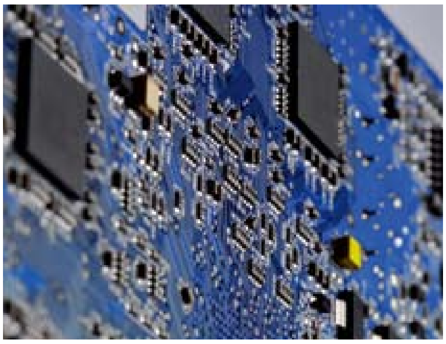
2012 Coface Corporate Credit Risk Study for China

Introduction



The ups and downs of the eurozone crisis and the sluggishness of US economy continue to affect China's exports during 2012. On the other hand, China's domestic market continues to rise. To adapt to the changing economic environment, many Chinese exporters are transforming their production models, aiming for better productivity and product quality in order to secure their export markets. Some are diverting resources to develop the domestic market.

This paper covers Coface's assessment of China's economic performance, a survey on payment performances of Chinese companies, and an analysis of high risk sectors. There is also advice on credit risk control.

Key points:

- China's economic growth will outperform the global economy in 2012
- Domestic consumption is an increasingly important component of China's economic growth in 2012
- More Chinese companies are aware of the importance of credit risk management and implement credit management procedures in their operations
- Most overdue debts of Chinese companies resulted from fierce competition and difficulties in finding financing resources
- Coface has categorised 48 sectors according to level of risk, with the following identified as high risk:
    - Construction Materials and Construction
    - Metals and Manufacture of Fabricated Metal Products
    - Furniture, Textiles, Clothing and Leather; Paper and Printing
    - Transport (Shipping) and Mechanical Engineering (Ship Building)
    - Solar Power and Wind Power
    - LED
- Close monitoring of existing trading counterparts and caution in offering credit terms to new buyers are essential in receivables protection
- Monitoring of industry performance is important in credit risk management, particularly for high risk sectors

China's Economy: Overview and Forecast

China's economic performance in 2011 (source: Statistics Bureau of China)

China's full-year GDP growth for 2011 was 9.2 percent. Growth in the fourth quarter slowed to 8.9 percent from Q1's 9.7 percent, Q2's 9.5 percent and Q3's 9.1 percent.

Significant figures for the year included:

- Total consumer goods retail sales in 2011 were 17.1 percent higher than in 2010. In December alone, the figure rose 18.1 percent year-on-year;
- Fixed assets investments jumped 23.8 percent from 2010 to 2011, with an increase of 27.9 percent in the real-estate sector;
- Industrial added value of major industrial companies grew by 13.9 percent; December saw an increase of 12.8 percent;
- The trade surplus decreased by US$26.4 billion from 2010; exports rose 20.3 percent to US$1,900 billion, while imports were US$1,740 billion, up 24.9 percent;
- By the end of December, M2, the broadest measure of money supply, rose 13.6 percent from the end of 2010; M1 was 29 trillion yuan, up 7.9 percent, compared with an increase of 21.2 percent from 2009 to the end of 2010;
- Chinese lenders extended 7.5 trillion yuan in new loans in 2011, down 390.1 billion from the previous year. Outstanding loans were 54.8 trillion yuan and the outstanding deposits stood at 80.9 trillion yuan;
- Per capita income of urban residents and farmers, deducting price factors, rose 8.4 percent and 11.4 percent, respectively;
- By the end of 2011, the number of urban residents in China exceeded that in rural areas for the first time, accounting for 51.27 percent of the total population; and
- Grain output in the year edged up by 4.5 percent, the eighth consecutive yearly growth.

The pace of growth in China eased in Q4 2011, which saw the slowest growth in two and a half years. This could be attributed to the impact of the eurozone crisis and measures adopted by China's government to combat inflation.

Through increasing interest rates and tightening investment, the government has been successful in preventing the economy from overheating and keeping inflation at a moderate level. As a result, GDP growth began to decelerate in the fourth quarter. At the end of 2011, US and European export demand plunged significantly. To avoid a “hard landing” in the economy, the government immediately eased capital lending. Nevertheless, the slowdown was in line with government plans for ensuring stable economic growth. Despite the drop in export demand, domestic demand remained strong in 2011.

