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Weekly Credit Brief
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Price pressures weaken credit health of debt-laden Chinese hog breeders

by Wang Yanfei & Amrita Parab

- **NUS CRI Forward 1-year PD suggests that Chinese hog breeders' credit risk is set to increase under the current operating environment of low hog prices and high leverage**
- **NUS CRI 1-year PD of Jiangxi Zhengbang Technology and Tech-Bank Food illustrates the stress faced by vulnerable players in the sector**

Although inflation has become a hot-button issue worldwide, China's inflation rate was only 2.1% YoY in May-2022, majorly driven by the 21.1% YoY decline in the price of pork[1]. The decreasing hog prices have adversely impacted the credit profile of many hog breeding enterprises. After the African Swine Fever in 2018 pushed hog prices to a high of CNY 38/kg, Chinese hog breeders rapidly expanded production capacity, which resultantly lowered prices. Partially due to the reduction in hog prices, and concurrent with an increase in raw material cost, most Chinese hog breeders reported losses in 2021, with their NUS-CRI Aggregate (median) 1-year PD (Agg PD) ranging above 100bps since May-2022, rising above to the BB- upper bound when referenced to PDiR2.0[2]. Despite the recent uptick in hog prices, the NUS-CRI Forward 1-year PD (Forward PD[3]) suggests that Chinese hog breeders' worsened profitability and leverage metrics are expected to push credit risk higher.

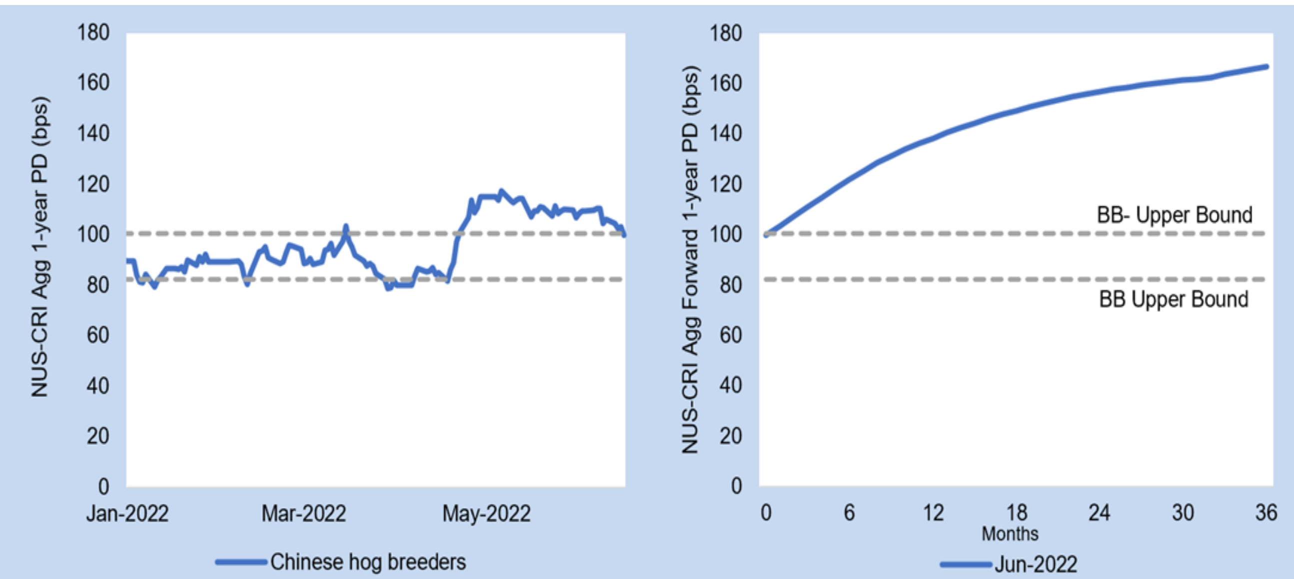

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese hog breeders from Jan-2022 to Jun-2022 with reference to PDiR2.0 bounds.
Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Chinese hog breeders as of Jun-2022 with reference to PDiR2.0 bounds.
Source: NUS-CRI

