

China: Carrot-and-stick



CONTENTS

- /02 Part I: Recent developments in China**
- /05 Part II: Sectoral risk assessment**
- /06 Part III: Industry analysis**
 - /06 Property**
 - /09 Consumer goods**
- /12 Part IV: Conclusion**

Since the beginning of the year, the Chinese government has continued its effort to carry out various items on the reform agenda, particularly on fine-tuning the structure of the Chinese economy. While various aspects of reform are underway, growth is by no means forgotten. With plenty of signs showing lackluster growth momentum in this year, it is believed that the government is likely to introduce stronger stimulus to sustain economic growth. More specifically, the continuation of targeted-stimuli is expected.

On the credit quality side, in-line with the suggestion from our China payment survey report, non-performing loan (NPL) has been rising in China, as the absolute amount of NPL soared 28.7% YoY in 1H2014. The growing NPL is leading to concerns over lending qualities, while the cost of financing remains to be a concern to various sectors and smaller companies that lack access to credit facilities.

In our sectoral risk assessment, we went through the conditions of metals, energy and wood-paper sectors. The overall sector assessments of our sectoral risk assessment did not change from the previous report in January 2014, except bringing up metals to very high risk.

China Sectoral Risk Assessment			
Sectors	Risk level	Sectors	Risk level
Automotive	●	Metals	●
Construction	●	Retail	●
Electronics & IT	●	Textile	●
Energy	●	Wood Paper	●

Source: Datastream, Coface ● Moderate risk ● Medium risk ● High risk ● Very high risk

In the later part of this report, we have discussed the property and consumer goods industries in China, respectively. These industries are the key drivers of growth for the Chinese economy, but they are facing headwinds in the near-term. While the property industry is facing pressure as a result of financing constraints and other reasons, the consumer goods industry is expected to slow as a result of lower income growth and the anticorruption campaign; economic growth will continue to moderate, to 7%YoY in 2015.

By Rocky Tung
Economist, Asia Pacific

By Rocky Tung
Economist, Asia Pacific

Carrot-and-stick

Part I: Recent developments in China

Reform efforts continued

Since the beginning of the year, the Chinese government has continued its effort to carry out various items on the reform agenda, particularly on fine-tuning the structure of the Chinese economy.

On May 1, in a highly regarded journal *Qiushi*, Premier Li Keqiang laid out his idea regarding how to push forward the structural reform agenda. In the article titled “A few issues related to the deepening of structural reforms”, Premier Li argued that the Chinese government should not widen its fiscal deficit position and should not make major movement in terms of liquidity.¹ The document provides a very good understanding of the chain of thoughts of the premier, and should be viewed as the key framework of the Chinese reform for the Xi-Li regime – not only in 2014, but also in the following years.

Albeit the doubts casted over the intention to reform by the government, the rhetoric from Premier Li suggested that the government is striking a balance between reform and growth. One of the ideas suggested by the premier in the article is that the policymakers would be more tolerating in terms of short-term turbulences, which include volatility in the market sentiment as well as short-term economic adjustment. Premier Li suggested that reform should be the top priority in the policy agenda, so long as economic situation remains stable, with growth staying above the tolerable threshold, inflation being contained, and enough of jobs being created. It was suggested in the article that it would not be the government’s intention to alter the policy stance as a result of views and opinions.

Growth weakened, but not forgotten

Yet, growth is by no means forgotten. With plenty of signs showing lackluster growth momentum in this year, it is believed that the government is likely to introduce stronger stimulus to sustain economic growth. More specifically, while broad-based massive stimulus is unlikely, more targeted-stimuli shall be in place to

prevent a noted discrepancy between government targets and reality.

The current regime that put much emphasis of 3 aspects: sustained job creation, growth stabilization, and moderate asset inflation. While the precedent government (i.e. Hu Jintao-Wen Jiabao) was more used to channeling support to the economy through stimulus measures – for instance, the RMB4-trillion plan amidst the Global Financial Crisis – the Xi-Li regime has long been advocating the much needed reform in the economic structure. Such policy stance should not change dramatically with the emphasis on reform and such policy direction is reflected in the base-scenario of our forecast, of which we expect there would be no substantial counter-cyclical fiscal stimulus in sight, despite the decelerating growth momentum as reflected in the various high-frequency indicators.

Despite the absence of major stimulus similar to the size of the RMB4trillion stimulus plan amid the global financial crisis, there are plenty of policy gestures by the Chinese policymakers signaling that the Chinese leaders have not let go of “growth” as a consideration of the policy stance. To be precise, the Xi-Li government is still keeping its eyes on the 3 key indicators as it has always stressed on since it came into power last year; they are, namely, i) growth stabilization, ii) prevention of asset inflation, and iii) job creation.

Amongst the industry participants we have talked to, an knowledgeable official in a large state-owned bank headquartered in Beijing shared with us that the Xi-Li regime is now managing the economy like how the US Federal Reserve in terms of its QE management. While

(1) [Qiushi \(May 1\)](#)

this may not be the mainstream comparison, we do find similarity, at least in a sense that the two largest economies have both flashed out what are the key objectives of policy directions going forward.

The Premier has vocally committed to the “targeted approach”. In his presentation during his trip in UK in mid-June, Premier Li has made it clear to the audience that the government did not intend to launch strong stimulus to meet the earlier-announced growth-target of 7.5%.² On the other hand, the Premier suggested that China will keep using this “targeted” regulations to keep the government-announced targets intact (e.g. around 7.5% GDP growth, 3.5% inflation ceiling, and roughly 10 million new jobs).

While we previously believed 7.5%YoY GDP growth was a far-reaching target in our previous publications, as the recent policy stance toward helping the real economy has stressed some of our concerns, we are now revising up the 2014 GDP growth target from 7.2% to 7.4%.

Risks flagged

Since the beginning of 2014, the “reform-centric” rhetoric of the top policymakers has been coupled with various aspects of risk.

On April 29, PBoC released the annual China Financial Stability Report, which showed stable conditions regarding the financial sector, with risks being manageable.³ The report was prepared by the Financial Stability Analysis Group of the PBoC, which is headed by Liu Shiyu. Nevertheless, risks regarding liquidity in the system and the interbank operations were mentioned to be in existence. Moreover, risks regarding the non-transparent off-balance sheet lending activities and wealth management products – which are generally regarded as the “shadow-banking” activities – were also spotted in the report. In addition, it was suggested in the report that orderly defaults of some products to be allowed, as the market-perceived guarantee of such products would lead to investment behavior with moral-hazard and increase systematic risks.

