

## Economics Group

### Special Commentary

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# Should We Worry About Chinese SOEs?<sup>1</sup>

## Executive Summary

Leverage in the non-financial corporate (NFC) sector in China has risen sharply over the past decade. Concerns about the country's state-owned enterprises (SOEs) wax and wane, but angst has dissipated over the past year or so due to the stabilization in China's rate of economic growth. However, we think it would be premature to state that Chinese SOEs are "out of the woods." There already are signs that economic growth in China may be inching lower anew. Should capital outflows pick up sharply again, authorities may need to tighten liquidity in an effort to staunch the outflow. Leveraged SOEs could be vulnerable to a rise in interest rates, potentially leading to renewed market angst about their financial health and the outlook for the Chinese economy.

## Chinese Companies Have Levered Up in Recent Years

Financial market participants fixate at times on the financial condition of Chinese SOEs due to the adverse effects that these large companies could potentially have on the Chinese economy if they encounter financial difficulties. As shown in Figure 1, the debt-to-GDP ratio of the NFC sector in China has risen from less than 100 percent about a decade ago to more than 160 percent at present. Although the NFC sector in China includes millions of privately-owned companies, SOEs account for a significant proportion of NFC debt as we describe in more detail subsequently.

Figure 1

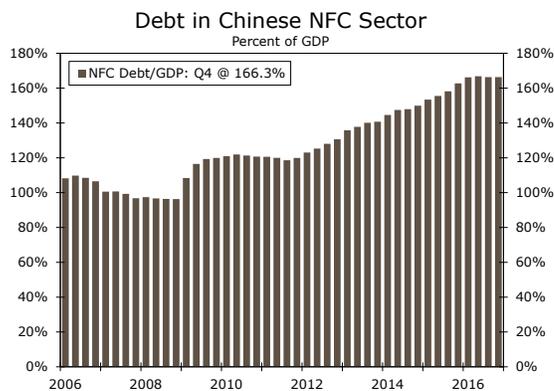
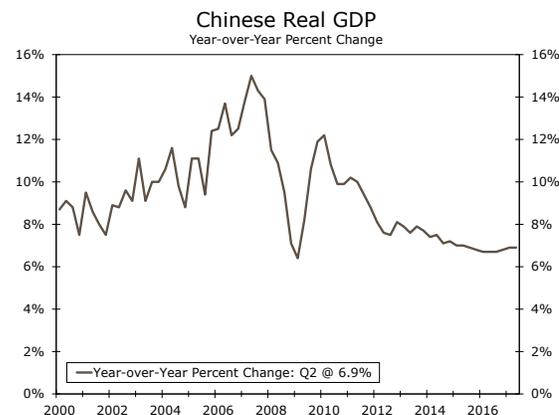


Figure 2



Source: Bank for International Settlements, Bloomberg LP and Wells Fargo Securities

The financial health of Chinese SOEs is more or less off the radar screen, at least for the time being, because Chinese authorities have managed to stabilize the rate of GDP growth in recent quarters (Figure 2). However, market concerns about the SOE sector have historically waxed and waned, and another bout of SOE-induced anxiety should not be categorically dismissed. Are SOEs

*Market angst about SOEs has waned, at least for the time being.*

<sup>1</sup> I am grateful to Anthony Leung (Wells Fargo Securities, Hong Kong) for helpful comments.



“out of the woods” or will another bout of concern rear its head? In this report, we discuss recent financial developments in the Chinese SOE sector to shed some light on their future viability.

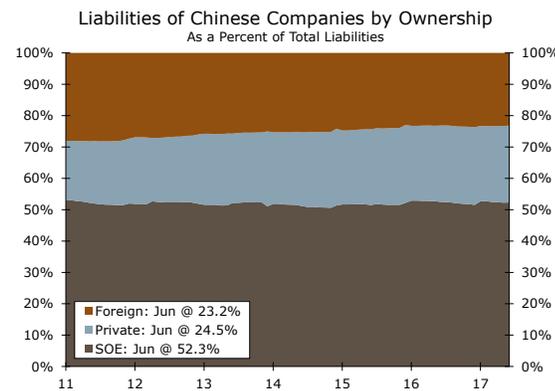
### High Levels of Debt in the Industrial SOE Sector

In the Chinese industrial sector there presently are about 21,000 state-holding enterprises and collectively-owned enterprises, which we use as our operational definition of SOEs.<sup>2</sup> Although SOEs represent only 7 percent of all industrial companies in China, they account for more than 50 percent of the liabilities in the overall industrial sector (Figure 3). How can industrial SOEs account for so much of the sector’s liabilities if they represent a relatively small proportion of the sector’s companies?<sup>3</sup>

