBA

Graph 2

China – Listed Company Financial Indicators



* Seasonally adjusted

** Excludes goodwill writeoffs

Sources: RBA; WIND Information

industry, which has helped boost profitability. The exception has been for SOEs in the construction industry: their return on equity has declined as they reduced their leverage, but their profits relative to assets have been little changed. By contrast, the profitability of listed firms in the manufacturing and services industries, which are dominated by private firms, has generally declined.

The slowdown in revenue and profits has occurred across all the sub-components of manufacturing. The profitability of car manufacturers has also been severely affected by tighter emissions standards, which have forced manufacturers to reduce production of models designed to old standards faster than they can increase production of cars designed to the new standards (Cui 2019). The falling profitability of listed services industry firms appears to be related to slowing growth in consumer spending; the decline in profitability has been particularly acute for the accommodation, entertainment and retail industries.

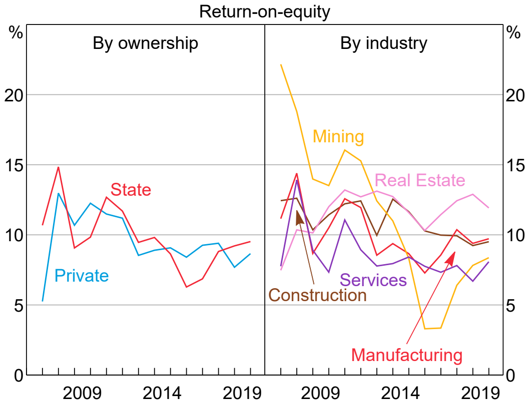
The Private Sector Has Been Most Exposed to the Global Trade Slowdown

The deteriorating profitability of private companies, particularly manufacturing firms, in China is partly related to global developments. The global slowdown in trade, underpinned by weaker growth in some advanced economies and exacerbated by the US–China trade and technology disputes, is likely to have weighed on corporate cash flows, particularly for export-oriented manufacturing firms.

Graph 3

China – Listed Company Profitability*

Return-on-equity



* Excludes goodwill writeoffs

Sources: RBA; WIND Information

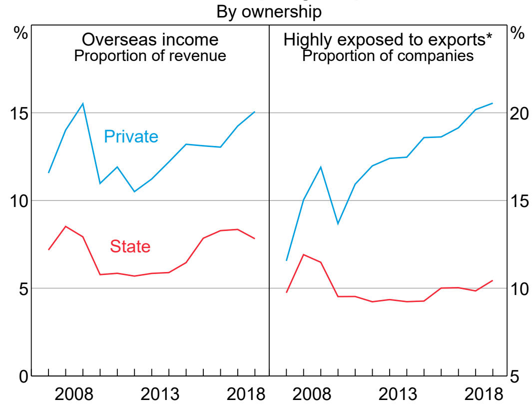
Listed private companies receive a noticeably higher proportion of their revenue from offshore than SOEs, and this has been increasingly the case over time (Graph 4). This is also reflected in the fact that the proportion of China's exports coming from the private sector has increased from 5 per cent in 2000 to 45 per cent in 2018, while the contribution from SOEs has declined (Graph 5). In 2019, around 70 per cent of listed exporting firms were private. This means that private firms are more directly exposed than SOEs to downside risks emanating from trade tensions or to a broader slowdown in global trade.

Downward pressures on profits stemming from the global trade slowdown are starting to weigh on employment in the private sector. The activity of

Graph 4

China – Listed Company Export Reliance

By ownership



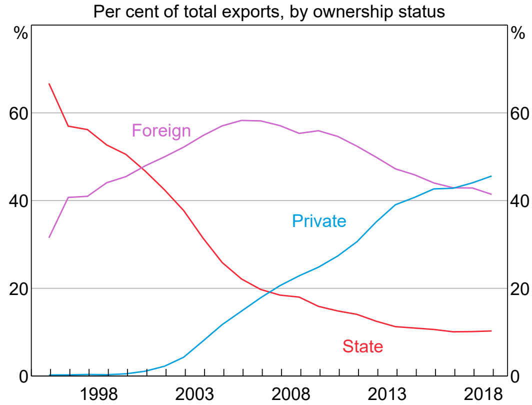
* Proportion of companies whose overseas income is more than 30 per cent of its operating revenue

Sources: RBA; WIND Information

Graph 5

Chinese Exports*

Per cent of total exports, by ownership status



* Exports by privately owned firms are estimated as the difference between total exports and the sum of exports by state, foreign and collective firms prior to 2013.

