Chinese apparel firms experience a deteriorating credit profile due to recent challenges

by Benjamin Lau

The apparel industry in China was traditionally one of the nation's most robust and accomplished industries, where China still remained as the top exporter of clothing in the world in 2018 according to the World Trade Organization. Despite global competitiveness, Chinese apparel companies were able to get the edge over their international peers due to its constant brand innovation and industrial upgrading. However, being a labour-intensive business in a saturated market, these Chinese apparel firms face obstacles in remaining the king of the hill. In this report, we will analyse both internal and external factors which affect the creditworthiness of the Chinese apparel industry.

One of the main features of China's apparel industry is its substantial export-driven nature, which makes it especially susceptible to emerging competitors, policy concerns, and global macro events from other nations and regions. In Figure 1 below, we study the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) of Chinese firms in the apparel industry from 2009 to 2019, and we study its trends against the Agg PD of all China-domiciled firms.

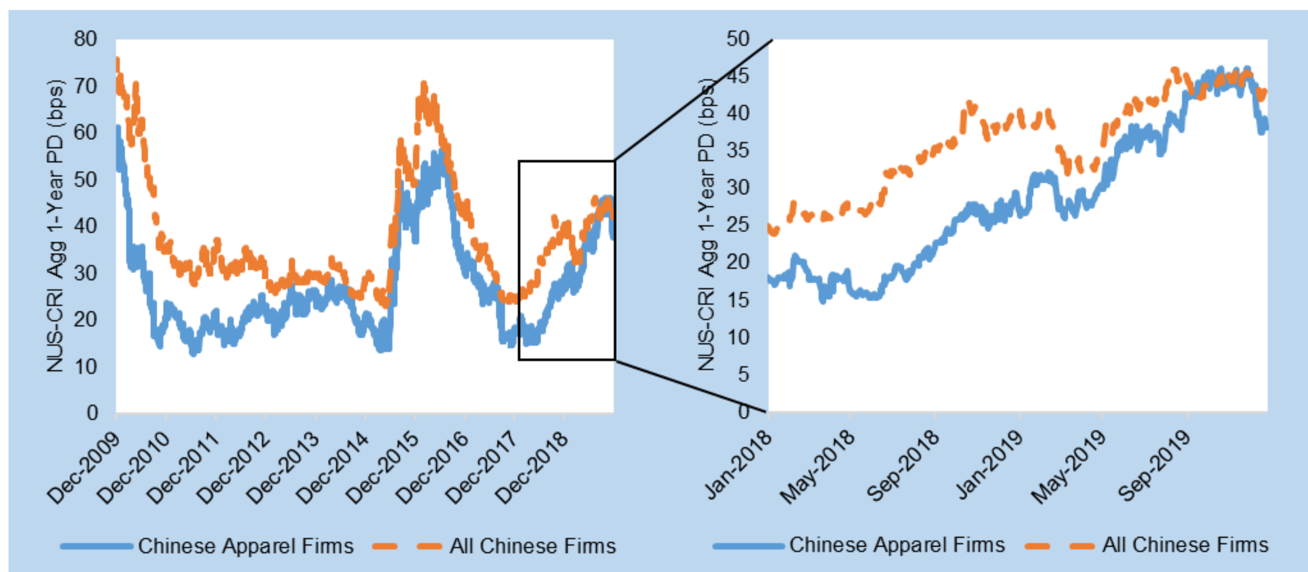

Figure 1a and 1b: NUS-CRI Aggregate 1-year Probability of Default (Agg PD) for China-domiciled firms in the apparel industry and Agg PD for all China-domiciled firms from 2009 to 2019 and from 2018 to 2019. *Source: NUS-CRI*

As seen in Figure 1, Chinese apparel firms have a consistently lower Agg PD compared to the Agg PD of all Chinese firms – a testament to China's strength as an apparel manufacturing powerhouse. Excluding the instances where there were sharp spikes and falls in Agg PD due to global financial crisis in 2008 and Chinese stock market crash of 2015, we do observe the trend where the spread between the two Agg PDs begins to tighten. In recent years, Agg PD of Chinese apparel firms have also increased to a high of 45bps.

Looking at the business, Chinese apparel firms are currently being squeezed due to global competition, specifically the emergence of Southeast Asia as a fast growing apparel hub. The apparel business is a high-volume business – it has low profit margins, has high dependency on fast investor turnover, and relies on a stable supply chain management (working with raw materials, textile production and retail companies). However, in recent years, Chinese apparel firms have been hit by significant industry restructuring. For example, minimum wage in China has been increasing at an unprecedented pace in the last decade, with minimum wage at manufacturing boomtown Shenzhen at about USD 336 per month, more than double the rate in some Southeast Asian countries and highest among global apparel manufacturing countries.