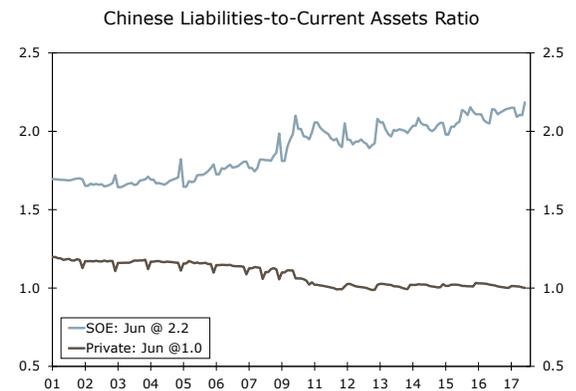
**SOEs tend to be more levered than their private sector counterparts.**

First, SOEs tend to be relatively large companies. At the end of Q2-2017 the average industrial SOE had CNY1.4 billion (about \$200 million) worth of liabilities. The comparable figure for a private sector industrial company was CNY230 million (roughly \$34 million). Second, SOEs tend to be more levered than their private sector counterparts. The ratio of liabilities-to-current assets among industrial sector SOEs has trended higher over the past decade and currently exceeds 2, more than twice as high as the ratio in the private sector (Figure 4).

**Figure 3**



**Figure 4**



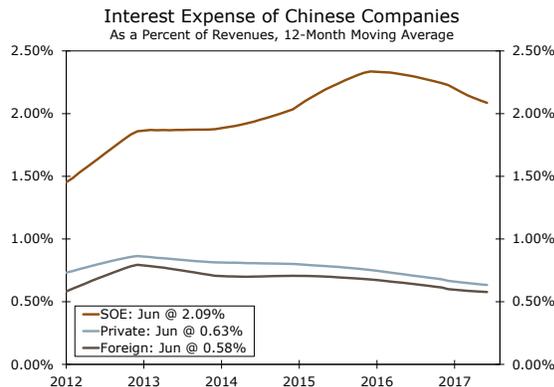
Source: CEIC and Wells Fargo Securities

The relatively high level of debt that SOEs carry means that they tend to have high interest expenses relative to their private sector counterparts. As a percent of revenues, interest expenses among industrial sector SOEs rose from 1.5 percent at the beginning of 2011 to more than 2 percent in 2015 (Figure 5). The ratio has receded recently, but it remains high relative to the level that prevailed at the beginning of the decade.

<sup>2</sup> State-holding enterprises include companies that are state owned and operated as well as companies that are simply owned by the state. Due to data limitations, we focus solely on SOEs in the industrial sector in this report. The industrial sector accounts for more than 40 percent of value-added in the Chinese economy.

<sup>3</sup> We take a top-down perspective to SOEs in this report. In reality, there are different types of SOEs depending upon ownership by government hierarchy. There are SOEs which are owned by the central government, by provincial governments and by municipal governments. It is our understanding that internationally-focused SOEs tend to be in better financial shape than the municipally-owned SOEs.

Figure 5



Source: CEIC and Wells Fargo Securities

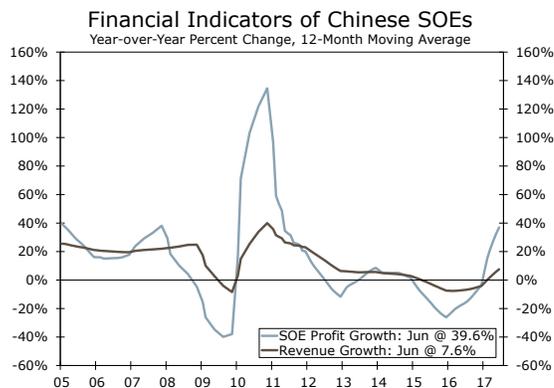
### What Happens Now That Growth Appears To Be Slowing Again?

As noted above, Chinese authorities have managed to stabilize the country’s real GDP growth rate over the past year or so. Financial market volatility spiked in August 2015, when authorities devalued the renminbi, and again in early 2016 when concerns about slowing Chinese economic growth ran rampant among financial market participants. To support economic growth, officials “encouraged” banks to relax credit conditions. Housing starts in China soon accelerated, real GDP growth stabilized, and financial market volatility subsided.

The economic stimulus has been an elixir for China’s industrial SOE sector. Revenue growth in the sector, which turned negative in 2015, is back in the black this year, and profits are up sharply on a year-over-year basis (Figure 6). However, authorities appear to have become alarmed at the sharp increase in home prices in some major cities, and they have eased up on the policy pedal in recent months. The new flow of total social financing, which includes bank loans, corporate bonds, equity issuance, trust loans and entrusted loans, has moved sideways recently (Figure 7).

