

panorama

21 January, 2014



Panorama China - What to expect in 2014



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Since the Third Plenary Session of the 18th Communist Party of China Central Committee (CPCCC) in November, a broad spectrum of exciting reform plans have been announced, and the government had a series of follow-up actions. These are clear signals that the Chinese effort to restructure the economy is more than just rhetoric.

While we should be excited for the many moving parts in the Chinese economy, we cannot forget about the risks. In the near-term, potential negative impacts on the real economy as a result of the reform effort and credit risks associated with the rising cost of fund have to be watched out for.

We characterize 2014 as a year of divergence for the Chinese economy, representing the diverging trends of macro and micro environments. On the macro side, economic growth will remain strong with headline economic growth mildly slowed to 7.2% YoY, while other key macro indicators will remain stable.

But businesses will be facing challenges. Our sector barometer – which reflects financial performance of companies in various industries as well as our payment experience – shows that there are rising risks in the Chinese economy. Particularly for companies in the electronics sector – where we have seen deteriorating payment experience – credit management practices should be adopted.

China Sector Barometer			
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

Items on the Chinese reform agenda, like measures against overcapacity issues, would benefit the oversupplied industries in the long-run but turbulence shall be expected in short and medium terms. The steel and coal industries should benefit from the leaders' determination to speed up urbanization in the country, but the demand growth is only coming from selected regions as a result of the leaders' determination to cut overcapacity. With environmental-friendly policies in the pipeline, these sectors will see continual shakeups, while smaller and inefficient industry participants will see pressure intensifying in the near-term.

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2014 – A Year of Divergence

Part I: Recent developments in China

Reform rhetoric and follow-up actions

As indicated in our previous report, top Chinese policymakers have shown that they are reform-minded, leading us to believe that massive dynamic reforms in the country are on the way.¹ It was again confirmed in the communique of the Central Economic Work Conference (CEWC), where the policymakers have regarded 2014 as a “reform year”, in line with what the Xi-Li regime has indicated all along.²

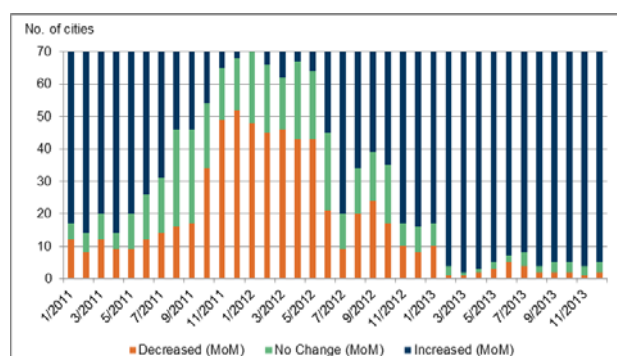
Since the Third Plenary Session of the 18th Communist Party of China Central Committee (CPCCC) in November, a broad spectrum of exciting reform plans have been announced, ranging from i) the population reforms that is highlighted by the one-child policy reform, ii) property rights reform that is highlighted by allowing transfers of property rights among farmers and residents in rural area, iii) fiscal reforms, including the source of government financing, and iv) government structure reform, which was highlighted by the realignment of government agencies' responsibilities, and others.

Following the 4 day plenary session, the government had a series of follow-up actions. To facilitate smoother business operations, policymakers are taking an active role in pushing towards a more market-based economy, which can be reflected in the continued development in the Shanghai Free Trade Zone (SHFTZ), including the proposal of granting fully currency convertibility under the “resident free trade accounts when conditions are ripe”.³ Moreover, China has also formally abolished the decades-long one-child policy, according to the state-run news agency Xinhua.⁴ These are clear signals that the Chinese effort to restructure the economy is more than just rhetoric.

Urbanization to gain pace

Acceleration of urbanization and better local government debt management were two key themes in the CEWC and it is believed that the government will be paying close attention on those fronts. For urbanization, it is the government's intention to boost land supply for both residential and commercial uses. With the increase

in land supply for residential and commercial properties, it is expected that the government can also contain the growth in property prices. This is expected to deliver mixed effects to the housing market: upward price pressure is expected to be tamed with growing supply in certain regions, while transaction volume will likely increase in those areas.



Source: CEIC, Coface

Such strategy does not come without any influence, however; it is in the expense of the industrial sector. In the communique, the government has proposed to reduce the supply of land for industrial usage. Clearly, it is a signal that aligns with the government's direction to climb up the value chain by engaging more actively on services industries and reducing the economic reliance on manufacturing sectors.

Environmental-friendly sectors will be the other beneficiaries of the government's infrastructure plan. In the communique, it was mentioned numerous times that the government intends to reserve clean air and water

(1) [Coface \(November 2013\)](#)

(2) [National Development and Reform Commission \(December 2013\)](#)

(3) [People's Bank of China \(December 2013\)](#)

(4) [Xinhua \(December 2013\)](#)

for the people; such address reaffirms our belief that infrastructure investments on environmental-friendly industries will become a key aspect of urban development. As suggested in our previous report, higher environmental standards will be introduced in the near future, while the government will continue to boost investments in sectors that could help improve water and air quality.

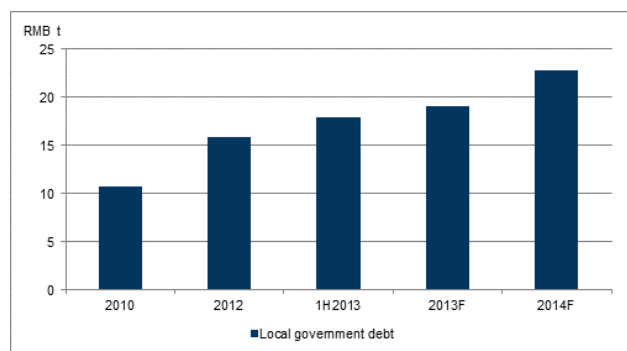
Refining management of local government financing

A key aspect related to infrastructure is the source of funding. The government has indicated numerous times over the past few months that it would not expand the fiscal deficit positions, while the aforementioned acceleration of infrastructure is also on the move. As contradictory as these statements sound, the government does have a plan to take these forward.

