Credit Research Initiative
Risk Management Institute, National University of Singapore
transforming big data into smart data
Weekly Credit Brief
Jul 16 - Jul 22 2019

Stable credit outlook supports China healthcare firms to transform and expand

by Luo Weixiao

Health expenditure in China as share of GDP has stood at 6.39% in 2018 and is expected to rise during the "13th Five-Year Plan" period. The increasing spending and robust growth are boosted by aging population with more disposable income and policy support as well.

China has reported lowest new-borns since 1961 in 2018 and a substantially increasing life expectancy even higher than some high income countries. As estimated, the population aged above 65 will exceed 240mn by 2030, accounting for 17.1% of China's total population and a quarter of global aged population. Since aged generation generally has higher health spending than the overall average level, a higher health expenditure and a larger healthcare market is foreseeable. As proposed in Plan of Health China 2030, healthcare market is expected to reach RMB 8,000bn by 2020 and RMB 16,000bn by 2030.

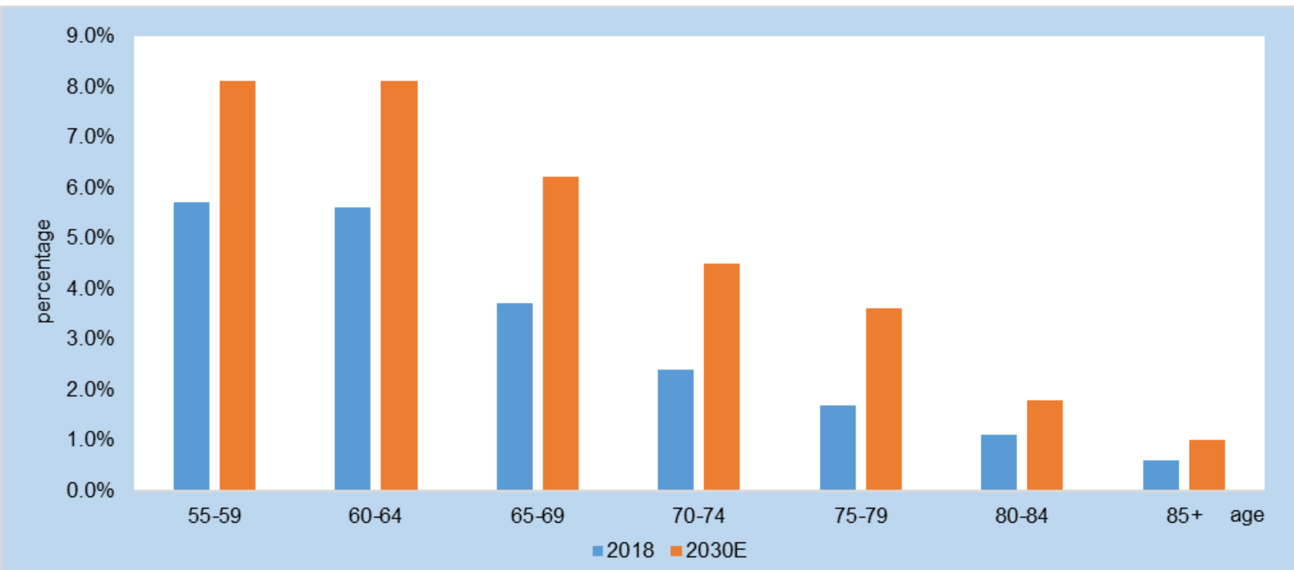


Figure 1. Percentage of China's aging population in 2018 and 2030(estimated). *Source: Public Institutions and Digital Government Department of Economic and Social Affairs*

China healthcare companies report lower credit risk on average compared to other industries in the country. As shown in Figure 2, the RMI-CRI Aggregate (Median) 1-year Probability of Default (Agg PD) for China healthcare industry has been steadily lower than the overall economy. The gap between China healthcare industry and global healthcare industry has been narrowing as well since mid-2016. Though Agg PD for China healthcare has been increasing after reached historical low at 4.6bps in 2018 – first time to reach at the same level as global healthcare sector after 2014, it still stays at a safe zone now at 17.7bps and a rating of A- if translated into letter ratings by taking reference from the historical observed default rates of Standard & Poor's (S&P) rating categories.