Such view is in-line with our expectation of the first onshore publicly-traded bond-default back in March.⁴ As China has moved beyond such “milestone”, more clients and China-observers that we talk to have become increasingly convinced that such move will be helpful in leading the financial market toward becoming market-driven.

Nevertheless, as we argued in our report China – What to expect in 2014 (January 21, 2014), liquidity in the financial system has not been made available to the SMEs,⁵ and the default of such product could lead to hiking cost of fund for the smaller companies, which are a vital part of the Chinese economy.⁶ Together with the local government debt repayment due in 2014 – around RMB2.3 trillion, according to figure disclosed by National Audit Office) and slowing money supply growth, it could lead to substantial risk to the real economy.

Concerns over the collapse of non-bank financing

As mentioned above, shadow-banking activities are under the radar of – not only general China-observers, but also – policymakers. While threats from shadow-banking activities may not be too substantial as suggested by the official numbers, real risks do exist.

First and foremost, we must understand that off-balance sheet lending is nothing new in China or anywhere in the world. In a report published by the Financial Stability Board in 2013, among the economies that covered 80% of the world GDP and 90% of financial assets globally, shadow banking asset grew US\$5 trillion to US\$71 trillion as of the end of 2012.⁷ The major reason why this concerns the business and investment community is that situation in China is not transparent. While information is made available about the size of local government debt, such data is only provided irregularly and thus leading to uncertainty. Moreover, disclosure of information regarding other non-bank financing channels is.

On the credit quality side, we have flagged in our previous report Reality check – Corporate payment trend and sectorial risk in China (February 2014) that the situation was deteriorating.⁸ Such trend would later be re-confirmed in the data coming from China Banking Regulatory Commission (CBRC). Non-performing loan (NPL) has been rising in China, both in terms of absolute amount and in relative basis comparing to the aggregate loan. To put that in context, the absolute amount of NPL soared 28.7% YoY in 1H2014, while NPL ration has already reached 1.08% of aggregate loan. These trends are in-line with our findings and suggestions in the Reality Check report, when we suggested deteriorating corporate payment experience was found in 2013 comparing to a year ago, and was expected to continue in 2014.

(2) [IISS and Chatham House Key Address](#)

(3) [China Financial Stability Report 213](#)

(4) [Bloomberg \(January 2014\)](#)

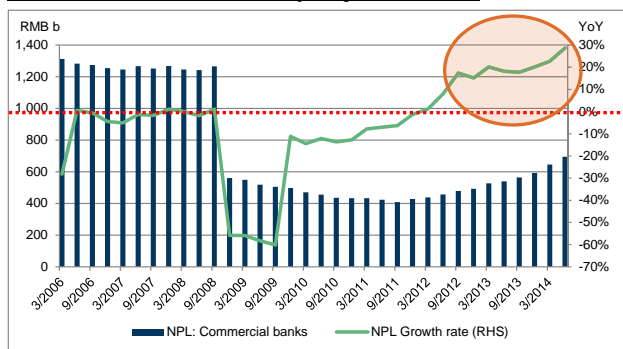
(5) [China Economic Review \(May 2014\)](#)

(6) [Tung \(January 2014\), China – What to expect in 2014, Coface](#)

(7) [Financial Stability Board \(2013\) Global Shadow Banking Monitoring Report 2013](#)

(8) [Tung \(February 2014\), Reality Check: Corporate Payment Trend and Sectorial Risk in China, Coface](#)

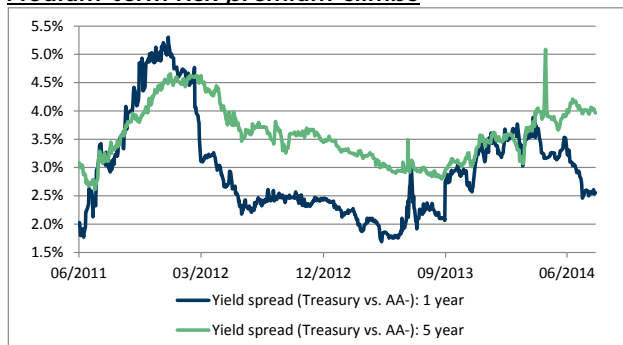
NPL continued to rise rapidly in 1H2014



Source: CEIC, Coface

According to the National Audit Office, local government debt. The aforementioned risks associated with the deteriorating credit quality and payment experience are one of the two key tail risks to the Chinese economy in the short and medium term. Since the first publicly traded onshore bond default happened in March, more high-profile default payment of bonds and other non-bank financials have surfaced. Such trend is expected to continue – particularly with the slowing property market since the beginning of 2014 – and it would be beneficial to the development of the Chinese economy as it would normalize risk premium – as shown by the difference between treasury yield and AA- bond yield – which has been climbing since the Chaori incident.

Medium-term risk premium climbs



Source: CEIC, Coface

Overall, these developments should sustain the high cost of fund pressure for smaller corporates, especially those with lesser credit facilities from banks. On one hand, the regular banking system should become more risk-aware and risk could be priced higher. On the other hand, the day-to-day media reports of potential threats from the shadow-banking system may lead to lower liquidity to the non-bank financials, despite government agencies' advocacy of SME lending. While the international investment community has already been aware of such trend and has hardly been part of the loop, domestic retail investors may start to become less willing to invest in wealth-management products, which were the behind-the-wheel driver of the shadow banking system.

Mini monetary stimuli already in place

As of the completion of this report in August, the monetary environment in China has gone through some slight and low-profile adjustments. Particularly targeting at rural and agricultural development and supporting small and micro-sized firms, the PBoC has launched two rounds of selective required reserve ratio (RRR) cuts, announced in April and May, respectively. Such selective approach is different from the broad-based adjustment approach as the market was accustomed to with the precedent government regimes – for instance, in the last RRR-easing cycle that began in 2008, adjustments were made for all financial institutions, both for large and small-and-medium depository institutions. This reaffirms our view that the policy movements of the Xi-Li regime differ from what we were used to in the Hu-Wen regime. The shift in such policy principals is viewed as part of the reform agenda, which indicates that the current government is providing the right remedy addressing specific concerns.

