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Chinese healthcare in focus: favorable demographics and system reforms assist the restoration of credit health

by Wang Chenye

- **NUS-CRI Agg PD for Chinese healthcare firms improves with robust demand expectations as the government's anti-graft crackdown wanes**
- **NUS-CRI Forward PD for the sub-sectors shows that both Biotech & Pharma and medical equipment & devices firms' credit outlook next year will stabilize within investment grade**

The Chinese healthcare sector is showing signs of improvement, amidst increasing indications that the severity of the government's anti-graft crackdown is diminishing. As seen from Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for the Chinese healthcare sector improved significantly in Q4-2023, dropping below BBB upper bound when referred to PDiR2.0 bounds[1], possibly due to the positive effects of China's crackdown on corruption in its health system from Jul-2023 starting to offset the negative impacts for the public firms. The interquartile spread indicates that the improvement in the sector median is primarily attributed to a noticeable positive shift in the performance of the vulnerable companies in the sample, potentially due to industry consolidation and exits of a few bad performers. In addition, as seen from Figure 1b, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) suggests that despite the current macro conditions where uncertainties are building, the credit health of the healthcare sector might be restoring faster than expected, with the outlook for 2024 improving significantly in Dec-2023 as compared to Jan-2023.

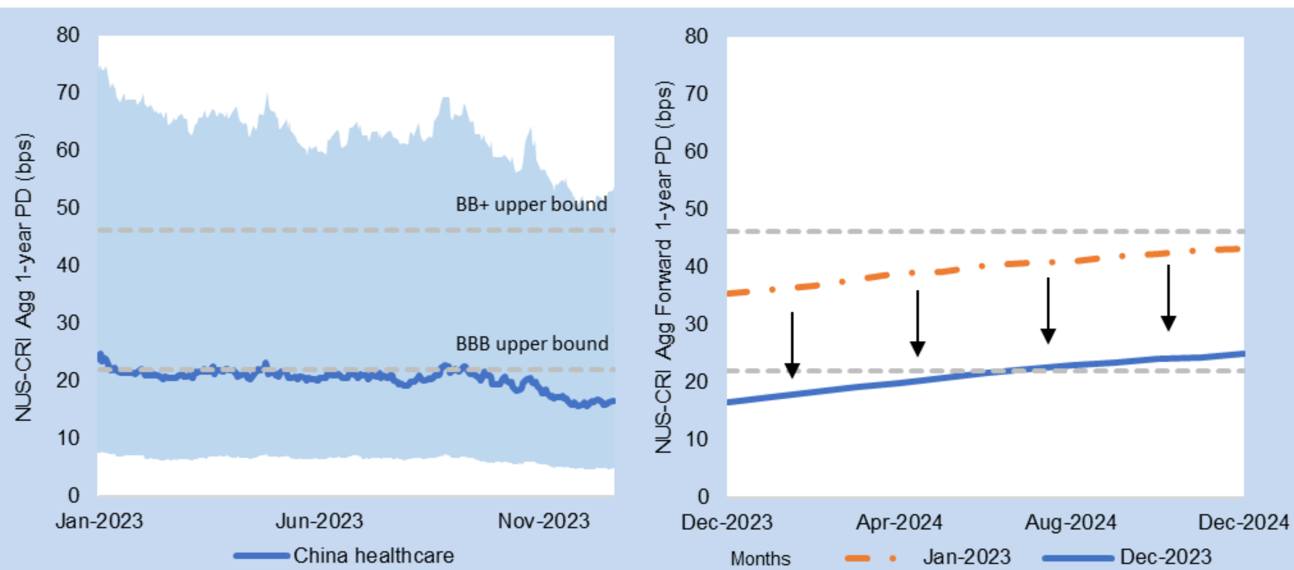

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD and interquartile spread for Chinese healthcare firms, with reference to PDiR2.0 bounds. Figure 1b (LHS): NUS-CRI Agg (median) Forward 1-year PD for Chinese healthcare firms as of Jan 03, 2023, and Dec 19, 2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Although the Chinese government's anti-graft policy once threatened to hurt the healthcare firms' revenue generation, the policy supports the long-term growth, stability, and health of the whole system. As the crackdown wanes and the industry consolidation enhances the competitiveness of the survivors, an aging population, and a growing middle class buoy the prospects of the healthcare sector. With the declining birthrate in China, the issue of an aging population has emerged as a persistent and significant concern for the country's economic

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

development. However, this demographic shift may present an unexpected opportunity for the healthcare sector. Seniors, who generally possess lower spending power compared to actively employed individuals, often rely on pension payouts, with a considerable portion of their wealth tied up in the real estate market where housing prices are in decline. Consequently, the elderly demographic is showing a decreased inclination towards investing in tangible manufactured goods and is shifting their focus towards services, particularly in the realm of medical and healthcare services. This transition in consumer behavior among seniors could prove advantageous for the healthcare sector in catering to the evolving needs of an aging population. As discussed in our previous report on Chinese manufacturers, sluggish domestic demand poses a major concern for their credit outlook, a concern that is comparatively less pressing for the healthcare sector.