Domestic consumption will be an important factor of Chinese economic growth in 2012.

China's economy faces many uncertainties in the external political and economic environment. For instance:

- Political changes have recently occurred or are imminent in major economies, notably with presidential elections in Russia (March), France (late April), and the US (November);
- The US presidential election will likely result in bearish sentiment affecting the US throughout much of this year;
- The eurozone crisis is still unresolved, though the eurozone economy is forecast to stop contracting by Q4 2012; and
- There is potential for emerging markets to fall in 2012. The World Bank downgraded economic forecasts for developing countries in its 2012 Global Economic Prospects, released in January 2012.

The gloomy external environment will continue hindering China's exports in 2012. Even so, the government is striving to continue restructuring the economy through a transformation to a business model based on advanced technology and focusing on developing domestic consumption.

Importantly, too, this is also a handover year for Chinese government's top leadership team. The government will strive to ensure a stable political transition. We therefore anticipate the government will retain its mix of "prudent monetary policy and proactive fiscal policy", while the central bank may further lower the requirements for bank reserve levels. GDP growth is expected to further decelerate in the first half of 2012; the contraction may halt during the second half of the year.

In conclusion, we maintain a moderately optimistic view of China's economy, as it is still one of the best performing countries worldwide. Despite a global economic slowdown, China can achieve a soft landing in 2012. Domestic consumption will play an important role as a key driver for sustaining China's GDP growth.

Coface Survey Results: China's Corporate Credit Management Practices in 2011

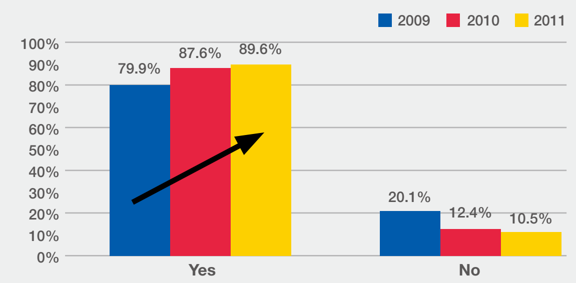
In order to better understand corporate credit risk in China and help businesses manage their domestic trade risk, Coface has conducted annual surveys of corporate credit management in China since 2003. Hence, the 2011 survey is Coface's 9th edition.

As credit sales increased, credit management procedures and risk mitigation concepts have been well implemented in business practices.

Credit sales* are becoming increasingly common in domestic trade. Around 89.6 percent of companies interviewed (Graph 1) confirmed that they offered credit sales in their domestic business in 2011; this figure was up from 88 percent in 2010 and 80 percent in 2009. These figures reflect intense competition forcing companies to offer more credit sales to sustain business growth. Also, there is improved business information transparency, leading to businesses being more confident to trade on credit terms.

** Credit sale: arrangement between a seller and a buyer, whereby goods are invoiced for and delivered prior to the effective payment of the debt (which is expected to be paid under agreed terms at a future date).*

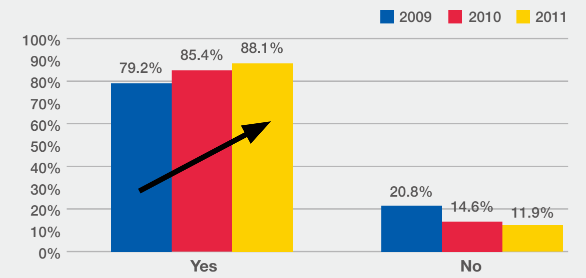
Companies offering credit sales in their domestic trade



Graph 1 Credit sales are increasingly common in domestic trade

As credit sales increase, credit management procedures have been well implemented in business practices. The survey reveals an upward trend in the percentage of companies interviewed that have implemented credit management procedures in the last three years, with the figure reaching 88.1 percent in 2011 (Graph 2). Clearly, the concept and importance of credit management has been recognised in China's business environment.