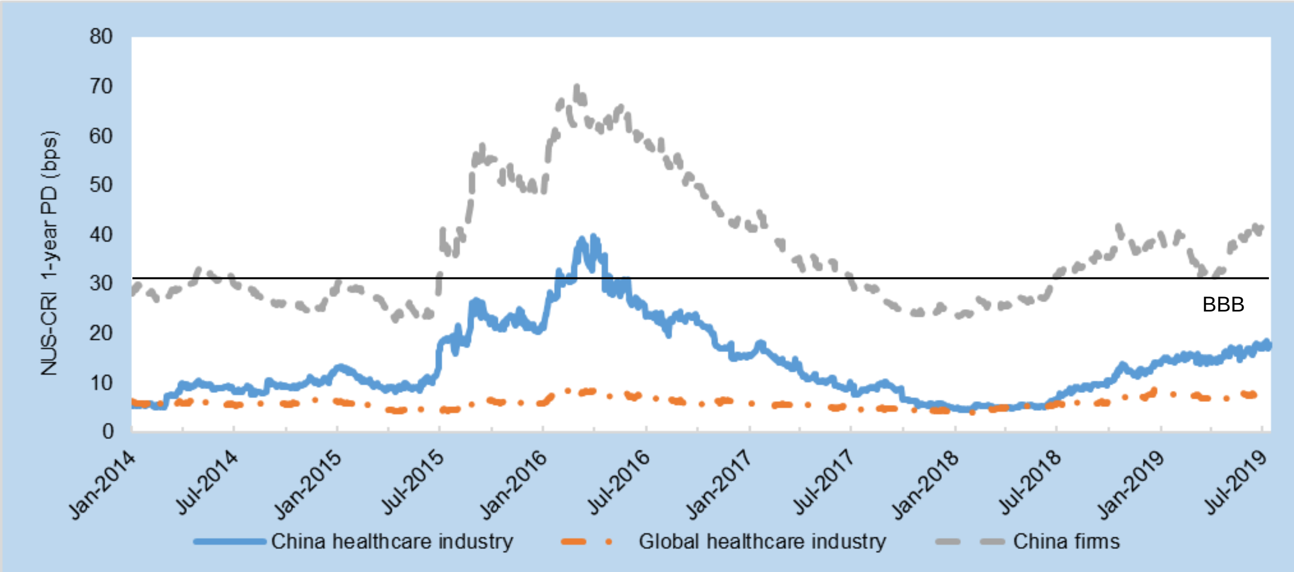
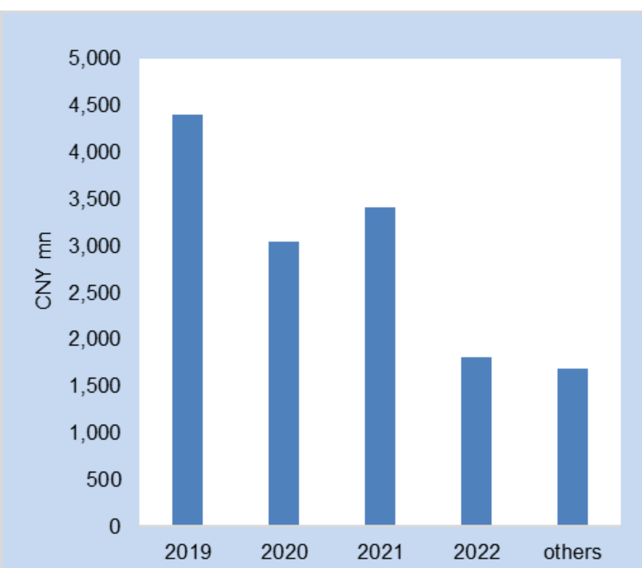


Figure 2. NUS-CRI Aggregate 1-year PDs for China healthcare industry, global healthcare industry and China firms. *Source: RMI-CRI*

As shown in Table 1 Healthcare firms in China have relatively healthy balance sheets despite decreasing profitability. Median leverage ratio for the industry stood at 16.21% in FY 2018 and the low leverage leaves room for healthcare companies to build up debts and expand further to meet the growing demand. However, profit margin is falling despite rising revenue. High R&D cost and lower pricing power have pressured companies' bottom line, but haven't imposed a threat to firms' creditworthiness. As shown in Figure 2a, the entire industry has CNY 4,405mn of debts maturing in 2019, half of which are issued by Sinopharm Group, the largest pharmaceutical distributor in China with 15% market share in 2018. It is also backed by the government - its parent company is China National Pharmaceutical Group Corp, which is one of the 98 state-owned enterprises directly under State-owned Assets Supervision & Administration Commission of State Council.