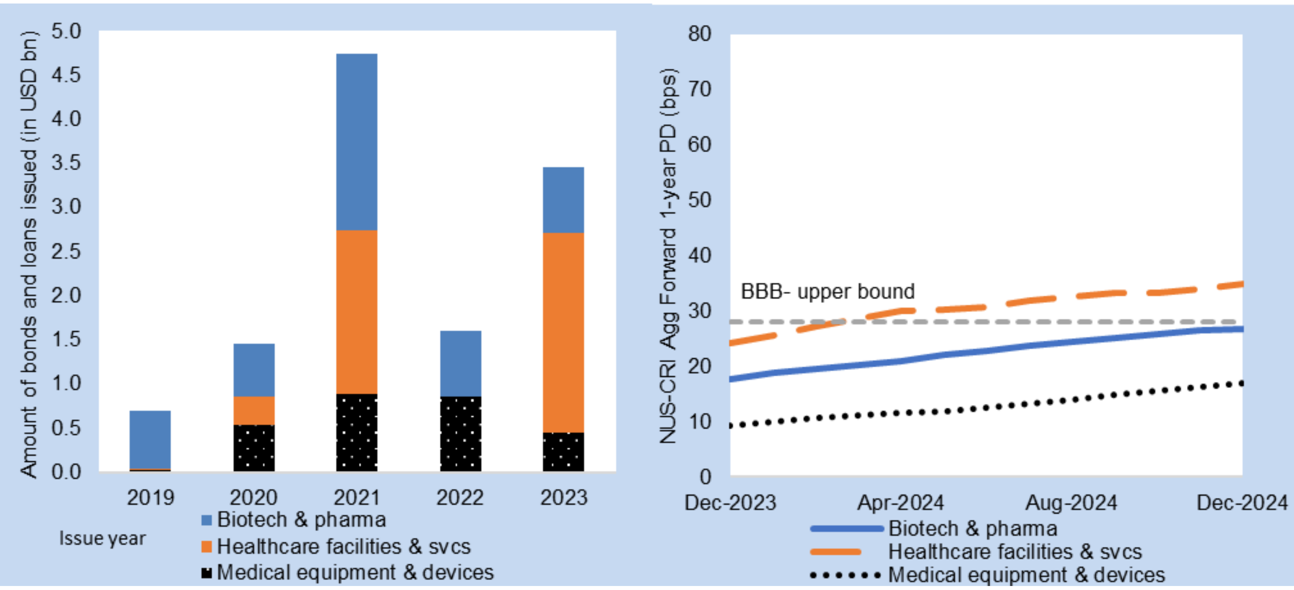

Figure 2a (LHS): Amount of bonds and loans issued by biotech & pharma, health care facilities & services, and medical equipment & devices sub-sectors; Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for biotech & pharma, health care facilities & services and medical equipment & devices sub-sectors as of Dec 2023, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

The Chinese healthcare sector, particularly the biotech and pharma industries, had been perceived as overinvested before the pandemic. As illustrated in Figure 2a, debt issuances exhibited robust growth from 2019, reaching a peak in 2021. The substantial inflow of funds from both credit and equity[3] markets facilitated the rapid expansion of the biotech and pharma industries, contributing to the development of upstream and downstream firms and, consequently, the overall sector's growth. However, biotech and pharma firms faced challenges in 2022, experiencing a contraction in debt financing compared to the previous year. Simultaneously, a series of lockdowns in 2022 impeded the operations of healthcare facilities and services companies, particularly those specializing in product distribution and medical services, which resulted in a slowdown in financing activities. Conversely, the medical equipment and devices industry, potentially benefiting from domestic protective policies, managed to sustain credit growth amid the challenges faced by other segments of the healthcare sector. The Chinese healthcare sector is gradually back on the right track and restores its credit health in 2023 with ongoing industry consolidation and policy-driven system reforms. The healthcare facilities & services industries show the intention of expansion by issuing the most debt over the past 5 years, possibly also contributing to the highest level of the forward PD over 2024 among the three segments, as shown in Figure 2b. Both biotech & pharma and medical equipment & devices firms' credit outlook over the next year will stabilize within investment grade when referred to PDiR2.0 bounds with relatively stable capital structure, as the government shows support for medical innovations.

The healthcare sector, in contrast to consumption-focused sectors, typically demonstrates greater resilience during economic downturns, owing to a relatively certain demand driven by demographic factors. Historically, China's pension system heavily leaned on the basic state pension and voluntary employee pension plan. However, as the aging population poses challenges to the sustainability of this system, there has been a heightened emphasis on individual retirement accounts (IRAs) since 2022. The flexibility of IRAs has the potential to invigorate commercial healthcare industries, injecting vitality into the healthcare products and services market. Relatively stable demand expectations and favorable policies bring tailwinds to the credit outlook of the Chinese healthcare sector, as shown in Figure 1b.

[3] The Shanghai Stock Exchange Science and Technology Innovation Board focused on the equity market was established in Jul-2019, which facilitated the biotech & pharma IPO.