Going forward, the government will address on encouraging infrastructure investments – particularly on building “networks of cities” in the mid-western and northeastern regions – by the private sector. With funding coming in from the private sector, the government can achieve the goal of improving infrastructure development in the targeted regions, without having to dig deep into the government’s pocket. Such development should be supportive of accelerated development of environmental-friendly projects (e.g. alternative energy plants industrial pollution treatment plants) and transportation projects (e.g. railway, high-way).

This is in-line with the government’s intention to create and refine a system for the local government bond issues. Moreover, the need to better manage such local government financing vehicle has also been cited in the communique.

According to the National Audit Office, local government debt has gone up by 67% to RMB17.9t as of June 2013, comparing to the RMB10.7trillion last reported in December 2010.⁵ With investment activities estimated to be picking up at around 20% YoY, local government debt should have ballooned to RMB19trillion in 2013 and will continue to inflate to RMB22.5trillion, representing close to one-third of the country’s nominal GDP. The local government debt, from a retrospective point of view, was only 26.6% of nominal GDP in 2010, standing at RMB10.7trillion at the end of 2010.



Source: CEIC, Coface estimates

(5) National Audit Office (December 2013)

Mind the moving parts

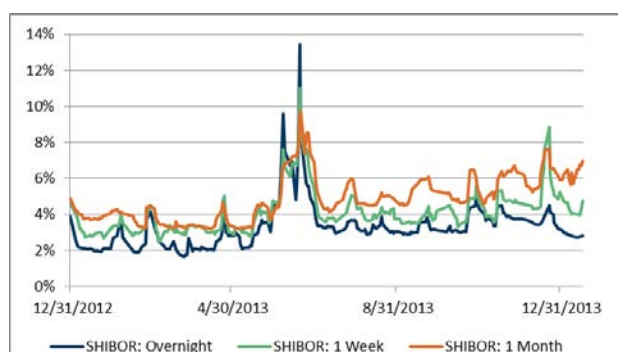
While we should be excited for the many moving parts in the Chinese economy, we cannot forget about the risks. Worries about rising local government financing vehicles and the potential rising non-performing loans (NPLs) emerging from it have lingered in the past two years, proper development and refinement of the system will boost investor confidence. Such development will be beneficial to the long-term development of the onshore bond market – which will be extremely valuable for the country’s long-term development as a representative yield curve can be derived from it – and it will also facilitate non-bank financing through a more regulated, transparent and managed channel. With all these moving parts in the reform agenda, risks cannot be neglected.

With interest rate reform and RMB internationalization on the agenda, financial reform is at the heart of China’s reform roadmap. Combine that with the strong push toward a market-based economy, these reforms could bring in competitiveness to the various industries in the long-run; but they would also create near-term turbulence, particularly to the giants in various industries in China. Increasing competition from foreign and private enterprises, as well as the rising cost of capital, for instance, are expected to bring negative impact to the traditionally dominating enterprises in the various industries within China.

Credit risk, partly due to business reasons, is on the top of our list of worries. As of the end of November, our internal data shows that there is a sign of deterioration in the Chinese economy in terms of payment experience on a year-on-year basis. While our portfolio is only representative of a specific business segment in the vast Chinese economy, with the number of claims and the size of claims increasing, it could be indicative to us that credit risk is on the rise. While such trend did not cause us to press the panic-button just yet, it certainly is a red-flag and we shall keep monitoring the situation.

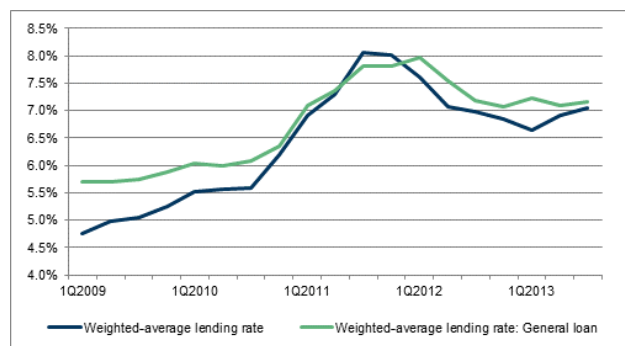
Potential impact of the rising cost of fund

Another key aspect of risk is the potential of rising cost of fund. Textbook-economics explains why high interest rate environment is negative to businesses – cost of capital is negatively correlated to propensity to invest. Particularly, together with the effect of tapering in the US, a rise in cost of capital for companies is expected in the near-term. Toward the end of 2013, local bond and money markets experienced heightening pressure, as the market was factoring in tightened liquidity condition going forward. Such situation was reflected from the interbank exchange rate in China – 1-week and 1-month Shanghai Interbank Overnight Rate (SHIBOR) has risen to 8.8% and 7.7% in late-December, causing worries from the market regarding the tight liquidity situation.



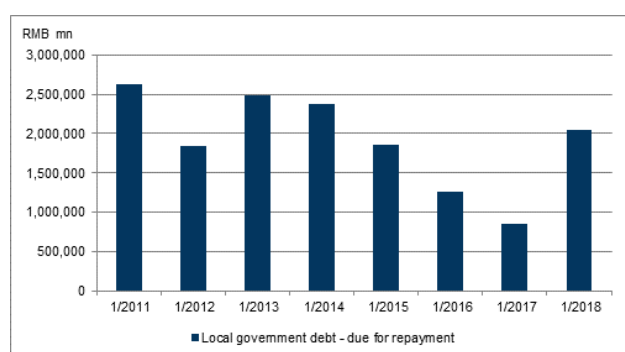
Source: CEIC, Coface

With the lending rate liberalization introduced in July 2013, banks' lending would become more market-based and tightness in the interbank market would translate into higher lending rates. From the figure below, weighted-average lending rate in China has already been picking up slowly in 2013, and such trend should extend to 2014 given the market development in 4Q2013. Pressure should be higher for small and medium enterprises (SMEs) that, traditionally, did not receive abundant credit facilities from banks.



Source: CEIC, Coface

With stable money supply growth, overall liquidity could become even tighter in 2014. The rapid development of bond market began in 2009/2010 coincided with the RMB4trillion stimulus package introduced around the same time. Many provincial and city infrastructure projects were financed by non-traditional financing vehicles; corporate bonds and trust-loans were among the key instruments used, explaining why the new credits in these formats have grown more than 4 and 6 times, respectively, in 2013 comparing to 2009. Assuming that these vehicles bear a 3-to-5 year maturity, the principles will have to be paid in 2014 and 2015. Combining with the local government debt dues, these repayment obligations will further tighten liquidity in the market, while failure to repay the debts will create a significant ripple effect, affecting stakeholders in the supply-chain. Development in this area has to be watched out for in 2014.



