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# Shanghai's Share Market Correction Isn't Surprising Given The Declining Profitability Of China's Corporates


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# Shanghai's Share Market Correction Isn't Surprising Given The Declining Profitability Of China's Corporates

The recent correction in the Shanghai Stock Exchange isn't surprising. The price-to-earnings ratio of its composite index doubled in the first half of 2015 against a backdrop of limited improvement in the profitability of Chinese companies. Standard & Poor's Ratings Services forewarned three years ago that the average profitability of the largest corporates was declining. Indeed, the financial risks of listed companies worsened over the five years to 2014 before steadying last year.

The impact of the market correction on corporates is pretty much dependent on their reaction to it and the central government's efforts to shore up the market and economy. Ironically, if Chinese corporates become overly conservative towards investing, the feedback loop from a contraction in overall business activity could undermine their credit profiles.

**Overview**

- The declining profitability of Chinese corporates over the past few years had subdued share price gains prior to 2015.
- Since 2009, financial risks have risen in China, by the equivalent of about a notch.
- The corporate credit cycle in China appears to be slowing, which allows corporates more time to manage existing operations and investments but increases the difficulty of fund-raising.
- We believe the stock market correction could reduce new issuances, trigger a policy response that may support corporates, or slow the pace of investments.
- Any contraction in overall business activity as result of overly conservative investment could undermine credit profiles.

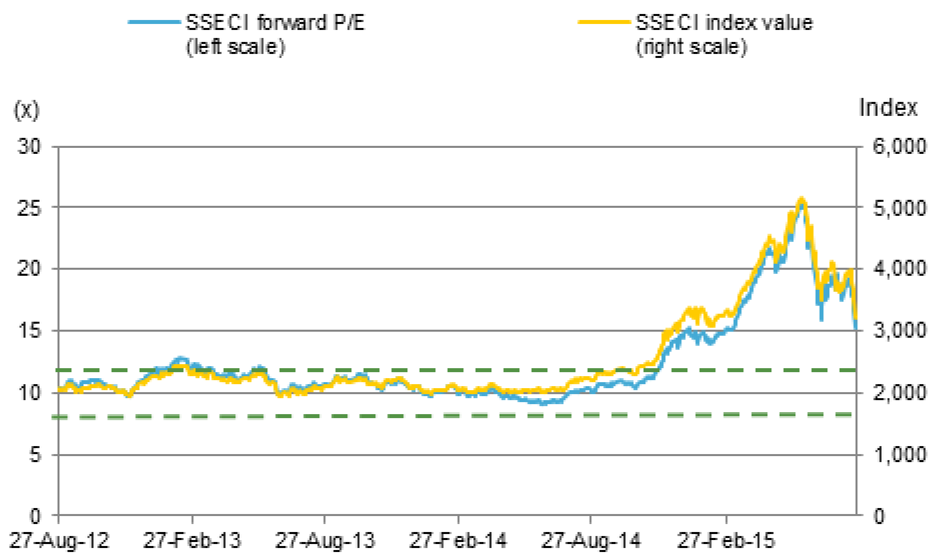
## Weak Profitability Growth Is A Price Constraint

Investors commonly reference the ratio of share price to forward earnings (P/E) in assessing equity value. Logically, weak growth in profitability (see "China Credit Spotlight: Significant Financial Risks Fan The Flames For China's Top Corporates," published on RatingsDirect on Sept. 10, 2012) would keep share price gains subdued, especially given China's lower GDP growth rate over the past few years.

Yet, the Shanghai Stock Exchange composite index inexplicably broke out of its three-year P/E range of 9x-12x (see dashed lines in chart 1) in December 2014, climbing to a peak of 25x in June 2015. The climb has been widely attributed to a sudden and curious increase in Chinese retail investors' appetite for using leverage. The government's subsequent crackdown on the usage of leverage triggered the market sell-off in July. If the market reverts to 2012-2014 P/E levels, the index would return to the low 2,000s (it's currently around 3,000).

**Chart 1**

**Shanghai Stock Exchange Composite Index (August 2012-August 2015)**




SSECI -- Shanghai Stock Exchange Composite Index. Forward P/E-- price-earnings ratio over next 12 months. Data source: S&P Capital IQ. Source: Standard & Poor's Ratings Services.