Selected targeted stimuli since April (non-exhaustive)

Month	Measure
April	(Apr 22) PBoC lowered RRR for rural commercial banks (200bps) and lenders with agricultural purposes (50bps)
May	(May 7) The Finance Ministry and State Administration of Taxation said that any company with annual taxable income below RMB100000 would have 50% tax cut (i.e. 20%) from 2014 till 2016; two million firms to benefit. Firms with under 100 employees, with revenue limits, will also benefit
June	(June 9) PBoC lowered the RRR for more selected financial institutions that fulfilled requirement of lending to agricultural sector and small & micro firms, as well as finance companies, financial leasing companies and auto finance companies (June 11) PBoC said it'd encourage banks to lend more to exporters to boost activities (June 13) China to cut VAT (i.e. from 4-6% to 3%) on small firms (June 30) Regulators increased banks' lending capacity by altering the way loan-to-deposit ratio (i.e. ceiling at 75%) are measured
July	(July 24) CBRC said it would continue to extend support to small companies through reducing "inverted" lending activities

Source: Various news agencies, State Council, Ministry of Finance, PBoC, Coface

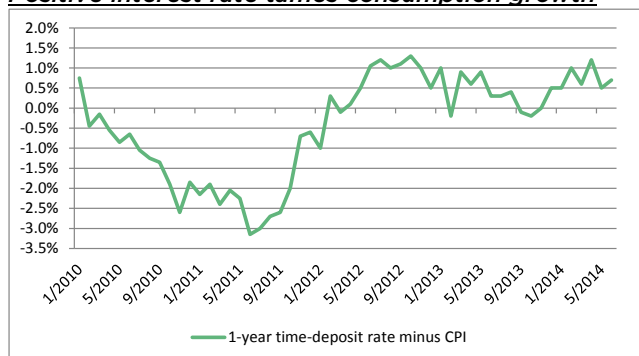
(9) Solar panel manufacturer Shanghai Chaori Solar Energy Science & Technology (Chaori) failed to make an RMB90m (US\$14.6m) interest payment owed to its domestic bond holders of the RMB1b bond issued in 2012. It is the first time a Chinese firm has ever defaulted in the onshore corporate bond market.

Targeted stimulus to continue, but more is needed

While near-term growth is stabilized through a less tightening-biased environment, the prospect of accelerated economic recovery is less optimistic. Taking the decline in SHIBOR as an example, better liquidity management may not be the only reason, as we argue that money demand has also weakened as a result of weakened momentum of economic activities. With inflation well below government's target, property market facing pressure, and corporates facing high cost of borrowing, it is becoming more convincing in recent months that there is further room for policy adjustment.

Despite the government's signal stating that it is more likely to continue to adopt a targeted-stimulus approach, an interest rate cut would help stimulate the demand side of the equation in the economy. First, with the low inflation, an interest rate cut would reduce the positive interest rate, which is weighing on consumption behavior. Moreover, the lowered interest rate would directly lower the cost financing by borrowers of all walks. Nevertheless, the PBoC would have to balance the potential credit risk brought by such loosened monetary situation.

Positive interest rate tames consumption growth



Source: CEIC, Coface

Part II: Sectoral risk assessment

China Sectoral Risk Assessment			
Sectors	Risk level	Sectors	Risk level
Automotive	●	Metals	●
Construction	●	Retail	●
Electronics & IT	●	Textile	●
Energy	●	Wood Paper	●

Source: Datastream, Coface

● Moderate risk ● Medium risk ● High risk ● Very high risk

The overall sector assessments of our sectoral risk assessment did not change from the previous report in January 2014, except bringing up metals to very high risk. Sectors with high risks include construction, while retail and automotive sectors are considered to have moderate risk.

As we expect the economy to move toward a less-tight macroeconomic environment with targeted-stimuli to continue, some selected industry participants would benefit if 1) they are granted access to optimal financial resources, 2) the targeted-stimuli could effectively stimulate their downstream demand.

Yet, as we expect the economy to see moderated growth in 2015, with weakened demand from investment and consumption, the business environment for metals, energy and wood-paper sectors will stay challenging.

a) Metals

The metals sector in China presents very high risk.

Underwhelmed by the lingering overcapacity issues, the steel sector in general continues to bear razor-thin profitability, while leverage continues to stay at high level. Net profit margin is estimated to be around 0.4% as of the 1H2014 comparing to 0.6% in 2013, while debt-to-equity ratio remained flat at 225% comparing to 226%. With weaker demand from the construction and property sector, steel industry will continue to see pressure to phase out outdated production capacity.

Moving upstream, demand of the iron ore sector would also see hiking pressure as a result of the weaker steel demand. With weaker than expected demand, iron ore inventory reached historical level in June when inventory at ports reached 113m tons. Price will continue to be pressed, and given such trend, there is rising need for private mines with high cost structure to shut down their operation.

b) Energy

The energy sector in China presents medium risk.

Energy consumption in China is growing, but the growth rate is moderated to a level lower than previous years, 4.9% YoY as of the end of July, lower than the 7.3% and 5.5% in 2013 and 2012. While demand side of the coal sector is not too

much an issue as economic momentum is stabilized, as discussed in our previous China Panorama, the high coal-price during last winter would not be sustainable. After the adjustment process, coal prices have declined by more than 20% on average across all qualities while inventory has piled up to higher than normal levels. Such dynamics should allow moderate price increase as winter approaches and coal demand would be higher.

Indeed, with the established downtrend of coal prices, some firms may be facing financial difficulties. From our discussion with analysts and consultants in the coal industry, some firms - even major firms - in the industry could be loss-making as coal prices fall being RMB500/ton. If the weak price-trend continued, it would most likely lead to financial difficulties and risk level could be on the rise.

c) Wood-paper

Wood-paper sector in China presents medium risk.