Sources: CEIC Data; RBA

highly export-oriented firms is relatively more labour intensive than that of firms with low export exposure (Graph 6). Exporters have responded to the slowdown in trade by reducing their labour intensity. This is likely to have contributed to job losses; surveyed employment in the export-oriented industrial sector contracted by 10 per cent in 2018 according to official data.

Leverage Has Fallen for SOEs but Risen for Private Firms

Corporate sector leverage, measured by the debt-to-equity ratio, has stabilised in the past few years (Graph 7). The amount of leverage among SOEs has declined reflecting the success of supply-side policies, which were reinforced by the introduction of deleveraging as a key performance metric for centrally supervised SOEs (State Council 2018). By contrast, leverage among private firms, particularly in the real estate sector, has risen.

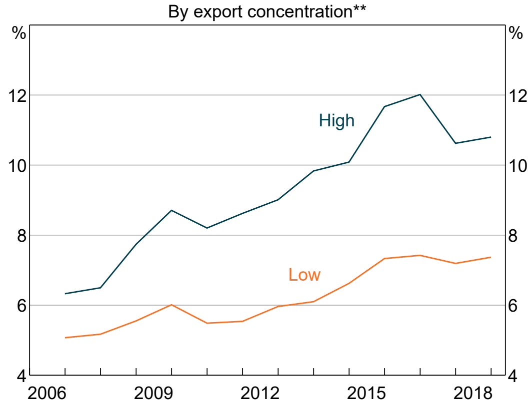
Leverage has been declining over recent years in the construction and mining industries, which is largely driven by SOEs. Some of this deleveraging, particularly in the mining industry, may have resulted from the implementation of supply-side policies designed to reduce excess capacity. The reduction in excess capacity is likely to have contributed to increased profitability of remaining firms, increasing their scope to reduce leverage. The reduction in leverage among listed construction firms has also been supported by cash flows being directed away from capital expenditure and towards debt repayment. Leverage in the manufacturing and services industries – which are dominated by private firms – has moderated since the early 2010s but has been stable for the past couple of years.

Leverage remains elevated in the real estate industry, having increased strongly over a number of years, but has been stable since the beginning of 2017. However, conventional leverage measures, such as the debt-to-equity ratio, do not fully capture the financial risks facing property developers, because they exclude non-debt liabilities such as pre-sold apartments (Graph 8). Accounting for both debt and non-debt liabilities, data on financing flows for both listed and unlisted Chinese real estate developers suggest that they had at least CNY25 trillion in debt outstanding by mid 2019 (27 per cent of GDP).[5] The authorities have imposed restrictions to curb the amount of financing directed to the real estate sector amid concerns that financing to other industries may be 'crowded out' (Guo 2019). Developers have responded by increasing new home starts and pre-sales, while delaying construction and extending delivery times to reduce near-term expenditure. This has increased the risk that developers could face financial pressure should they encounter a shortage of funding needed to deliver pre-sold homes. Increased regulation of real estate financing may help prevent leverage from ratcheting up further, but may also increase the sector's

Graph 6

China – Listed Company Labour Intensity*

By export concentration**



* Labour concentration is measured by the ratio of cash paid to employees to operating revenue.

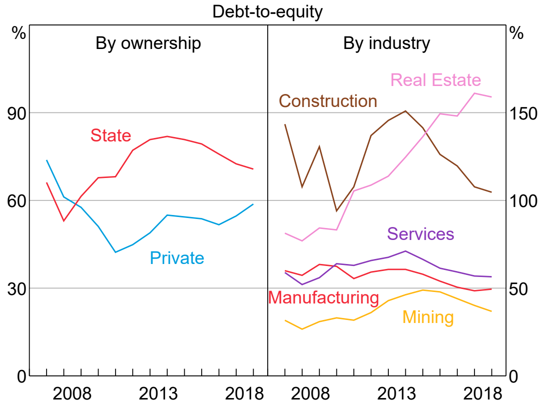
** High export concentration is defined as companies whose overseas income is more than 30 per cent of its operating revenue. All other companies are defined as low export concentration.

Sources: RBA; WIND Information

Graph 7

China – Listed Company Leverage

Debt-to-equity



Sources: RBA; WIND Information

vulnerability to a negative shock. The risks appear larger for privately owned real estate firms, as the level and increase in leverage in recent years has been higher for these firms than for state-owned firms.

