Weekly Credit Brief

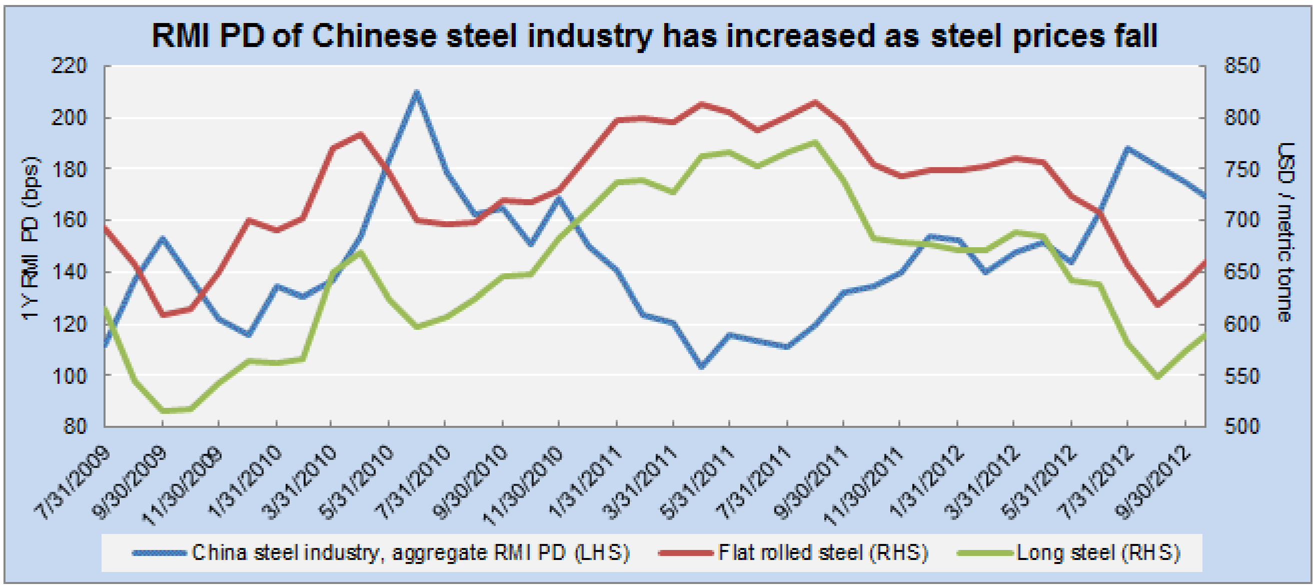
Oct 16 - Oct 22 2012

Story of the Week

Chinese steel producers face heightened credit risk

The aggregate 1-year RMI probability of default (RMI PD)* for Chinese steel companies has increased noticeably since the start of 2012. This trend highlights deteriorating credit quality within the sector, caused by stiff competition, falling steel prices, weakening real estate demand and unfavorable regulations. Reflecting this, the sectoral RMI PD has become visibly correlated with domestic steel prices.

According to the China Iron and Steel Association, the industry is experiencing its toughest period since 1975. Out of 81 steel producers the association tracks, 38 firms recorded losses in the first seven months of this year. Insiders in the industry are hoping that the construction of the upcoming steel logistics park in Zhangjiagang may help alleviate cost pressures and improve the supply chain within the steel sector.



Industry background: Growth in the Chinese construction industry has been rampant. China is now the world's largest consumer and producer of steel, accounting for 45.1% of the world's production, up from 18% in 2001. China consumes 45.5% of the world's steel products, with 79% of the demand stemming from the construction industry. Besides construction, steel is utilized in the machinery (12%), automobile (5%), household appliances (2%), railways (1%) and shipbuilding (1%) sectors of the economy.