Although price expectation earlier in the year was more optimistic, price trend during the 1H2014 showed that such expectation did not materialize. As retail sales growth is expected to moderate further going forward, the weaker demand growth is unlikely to bring major gains in prices.¹⁰

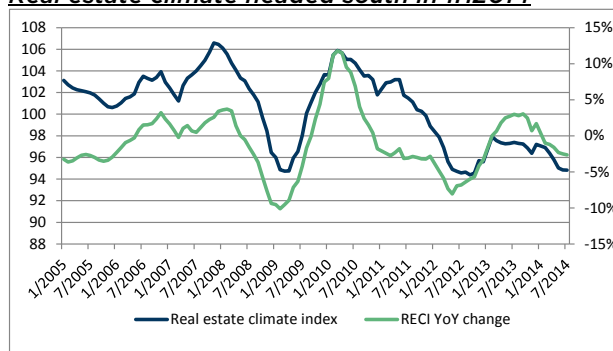
Overcapacity issue in the sector is a key driver in leading to weak demand-supply dynamics. The Chinese government has been setting out plans to eliminate the outdated production capacity, and it had taken up its effort in 2013 with an elimination target of 7.5 million tons. The Ministry of Industry and Information Technology has announced in July and August 2 rounds of production capacity ousting that involved 221 and 45 paper making companies, respectively. While the government has set a target for these production facilities to cease production by the end of this year, the effectiveness of the execution of such regulation would vary in different regions. A successful implementation of such policy should improve the supply-demand dynamics - not in 2014, but - starting from 2015 and in the medium-term.

Part III: Industry analysis

Property: an important sector that sees challenges ahead

The property market in China has been receiving a lot of attention from around the world during the last decade. First, the soaring property prices during the last decade since the mid-2000s caught the attention from the world. Then, it came about concerns related to over-investments, which have led to the stories of “ghost towns” - a term that describes built but significantly underutilized, sometimes never used, towns.¹¹ Roughly three years since the ghost town stories first broke out early in this century, it came around what we faced during the first half of this year - the unusual and country-wide decline of property prices (i.e. average decline of -0.57% since Dec 2013) that underwhelmed investment sentiment during much of this year, as reflected in the real estate climate index (RECI). As of the end of July, RECI is at a level (94.82) only seen in 2009 in the midst of global financial crisis and 2012 when GDP growth declined in 6 consecutive quarters as a result of the withdrawal syndrome of the RMB4trillion stimulus plan.

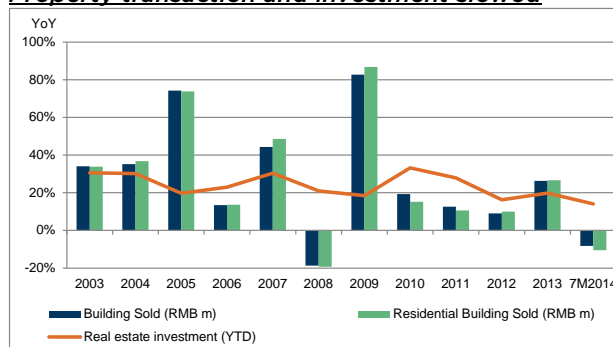
Real estate climate headed south in 1H2014



Source: CEIC, Coface

Indeed, from the macro perspective, sentiment toward the property market has been weak in 2014, both on the supply side and the demand side. On the supply side, property developer has been deferring or canceling their investment plans, reflected in the real estate investment figure made available by the National Bureau of Statistics (NBS). Through 7M2014, real estate investment climbed 13.7% YoY to slightly over RMB5trillion during the period, and on track to achieve the slowest growth rate since at least 2000.

Property transaction and investment slowed



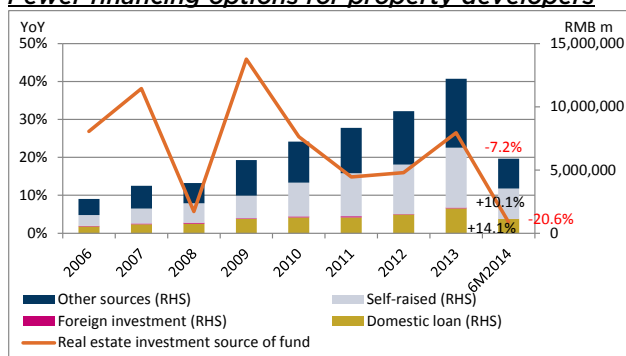
Source: CEIC, Coface

(10) www.paper.com.cn

(11) [Daily Mail \(April 2014\)](#)

We attribute the recent deteriorated condition of the property sector to the lack of alternative financing sources. As we can see from the chart below, “other sources” – including trust loans, trust fund, corporate bonds, etc. – has been the major source of fund to real estate investment, representing some 44.6% in 2013. As a result of the clamp down of the shadow-banking activities (see Part II), such financing options have been relatively futile during 1H2014, declining -7.2% YoY. While the other major source of fund, “self-raised” – which would include companies’ retained earnings from property sales – has shown strong support in the absence of external financing sources, the sustainability of such trend is questioned as property sales have been weak in 2014.

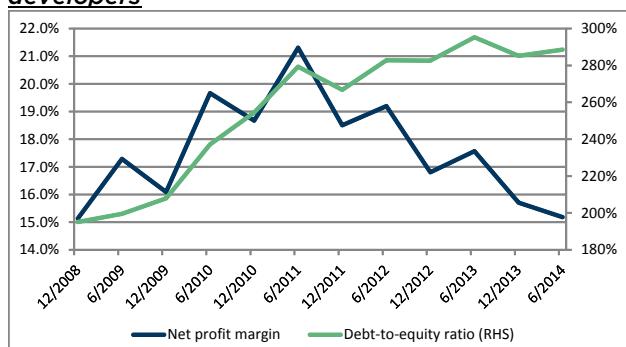
Fewer financing options for property developers



Source: CEIC, Coface

At the same time, financials of top real estate developers are showing signs of deterioration. Using data made available by the top 10 Chinese property developers, it is found that both profitability and the leverage of these companies have worsened in recent years.¹² The weighted average net profit margin of these developers was 15.2% as of the end of 1H2014, the lowest level since at least 2008. At the same time, the weighted average debt-to-equity ratio was 288.6% as of 1H2014, only behind the 295.3% in June last year. With lowered profitability and high leverage level, any upward pressure on the cost of fund would lead to further financial pressure for these developers.