The squeeze on private sector cash flows is partly the result of a rebound in net receivables (accounts receivable less accounts payable) of private firms with SOEs (Graph 9). This has involved a transfer of liquidity from the private sector to SOEs. The rise in private sector accounts receivable implies that the financial position of SOEs is worse than suggested by standard leverage ratios that do not account for this type of liability. After stabilising in 2016 and 2017, the recent resurgence in private firms' net receivables is likely to reflect SOEs delaying payments to private suppliers to improve their own liquidity position. For private companies, the increase in net receivables from SOEs equates to 9 per cent of their stock of bank loans. The owners of listed private companies, especially smaller-sized firms, have responded to this tightening in financial conditions by pledging an increasing proportion of their equity as collateral to obtain funding.[6] The tightening of financial conditions has also contributed to a rise in corporate bond defaults by private enterprises (from low levels).

In addition, private companies typically pay higher interest rates than SOEs, which has increased their repayment burden and weighed further on their cash flows (Graph 10). As funding conditions in China have tightened in the past couple of years in response to tighter regulatory scrutiny by financial supervisors, listed private firms have been affected disproportionately; implied interest rates for these firms increased more rapidly than for SOEs over 2018. Higher interest rates and falling profitability for private firms imply that their interest coverage ratio (how many times annual earnings can pay interest expenses) has deteriorated sharply while the interest coverage ratio for SOEs has improved.

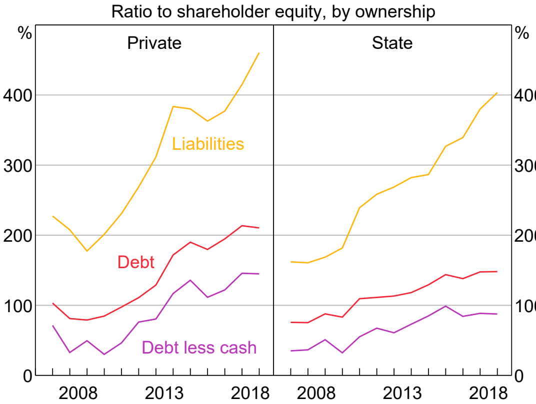
Authorities Have Responded by Announcing Easing Measures Directed towards Private Firms

The Chinese authorities have enacted a number of targeted easing measures that are focused on easing the financial pressures facing private firms, particularly small-sized enterprises. Some of the key

Graph 8

China – Listed Real-Estate Company Leverage

Ratio to shareholder equity, by ownership

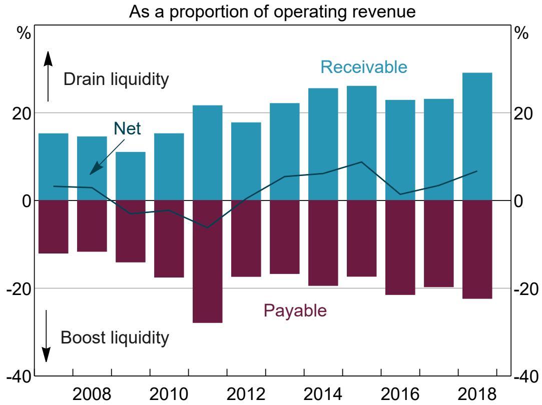


Sources: RBA; WIND Information

Graph 9

China – Listed Private Companies Accounts

As a proportion of operating revenue

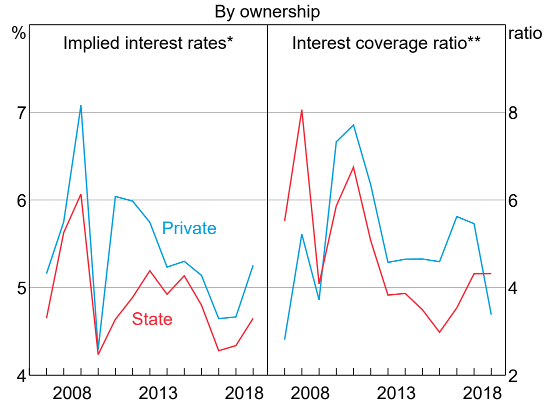


Sources: RBA; WIND Information

Graph 10

China – Listed Company Debt Metrics

By ownership



* Ratio of annual interest expense to average debt in the current and previous year