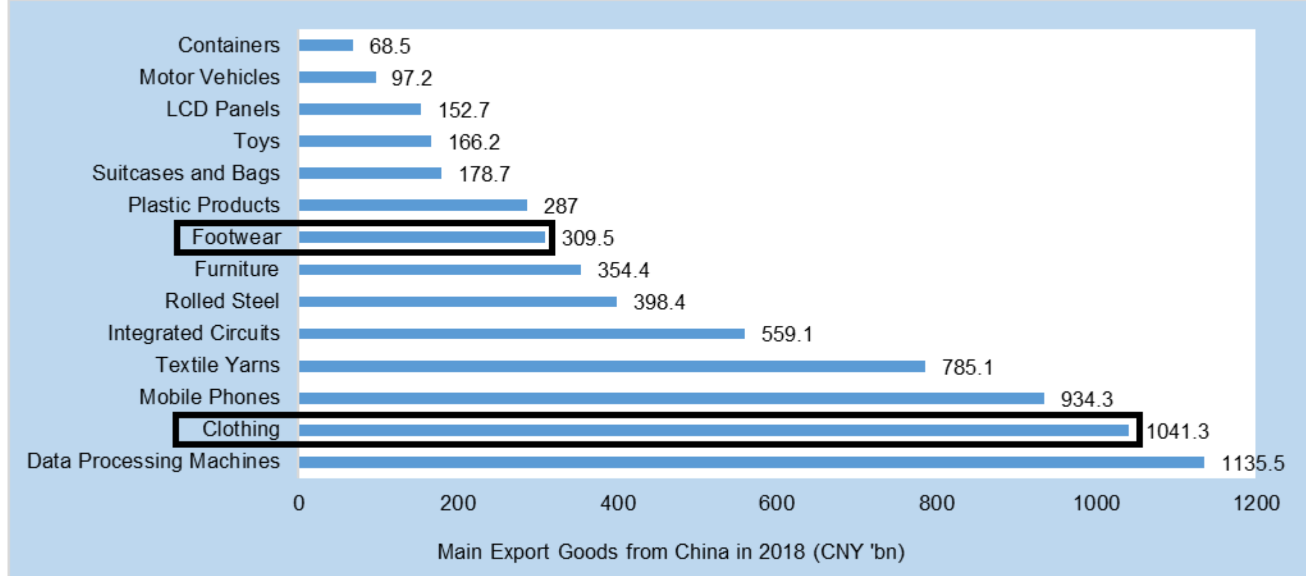

Figure 2: Notional value of main exports from China in 2018, apparel values highlighted. *Source: Statista*

Another major external consideration which affects the apparel business is the emergence of a prominent macro event in recent years – the US-China trade war. With apparel being one of the most prominent export goods from the nation, totalling up to about CNY1.341tn worth of exports in 2018 as seen in Figure 2 above, the impact of trade war on the economy is definitely substantial. In June 2018, the Trump administration announced 10% tariffs on List 3 goods, which include various clothing, apparel and fabric products. Subsequently, List 4A tariffs, which further imposes a 10% levy on goods including a wide range of apparel products, was announced in August 2019. These tariffs ultimately led to a large plunge in Chinese apparel exports – overall China's export loss in apparel shipments to the US during the first half of 2019 was estimated at USD 1.19bn, which is about 24% from the previous period, according to a report by the United Nations. This phenomenon is in line with the significant tightening of the spread between the Agg PD from 2018 of Chinese apparel firms and all Chinese firms as the industry has become increasingly riskier.

The industry is also under scrutiny for their management of environmental, social and governance (ESG) risks related to the sourcing and procurement of raw materials. Common ESG concerns include how firms deal with climate change, water scarcity and land usage, impacting the industry's ability to source materials for manufacturing. With this in mind, China is now playing catch up with the global ESG wave, where the country attempts to shift from one of the world's greatest polluters to one of its greatest environmental champions, but the trade-off is the increasing cost of production which are squeezes the already razor-thin profit margins of Chinese apparel firms.

Figure 3a and 3b: NUS-CRI Aggregate Forward 1-Year Probability of Default (Forward PD) for China-domiciled apparel firms compared to Forward PD for all China-domiciled firms; for Dec 2017 – Dec 2022 (LHS) and for Dec 2019 to Dec 2024 (RHS). *Source: NUS-CRI*

To analyse the outlook for creditworthiness of China-domiciled apparel firms, we look at its NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD). We compare the Forward PD of Chinese apparel firms to the Forward PD of all Chinese firms across two time horizons – Dec 2017 (before the trade war) and Dec 2019 (today). From Figure 3 above, we observe that the outlook for Chinese apparel firms have increased considerably, both from an absolute basis and in relation to the Forward PD of all Chinese firms. This aligns with our previous conclusions where there is a worsening outlook for Chinese apparel firms from 2017 to 2019. However, we do see a slight downward trend for the credit outlook from Dec 2019 to Dec 2024. This may be due to increasing optimism surrounding the US-China trade war. A "phase two" trade deal between the 2 parties are set to be held, focussing on the US's key complaint that China is effectively stealing US intellectual property. Brand innovation is another strong front of the Chinese apparel firms, with local brands continuing to aggressively expand within China and abroad. With strong influence from both internal and external factors which affect the creditworthiness of the global apparel market, developments in the Chinese apparel industry are to be watched.