Weakened profitability and rising leverage for developers

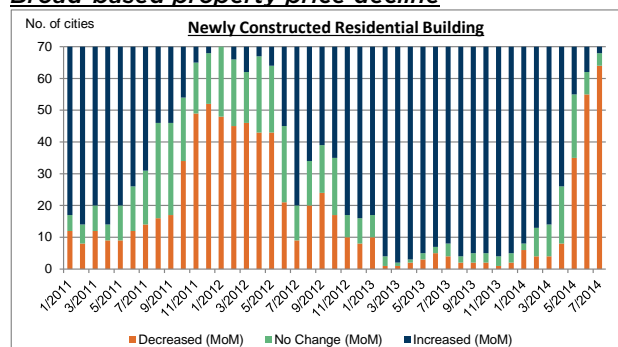


Source: CEIC, Coface

Besides concerns over the supply-side of the equation, demand of property market has also weakened notably. Transaction volume of property market also weakened in 2014, declining on a year-on-year basis for the first time since 2008. NBS reported that transaction of building and residential building during 7M2014 were RMB3.6 trillion (i.e. -8.2% YoY) and RMB3 trillion (i.e. -10.5% YoY), respectively. The weakened pricing power is a factor of the decline of building transaction volume.

After property prices having grown 9.2% (i.e. simple average) on average in 2013 among the 70 cities tracked by the government – and rose between 16.2% and 20% in Beijing, Shanghai, Guangzhou and Shenzhen – trends of property prices have softened in 2014. In the survey conducted by the National Bureau of Statistics, among the 70 cities tracked, 64 of them saw month-on-month price decline as of the end of July. Comparing July’s prices against 2013 year-end’s prices, property prices in the 70 cities have declined -0.57% on average; for the 4 first-tier cities mentioned, the average decline was slightly less serious at -0.16% comparing to the end of 2013. Such trend is significantly different from the trends observed throughout 2013, and the widespread month-on-month decline in property prices was indeed unseen since the compilation of data was revamped in 2011.

Broad-based property price decline

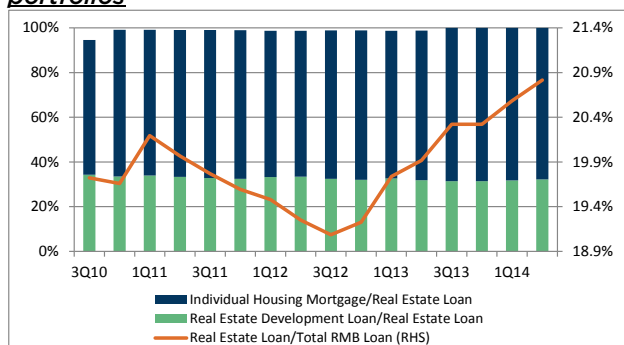


Source: CEIC, Coface

Nevertheless, since the property sector is too important to the Chinese economy, we argue that the government will not neglect and allow a freefall. Discussed earlier in this section, even though domestic loan from banks is only the third source of fund for property developers, it still represented 16.1% of the source of fund in 2013. Traditionally speaking, property-related loans weigh around one-fifth of banks’ portfolio and such trend has been climbing since the trough in 3Q2012, and has reached 20.8% as of the end of 1H2014. With its heavy-weight on the banking sector – the facilitator of the Chinese economy – it is believed that the government would not allow the sector to go astray.

(12) The top 10 developers are China Vanke, Evergrande Real Estate, Poly Real Estate, China Overseas Land & Investment, China Resources Land, Country Garden, Shimao Property, Longfor Properties, Guangzhou R&F, Sino-Ocean Land

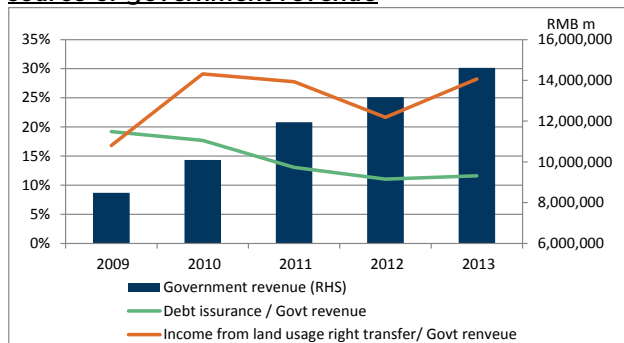
Property demand importantly-represented in bank portfolios



Source: CEIC, Coface

Moreover, besides its influence toward the banking sector, the property sector is indeed the key contributor to government revenue. While government revenue has been climbing steadily over the years, a key contributor of growth is the income from land usage right transfers, which contributed some 28.2% of total government revenue in 2013, compared to the 16.8% in 2009. During the same period, debt issuance as a percentage of government declined from the 19.2% in 2009 to 11.6% in 2013. As we have pointed out in our last China Panorama,¹³ it is the government's intention to reduce its reliance on debt issuance to finance infrastructure projects, and thus it would be reasonable to believe that the income from property market will continue to stay as an important component in the government revenue mix.

Income from land usage right transfers is a major source of government revenue



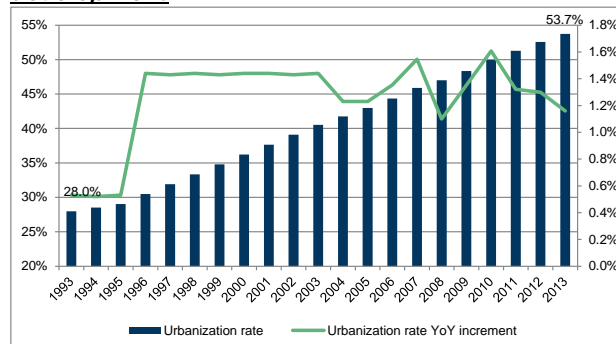
Source: CEIC, Coface

Indeed, development of the property sector will ride on the bloom of urbanization. Earlier this year, Premier Li has reinforced that the Chinese economy will put forth urbanization as one of the 2 key foci in 2014, which confirms our view that investment would continue to be the leading growth driver of the Chinese economy in the medium-term.