** Ratio of EBIT to interest expense

Sources: RBA; WIND Information

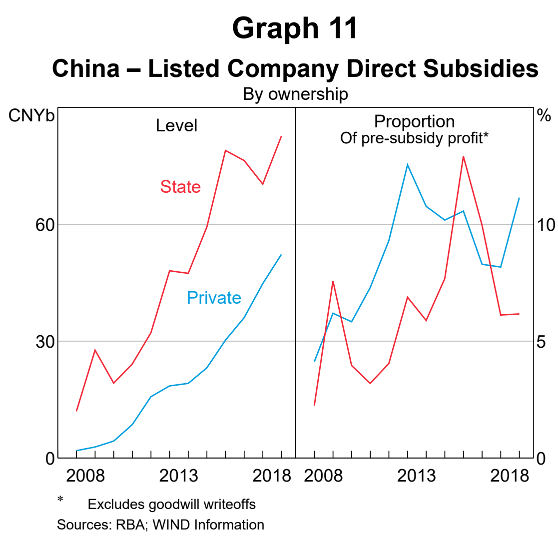
measures announced to date include the following:[7]

- Financial regulators have instructed banks to increase lending to private enterprises (Guo 2018).
- The People's Bank of China (PBC) has increased liquidity provision to banks conditional on increasing the proportion of loans made to private enterprises.[8]
- Fiscal authorities have offered tax exemptions for interest income that financial institutions earn from making loans to micro- and small-sized firms, which are predominantly privately owned.
- China's Premier Li Keqiang (2018) has instructed SOEs that they 'must resolutely put an end to the arrears of private enterprise accounts', to reduce the rising stock of accounts receivable owing to private companies.

The authorities have also supported private enterprises by steadily increasing the amount of direct government subsidies directed towards them. By contrast, the level of direct subsidies to SOEs has been little changed since 2015 (Graph 11). Historically, the ratio of direct subsidies to pre-subsidised profits has generally been higher for private companies than for SOEs. However, the authorities can also provide support to companies through other means; for example, many analysts believe that state firms receive loans on better terms from banks (Yi and Liang 2016). The extension of credit on preferential terms to SOEs could partly explain why SOEs have a lower implied interest rate on their debt, but it may also be partly because SOEs have a lower perceived credit risk than private firms (Fan and Hope 2013). The recent rise in private firms' borrowing costs has occurred despite efforts by the authorities to lower these costs. This suggests that easing financial conditions for private firms may prove to be a challenging task for the authorities in practice.

Conclusion

Revenue and profit growth have slowed in China's corporate sector alongside the broader moderation in economic momentum, weighed down by tighter domestic financial regulation and the global trade slowdown. The decline in profitability has been driven by private enterprises, and is likely to have contributed to recent job losses in the industrial sector. Recent efforts by authorities to reduce risks in the financial system appear to have been effective in reducing leverage for SOEs. However, the standard leverage ratios are likely to overstate how much their leverage has declined, because they are accumulating large stocks of unpaid bills owed to private firms. The private sector appears to be most fragile at present, as reflected by reduced cash flows and rising average interest costs. This is despite increases in government subsidies to private companies and efforts to reduce the cost and increase the availability of bank financing to these enterprises. Risks also remain elevated in the real estate sector, where tighter regulation of financing flows has led developers to rely increasingly on non-debt liabilities such as pre-sales of apartments.



Footnotes

[*] The author is in Economic Analysis Department.

[1] These include: Lam *et al* (2017); Laurenceson and Ma (2019); Read (2017); Roberts and Zurawski (2016); and Zhang *et al* (2015).

[2] China's National Bureau of Statistics (NBS) publishes aggregate data on the financial position of industrial (mining, manufacturing and utilities), real estate and construction firms with annual revenue exceeding CNY20 million. The Ministry of Finance (MoF) publishes comprehensive data on the financial position of state-owned enterprises.

[3] The data are sourced from financial statements collated by WIND Information. The data include all nonfinancial 'A' shares listed on the Shanghai and Shenzhen stock exchange. The sample is unmatched, so it includes all companies listed on the exchange at each point in time.

[4] This work identifies state versus private firms using the ownership classification scheme from WIND Information. State companies include those classified as local or central state-owned companies and public enterprises. The ownership classification is time varying. In 2018, state owned companies' share of total listed company assets was 70 per cent, privately owned companies accounted for 27 per cent and foreign-owned companies accounted for less than 3 per cent.

[5] This consists of CNY11 trillion of bank loans, CNY3 trillion of trust loans, CNY2 trillion of entrusted loans, CNY4 trillion of bonds outstanding and CNY6 trillion in deposits and advance payments.

[6] For further details see IMF (2019).

[7] Further details on the financing problems for smaller private businesses and policy response in China is articulated in a joint White Paper (PBC, CBIRC 2019).

[8] Some of these instruments include a number of targeted reserve requirement ratio cuts, 'targeted' medium-term lending facility injections and increased quota for its rediscount window facility.

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