Source: CEIC, Coface

Part II: Macro environment

	2011	2012	2013	2014F
GDP growth (%)	9.3	7.8	7.7	7.2
CPI (%)	5.4	2.6	2.6	3.3
M2 (%)	13.6	13.8	13.6	13.0
Fixed Asset Investment (%)	23.8	20.6	19.6	20.0
Retail Sales (%)	17.1	14.3	13.1	11.5
RMB/USD (year-end)	6.301	6.286	6.097	5.945

Source: CEIC, Coface estimates

Year of Divergence

2014 is a year of divergence for the Chinese economy, reflected by the diverging trends of macro and micro environments.

On the macro side, overall growth will remain stable with headline economic growth mildly slowing to 7.2% YoY, partly due to higher inflation. Despite everyone's desire to see consumption to gain momentum and become the new growth driver, investment will stay as the primary engine of growth for the Chinese economy. Monetary policy will remain stable, while we expect banks to start extending more credits to SMEs.

For businesses, with the basket of new reforms, certain industry participants will start facing climbing pressures. Highlighted by the government's advocated effort to tackle overcapacity issues, smaller and inefficient participants in these "oversupplied" industries will be facing pressure, from rising costs to policy uncertainties.

GDP

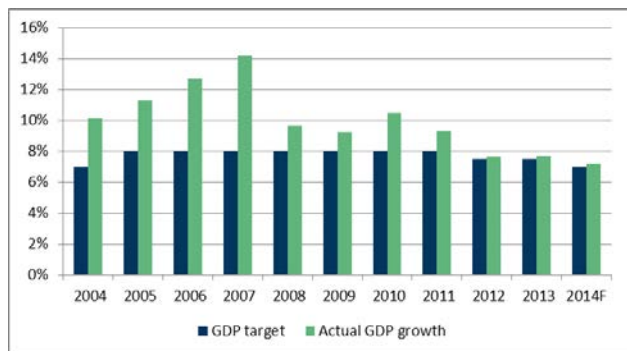
At the regular meeting on 3 December, top party members have retained the wordings on policy direction of "achieving important advancement under steady progress", similar to what was used for 2013. In hindsight, for 2013, macroeconomic environment remained stable as the government tried to move the reform agenda forward and such direction is expected for the year to come.

Reforms are the key focus for the country in 2014, while counter-cyclical measures will be adopted to maintain growth at 7-8%. At the Economic Working Conference, top policymakers have again set "proactive fiscal stance to work with prudent monetary stance" as their near-term policy direction.⁶ While the exact target shall be officially announced in the National People's Congress in March, compared to the 7.5% GDP growth target set for 2013, growth target could have been set as low as 7.0% for 2014 (Coface Country Risk Assessment: A3).

The lower government GDP growth target for 2014 is representative of the government's intention to accelerate reform efforts; the higher the growth target, the lower the possibility the economy can move away from being "growth-centric". Taken into

(6) [Xinhua \(December 2013\)](#)

account an accelerated reform effort, our lower GDP growth forecast is also representative of an expectedly higher inflationary environment and stable government-driven investment momentum, despite expecting recovering export activities and reemerging investor sentiment.

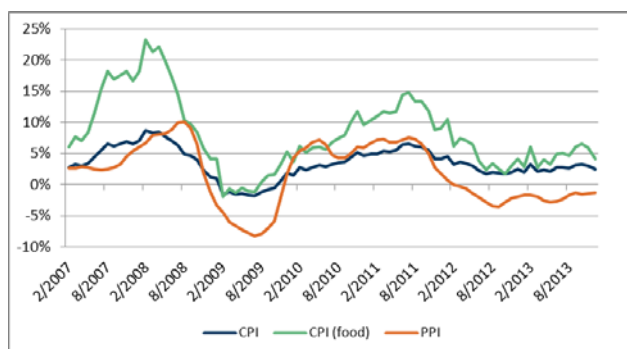


Source: CEIC, Coface estimates

Inflation

Inflation has not become a worry for 2013 as many had expected. Headline CPI was 2.6%, much lower than the 3.5% set by the government, while PPI continued the downward momentum carried over from 2012 (-1.7% YoY) and declined 1.9% YoY in 2013.

Government's inflation target is expected to be set at 3.5%, unchanged from what we have seen in 2013. We expect inflationary pressure to slightly pick up in 2014 as a result of the low comparable base set in 2013. Moreover, continual stable positive development in the international market could lead to higher imported inflation, though it could be slightly offset by the appreciation of RMB. In addition, as a result of the government's effort to move toward a market based economy, subsidies on resources will be moved from some industries, leading to higher PPI. Our expected CPI for 2014 is 3.3%.

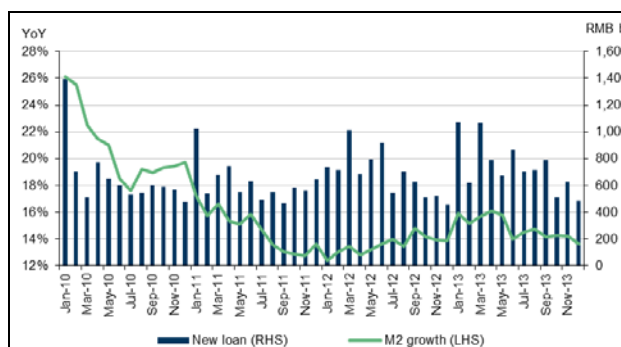


Source: CEIC, Coface

Seasonally speaking, in the last 10 years, CPI has an intention to peak during summers and winters. Food-price driven inflation is expected to become a theme in summer 2014. Nevertheless, the relatively dynamic inflation in near-term should be well within the government tolerance level and should not trigger tightening monetary stance in the near-term.