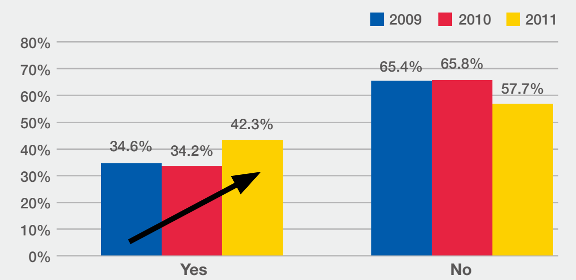
Credit management procedures in force



Graph 2 Upward trend in the percentage of companies interviewed that have implemented credit management procedures in the last three years

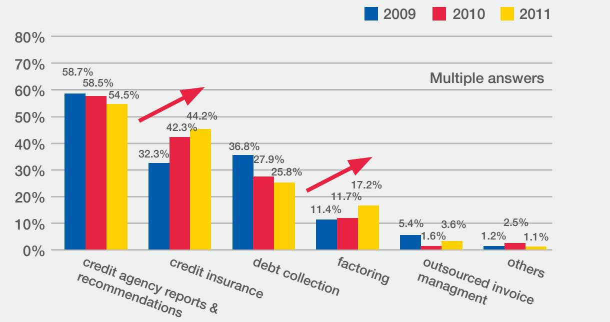
Use of credit management tools is increasing, with more companies adopting them as part of their risk mitigation strategy (Graph 3). More interviewees used credit insurance and factoring as their credit management tools in 2011 (Graph 4). As Chinese companies increasingly trade with credit, they have growing need for credit insurance to protect their receivables. In the environment of contractionary monetary policy, capital financing remains difficult for companies in China. As credit insurance and factoring can facilitate capital financing, more companies are using these tools among their financing solutions.

Use of credit managemnet tools



Graph 3 Increasing use of credit management tools

Populariity of credit management tools used



Graph 4 More companies are using credit insurance and factoring as their credit management tools

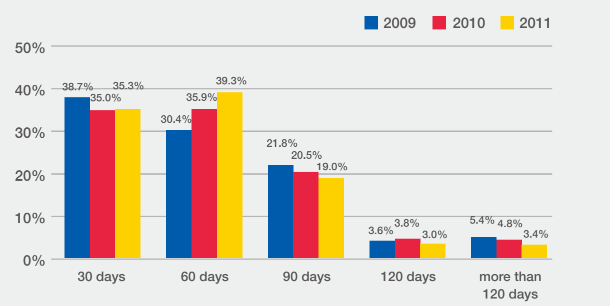
The situation of long term payments overdue has improved, returning to pre-crisis levels.

Despite the weak recovery of the global market, China achieved 9.2 percent GDP growth in 2011. As credit sales continued to play increasing roles in domestic transactions during 2011, the number of companies experiencing overdue payments* also increased. Nevertheless, companies are more aware of the importance of credit management, and are beginning to minimise their payment risks by reducing the credit terms offered.

The survey revealed that in the last three years, Chinese companies offered shorter credit terms: 74.6 percent of interviewees typically offered their buyers credit terms that were within 60 days. This figure was up from 69 percent in 2009 and 70 percent in 2010. Also in 2011, most companies interviewed could only accept maximum credit terms of up to 90 days (Graph 5). These results show that companies have improved their risk mitigation mindset and better understand their buyers' financial situations.

**Overdue payment: unpaid after due date indicated in the commercial contract.*

Average credit terms offered in domestic sales

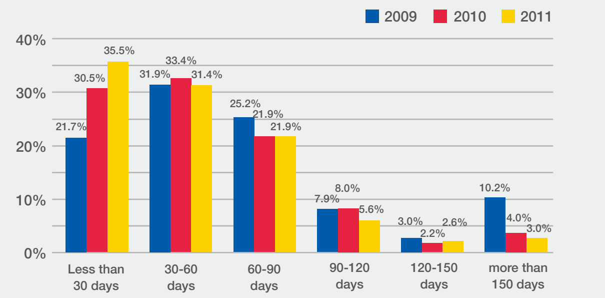


Graph 5 Upward trend in number of companies offering their downstream buyers credit terms of within 60 days in the last three years

The average number of days of overdue payments in domestic trade has been shortened. According to the survey, 67 percent of interviewees restricted their average overdue days of their receivables to within 60 days (Graph 6). Moreover, about 70 percent of interviewees reported that payments exceeding six months overdue were kept within 2 percent of their annual turnover (Graph 7). In fact, 43.5 percent of companies interviewed claimed that their receivables outstanding for over six months were below 0.5 percent of their annual turnover, which was better than the level before the crisis in 2008. According to Coface's experience, receivables overdue for over six months have a high possibility of turning into bad debt. The larger an overdue payment carried by a company, the higher the credit risk.