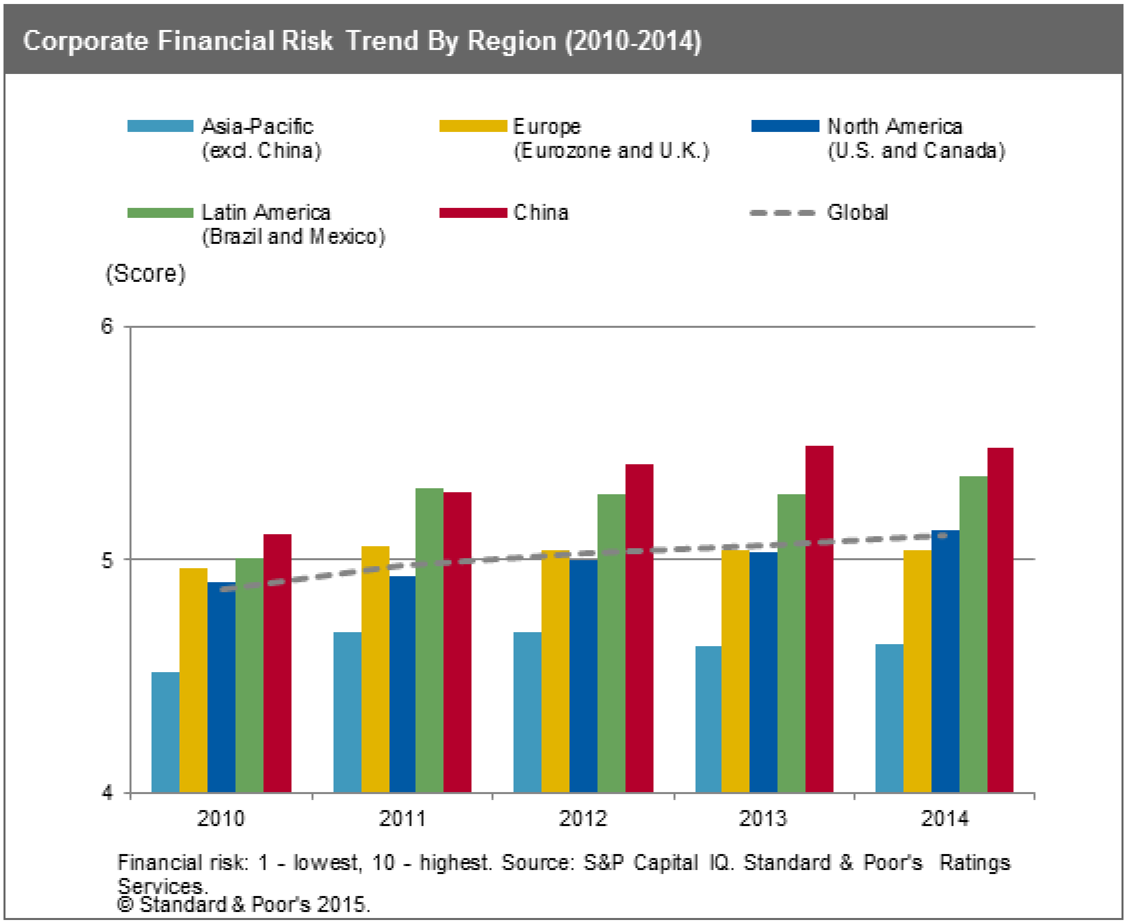


## Financial Risks Have Been Stabilizing

We recently analyzed the financial risk of a sample of 6,238 listed companies globally (see "Global Corporate Credit: Twin Debt Booms Pose Risks As Companies Seek US$57 Trillion Through 2019," published July 15, 2015). The results show that since 2009 financial risks have risen the most in China, by the equivalent of about a notch (see chart 2) (Note: This exercise does not use actual credit ratings.)

The sample of Chinese corporates shows moderate to moderately high financial risks. The risk score average is only slightly worse than the global level. The score decline over 2009-2014, however, is noteworthy--although the risk level seemed to even out in 2014. We recently assessed that the credit profiles of bellwether Chinese real estate developers may be steadying although profitability remains under strain (see "China Property Watch: A Sales Rebound And Greater Funding Ease Are Steadying Developers," published Aug. 13, 2015).