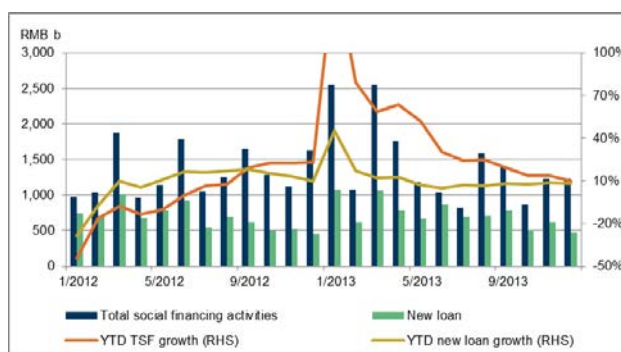
Money supply

After a decade of rapid expansion, the new credit cycle will be symbolized by PBoC's intention to slowly put market order into place. Albeit the low inflationary environment we have seen in 2013, the overall monetary policy tone will be set as prudent for 2014 - very much in-line with what we have seen in previous years - as it has almost become a tradition of the central bank. With an expectation of stable monetary situation, M2 growth is expected to be 13.0% for 2014, slightly lower than the 13.6% M2 growth seen in 2013.



Source: CEIC, Coface

As discussed in Part I, it is not the central bank's intention to loosen monetary policy stance as country leaders are trying to be less reliant on credit-led growth. Certain business segments - most notably SMEs - will benefit more from such growth rate of money supply in the expense of the others. Although lending rate will be relatively higher comparing to that for larger enterprises, traditional banking institutions will become more accommodative to SMEs in terms of granting credit facilities. Such development will be beneficial to the real sector as they will, ideally, not need to turn to shadow bankers for liquidity at costs north of 20%.

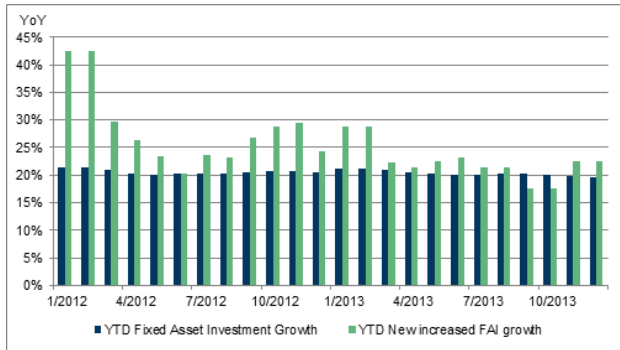


Source: CEIC, Coface

The SHIBOR hike in December is indicative that PBoC's intention to reduce the pace of balance sheet expansion going forward. As we have witnessed in 2013, instead of merely using banks' lending as a channel to manage liquidity, PBoC has become more actively using open market operations to stay on top of the money market. Such trend should extend to 2014, as the PBoC is taking this opportunity as a channel to advise banking institutions to better manage their resources.

Fixed asset investment

Fixed asset investment (FAI) in 2013 remained strong at 19.6% YoY, led by strong momentum coming from property development as well as an accelerated pace of infrastructure projects. For 2014, FAI is forecasted to grow 20.0% YoY, highlighted by the continuum of the government-led infrastructure projects and the acceleration in affordable housing development. As top country leaders have placed urbanization on the top of the agenda, infrastructure investment, particularly in western regions, will contribute significantly to the country's FAI growth in 2014.

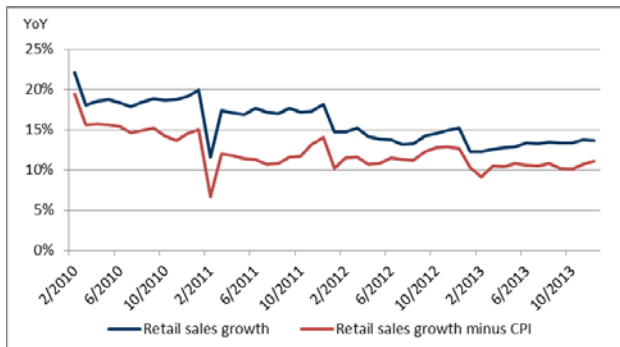


Source: CEIC, Coface

A major downside risk for our expectation on FAI in 2014 is the potentially stricter lending conditions to property developers and local governments. As discussed, there is a possibility that banks will turn their lending appetite toward SMEs as it is in-line with the government's guidance. Property developers and local governments, among the others, will thus receive less banking facilities from the regular banking system, which would be negative to their operations. Moreover, the expected mini-peak of repayment period for some corporate bonds and trust loans during the year will create heightened liquidity pressure for these companies and governments. These will be closely monitored at Coface.

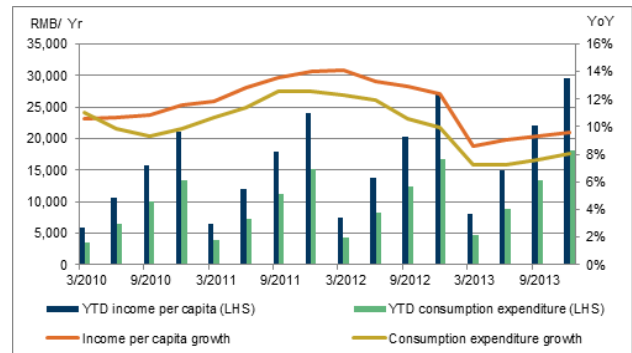
Retail sales

Year-on-year retail sales growth was 13.1% for 2013, comparing to the 14.3% in 2012 and 17.1% in 2011. We believe the downtrend will be extended to 2014, leading to our forecast of 11% retail sales growth for 2014 as a result of slower income growth.



Source: CEIC, Coface

A key reason attributing to our lower retail sales forecast is the slowing income growth, which has slowed down from 12.4% in 2012 to 9.6% in 2013, while growth of consumption expenditure slowed from 10% in 2012 to 8.1% during the same period. As we expect income growth to slow to 9% on a YoY for 2014, retail sales growth would come in slower at 11.5% for 2014.











Source: CEIC, Coface

Another reason why we expect a slower retail sales growth in china is policy-drive, related to the countrywide effort against corruption and extravagant spending by government units. For instance, according to the Central Commission for Discipline Inspection (CCDI), as of October 31, 19,896 officials have been prosecuted for violating the "eight-point" bureaucracy- and formalism-fighting guidelines that were introduced on December 4, 2012.⁷ The "eight-point" guidelines were introduced to reduce overseas bureaucratic visits and unnecessary ceremonial spending by officials. Earlier in 2013, reportedly, spending on discretionary items, including mooncakes and alcohol have reduced tremendously. While the aforementioned discretionary items may only contribute to a low fragment of the total consumption in China, the basket of goods negatively impacted by the anti-corruption campaign could be more broad-based, leading to further slowdown in consumption.⁸

(7) [People's Daily \(December 2013\)](#)

(8) [Financial Times \(December 2013\)](#)

Part III: Sector barometer

China Sector Barometer			
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

a) Auto

The automotive sector in China presents a moderate risk.