The profitability of Chinese hog breeders remains low owing to depressed hog prices and rising raw material costs. Although hog prices have begun to show signs of recovery over the past 2 months, rising from CNY 12.2/kg to CNY 15.8/kg, they are still below the breakeven cost for major hog breeders[4]. As a result, profitability of Chinese hog breeders is most likely to remain muted in the short term. The number of breeding sows, a key determinant of hog prices, remains elevated, with the supply of hogs reaching a record high of 196mn in Q1 2022. As a result of the Russia-Ukraine war, the prices of key raw materials such as corn and soybean, which

[1] Allocated the highest weight in the China's CPI basket for food
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through 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.
[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 – this is conditional on the firm's survival in the next 6 months.
[4] According to the disclosure reports of New Hope Liuhe Co Ltd and Jiangxi Zhengbang Technology Co Ltd, two major companies in the sector, losses will be recouped only when hog prices surpass CNY 18/kg and CNY 20/kg, respectively.

contribute to major feed sources for the hog industry, have been increasing rapidly this year[5], adding further pressure to the profitability of Chinese hog breeders. Resultantly, nine out of the ten listed hog breeders made losses in Q1 2022, with the median gross profit margin of the sector reaching -2.2% (See Figure 2a). Given that the current operating climate is likely to persist, it is unlikely that the industry is going to become profitable in the short term, as showcased by the Forward PD in Figure 1b, which suggests a worsening short-term credit outlook.

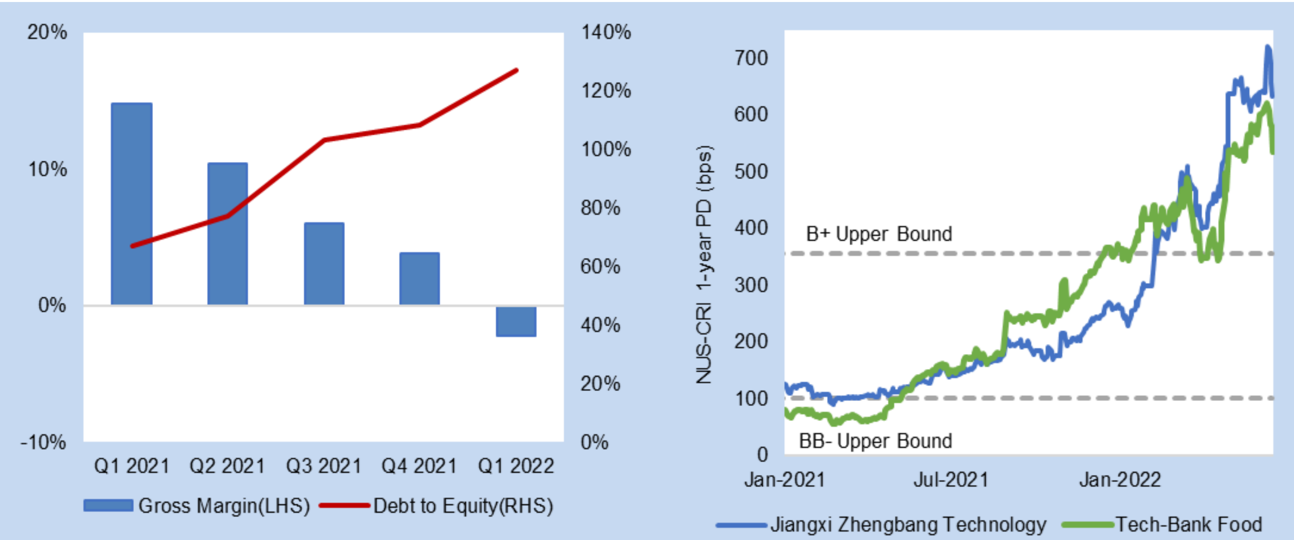

Figure 2a (LHS): Key financial ratios of Chinese hog breeders. Figure 2b (RHS): NUS-CRI 1-year PD for Jiangxi Zhengbang Technology Co Ltd and Tech-Bank Food Co Ltd from Jan-2021 to Jun-2022 with reference to PDiR2.0 bounds. *Source: WIND, NUS-CRI*

