

Hong Kong, 09 August 2016

China's two-speed economy: Sector winners and losers

China's economy grew by 6.9% in 2015, the slowest expansion pace in 25 years. Growth should continue to slow in 2016 and 2017, and will probably undershoot the government's average annual growth target of 6.5% - as set out in the 13th five-year plan for 2016-2020. China's ongoing structural reforms have shifted to a greater focus on services and consumption, making the country's two-speed economy even more evident. The divide between winning and losing sectors is linked to their medium and longer term growth potential, relevant government policies and structural demand.

Sectors with growth potential

In general, sector winners likely to enjoy brighter longer term growth outlooks, such as pharmaceuticals and retail, have been assigned with low or medium risk assessments. The **Information communication technologies (ICT)** segment is an exception to this, being a sector winner assigned with a high risk rating. This would indicate that the credit risks of Chinese corporates in the ICT sector are probably high due to keener regional competition, despite the market's strong longer-term growth potential (see Table 1).

The **pharmaceutical** sector remains the brightest spot and is showing steady profit margins. Besides a clear improvement in corporate payment experience in 2015, pharmaceutical enterprises are less dependent on borrowing for their operations and fixed asset investment expansions. The medium term outlook is positive, with a structural increase in demand backed by the continuing rise of the middle classes and the ageing population.

Sector losers with high credit risks




Sector losers that are likely to face longer term growth challenges, such as **chemicals** and **metals**, are assigned with either high, or very high risk ratings. From the perspective of credit risks, Chinese corporates within these sector losers are assigned with high, or very high, risk ratings - indicating a higher probability of defaults and insolvencies, due to challenging business conditions. Neutral sectors, which are those not directly benefiting from the government's structural reforms (such as **agrofood**, **paper-wood** and **textile-clothing**), have been assessed as either medium or high risk.

Among the 12 sectors, **construction** and **metals** are the only two assessed as very high risk. The risks for these two sectors are linked to recent hot topics, such as debt problems amid a surge in non-performing loans, a number of corporate bond defaults, industrial overcapacities and zombie companies. With sluggish private investment and slowing SOE investment, within a backdrop of low profitability, growth in construction and installation is likely to cool in the second half of the year. This will cast a shadow over the construction sector and reduce the demand for construction materials - in particular cement and metals, which have already been suffering from overcapacities. These risks could be somewhat addressed by reforms of state-

owned enterprises (SOEs), where measures concerning “Closure”, “Reorganisation” and “Public-private-partnerships (PPP)” are likely to be implemented. Despite some signs of deleveraging and government reforms, credit risks for construction enterprises (including construction material manufacturers) appear to be intensifying, with a negative outlook.

‘It is expected that the Chinese government will continue to introduce favourable policy initiatives concerning supply side reforms. These will have a greater focus on boosting potential growth for tertiary industries and supporting added-value manufacturing activities in the medium and longer term. However, against the backdrop of ongoing structural and SOE reforms, the Chinese economy is set to continue its slowdown in 2016 and 2017, with an overall increase in credit risks for Chinese enterprises’ said *Jackit Wong, Asia-Pacific economist of Coface.*

Table 1: China’s sector winners and losers vs. Coface’s sector risk assessments

Winners		Losers		Neutral	
Automotive		Chemical		Agrofood	
ICT*		Construction		Paper-wood	
Pharmaceuticals		Energy (Coal)		Textile-clothing	
Retail		Metals			
Transportation					

Source: Coface (Last update: Jul 12, 2016)

 Low risk

 Medium risk

* Information and communications technologies

 High risk

 Very high risk

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