The implementation of measures to control the number of cars in various major cities in China should neutralize the government's support of greener vehicles.

Potential negative shocks could be seen should the Sino-Japan relationship intensifies. This would, however, not hurt the overall demand as drastically as the demand of Japanese automobiles. As we have witnessed in 2012, where Sino-Japanese relations came at a low point as a result of the dispute over an island chain, Japanese automakers suffered tremendously, while overall automobile sales stood relatively firmly. During such period, accumulated auto sales of Guangqi Honda Automobile Co. and FAW Toyota Sales Co. went down by 46%, 61%, 38% and 31% YoY between September and December of 2012.

b) Retail

The retail sector in China presents moderate risk.

This sector continues to perform well in terms of credit risk, but outlook could be clouded by various factors. The sector - particular the high-end product segment - is hurt by the government's effort to tackle corruption and the effort will surely be extended to 2014. Income (12.4% in 2012 vs. 9.6% in 2013) and capital expenditure (10% in 2012 to 8.1% in 2013) growth has also slowed noticeably from previous years. Moreover, the existence of import duties and VAT, and RMB appreciation have been key factors driving Chinese consumers to bring their shopping sprees aboard.

c) Electronics and IT

The sector is producing mixed results according to its different sub-sectors, but in general, the sector is showing boarder-line medium-risk, with risk on the rise.

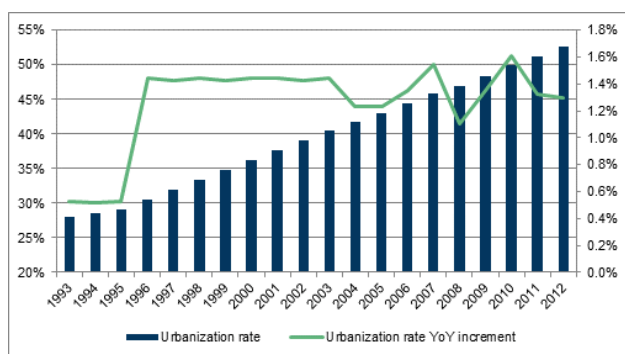
While domestic demand remained fairly healthy, mid-tier domestic appliances still experienced recessionary pressure in 2013 from their export markets, most notably in Europe and the US. These appliances could see pick-up in demand in

2014 as these regions are expected to see economic recovery.

OEMs that focus on assembly will continue to see continual pressure on rising wages and margin squeezes, while volume is expected to be healthy due to the healthy economic outlook in China and global recovery. Nonetheless, we have also experienced a rise in claims in the sub-sector, implying that the sector is seeing hiking liquidity risk.

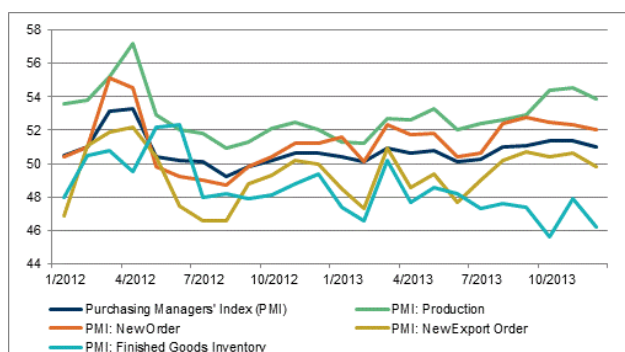
Part IV: Industry analysis

As of the end of 2012, urbanization rate has reached 52.6%, surpassing the 51.5% target set in the 12th Five-Year Plan, while urbanization continues to be a key focus of top policymakers. Investment has been and will continue to be the biggest growth driver in China in the medium-term, while steel and cement sectors have been big beneficiaries of the trend. With the government's plan to keep the urbanization process going, will these sectors continue to shine and glow? We will discuss in the following section.



Source: CEIC, Coface

For trends of these industries in the near-term (i.e. with a 6-month horizon), we use indicators including PMI as a general leading indicator for these sectors, which should be indicative of the overall sentiment and reflective of the momentum of the overall economy.



Source: CEIC, Coface

For the medium-term outlook (i.e. between 6 months and 2 years), we look at overall fundamentals of the industries. With pollution stood out as an alarming issue in 2013, it has become a key aspect of policy-direction going forward. Top-ranked government officials have vocally been pushing for an evolution of industry practices to reduce overall emissions, targeting at solving overcapacity situation while urging for tightening standards and facilities upgrades.

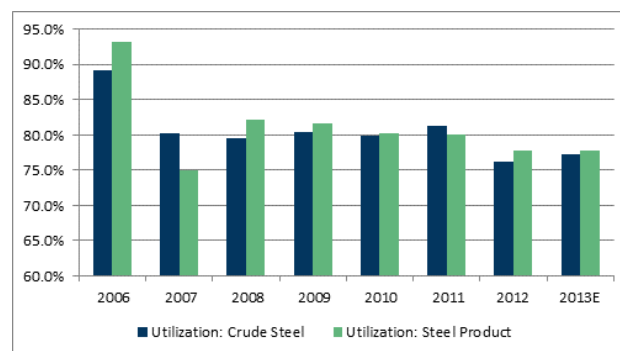
As a general trend for participants in these sectors, administrative costs and environment-related capital expenditure should generally take-off. The overall impact of each company varies, but smaller companies would be hurt relatively more severely and some would eventually be go out of business.

Nevertheless, with the strong policy tone, the trough of capacity utilization rate in these sectors could be behind us if the government is able to close down the outdated capacity while successfully keep new capacity buildups at low level, if that is allowed at all.