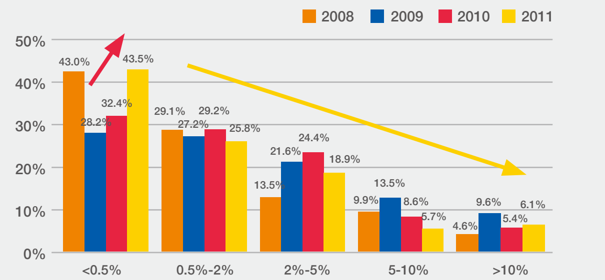
These results show an improvement in payment experience of Chinese companies, which in turn means their financial positions have become more secure.

Average overdue days of domestic sales



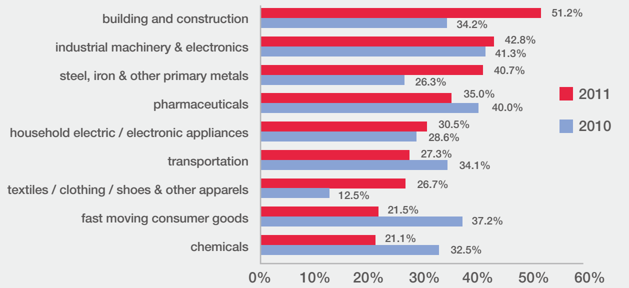
Graph 6 Downward trend in number of companies with average payment overdue days of more than 6 months

Companies with payments overdue over 6 months, grouped by percentages of domestic annual turnover



Graph 7 The numbers of companies reporting seriously overdue debts (over 6 months) representing over 0.5 percent of their annual turnover has decreased

Overdue payments averaging more than 60 days by sector

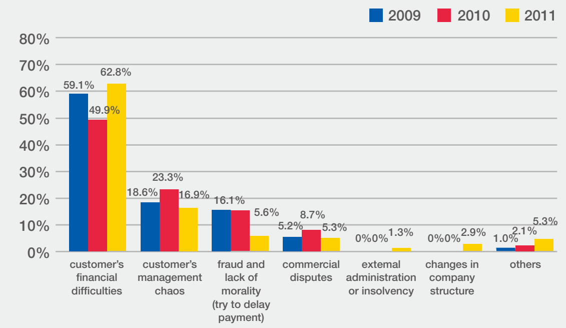


Graph 8 Better payment behaviour, with shorter overdue periods, in most sectors

Fierce competition and customer financial difficulties are the main reasons for payment defaults.

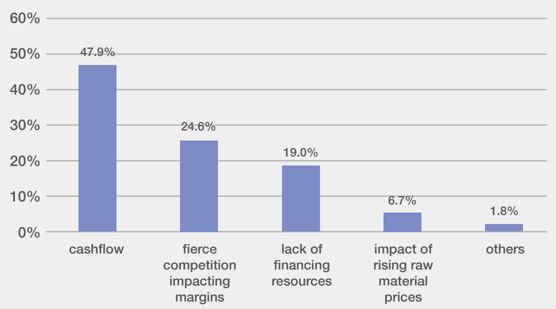
According to 62.8 percent of companies interviewed, payment defaults were largely due to the financial difficulties of downstream buyers, especially in 2011 (Graph 9). Defaults were triggered by poor cash flows of buyers, which faced fierce competition and were unable to find financing resources (Graph 10). In 2011, the capital market was tightened by the contractionary monetary policy and many companies had difficulty finding capital. Companies that could not solve their cashflow problems readily defaulted on payments to their suppliers.

Main reasons for payment defaults



Graph 9 Payment defaults in 2011 were mainly due to buyers' financial difficulties

Main reasons for buyer financial difficulties

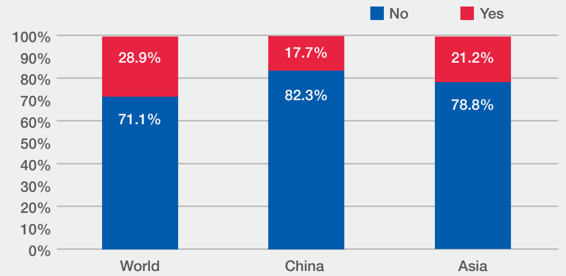


Graph 10 Payment defaults were triggered by poor cash flows of buyers, which faced fierce competition and were unable to find financing resources

All companies interviewed had a strong belief that the Chinese economy will outperform the world economy in 2012.