	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Revenue (CNY mn)	240.41	206.08	290.42	386.31	429.86
Profit Margin (%)	10.49	9.95	11.89	9.42	5.68
Total Debts to Total Capital (%)	13.23	16.91	9.33	10.94	16.21
EBITDA to Interest Expense (X)	8.56	4.94	7.93	9.52	7.69

Table 1: Financial analysis for China healthcare industry. *Source: Bloomberg.*



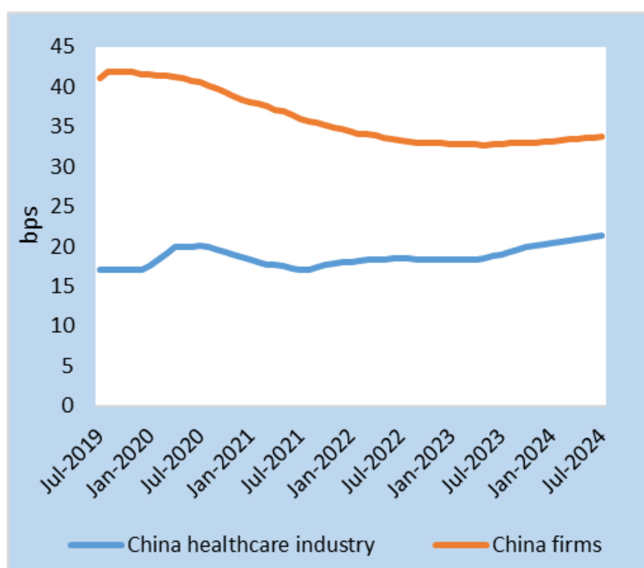


Figure 2a&2b: debt distribution of China healthcare industry; NUS-CRI Forward 1-year PD term structure for China healthcare industry and all China-domiciled firms based on information on July 2019.

In the meanwhile, China long ago set ambitious goal to provide "safe, effective, convenient and affordable" healthcare to all residents and some far-reaching reforms will be implemented to achieve the goal. On the demand side, as China's healthcare market continues to mature and citizens are more willing to pay for healthcare product and service, high-end medical treatments and technology innovation are expected to rise rapidly from their low bases. Some technology giants have started to combine high technology with healthcare industry, such as 3D printing, cloud computing and AI. For example, billion-dollar startup WeDoctor, backed by Tencent, is building AI to analyse data, helping detect ailments like cervical cancer. The transformation may need more capital investment, but will provide higher efficiency and stronger demand in the long run. NUS-CRI Forward 1-year PD (Forward PD) term structure for China healthcare industry indicates its positive credit outlook. Forward PD for China healthcare industry stabilizes around 15-20bps, consistently lower than all China-domiciled firms.

Credit News

China's USD 40tn banking system learns a lesson on risk

Jul 22. Two months after China shocked investors with the seizure of Baoshang Bank Co. on May 24, market confidence in the nation's smaller lenders is still waning. When the government took control, they upended the long-held assumption that it would always provide banks with a 100% backstop. The result has led to a repricing of risk for all but the largest Chinese lenders. While the upheaval has underscored the fragility of some smaller banks and added to short-term headwinds buffeting the economy, it may help to put China's USD 40tn banking system on a more sustainable path by separating between the strong and weak lenders. Before the takeover, funding costs for small and mid-sized Chinese banks were remarkably similar to blue-chips. The rationale behind this would be that the authorities would always make sure that even the smallest banks fulfilled their obligations to its creditors. However, a government backstop is no longer a guarantee. In the interbank funding market, some strong banks began rejecting collateral from all but the most creditworthy companies. Repurchase volume tumbled by 43% in a week, according to JP Morgan Chase & Co. For Baoshang, about 99.98% of the bank's corporate creditors received full principal and interest payments. However, creditors are still wary. The yield gap between low- and top-rated NCDs, a key measure of the market's wariness toward smaller Chinese banks, is still more than four times wider than it was before the Baoshang seizure. (Bloomberg)

Distressed debt traders have tons of cash and nothing to buy

Jul 19. Distressed debt investors – those betting on companies struggling to pay their debt or already in bankruptcy – are facing pressure and difficulties looking for opportunities for their USD 80bn cash reserves. With central banks globally adopting easing policy, corporations have taken on ever larger amounts of debt while weaker borrowers are protected by low interest rates. The supply of US distressed debt has dropped about 30% since mid-January and corporate bankruptcy filings have fallen about 23% since February. The supply of distressed debt may also be curtailed by the rise of "covenant lite" lending agreements, which give creditors fewer ways to trigger bankruptcy or other restructurings for struggling companies. The economy is expected to turn eventually, however, and the supply of distressed debt will rise. There are incipient signs of stress at US companies and the economy: EBITDA of companies fell in the first quarter and as of July 2019, more than 80% of S&P companies had cut their forecasts. (Bloomberg)