In many of our conversations with our clients and partners, we always receive questions about why urbanization had to go forward, despite the fact that the 12th Five-year Plan (i.e. 2011-2015) has set an urbanization target of 51.5%, and urbanization rate has already reached 53.7% as of the end of 2013. It is understood that China has indeed come a long way in terms of the urbanization process as urbanization rate has climbed from the 28% in 1993 to 53.7% in 2013;

yet, it is still well behind developed nations like Australia (89.2%), France (85.8%) and the US (82.4%), or even its peers of emerging economies like Brazil (84.6%), Russia (73.8%) and North Korea (60.3%).¹⁴ As a result of such basis, we believe there is still room for urbanization rate to go up in China.

Continuous urbanization will drive further development



Source: CEIC, Coface

In light of the dramatic slowdown in the property market, PBoC is said to have indicated to the banks that they should continue to extend credit facilities mortgage applicants in May.¹⁵ Moreover, as a combat of the wilting property market in China, 31 cities are said to have lifted their individual home purchase restrictions.¹⁶ Many developers are also using various schemes and discounts to customers to attract homebuyers, with Vanke - China's biggest development - and Alibaba recently developed a program to offer rebate up to RMB2million for their customers in their next home purchase.¹⁷ All of these measures would give a break to further downward momentum in the near future, but the medium-term outlook is clouded.

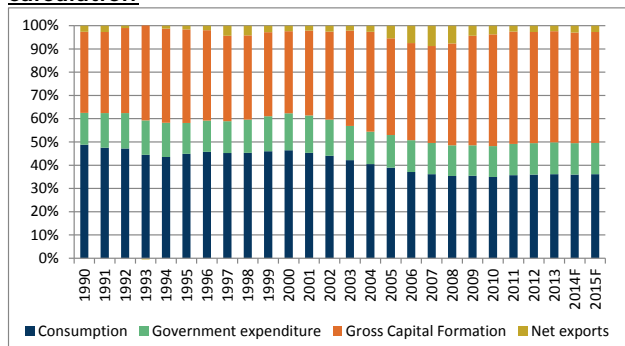
The importance of the property sector to the Chinese economy is significant and a collapse in the sector should be avoided. The medium-term demand will continue to be led by the government's urbanization plan, which will focus more on quality instead of the volume of investment. Nevertheless, the debt level of property developers is increasingly worrying, and with the high level of inventory to-be-digested, the near-term outlook of the sector remains bleak.

(13) [Tung \(January 2014\), China – What to expect in 2014, Coface](#)
 (14) [United Nations – World Urbanization Prospects \(2011 Revision\)](#)
 (15) [Wall Street Journal \(May 2014\)](#)
 (16) [Want Daily \(August 2014\)](#)
 (17) [Taobao website](#)

Consumer goods: sowing seeds for harvest

Since the 2000s, the rise of purchasing power in China has been a key driver of growth for the Chinese economy. As a matter of fact, household consumption, which now only accounts for 36.2% of China's nominal GDP as for 2013, is expected to gain weight in terms of the importance of the country's economic activities.

Household consumption stayed low in current GDP calculation

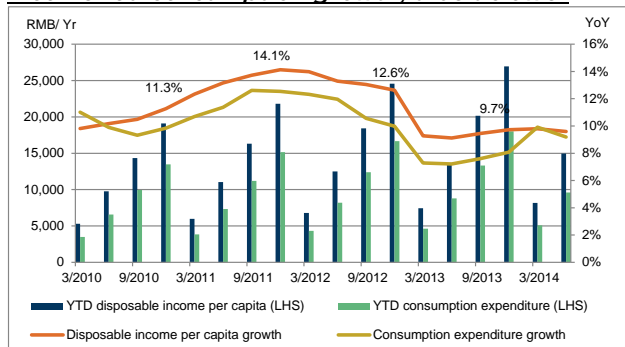


Source: CEIC, Coface

In this section, we will discuss the outlook of the consumer sector. In short, it is believed that the sector will continue to benefit from the economic development in China. Particularly, we attribute the growth of consumption in China to 1) rising middle-class and thus improving affordability, 2) increasing number of people in the working-age category, 3) rising living standards through urbanization, and 4) new retail channels. On the back of these developments, despite recent less favorable environment, the consumer staples sector should continue to evolve in China. After taking a look at the aforementioned macro trends, we will take a look at specific trends for a few consumer staple goods in China, namely food & beverage, and liquor.

It is no secret by now that there is an emerging middle-class in China. Suggested by Barton, Chen, and Jin (2013), more than 75% of the urban households would make between RMB60,000 to RMB229,000 per year, making it comparable to the average income in Brazil (the lower end) and Italy (the upper end) in purchasing power parity (PPP) term.¹⁸ Indeed, despite falling under the 10%-mark for the first time in at least more than a decade, the 9.7%YoY growth in nominal disposable income in urban households continued to support consumption growth, albeit at a slower pace. Such trend will continue to be the helm of China's growth and benefit consumption-related companies.

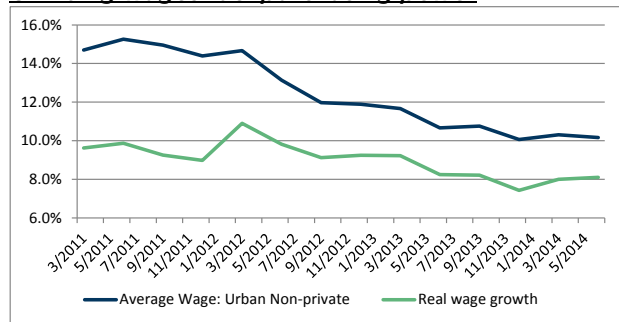
Income-led consumption growth, albeit slower



Source: CEIC, Coface

The reason behind the income trend is related to the rising wage level in China, which has been rising more than 10% YoY steadily over the last decade. During the same time, the rise of minimum wages has almost become a routine in most of the provinces, with the average minimum wage level rising 12.5% YoY (simple average) in 2013 among the 32 provinces and municipalities. As inflation has been tamed and contained at low level, the rising wages have released more purchasing power to the workers in the country, which is directly related to the rising consumption behavior in China.