The majority of companies interviewed were optimistic regarding China's economy. More than 80 percent of companies interviewed believed that China will not go into recession in 2012, and about 70 percent thought a global recession is unlikely in 2012 (Graph 11).

Views on potential for economic recession in 2012

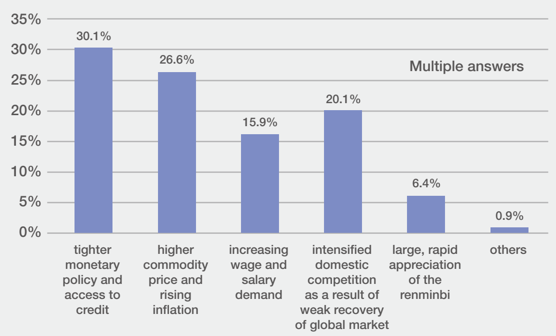


Graph 11 Companies expressed optimism regarding China's economy

Tighter monetary policy and access to credit are the main concerns for Chinese companies in 2012.

Owing to the slow recovery of global markets and rising pressure on inflation, it is believed that in 2012 the government will continue its measures for tightening monetary policy and access to credit. According to the survey, 30.1 percent of companies interviewed reported that tight monetary policy and bank credit are their chief business concerns in 2012. This figure is followed by 26.6 percent of companies listing higher commodity prices and rising inflation, and 20.1 percent listing intensified domestic competition as their main challenges in 2012 (Graph 12).

Key concerns for the coming year



Graph 12 Tighter monetary policy and access to credit are the main concerns for Chinese companies in 2012

2012 Sector Analysis

Coface sector risk map

We have categorised 48 sectors in the sector risk map. Different colours indicate the level of risk.

Low Risk

- Agriculture & Fishing
- Agro Food Industry (Tobacco)
- Petroleum & Hydrocarbons
- Pharmaceutical Industry & Perfumery
- Chemical Industry (Power Operation & Basic Chemicals)
- Mineral Products (Diamonds)
- Metal (Precious-Metals)
- Electric Consumer Goods & Telecomm (Apple products)
- Telecommunication Services (Network Providers)

Medium Risk

- Cattle
- Meat
- Agro Food Industry
- Alcoholic Beverages
- Wood
- Glass & Ceramics
- Electric Domestic Appliances
- Mineral Pproducts
- Metal
- Chemical Industry
- Transformation of Plastic and Rubber
- Media and Entertainment
- Packing
- Motors Vehicles and Motorcycles
- Other Vehicles
- Transport (Air Transport) & Freight Transport by Road and Railway
- Measure and Precision Intruments
- Electric Consumer Goods and Telecomm (Non Apple Products)
- Computer and IT Software/ Hardware
- Non-specialized Trade
- Community Services
- Services to Enterprises (Except Financial)
- Private and Households' Services
- Miscellaneous
- Financial Risk

High Risk

- Construction Materials
- Construction
- Manufacture of Fabricated Metal Products (Iron & Steel)
- Metals (Metal Manufacturing)
- Furniture
- Textiles
- Clothing
- Leather
- Paper
- Printing
- Transport (Shipping)
- Mechanical Engineering (Ship Building)
- Chemical Industry (Solar Power & Wind Power)
- Measure and Precision Instrument (LED)

Analysis of high risk sectors

Construction Materials and Construction

Performance of this sector is largely linked to the development trends in the main downstream sectors, which include property development, infrastructure construction and construction of factories and plants. The property market is expected to experience a sharp decline during 2012, given that the government has given no sign of loosening restrictions on the housing market. There has been a slowdown in infrastructure construction, triggered by a major train crash and cancellation of local government financing vehicles. The slowdown is projected to continue in 2012. This would leave increased investment in constructing factories and plants as the only hope for the construction sector in 2012. However, the sluggish PMI index that was recently released suggests that the unfavourable investment climate will persist in the near-term. In 2011, the growth rate of China's fixed-asset investment was down 0.7 percent, at 24.5 percent.

