If Chinese Corporate Debt Growth Doesn't Slow, It Could Cost Banks US$1.7 trillion

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MELBOURNE (S&P Global Ratings) Oct. 11, 2016--Unabated growth of China's corporate debt could cost the country's banks dearly. S&P Global Ratings estimates that if the growth doesn't slow, the ratio of problem credit to total credit facing China's banks could triple to 17% by 2020. The banks may then need to raise fresh capital of up to RMB11.3 trillion (US$1.7 trillion), which is equivalent to 16% of China's 2015 nominal GDP. That's according to "Is China's Debt Growth Sustainable?" and "High Leverage, Slack Demand Are Curtailing Recovery For China's Top Companies," two reports published today by S&P Global Ratings.

We believe that the current growth rate of China's debt is not sustainable for long. "Our base-case expectation is that the momentum of corporate debt growth, in particular, will persist for another two years," said Terry Chan, a credit analyst at S&P Global Ratings. It should then ease as the Chinese economy further rebalances from being investment- and heavy industry-led toward one more reliant on consumption and services.

"Admittedly, such growth would worsen corporate debt leverage, which may lead to a higher level of problem loans," added Christopher Lee, a credit analyst at S&P Global Ratings. In the base case, we project the problem credit ratio could double to 10% by 2020 from our 2015 estimate of 5.6%. (Problem credit here is defined as nonperforming credit plus special mention loans).

"We expect leverage for China's top companies to increase further by the end of 2016, and see limited prospect for improvement in 2017," said Christopher Lee. "We estimate the median debt-to-EBITDA ratio for our sample to increase to 5.0x-5.5x, from about 4.8x at the end of 2015."

The annual study of the top 200 companies in China shows that the leverage of state-owned enterprises (SOEs) continued to increase as sluggish demand and weak pricing more than offset a reduction in costs and capital expenditure. SOEs comprise about 70% of the sample companies and 90% of their total debt. The survey covers the leading companies or largest borrowers in 19 major industry sectors in the country.

"We believe China's banks and financial system can withstand higher nonperformers. However, in the downside scenario where the current growth rate continues unabated over the next five years, the likely rise in nonperforming debt could place greater strain on the financial sector, possibly leading to some bank recapitalization," explained Qiang Liao, a credit analyst at S&P Global Ratings.

Since the global financial crisis, the debt-to-GDP ratio for China has grown by a third, based on International Monetary Fund estimates. The debt ratio for local governments (inclusive of local government financing enterprises (LGFE) has grown by two-thirds; that for households by nearly half; and corporates (inclusive of state-owned enterprises and quasi-public sector entities) by nearly a third. Meanwhile, the ratio for the central government has declined by nearly a third. In absolute terms, the corporate sector has consistently been the largest sector, representing 57% of total debt at end-2015.

The growth in corporate debt has been with the tacit approval of the central government, given the dominance of the state-owned commercial banks in the financial system. While different sources report varying credit-to-GDP ratios, all data show a significant upward trend in debt.

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