Steel industry

In 2013, we estimate China's crude steel production amounted to 772 million tons (mt), up 6% YoY. Traditionally speaking, production of China's steel industry has been positively correlated to GDP growth, and it has also been the case for 2013. Going forward, however, the trend should be less apparent as the industry will continue to see pressure coming from the government's effort to tackle the overcapacity issues, which will bring tremendous uncertainties to the industry. Although we are still expecting China's crude steel production to climb modestly to 800mt in 2014, most of the increase in production volume will come from larger steel mills, while smaller and less efficient industry participants would continue to see pressure on dimensions of pricing, policy measures, and cost.

As mentioned in our last report, the central government is being active and serious on tackling overcapacity issues in China. Steel sector was among the five sectors that were singled out for a strong near-term effort to see capacity-cut in State Council's proposal in October 2013.⁹ The proposal has suggested cutting steel production capacity by 80mt among six key production provinces, though details were still lacking. Following up on such proposal, we have seen unofficial reports stating that Hebei province, alone, will need to oust 60mt worth of production capacity by 2017, representing a-third of the province's existing capacity.¹⁰ Reportedly, in 2014, the province aims to cut down its production capacity by 15mt. If it was true, the plan most certainly sounds aggressive and will be helpful to ease the overcapacity situation.



Source: CEIC, Coface

Yet, it remains unclear whether local governments would be reluctant to compromise their government revenue and employment for the plan. According to an article on Hebei's government website that was published by the state-backed China Daily, the impact could be even bigger if we take into consideration the steel-related industries, and potentially "400,000 people would have to look for new jobs when the projects on which they are working shut down",

(9) Ministry of Industry and Information Technology (October 2013)

(10) [China Daily, The People's Government of Hebei Province \(December 2013\)](#)

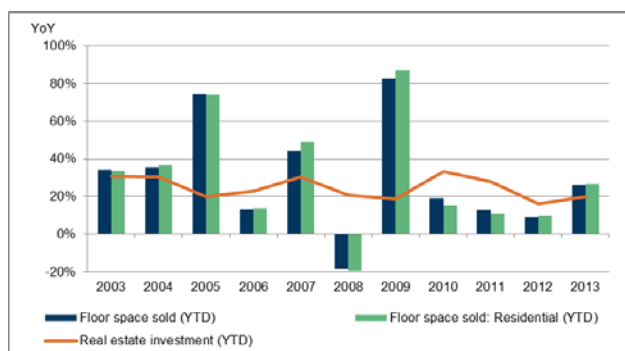
according to the article.¹¹

With such vast implication on employment, it is expected the central government will be coming up with an action plan to absorb part of the shocks brought by such reform. When we look at the period when reform was carried out by former Premier Zhu Rongzhi, unemployment has become a significant issue. As top policymakers have repeatedly identified job creation as one of the 3 key policy objectives for the country, the current regime would utilize its outstanding macro-management skills to avoid massive unemployment. One of the key areas is the government's strong push for alternative energy and other green industries, which could become the new driver of job opportunities.

Aside from the clouds over the overcapacity issue, demand outlook for the Chinese steel industry remains quite positive when we look at the outlook of real estate, infrastructure, automobile sectors, which are the most significant steel-consuming industries.

About 50% of the end-demand of steel products is related to real estate industries and infrastructure investment. As we have laid out in *Part II* of this report, we expect fixed asset investment (FAI) to stay at relatively strong level (i.e. 20.0% YoY in 2014 compared to 19.6% in 2013) due to the favorable environment provided by the government's push of urbanization. Moreover, the Chinese government has reportedly revised the investment on railway projects during the 12th Five-Year Plan (12thFYP) up by RMB500b, from RMB2.8t to RMB3.3t, in July 2013. Considering that prices of high-speed rail steel products have remained relatively flat, such development should lead to stable growth in railway construction for both 2014 and 2015.

At the same time, we expect property investment to grow 23.0% YoY in 2014, up from 19.8% YoY in 2013 - despite the presumably less favorable policy environment, including the banks' weaker lending appetite to real estate related projects - with more investment on affordable housing in the pipeline. Besides, with strong sales (i.e. +26.3% YoY) in 2013, property developers are also expected to reinvest in existing and new projects, providing support to the steel industry. Nevertheless, with softening increases in household income and wages, the consistent annual growth of floor-space sold could be peaking in the medium term (e.g. in 2-year time).



Source: CEIC, Coface

Machinery is the next end-demand for steel products, and momentum of such demand remains relatively stable. Particularly, while situation for the shipping sector - which traditionally takes up around 8% of steel demand - is improving, strong recovery is not anywhere in sight. From our discussion with a shipping analyst at a Chinese investment bank, we were told that companies in the sector are receiving new orders. However, order sizes are substantially lower than that in 2007/08 so growth contribution to steel demand should remain weak. As for automobile industry - which occupies about 9% of steel demand in China - we remain positive on its demand outlook. Particularly with the government's determination to reduce pollutant emission by vehicles, some supportive policy measures in the form of vehicle trade-in programs could be in place to support vehicle demand.

White goods segment, traditionally speaking, is also a big sector for steel industries as it demands roughly 8% of the total steel demand. After seeing a strong demand boost amid the government's favorable consumption-centered policies in 2010/2011, growth has normalized in the last two years. In 2013, refrigerator was the product that saw the highest growth in sales, while air-conditioners and washing machines have only seen high single-digit growth rates. As we do not expect the central government to launch any massive fiscal stimulus package in 2014, white goods demand growth should remain relatively stable at around 9%, close to the increase in income.

Risks

For steel mills, on the demand side, high FAI growth, moderate growth in the machinery and white goods segments will lead to stable demand growth in 2014. However, overcapacity issue will continue to underwhelm the sector and policy risks remain key to most of the industry players, particularly for smaller and inefficient steel mills.