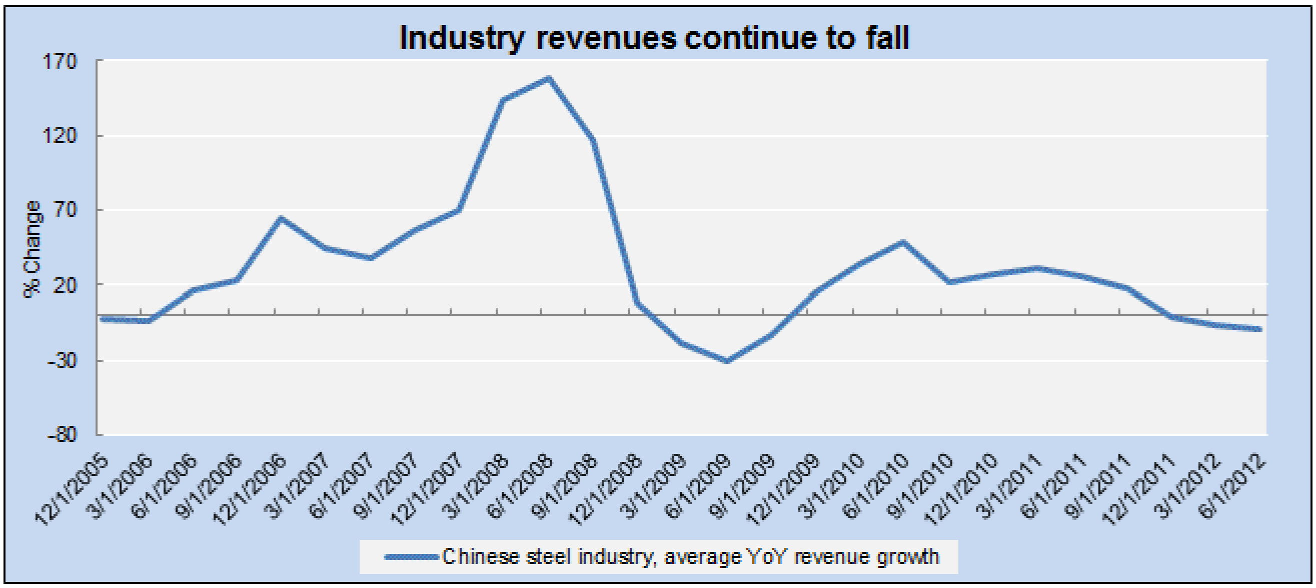
Market structure: Competition within the industry is intense as nearly 50% of the industry's volume is produced by the top 10 players. Hebei Iron and Steel, the largest company by volume accounts for 10% of the market's total annual production. Total output is spread across 35 significant producers, a marked contrast to the oligopolistic market structure of 4-5 major players in other steel producing countries such as Brazil. The closest market structure is the United States with 9 significant producers. A negative implication of this level of fragmentation is the loss of pricing power on both the supply and demand side. This increases sectoral sensitivity to price changes. The industry has been negatively affected by ongoing declines in domestic steel prices and a recent recovery in iron ore prices.

Steel prices have fallen: Going forward, the business outlook for the sector is less favorable as the Chinese economy is likely to experience a slowdown in the short-term. Overproduction and falling steel demand within the industry continue to place downwards pressure on steel prices, which have reached levels not seen since 2009. Flat-rolled steel for example, was priced at USD 620 per metric ton in August 2012, the lowest since October 2009. With lower product prices, steel suppliers face limited pricing power due to their inability to pass on increased production costs to customers.

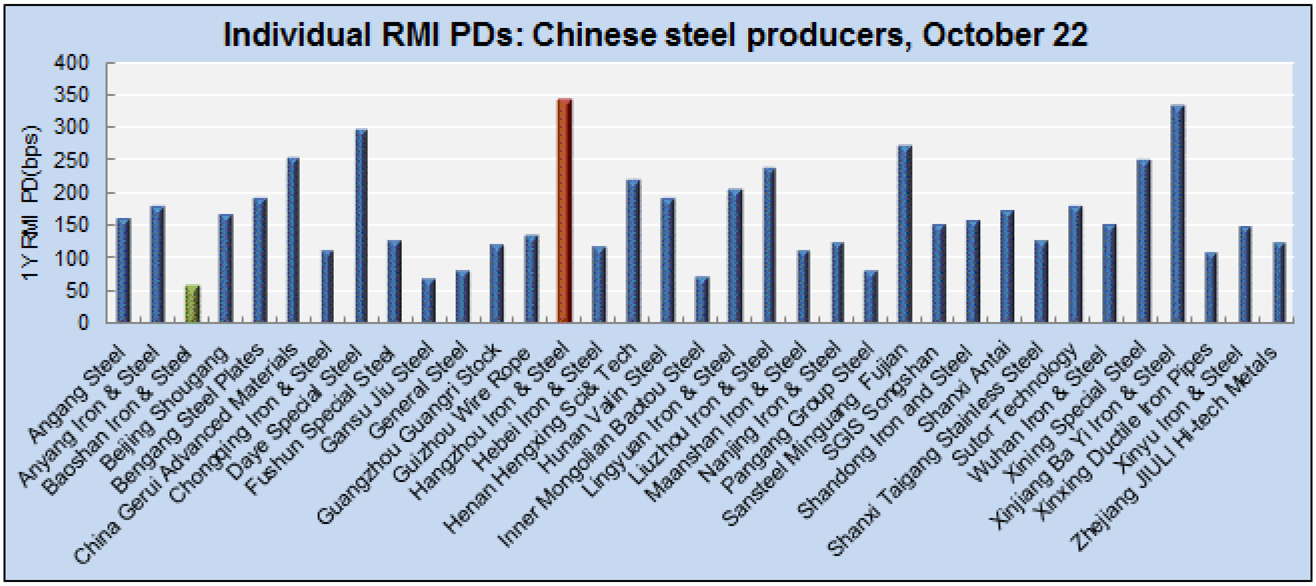
New regulations for the sector: The steel industry has been challenged by recent regulatory changes. In the past decade, the industry has benefitted from regulatory tailwinds. The Chinese government encouraged the growth in steel volume, creating massive growth opportunities for the domestic steel industry. Recent developments suggest that this is not likely to continue. As a result of rapid expansion in the early years, the Chinese steel industry has been accused of overcapacity and environmental degradation. In response, the government's 12th Five Year Plan marked a shift in emphasis to energy efficiency and high end steel production. This implies a less favorable operating environment for small and midsized steel producers and more consolidation for the industry as less efficient players exit the market.