Credit News

US bonds are on the best run since March

Dec 23. Treasuries have seen their fourth consecutive week of gains, marking their best performance since March, fueled by growing investor confidence that the Federal Reserve may start reducing interest rates next quarter. This sentiment strengthened on Friday, despite a shortened trading day, following a report indicating a minimal rise in the Fed's preferred inflation measure for November. This supports the belief that the Fed has effectively curbed inflation and might adopt a more aggressive easing policy in 2024. Consequently, there has been a surge in Treasury investments, with Citigroup Inc. noting an extreme level of such positioning. (Bloomberg)

China's 30-year yield hits lowest since '05 on deposit rate cuts

Dec 22. Chinese government bonds have experienced a significant upturn, with long-term yields reaching their lowest levels in nearly 20 years. This surge is attributed to major banks cutting deposit rates, prompting a shift in investments towards bonds. Notably, 30-year sovereign bond yields have dropped to 2.84%, a potential record low since 2005. This trend was catalyzed by confirmed reports of large state-owned banks reducing yields on deposit products. The reduced deposit rates lower the cost of funding for banks, making bond investments more attractive. Additionally, investors are increasingly considering bonds due to economic uncertainties and expectations of the People's Bank of China easing its monetary policy in response to potential Federal Reserve rate cuts. (Bloomberg)

Emerging market debt wall looks scalable as investors warm to risk

Dec 22. Developing countries, recently strained by high interest rates and defaults, are approaching a significant rise in debt maturities with optimism. Emerging market Eurobond repayments are expected to jump to USD 78.4bn in 2024, a sharp increase from USD 43.6bn in 2023. Despite the daunting figure, investors remain hopeful, buoyed by the U.S. Federal Reserve's easing monetary policies, which could boost investment in riskier assets like emerging market debts. Some countries, like Gulf nations and Turkey, are well-positioned to manage their debts, thanks to robust oil revenues and improved economic policies. The reduced bond issuance in 2023 also hints at potential borrowing opportunities in the upcoming year. (Reuters)

Small US banks are increasingly at risk in commercial-property slump

Dec 21. A recent study indicates a growing risk for many U.S. banks due to falling commercial property values. Around 14% of commercial real estate loans, notably 44% of those for office buildings, are now worth less than the debt they carry. This "negative equity" raises the likelihood of defaults, potentially affecting hundreds of smaller regional banks. With U.S. banks holding USD 2.7tn in such debts, and property values down by 22% since early 2022, the risks are heightened. The report estimates that a 10% default rate could lead to USD 80bn in bank losses, doubling to USD 160bn if defaults reach 20%. (Bloomberg)

Japan strives to control debt in face of rising rates

Dec 22. Japan's finance minister has pledged to control escalating debt as the country plans to depart from over two decades of ultra-loose monetary policy. Facing the challenge of the world's highest national debt among industrialized countries, Japan anticipates higher borrowing costs in its latest budget. The government projects a rise in interest rates to 1.9% from 1.1%, marking the first increase in 17 years. The budget for the upcoming fiscal year is set at JPY 112.07tn (USD 787bn), slightly lower than the current year but still high due to military and welfare expenses. This situation reflects Japan's relaxed fiscal approach, a result of prolonged low interest rates and extensive fiscal stimulus. (Reuters)

Russia's economy has a surprising problem: a property bubble (WSJ)

US 'buy now, pay later' splurges raise holiday debt hangover risk (Reuters)

Discount London office deals show more pain coming for lenders (Bloomberg)

Regulatory Updates

US Fed pivot dominates as global rate hike cycle stutters in December

Dec 22. In December, a significant shift occurred in global monetary policy, particularly with the U.S. Federal Reserve. This period saw most major developed central banks, including the European Central Bank, Britain, Japan, Australia, Canada, and Switzerland, maintaining their interest rates, with only Norway opting for a minor hike. The U.S. Federal Reserve's unexpectedly dovish stance, suggesting a potential for earlier and faster interest rate reductions, surprised the markets. However, this approach wasn't mirrored by European and other global policy makers, leading to a disconnect between market expectations and the actual timing of policy changes, especially in interest rate adjustments. (Reuters)

Bank of England losses on QE greater than other central banks, says ex-rate setter

Dec 22. The Bank of England (BoE) is expected to incur larger losses from its quantitative easing program compared to other central banks, as highlighted by former committee member Michael Saunders. This is mainly due to the BoE's strategy of buying longer-dated bonds since the 2008-09 crisis, which became riskier when interest rates rose in 2021 to combat inflation. The program's cost is now estimated at GBP 126bn, significantly higher than initial forecasts. Saunders recommends revising the scheme, where the Treasury currently covers these losses, to protect the BoE's independence and prevent potential fiscal challenges for Chancellor Jeremy Hunt. The BoE's asset purchases totaled GBP 895bn, primarily in fixed-rate gilts with 15 to 20-year maturities. (FT)

Bank Indonesia keeps benchmark rate unchanged (WSJ)

Turkey hikes interest rates again and announces new tightening measures (Bloomberg)

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