Given these considerations: Coface expects the growth of fixed-asset investment will slow to around 18 percent in 2012.

Manufacture of Fabricated Metal Products (Iron & Steel) and Metals (Metal Manufacturing)

Downstream sectors of Iron & Steel are construction (housing, infrastructure, and industrial buildings), and automobile, home appliance and consumer electronics producers. As explained in the analysis of the construction sector, it is expected that demand from construction will weaken in 2012. In addition, after three years of "golden growth", China's auto market is expected to experience a slowdown in growth during 2012. Withdrawal of favourable policies for home appliance producers could eventually impact end-user demand. Moreover, inflation will also restrain consumer demand for new electronics products.

The price of steel dropped from Q2 until the end of 2011, as demand weakened. Yet costs arising from high prices of iron ore and coking coal could not been transferred to downstream markets.

Coface's views on Iron & Steel and Metal manufacturing sectors:

- *More small steel mills will close down. Medium sized and large steel makers may report either net losses or sharp declines in profits in 2012 H1;*
- *Steel makers can only hope for the recovery of the housing market though it is quite unlikely; and*
- *Risks in manufacturing or sale of high-end steel products will be generally lower than risks facing manufacturers of low-end steel products.*

Furniture, Textiles, Clothing and Leather

These sectors are dominated by export-oriented, labour-intensive companies. They face challenges including weak demand from the EU and the US, appreciation of the Yuan, volatility of raw materials prices, increasing labour costs and the credit crunch driven by tightening momentary policy. Hence, there may be difficulties for SMEs in these sectors.

Coface's views on these sectors:

- *Companies with their own brands will outperform OEM or ODM manufacturers in the domestic market;*
- *Suppliers of well-known domestic or global brands will face lower risks; and*
- *Companies whose products are designed or produced for pregnant women and babies and have market recognition will benefit in 2012.*

Paper and Printing

Shrinking global demand has resulted in over-capacity issues for both these sectors. In addition, costs for environmental protection will rise in 2012, as paper and printing industries create heavy pollution and problems with deforestation. Moreover, both sectors rely on bank loans to build factories and production lines. Should they experience reduced profits or losses, these companies will be exposed to high risks of insolvency.

Coface's view:

- *Companies making high-end products or delivering special services will be better safeguarded from risks in 2012.*

Transport (Shipping) and Mechanical Engineering (Ship Building)

Global shipping faces a turbulent year as a result of a combination of falling freight rates, ship oversupply and tighter bank lending. This creates difficulties for all shipping companies worldwide. In the shipping industry, we are focusing on three business lines: dry bulk cargo shipping, container line shipping and oil/LPG tanker shipping.

For dry bulk cargo shipping, overall global consumption demand was sluggish in 2011, due to the major slowdown in economic growth in the US and eurozone, triggered by the debt crisis. This slowdown eventually impacted upstream sectors, through falling demand for raw materials (iron ore and coking coal, two major commodities in the world economy). In addition, the slowdown in infrastructure investment and the property market in China further triggered a sharp drop in demand for steel and other metals, leading to reduced shipping of iron ore and coking coal from overseas. Eventually, the Baltic Dry Index dropped to the level of the 2008 crisis. This series of factors has made dry bulk cargo shipping more challenging in 2012.

For container line shipping, the first half of 2011 was a good period as there was stable demand in international trade. As the euro debt crisis continued deteriorating, demand sharply decreased in the second half of 2011. China is a major exporter, and exports have fallen since the second half of 2011 – impacting container line shipping.

Overall performance of oil/LPG tanker shipping is stable, as demand for oil and LPG has been maintained. However, demand could be affected if the price of oil increases to over US$100 per gallon.

Ship building is the upstream sector of shipping. Given the extremely challenging downstream sectors, ship builders are also expected to face difficult times.

Coface's views on these sectors:

- *Large scale state-owned companies in shipping and ship building can survive in 2012;*
- *Domestic shipping will be better-placed than international shipping, while builders of domestic transport and multifunctional ships are expected to outperform other ship builders; and*
- *The Baltic Dry Index (BDI) and China export growth rate are the two key indicators that require continuous monitoring for these sectors.*

Solar Power and Wind Power

This sector faces several challenges, including over-capacity and over-production. It is now growing slowly in Europe, as a result of the debt crisis and European countries cutting industry subsidies. In China, the sector contributes only a small proportion of energy consumption, as solar and wind power are still expensive for Chinese consumers, and there is no nationwide subsidy policy. Plus, the government has become concerned about severe pollution arising from manufacture of solar cells, solar panels and other equipment, leading to some manufacturers being closed or having production restricted.