Credit News

China's government is letting a wave of bond defaults just happen

Dec 27. China has had another record year of corporate bond defaults valued USD $21bn in total. Investors have long assumed that the state would step in and support many companies, but that is no longer the case. Now with more global investors coming into China's bond market. China's government is getting more comfortable with default, and is letting a wave of defaults just happen. The policymakers believe that investors would have more incentive to make careful assessment of a company's creditworthiness. Rising default in China means that global investors need to abandon the assumptions about which borrowers are safe due to the state's support, and it is hard to figure out which companies still qualify as strategically important. (Bloomberg)

Australia suffers worst of China's coal curbs after earlier boom

Dec 27. Australia is bearing the brunt of China's year-end coal import curbs, ceding market share to other exporters including Russia and Mongolia, after shipments soared earlier in 2019. China regularly adjust its import limits to protect domestic miners and power plants. In November 2019, Australian shipments to China sank 31%, while total purchases by China rose 9%. As the world's biggest exporter of coking coal and second largest shipper of thermal coal, Australia is particularly sensitive to China's import policy. The nation's miners also face the local environmental pressure amid devastating wildfires. (Bloomberg)

Japan investors plan bigger bets on emerging market debt in 2020

Dec 26. Japanese asset managers are planning to venture deeper into emerging market debt in 2020. Japanese investors have been routinely bought bonds around the world to diversify from the extremely low interest rates at home. Traditional bond investment destinations such as Europe are gradually losing appeal to Japanese investors as their expectations of further lower interest rate. To lower the grade they invest in, Japanese investors will increase exposure in Mexico and look for opportunities to enter South Africa, which has one of the steepest yield curves around. (Reuters)

Indonesia's bond metrics suggest outperformance against India

Dec 26. Although India's economy and Indonesia's economy share a lot of similarities, they face a potentially divergent outlook in 2020 thanks in part to their contrasting monetary and fiscal policy stimulus. Indonesian bonds already pipped India for 2019, with 14% returns compared with 11% as of December 23. With a yield premium of about 50 basis points on 10-year local-currency nots, a slightly stronger investment-grade rating, and a more welcoming regulatory structure for foreign inflows, Indonesia enjoys a number of advantages. It has a smaller government debt-to-gross domestic product ratio and a smaller deficit, allowing it to boost economic growth without triggering immediate financing concerns. Moreover, Indonesia enjoys a lower inflation rate, with the advantage projected to extend into 2020. (Bloomberg)

The corporate bond market's USD 100bn buyer is here to stay

Dec 26. The U.S. corporate-bond market's USD 100bn benefactor isn't going anywhere in the coming year. According to market watchers, foreign demand will continue to underpin high-grade debt in 2020 as global investors extend the hunt for higher-paying assets in the face of over USD 11tn of negative-yielding securities around the world. Although the corporate bond market already looks expensive, solid single-digit gains is still predicted. That's partly based on the expectation that asset managers outside the U.S. will continue to pile in as loosening monetary policy of global central banks last year makes it very hard for the average foreign investor to survive. (Bloomberg)

Deepening negative rates would do more harm than good (Reuters)

HNA Group is said to repay Yuan bond, avoiding default (Bloomberg)

Leveraged loan market size doubles in ten years, private credit explodes (Reuters)

Regulatory Updates

China to switch benchmark for floating-rate loans to lower funding costs

Dec 28. Loan prime rate (LPR) will be the new pricing benchmark for existing floating-rate loans in China and the revamped LPR is linked to the medium-term lending facility (MLF), a key policy rate of the central bank. The change is expected to help lower borrowing costs and underpin economic growth. Beijing has unveiled a raft of stimulus measures this year, including tax cuts, more infrastructure spending and reserve requirement ratio cut to boost credit. Analysts expect the central bank to cut the MLF rate by 20-30 basis points in 2020, which could pave the for way for lowering the LPR further. (Reuters)

Russian central bank to assess corporate debt burden to curb systemic risks

Dec 27. The Russian central bank is bolstering financial sector stability after Western sanctions and a sharp drop in oil prices in 2014 triggered a rapid rouble fall. The currency depreciation increased the corporate sector's debt burden since many loans were denominated in foreign currencies. The central bank is developing new criteria for a maximum debt level for domestic companies to prevent any possible systemic risk at an early stage. (Reuters)

China central bank publishes draft rules regulating corporate bond default disposal (Reuters)

ECB's Holzmann: Return to positive interest rates in 2020 unlikely (Reuters)

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