Real estate impact: The growth of the steel industry was a by-product of the booming real estate sector, which has been the largest driver of the Chinese GDP. In order to prevent overheating of the market, the Chinese government has introduced property cooling measures since 2010. Steel producers have experienced a large decline in revenues, as demand from the construction sector dampens.

Revenues and profits in a downtrend: Weakening revenues and net profit margins at Chinese steel producers indicates the industry may continue to struggle with profitability in the near term. Aggregate revenues fell by 6.7% in Q1 and 9.1% in Q2, while the aggregate net income to revenue ratio was in negative territory during Q2 2012 and Q4 2011.



Risk breakdown: Chinese steel companies used excessive leverage to expand their production capacities after the GFC, as the average debt to equity ratio climbed from 0.83 in Q3 2008 to 1.22 in Q2 2012. Moreover, overexpansion has led to increased supply as demand continues to fall, with resultant price declines hitting steel producers' bottom lines in recent quarters and elevating their risk profiles. On October 22, RMI data indicated that Hangzhou Iron and Steel is the most likely to default within the sector.



* Our aggregate includes all companies listed in the graph above, and is equally weighted.

Sources:
Nerves of steel (China Daily)
China's steel traders expose banks' bad debts (Reuters)
China's 12th Five Year Plan: Iron and steel (KPMG)
Steelmakers bend as realty wanes (China Daily)

In the News

Mainland credit rating to lift HK's dim sum bond market

Oct 22. Chinese credit rating agencies will begin rating CNY-denominated bonds issued in Hong Kong. The booming CNY bond market is a vital fund-raising channel for mainland and overseas companies, which has matched robust investor demand for CNY-denominated products in the city. However, CNY bonds largely lack covenant protections and credit ratings, which can affect the credibility of the securities. Insiders expect that credit ratings may increase the investor base of CNY bonds and could lower funding costs. According to the Hong Kong Monetary Authority, in the first seven month of 2012, aggregate CNY bond issuance reached CNY 79bn, a 50% increase from 2011. (China Daily)

Sharp's malaise risks bad-loan surge at megabanks

Oct 21. Japanese banks might have to increase their bad loan provisions moving forward, as conditions in the Japanese electronics industry worsen. The average ratio of reserves for delinquent loans to total loans fell to 1.4% according to bank's latest filings, by far the lowest level in 12 years. However, this measure could increase as stiff competition, slowing economic conditions and a rising JPY are hurting the largest Japanese electronics manufacturers. But these companies have also secured more funding from their lenders. Sharp secured JPY 360bn of funding from Mizuho and Mitsubishi UFJ Financial group from last month on condition of further cost cutting at the company. Japanese banks do not want their clients to fail as they have vested interests in their customers. (Bloomberg)

Spanish bad loans hit new record in August

Oct 18. Bad loans at Spanish lenders reached a record high during August, as high unemployment and deepening spending cuts weighed upon consumer and business borrowers. Loans in arrears increased to EUR 178bn in August, up from EUR 172.7bn in July. This could lead to even greater write-downs at Spanish lenders, who were forced to take large losses on their real estate portfolios earlier in the year. The government suggested that a "bad bank" designed to siphon soured property assets off lenders balance sheets may also accept defunct consumer loans, although only in the worst cases. The "bad bank," which will begin functioning by the end of this year, will hold up to EUR 90bn of assets, though the government expects the final size will be smaller. (Reuters) (Bloomberg, APRA)

ICE inks Markit deal to base futures on credit-swap indexes

Oct 16. Intercontinental Exchange, a leading operator of global markets and clearing houses, has obtained the right to develop futures and options contracts based on Markit's North American and European corporate CDS indices. The contracts are set to launch in the first quarter of 2013, and will provide credit-market participants with additional tools for managing credit risk exposures, and also open the market to small hedge funds and other investors. Currently, credit-index trades are made through privately negotiated, OTC swaps between dealers and their customers. The Dodd-Frank Act requires dealers to move a majority of these trades onto exchanges. (Bloomberg)

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Contributing Editor: James Weston