Market-based pricing disappearing on blue-chip US loans

Jul 19. Market-based pricing is disappearing in US investment-grade lending as Credit Default Swaps (CDS) become a less relevant measurement of risk, and lenders feel less of a need to buy protection against the loans as top companies continue to perform in a stable economy. The practice was introduced after the 2008 financial crisis when several blue-chip companies drew down on revolving credit facilities, shocking banks that had charged minimal interest margins on the assumption that the loans would remain undrawn. The practice linked loan pricing to real-time risk using bond and CDS trading levels rather than credit ratings. CDS are usually bought by banks and other investors as protection against a company's risk of negative credit events. Years of stable markets have led to a reduced interest of banks buying protection. CDS contracts fell significantly from USD 61.2tn at the end of 2007 to USD 9.4tn 10 years later, according to the Bank for International Settlements. (Reuters)

Yield hunters lured by junk bonds even as defaults pick up

Jul 17. Investors are rushing to buy high-yield bonds in Europe at a time when the number of issuers defaulting has reached its highest level since 2010. According to analysts at JPMorgan Chase & Co., while the 12-month notional-weighted default rate could rise to 2% by year-end compared with 0.6% in 2018, high-yield funds have attracted inflows totalling USD 3bn. Easy monetary policy conditions have pushed bond investors into riskier assets that yield enough to match their liabilities. Despite the hunger for yield, investors remain evasive of the riskiest high-yield bonds. (Bloomberg)

China boosts local government bond issuance to $104 billion in June to spur economy

Jul 16. China's local governments are on a path that has sharply accelerated bond issuance to ramp up infrastructure spending to support economic growth that slowed to a 27-year low. As the US-China trade war drags on, Beijing is hoping that a recovery in infrastructure investment could help to stabilize the economy. However, the economy has been slow to respond to earlier growth boosting measures, raising questions over whether more support is needed and if that is worth a sharper build-up in debt. Net local government bond issuance rose to RMB 717bn (USD 104.31bn) in June, which is the highest so far this year, and it accounts for a third of the first half's total. Over 60% of the funds raised from bonds in the first six months went to infrastructure projects. Recent economic data has also shown China's economic growth slowed to 6.2% in the second quarter, the weakest pace since 1992, from 6.4% in the first quarter as demand at home and abroad faltered in the face of trade tensions with the US. Premier Li Keqiang mentioned that China's economy was facing new downward pressure and the government would respond with more fiscal policy measures. Tax cuts worth nearly RMB 2tn and a quota of RMB 2.15tn for local governments to sell special bonds this year to fund key infrastructure projects have been announced. Fiscal spending increased 10.7% in the first six months from a year earlier, while revenue rose 3.4%. (Reuters)

Junk-bond fund draws USD 622mn as negative yields go global (Bloomberg)

Yield-starved investors snap up debt from obscure Italian bank (FT)

Indian lender DHFL courts foreign investment to stay afloat (FT)

Regulatory Updates

White House and Congress reach deal on US debt ceiling

Jul 23. The White House has struck a two-year deal with Congress to raise the US' USD 22tn borrowing limit, removing the threat of a US debt default and significantly raising federal spending. US Treasury secretary Steven Mnuchin warned this month that the US government was at risk of a debt default, triggering a rush to strike a compromise as such a debt default would be a risk for the US and global economies. However, while the rise in debt ceiling may successfully address the looming threat of sequestration – automatic cuts to federal spending passed under Barrack Obama's presidency in 2011 – it raised concerns about a lack of fiscal discipline in the US economy. For decades, US lawmakers have routinely raised the borrowing limit without much debate regarding the need for the government to meet payments it has already signed off on. (FT)

China expands access to financial markets with 11-point plan

Jul 21. China will expand the role of foreign credit rating agencies and brokerages in the bond market in order to free up markets in financial services. The 11-point liberalization plan allows S&P to rate all bonds traded on local securities markets while foreign brokerages will also be allowed to serve as lead underwriters for bond offerings in the interbank market. These reforms are the latest measures to open up markets as China, as the U.S have yet to resume trade talks despite agreeing last month to restart negotiations. The reforms also pave the way for foreign institutions to participate more in the country's asset management, pension management and currency brokerage sectors. (Nikkei Asian Review)

RBI Chief says India's interest-rate stance now depends on data (Bloomberg)

Indonesia pledges more rate cuts as it moves to spur growth (Bloomberg)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Yao Xuan