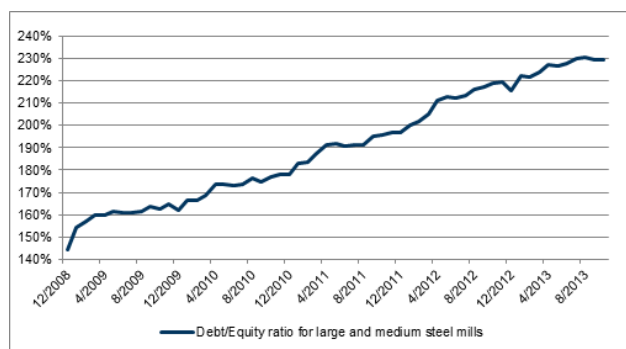
Large and medium steel mills are barely breaking even, and smaller steel mills - unless their products are not commoditized products - should see negative net profits due to its lack of economy of scale. To put it into context, for each ton of wire steel (*High 6.5, HPB235*) a large steel mill is producing, it is making RMB15.6 (equivalent to USD2.54)¹² worth of profit after cost in October 2013. Until overcapacity situation can be eased (e.g. utilization rate to climb to over 85%), the industry will continue to see tremendous price and cost pressure, and poor profitability of the sector should continue be expected. With the overall unfavorable policy-environment against the steel industry, some of the smaller and inefficient steel mills could be on its way out of businesses.

Moreover, the liability/equity ratio of the large and medium steel mills have been staying at around the peak level as of November. While there is no industry data compiled for the overall steel industry including the smaller steel mills, it is expected that the smaller industry participants should see higher liability/equity ratio. Such ratio shows that steel mills are now

(11) [China Daily, The People's Government of Hebei Province \(December 2013\)](#)

(12) $(\text{Average price} * \text{net profit margin}) / (\text{RMB-to-USD FX rate}) = (\text{RMB}3629 * 0.43\%) / 6.143$

operating under higher leverage. Industry-wide financing costs should be on the rise under normal situation, with such increase to accelerate under situation when liquidity is tight in the market. With profit margins staying at the current level and it is difficult to generate cash flow, we can also generalize that a rise of such ratio is showing that these companies are at a higher risk of insolvency and non-payment.



Source: CEIC, Coface estimates

For steel traders, traditionally, they profit from their expertise on the trends – demand, supply, costs, and prices. However, from our conversation with a couple of steel traders in Guangdong and Jiangsu provinces, we were told that the steel trading business in general is facing tremendous pressure.

On one hand, the traders have been hurt by the weaker than expected steel demand and prices in traditional peak season (e.g. September and October). On the other hand, with the transformation of information technology, steel mills are now selling directly to the end users, which negatively impacts the trading business by taking businesses away from these traders directly. Moreover, banks' lending appetite to steel traders remains weak and the tight liquidity situation in China is leading to higher financing costs. All these factors are detrimental to the steel traders in China.

Some traders would go into a specific segment of steel trading business, e.g. providing value-adding services on high-end products like stainless steel. Such practice would allow them to build an advantage against the peers in terms of expertise, and allow them to survive through the storm for the steel sector. Nonetheless, these traders do and will continue to see pressure and are operating on a thin-line of margin.

Coal industry

According to World Coal Association (WCA), as of 2012, China is by far the largest coal producer and importer.¹³ Not surprisingly, it is the core source of energy generation in the country, providing about 81% of energy generated in China in 2012, according to WCA. Yet, the coal demand outlook is clouded by a mixed basket of factors. Positive demand catalysts include aggregate power demand growth driven by economic growth and demand growth from higher steel and cement production. On the other hand, with the aggressive plans by the government to cut pollutant emissions – for instance, the State Council's

ban of new capacity buildup in sectors that are seeing overcapacity issues – lower coal usage should be expected.

Particularly, as the government is expected to be strict on implementing environmental-friendly policies, it will translate into slower demand growth. The decline in demand in cities and provinces around key and coastal regions (e.g. Beijing and Shanghai) would be more significant than the others. For instance, the aforementioned effort by the Hebei government's effort to dismantle 15mt steel production capacity in 2014 alone would translate into loss of 6.75mt potential coal demand.¹⁴ In addition, the other production capacity ousting would also contribute negatively to coal's demand outlook.

In the context of wide-ranged environmental-friendly policies, the rise of importance of alternative energies (e.g. wind and natural gas) in the overall power generation space would be a key downside risk for the coal miners. Nevertheless, industry analysts have shared with us that infrastructure for natural gas generation remains underdeveloped in most regions. While infrastructure can be built in the medium-term, the deadlock cannot be solved in the near-term and substitution effect between gas and coal generated power could be limited during this period.

In the short-to-medium term, under such environmental-friendly policy environment, there will be a diverging trend geographically among various regions. While overall demand of coal should still be growing modestly with the government's plan to enhance urbanization, demand growth in relatively more developed regions – most notably the coastal regions – will be relatively weak, as most of these regions have already gone through the rapid development phase. Moreover, the government is setting a priority to build power transmission networks, which will provide energy to these regions from inland for now. On the other hand, strong demand growth should come from mid-western regions, where the central government would launch widespread infrastructure projects. In short, much of the demand growth is driven from the urbanization in inland areas.

On the supply side, the coal industry is also seeing changing dynamics. Coal imports are posting supply shock to domestic miners. Particularly, imports from Australia and Indonesia are they key contributors of import. While Australian coal imports are competing against high grade coal, the low calorific value (CV) coal from Indonesia had been posting the competition to domestic coal miners, due to its relatively short transportation distance and the more-than-20% discount to domestic price of low-CV coal in 2013.

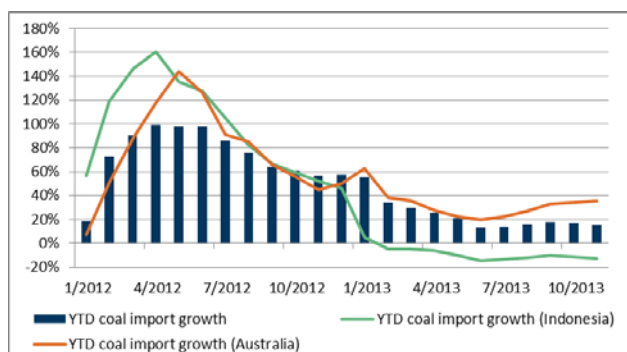
Good news for the domestic coal mines is that Indonesia government is becoming less supportive of the exports of the resources. As illustrated in the chart below, year-to-date coal imports from Indonesia is declining 12.9% YoY in 11M2013. Although coal imports remain as a small portion of the overall coal consumption in China – domestic production was

(13) [World Coal Association](#)

(14) Assuming that each ton of steel requires consumption of 0.45 ton of coal

3,650mt vs. imports of approximately 28mt in 2012 – the availability of lower-priced alternatives would hurt the pricing power of Chinese miners.