Increasing leverage is another key factor leading to the sector's deteriorating credit profile. To compete for a higher market share, most companies in the industry continue expanding production capacity by taking on additional debt. The industry's total debt has increased by approximately 40% from CNY 170bn in Q1 2021 to CNY 238.5bn in Q1 2022, pushing the median debt-to-equity ratio (See Figure 2a) up sharply and, in conjunction with negative earnings, the interest coverage down from 5.83x to -4.36x during the same period. For example, two of the largest Chinese hog breeders, Jiangxi Zhengbang Technology Co Ltd. and Tech-Bank Food Co Ltd., have increased their debts significantly even in the face of substantial losses[6] resulting in rapid deterioration of the companies' credit health (See Figure 2b). The liquidity position of Jiangxi Zhengbang Technology Co Ltd., in particular, also worsened, resulting in reported overdue commercial bills amounting to CNY 542mn as of Jun-2022. Additionally, with the industry's medium and long-term debt accounting for more than 50% of its total debt, should the current macroeconomic environment and low hog prices persist, the longer-term credit outlook for major industry participants may also worsen as seen by the Forward PD in Figure 1b, especially for those companies that currently face higher breeding costs. To add to their woes, the debt-fueled expansion in capacity may only translate to further excess supply, which could slow down the recovery of prices should a concurrent increase in demand not be witnessed.

Going forward, Chinese hog breeders' debt repayment ability may continue to remain pressured as the expected recovery of hog prices remains hampered by excess capacity. Moreover, with the destocking of breeding sows happening at a slow pace[7], the recovery of prices may take even longer than expected, resulting in continued losses in the upcoming quarters[8]. At present, authorities have been asking breeders to adjust breeding sow numbers as a measure to control potential future inflation, especially given the recent uptick in prices. The Chinese government has also released the Implementation Plan of Hog Production Capacity Control, aiming to build a counter-cyclical control mechanism and keep the hog prices at reasonable levels. For hog breeders, the ability to achieve high returns will be curbed. The strategy of debt-fueled capacity expansion currently adopted by Chinese hog breeders is most likely to continue to burden their balance sheets, and when combined with lower cash flows relative to their high debt position, could make servicing their debt difficult, pushing vulnerable companies closer to default.

[5] The DEC corn futures (5 months) prices have risen by 8.39%, while soybean futures prices have increased by 20.73% this year. *Source: Wind*

[6] Jiangxi Zhengbang Technology Co Ltd., the second largest player in the sector, is one of the over-leveraged breeders on the brink of a debt crisis. It reported a loss of CNY 18.8bn in 2021 which wiped out its cumulative profits in the previous decade. The huge amount of losses caused its leverage ratio to skyrocket to 1744% in Q1 2022. Similarly, Tech-Bank Food Co Ltd reported a loss of CNY 4.46bn and a gross margin of -13.44%, while its debt increased 58% YoY in Q1 2022, pushing the debt-to-equity ratio up to 163%.

[7] The number of breeding sows was 41.92bn as of May-2022, even higher than Apr-2022, and had decreased by only 8.15% from the peak of 45.64bn in Aug-2021. *Source: Wind*

[8] The National Development and Reform Commission declared on 16 June that hog production capacity is reasonably abundant and pork prices will not rise too fast this year.

Credit News

Russia defaults on foreign debt for first time since 1918

Jun 27. Russia is said to have defaulted on USD 100mn worth of interest payments due on May 27 as the month-long grace period closes. In response to Russia's invasion of Ukraine, the EU's sanction on the National Settlement Depository, Russia's paying agent, has obstructed the cash meant for interest settlements. Nevertheless, Russia denies any default event as it claims to have fulfilled its duties by transferring the amount due to the distribution agent. Apart from sanctions, the country continues to face additional headwinds, including a contracting economy, falling sovereign bonds, and soaring inflation. (Bloomberg)