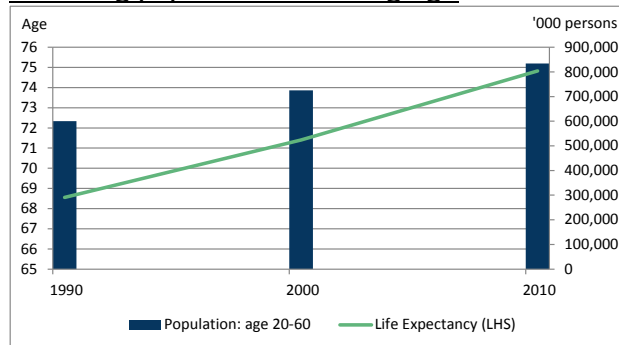
Climbing wages fuel purchasing power



Source: CEIC, Coface

Besides the rising income and wages, the rising number of people in the working age category also contributes positively to the consumption story in China. Probably due to better technology and medical care, the life expectancy of people in China has been climbing. Considered that the current retirement age in China is 60-years-old.¹⁹ If the "normal" working-age is between 20 and 60, we found that the population of the working-age has grown 39% from 600 million in 1990 to over 834 million in 2010. During the same period, life expectancy has also improved from 68.55-years-old to 74.83-years-old. With higher working population (i.e. more people can make money) and higher life expectancy (i.e. elderlies would also need to spend on food and other items), purchasing power would thus increase.

Increasing population in working-age



Source: CEIC, Coface

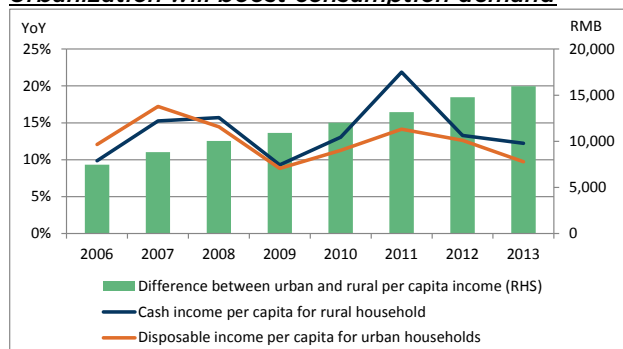
In addition, as more people in China start moving into

(18) Barton, Chen, and Jin (June 2013) "Mapping China's middle class", McKinsey Quarterly

(19) 60 is the retirement age for men and 50-55 for women.

urban areas, consumption will increase significantly. As discussed in earlier sections in this report, urbanization plan is a key focus of the Chinese government as it will not only carry growth momentum, but also improve the standard of living of its people. One of the key reasons why continued urbanization is identified as needed is the income differentiation between rural and urban households; even though rural household income is growing at a higher rate, with the lower base-value, the income differential has widen from RMB7,458 in 2006 to RMB15,972 in 2013. Since year 2000, urban population has increased by 272 million to over 731 million in 2013; while it is not believed that urbanization can sustain the 1.4% annually growth rate since 2000, it is believe that the continuation of urbanization process can drive consumption growth.

Urbanization will boost consumption demand

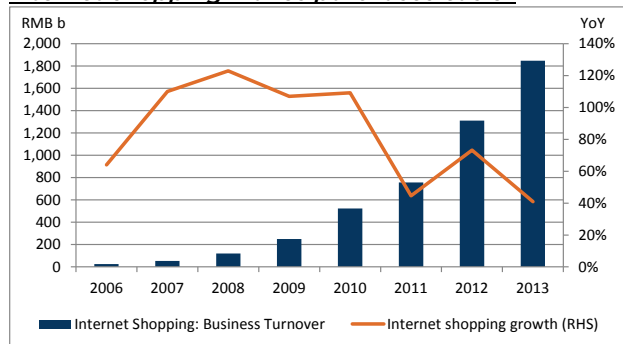


Source: CEIC, Coface

Moreover, as technology improves and the internet is being more widely used in China, purchases of goods have become easier and it will continue to be a catalyst of consumption in China. According to McKinsey's Dobb et al (2013), traditional retailers that relied on physical stores would need to modernize to adjust to such trend.²⁰ These changes in business dynamics in the industry is believed to see higher importance in the business landscape going forward.

Indeed, the development of the internet shopping has been substantial, partly because it had come from a low base. Comparing to 2005, when internet shopping data was first made available, business turnover of internet shopping has increased by 116 times as of the end of 2013. Although growth rate for 2013 has slowed to 40.9% YoY, the potential of the consumption market through internet purchases remains significant and will continue to be a driver of the Chinese consumers market.

Internet shopping makes purchases easier

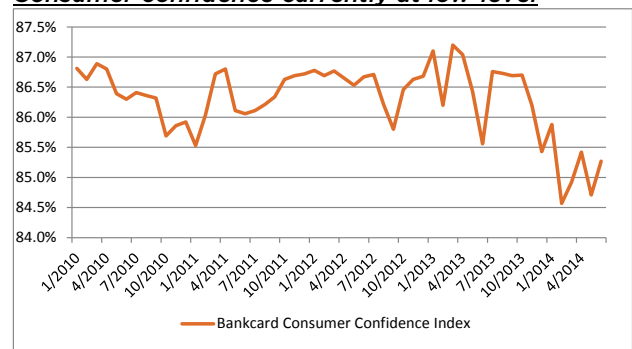


Source: CEIC, Coface

After looking into these medium-term trends, we now turn to the short-term trends.

While the medium-term indicators suggest that outlook of the Chinese consumption market should continue to be bright, the confidence index compiled by Xinhua News Agency and China UnionPay, a national bank-card group, shows that consumer confidence is around the lowest level since 2010. It is believed that one of the reasons why the index has started the declining trend since March 2013 was the launch and sustained effort of the anti-corruption scheme after the Xi-Li regime has begun. Nevertheless, there are slight signs of improvement in recent months, which are likely the results of more accommodative economic environment introduced by the government since the second quarter.

Consumer confidence currently at low-level



Source: CEIC, Coface

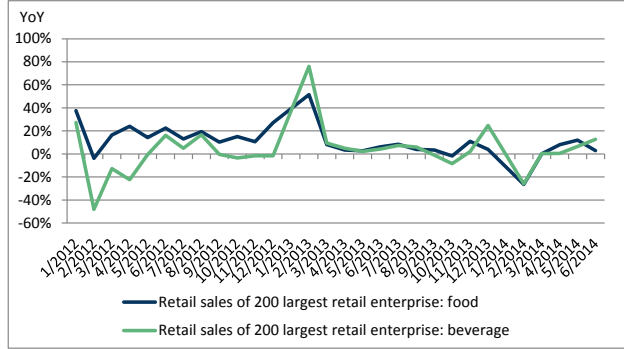
Different subsectors of the retailing business have seen various trends. In the following parts, we will discuss the trends of retail sales for food & beverage, and liquor industries.