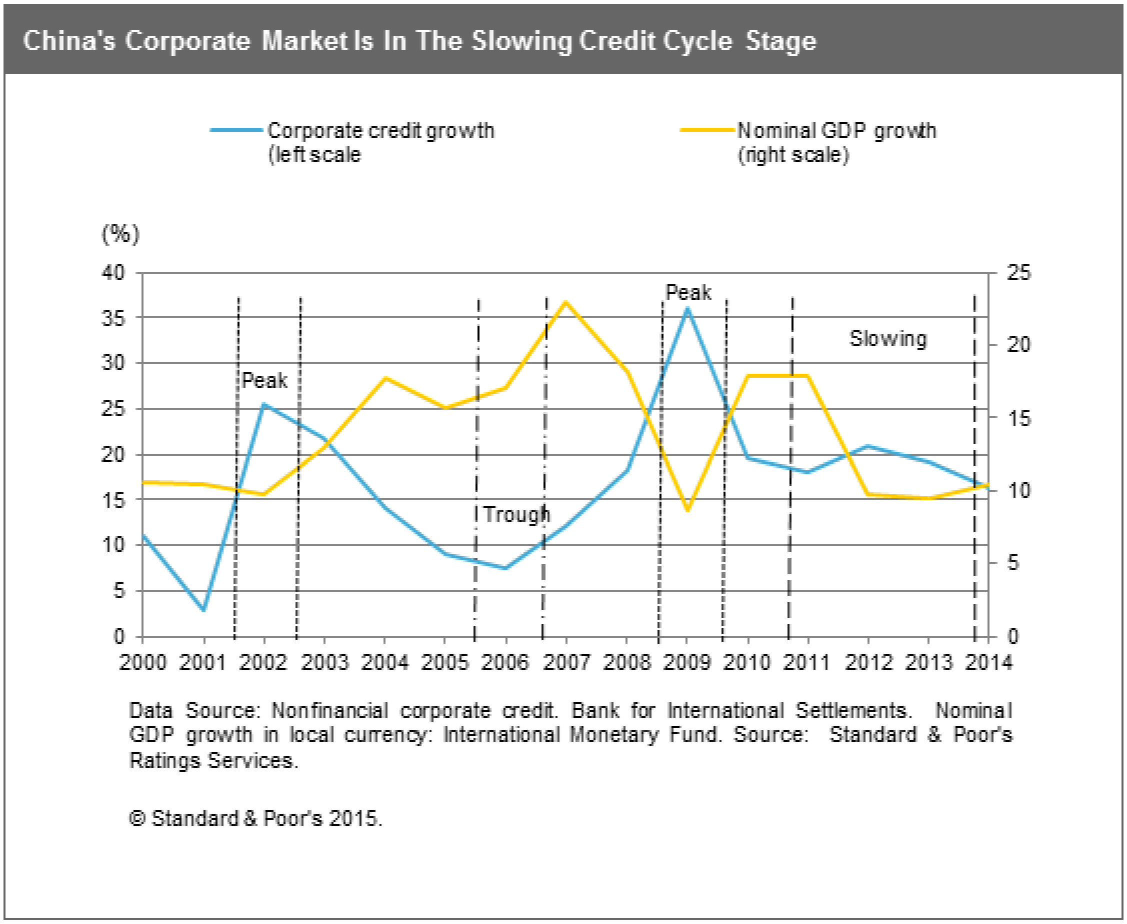
**Chart 2**




## The Corporate Credit Cycle Is Slowing

We assess the corporate credit cycle in China to be in a slowing phase (see chart 3), but the growth rate remains among the fastest in the world. The slowing phase is a two-edged sword for credit risk. On the one hand, slower credit growth allows corporates more time to manage existing operations and investments. On the other, weaker corporates may find it harder to raise new funding.

**Chart 3**




## The Impact Of The Correction Will Come In Three Waves

We see three waves of potential impact on Chinese corporates from the market correction.

### Potential issuance could be delayed

The first wave is from the actual fall in share prices. We see little effect on the majority of China's corporates from the event itself. While corporates may be reluctant to issue shares until the stock market settles, the lack of issuance is unlikely to change many credit profiles over the next 12 months or so. However, when prices were high, a minority of corporates had planned to issue shares to fund acquisitions or reduce leverage. Any delay in equity-raising may mean higher leverage, particularly if corporates source new debt to finance acquisitions.

### The government's policy response will be impactful

The second wave is from government policy response to the correction. Any easing of market liquidity and government encouragement of investments may benefit corporates over the near term. However, the adequacy of returns on any additional investment is less certain. We don't see the central bank's recently announced change to the central parity of the renminbi against the U.S. dollar as a competitive devaluation (see "China's New Exchange Rate Regime Is More Structural Reform Than Competitive Devaluation," published Aug. 12, 2015). Indeed, the devaluation could be seen as fueling demand for onshore debt.

### Investments may slow

The third wave is more critical over the medium-to-long term. This is the reaction by corporates in respect of investment. If companies view the stock market correction and the government's response as signals that the prospects for the Chinese economy may be less bright than previously assumed, the pace of investment may slow. This slowdown could bring about the reduced prospects the corporates fear, given the country's still high dependence on investments to drive economic growth. This self-reinforcing spiral would negatively affect corporate credit profiles.

With corporates viewing the equity issuance window as being closed, at least temporarily, they would have to rely on debt funding to support growth. Apparently recognizing this, China's central bank announced on Aug. 25, 2015, that it will further cut lending interest rates by 25 basis points and lower the reserve requirement ratio for banks by 50 basis points.

Not surprisingly, we intend to keep a close eye on the forward debt-raising and investment plans of China's corporate issuers in the coming months.

## Related Research


- China Property Watch: A Sales Rebound And Greater Funding Ease Are Steadying Developers, Aug. 13, 2015
- China's New Exchange Rate Regime Is More Structural Reform Than Competitive Devaluation, Aug. 12, 2015
- Global Corporate Credit: Twin Debt Booms Pose Risks As Companies Seek US$57 Trillion Through 2019, July 15, 2015
- China Credit Spotlight: Significant Financial Risks Fan The Flames For China's Top Corporates, Sept. 10, 2012