US banks pass latest round of Fed stress tests in sign of financial health

Jun 24. Amidst rising recessionary concerns, stress tests on US banks for 2022 called for stricter stress test scenarios. Results displayed that all banks are likely to be capable of handling harsher economic conditions, including a global economic downturn, and worsening conditions in the commercial real estate and corporate debt markets. The banking industry is expected to receive a hit of approximately USD 612bn, however, capital ratios would remain above the regulatory requirements. The stress tests also provide estimates of capital buffer stocks which may aid individual banks if such headwinds arise. (FT)

Frontier-debt buyers look past default risk in hunger for yield

Jun 27. With global markets showing signs of distress, it is expected that the poorest nations will be the most affected and will experience a wave of defaults. Post-Sri Lanka's economic distress, the yields of weaker economies reached 900 bps above US Treasuries, the highest level in 13 years barring the 2020 Covid collapse. However, the perception of the market is slowly changing, with many investors looking at the widened spread as a buying opportunity. Expectations that frontier market debt has been oversold in the recent selloff are gaining ground. A growing number of investors now believe that even in the case of restructuring, frontier market bonds may offer better recovery values. (Bloomberg)

Brazil's high interest rates sparks rush into corporate bonds

Jun 23. Contrary to global trends, Brazil's corporate bond market saw a 35% YoY jump in sales even as the interest rate surged to 11.25% in 2021. As investors shift their focus to fixed income investments, companies have also been willing to take advantage of the increase in demand despite higher borrowing costs. Retail investors and local funds accounted for 45% of total corporate bond sales YTD compared to 38% last year. The surge in demand has allowed companies to negotiate better terms and has also seen many companies raise debt from bond markets for the first time. (Bloomberg)

China panda bond market flashes economic warning sign

Jun 26. Issuances of panda bonds from Jan-2022 to Jun-2022 are down close to 50% compared to last year, reaching a six-year low of CNY 6.7bn, as companies brace for further economic worsening. Issuance has primarily reduced in the Chinese market as companies are cautious of the Chinese government's zero-COVID policy and the resultant impact on consumer spending. Panda bonds are primarily issued to hedge against exchange rate risk by automotive and financial companies. On a wider scale, a plethora of companies have reduced investment in China due to policy and economic uncertainty, with close to 48% of companies reducing and postponing investment plans in the country, as reported by the American Chamber of Commerce in Shanghai. (Nikkei-Asia)

Europe is now in its worst corporate-bond selloff in decades (Financial Post)

Saudi Arabia injects SAR 50bn in liquidity-starved banks (BT)

Jaguar parent's bond sinks as weak rupee blights India credit (Bloomberg)

Regulatory Updates

Banking body BIS urges decisive wave of global rate hikes to stem inflation

Jun 26. Amidst the surging inflation, the BIS posits that central banks should act and raise interest rates quickly to address it and prevent any more complications. While central banks have aggressively responded to tame inflation, they are wary of hiking rates too fast as this might cause losses and aggravate the already unfavorable economic condition, veering away from the goal of a soft landing. Aside from the timing of rate hikes, the central banks should also consider other factors in their decision-making. In particular, they should assess the permanence of inflationary shocks and the extent of their impact on the markets and the economy, to formulate an appropriate and timely response. (Reuters)

China vows stricter checks on smaller banks after losses, abuses

Jun 23. The CBIRC has pledged to enhance its supervision of smaller banks to curb illegal activities after investors suffered substantial losses due to a suspected financial scam in Henan province. The incident follows the slew of events that had infuriated the public after being denied access to their money. The CBIRC is also working with local authorities to resolve the case and uphold consumers' rights, in addition to improving their oversight of the banks. The stricter regulation is expected to affect nearly 4,000 small and medium-sized lenders, which collectively control USD 14tn in assets. Currently, these smaller banks face relatively manageable risks after authorities have aided them with the disposal of non-performing assets and replenishment of capital. (Bloomberg)

Buy-Now-Pay-Later lenders to get tighter regulation in the UK (Bloomberg)

India central bank deputy Patra expects inflation to breach 6% for 3 quarters (Reuters)

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