While imported coal from Indonesia is on a downtrend, imports from Australia remains at a high speed. Together with the government's effort to accelerate its investment on railway – which is expected to drive coal's rail-transportation capacity upward – the overall coal supply will be boosted.



Source: CEIC, Coface

Amid the challenging environment for the coal industry, on November 28, the State Council has issued a proposal targeting to stabilize the coal sector operations.¹⁵ Besides the usual rhetoric of encouraging sector consolidation, which is to be led by large SOEs, the State Council has also suggested ways to stop inefficient supply expansion. Particularly, the proposal has suggested to stop the approval of new projects with production capacity of less than 300,000 metric tons a year and to shut down coal mines where annual production is less than 90,000 tons. The document has also proposed to encourage imports of high-quality coal, while use and imports of high-ash and high sulfur-content coal to be prohibited. According to the document, a potential way to achieve the goal is to set differential tariffs based on differences in coal quality, while stricter administrative measures on imported coal products will also be on the way.

Although a deadline could be missing from the aforementioned document released in November, Mr. YANG Fu, Deputy Director of the State Coal Mine Safety Supervision Bureau, said in a different occasion that more than 2000 small-scaled (i.e. with annual production capacity less than 9mt) coal mines will be shut down by the end of 2015.¹⁶ While it remains unknown whether or not the end of 2015 is a definite deadline, smaller coal mines would be marginalized given the policy measures: they should also see more policy-uncertainties in their supply as the government is expected to be stricter on the mining compliance, both in terms of safety and environmental standards.

Risks

Risk of coal demand is on the downside, with magnitude of the capacity ousting and new environment standards in various industries still being put together. With no new capacity in the oversupplied industries while some existing capacities would be dismantled, demand growth would be limited and coal mines will need to rely on existing customers for growth.

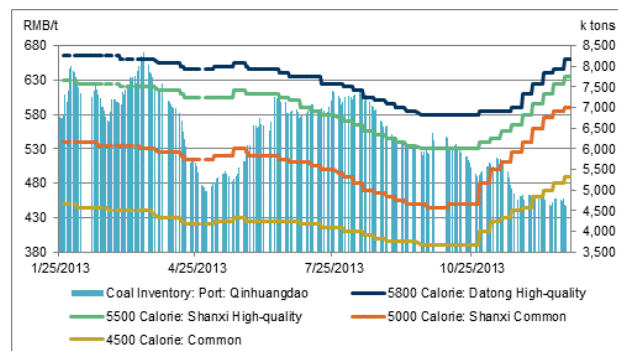
On the supply side, with the strong government tone to oust the small-scaled coal mines, it is believed that there will be stricter policies in place in 2014. Operations of the existing small-scaled sites will effectively be stopped by 2015, while some of them could be acquired by neighbor coal miners, which will reduce the negative impact on demand.

Structurally speaking, such closure of small-scaled sites would not heavily affect coal supply. Even if the State Council's proposal of phasing out 2000 small-scaled coal mines by 2015 is adopted and actions are carried out efficiently, it would at most only result in no more than 180mt annual reduction, which is around 5% of the total coal production in 2012.¹⁷

Moreover, coal imports will remain strong, despite the imports of low quality coals could be on a downtrend. As the government announced its intention to restrict imports of low-CV coal, it is expectedly receiving strong opposition from existing end-users. For instance, traditional steel mills and independent power providers use a blend of high-quality and low-quality coal in the production process, and the lack of imported low-CV coal would lead to higher costs.

Nevertheless, should the State Council be successful in putting together a tariff system that discourages low-quality coal imports, coal exporters in Indonesia should become the major victim, while additional imports could be coming from Australia.

As a whole, coal prices should remain relatively flat in 2014. The low inventory level at key Chinese ports was the main driver for the price spikes in late-2013. Albeit the price pick-up in domestic coal prices in late-2013, however, with the abundance of supply – both locally and internationally – and relatively flat in demand coming from the steel and cement sector, the strong momentum may not be sustainable and pricing of coal should be relatively flat in 2014 and beyond.



Source: CEIC, Coface

(15) [State Council \(November 2013\)](#)

(16) [China Mining Federation \(December 2013\)](#)

(17) Assumed all 2000 coal mines are operating at annual production of 90kt per year and none of them is acquired by existing coal mines

Part V: Conclusion

As a whole, Chinese leaders have laid out the most aggressive reform agenda in recent history, and execution of the agenda is being carried out by officials at various levels. After the plenary session, when top leaders sat down at the National Economic Work Conference, the policymakers have reaffirmed speeding up urbanization and managing local debt as two key aspects for 2014. With the Xi-Li regime, whose follow-up action is in-line with the government's rhetoric, success of the reform plan is highly anticipated.

While the successful reform effort would help the Chinese economy in the long-run, near-term turbulences - like the rising cost of fund as we have seen in December 2013 - brought to the economy cannot be neglected. With interest rate liberalization acting as one of the sprees of financial reform, interest rate volatility could be higher in 2014. With the many moving parts, the real sector and the financial market will become extremely vulnerable if any local government or major corporate default on their bond payment. The size and number of claims from our experience has alerted us that credit risk in China is on the rise, and businesses should manage their credit wisely.

From the macro perspective, while the double-digit high growth phase is behind us, the Chinese economy is still expected to growth beyond the 7% threshold in

2014 and 2015. In the medium-term, albeit the high hope of consumption taking over as the new growth driver of the Chinese economy, investment will stay as the main growth driver. Consumption will continue to grow, amid at a slower pace due to the slower income growth.

But 2014 will be a year showing divergence of macro and industry environments, as our sector barometer shows. Risks in certain sectors, particularly some subsectors under electronics and IT, are experiencing headwinds along the way. Policy risks presented in the Chinese economy is a common variable across the industries.

For the steel industry, high FAI growth, among the other factors, will lead to stable steel demand growth in 2014. However, overcapacity issue will continue to underwhelm the sector and policy risks remain key to most of the industry players. Some of the smaller and inefficient steel mills, as well as some steel traders, will be forced out of businesses.

Risk of coal demand is on the downside, with magnitude of the capacity ousting and new environment standards in various industries still being put together. With no new capacity in the oversupplied industries while some existing capacities would be dismantled, demand growth would be limited and coal mines will need to rely on existing customers for growth.