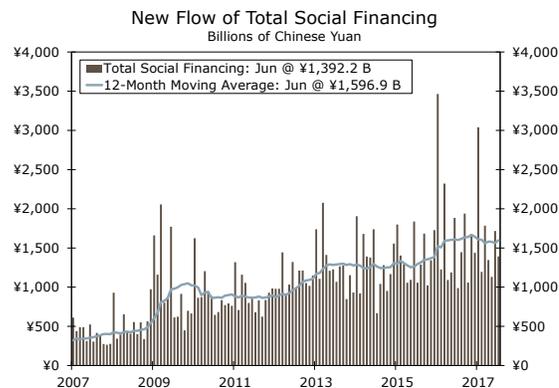
*Authorities have eased up on the policy pedal in recent months.*

Figure 6



Source: CEIC and Wells Fargo Securities

Figure 7



With growth in total social financing slowing, the year-over-year growth rate in housing starts is starting to roll over (Figure 8). Given that there appears to be some correlation between growth in housing starts and SOE profit growth, the slowdown in the former may be a possible harbinger of a slowdown in the latter. More broadly, any slowdown in the overall rate of growth in the Chinese economy should weigh on SOE profit growth. In that regard, there are already signs of slowing economic growth in China. The year-over-year rate of growth in industrial production slowed to 6.2 percent in the first two months of the third quarter from 6.9 percent in Q2. Investment

*Growth in housing starts is starting to slow.*

spending was growing in excess of 9 percent on a year-ago basis at the beginning of the year, but it has downshifted to less than 8 percent at present. Export growth should remain solid due to buoyant economic growth in many of China's trading partners, but likely not strong enough to prevent the modest slowdown in Chinese economic growth that we forecast.

Figure 8

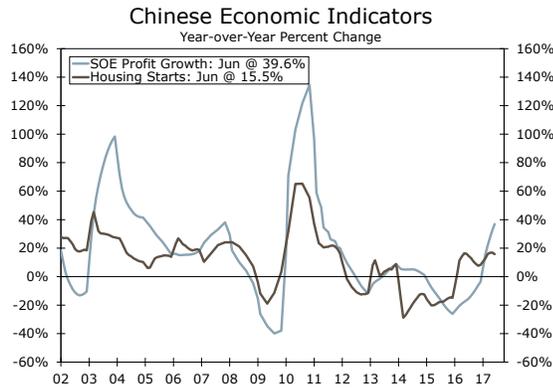
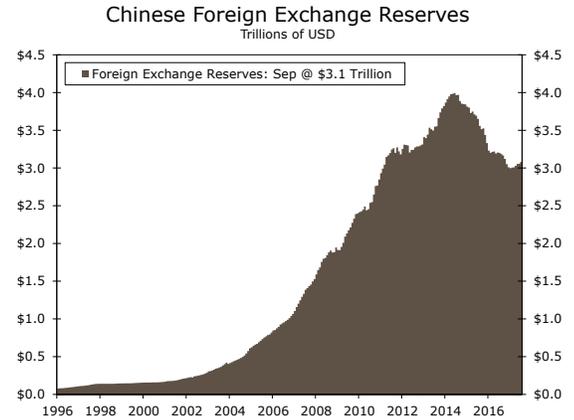


Figure 9



Source: CEIC, Bloomberg LP and Wells Fargo Securities

In our view, a sharp downshift in SOE growth prospects, and an attendant spike in financial market volatility, does not appear to be imminent. The Chinese stock market (as measured by the Shanghai Composite index) has risen to its highest level since its sharp selloff in early 2016. Spreads on Chinese corporate bonds over their sovereign counterparts have narrowed this year. If market participants were worried about the near-term financial health of industrial SOEs in China, we would think there would be more signs of financial stress at present.

***We think it would be premature to state that Chinese SOEs are "out of the woods."***

However, we also think it would also be premature to state that Chinese SOEs are "out of the woods." Although financial leverage in the overall NFC sector may have leveled off in the last few quarters, it remains at a high level (Figure 1). Thus, the NFC sector remains vulnerable to rising interest rates. In that regard, the country's foreign exchange (FX) reserves have stabilized around \$3.0 trillion in recent months (Figure 9), suggesting that the surge in capital outflows, which caused the sharp runoff in FX reserves over the past few years, have slowed markedly. But capital outflows could clearly accelerate again, which may induce authorities to tighten liquidity further in an effort to staunch the outflow. With leverage elevated, a rise in interest rates, should that occur, could put financial stress on SOEs. Another bout of market angst about Chinese SOEs could eventually rear its head.

### Conclusion

Leverage in the NFC sector in China has risen sharply over the past decade, and most SOEs appear to be more levered than their private sector counterparts. Market angst about the financial health of Chinese SOEs has waned this year due to the stabilization that has occurred in Chinese real GDP growth. However, authorities have eased up on the policy reins recently, and there are tentative signs that Chinese economic growth may be starting to inch lower. Revenue and profit growth of SOEs likely would follow.

We are not saying that another bout of financial market volatility emanating from China à la August 2015 and January 2016 is necessarily imminent, but the leveraged nature of Chinese SOEs leaves them vulnerable to slowing economic growth and/or rising interest rates. In our view, it would be premature to state that Chinese SOEs are "out of the woods."

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