According to data coming from the top 200 retail enterprises, it is found that growth momentum for companies in the food & beverage retail sector has been quite weak. Aggregate sales for food and beverage items from February to June this year declined 4% and 4.6% YoY, respectively, due to the significant setback in February (i.e. declined -26.5% and 25.9% respectively).²¹ Good news is that the retailers of the food & beverage industries have seen moderate gains on year-on-year basis since February, and as consumption of food and beverage is less sensitive to policy environment, it is believed that such momentum could be carried forward for the second half of 2014.

(20) Dobb et al (2013), "China's e-tail revolution", McKinsey Global Institute

(21) While we would be tempted to assume that such decline was due to the difference in timing of Lunar New Year, we avoided to do so as such argument cannot be proved correct as data from January 2013 is missing.

Slower, but still positive, growth for F&B segments

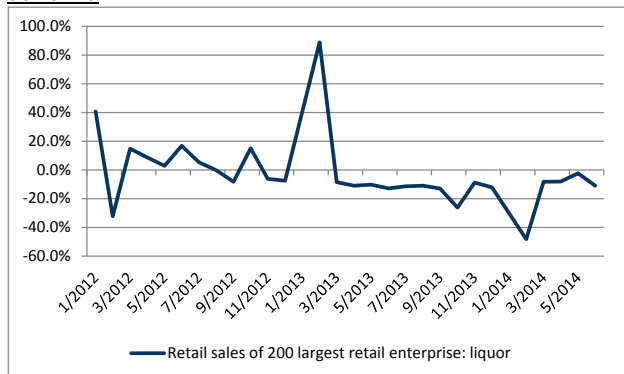


Source: CEIC, Coface

Retailers of liquor have been those of the most hard-hit in 2013 as a result of the anticorruption scheme, which included stricter regulation on wine and dine using public funding. Since the beginning of Xi-Li era in March 2013, the liquor industry has started to see negative year-on-year growth consistently, recording an average -13.5% YoY decline in retail sales during the period up to June 2014; such decline was expected to be primarily driven by price cut.

According to Euromonitor International, “super-premium” alcohol saw a 7% price decline at 2013 prices, as a result of the scheme that prohibits purchases of gift using public funds at national festivals and also bans officials from receiving gifts.²² Euromonitor pointed out that Maotai had to cut prices by as much 30% in the second half of 2013 to combat the shrink in demand from the ban of ostentatious spending. In the most recent interim result, Maotai, the leading publicly-listed distiller in China, has seen its net profit declined -0.25%, significantly different from the strong trends in previous years.²³ While the low comparable figures from last year could set ground for recovery in 2H2014, industry participants should adjust to the lower growth pattern and adjust their businesses strategy or they would face overcapacity and other issues.

Liquor industry hurt severely by anticorruption scheme



Source: CEIC, Coface

While the medium-term outlook for China’s consumer industry continues to be bright, near-term challenges are not neglected. Riding on the rising middle-class, the higher number of people in the working-age category, rising living standards, and improving retail channels, the consumers market in China will continue to gain pace as a growth driver of the economy in the medium-term. However, together with the anticorruption scheme, the weakened income growth rate would cast a ceiling for the potentials of the market in the near-term, which is in-line with our view that economic growth is moderating in China.

(22) [Euromonitor International \(August 2014\) Spirits in China, Country Report series](#)
 (23) [Maotai 2014 Interim Report](#)

Part IV: Conclusion

Since the beginning of the year, the Chinese government has continued its effort to carry out various items on the reform agenda, particularly on fine-tuning the structure of the Chinese economy. While various aspects of reform are underway, growth is by no means forgotten. With plenty of signs showing lackluster growth momentum in this year, it is believed that the government is likely to introduce stronger stimulus to sustain economic growth. More specifically, the continuation of targeted-stimuli is expected.

On the credit quality side, in-line with the suggestion from our China payment survey report, non-performing loan (NPL) has been rising in China, as the absolute amount of NPL soared 28.7% YoY in 1H2014. The growing NPL is leading to concerns over lending qualities, while the cost of financing remains to be a concern to various sectors and smaller companies that lack access to credit facilities. Hence, with inflation figure highly under control, a broad-based interest rate cut could help ease financing pressure of companies and bring growth closer to the government's 7.5% target.

In our sectoral risk assessment, we went through the conditions of metals, energy and wood-paper sectors. The metals industry continues to be underwhelmed by overcapacity issue and the weaker-than-usual demand growth is hurting profitability further and that explains why it has become a very high risk sector. Energy sector, using coal as a proxy, is also experiencing lower demand growth as the overall economic momentum slows; further weakness of the price trend

should lead to a rise in risk level going forward as it erodes profitability and brings financial difficulties. While it had optimism earlier in the year, the wood-paper sector saw weak price trends as end-demands saw softening growth; but as government's determination to carry out industry consolidation and production elimination move forward, supply-demand dynamics could see improvement in 2015 and beyond.

The property industry faced significant headwinds during 1H2014 and it is not expected to see dramatic reversal in the second half. The price pressure and the debt level of property developers is increasingly worrying, and with the high level of inventory to-be-digested, the near-term outlook of the sector remains bleak. Nonetheless, the importance of the property sector to the Chinese economy is significant and a collapse in the sector should be avoided. The medium-term demand will continue to be led by the government's urbanization plan, which will focus more on quality instead of the volume of investment.

Similarly for the consumers industry in China, the medium-term outlook continues to be bright, but near-term challenges are not neglected. Riding on the rising middle-class, the higher number of people in the working-age category, rising living standards, and improving retail channels, the consumers market in China will continue to gain pace as a growth driver of the economy in the medium-term. However, together with the anticorruption scheme, the weakened income growth rate would cast a ceiling for the potentials of the market in the near-term, which is in-line with our view that economic growth is moderating in China.