Coface's views on the sector:

- *Solar industry is high risk; and*
- *Regarding wind power, risks range from high to low for the following segments: manufacturers of wind turbines, wind power equipment makers, construction and design of wind farms, and wind farms.*

LED

This sector also faces challenges. With a lack of core technologies for producing raw materials for LED bulbs in China, raw materials costs are high. There is over-capacity in both production and assembly volume. Because of high retail prices, there is low acceptance in the household market. Growth is led by individual projects, and buyers in China are mainly municipal or 2nd-5th tier local governments.

Coface's view:

- *Conservative regarding underwriting new exposure.*

Advice on Credit Risk Control

Improve your knowledge of downstream sectors

It is important to have strong knowledge of your downstream sectors – including all downstream layers, distribution channels, different groups of end-buyers and their customers.

Closely monitor your current trading counterparts

Sellers can purchase credit reports or collect information from other suppliers in the industry, to understand the buyer's shareholders, operation, finance, management changes, any new production lines, funding situation and trading record with other suppliers. Obtaining first-hand information (such as financial information) through various channels is essential for understanding buyers' actual situations.

Restrict credit terms to within 60 days

To minimise credit risk, we recommend that credit terms offered to buyers should be restricted to 60 days – and no more than 90 days.

Be cautious in trading with new buyers

It is essential to establish a credit record for each buyer, by setting credit sales periods and restrictions according to the company size, industry recognition, shareholders' backgrounds and financial status. Be cautious in trading with new buyers, especially buyers that are recently established. Trade in cash at least 3-6 months before starting to offer credit terms to new buyers. It is always advisable to ensure trades are kept within approved credit amounts. Orders in excess of credit amounts should not be delivered unless payments are settled in cash or through other secured payments.

Avoid trading with high risk sectors

Try to avoid credit transactions with high-risk industries, or opt to trade with sub-sector companies of high-risk industries. Pay close attention to changing situations in high-risk industries.

Strengthen accounts receivable collection, ensuring it is prompt

As part of the performance evaluation of sales persons, set targets of days receivables or days for sales outstanding. Regular reminders should be sent for due payments. For overdue receivables, sales staff should actively follow up and provide feedback the finance department on reasons they are overdue. Reduce or stop shipments of goods to customers with payments overdue that are substantial and/or long overdue. If a buyer refuse to pay or a substantial amount is overdue, it is better to assign a professional lawyer or receivables management company to collect the debt.

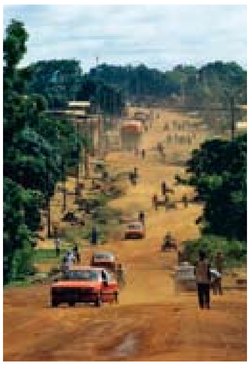
Introduce risk mitigation tools to protect your receivables

Purchase credit risk protection tools such as credit insurance, factoring and credit reports to minimise losses through non-payment. Provide credit management training for sales persons and related staff, to build a credit management culture in the business operation.

Collect up-to-date information on government policies and economic trends

Always pay attention to government news and economic policies, in order to implement timely preventive mechanisms as major changes occur. Understanding the trends in your buyers' industries could help you to make timely adjustments to your credit strategy, and so minimise risks of bad debts.

All analysis updated as of Feb 2012.



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About Coface

The Coface Group, a worldwide leader in credit insurance, offers companies around the globe solutions to protect them against the risk of financial default of their clients, both on the domestic market and for export. In 2011, the Group posted a consolidated turnover of €1.6 billion. 4,600 staff in 66 countries provide a local service worldwide. Each quarter, Coface publishes its assessments of country risk for 157 countries, based on its unique knowledge of companies' payment behaviour and on the expertise of its 250 underwriters.

In France, Coface manages export public guarantees on behalf of the French state.

Coface is a subsidiary of Natixis whose Core Tier 1 ratio is 10.2% end December 2011.

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