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PAYMENT SURVEY

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China Payment Survey 2019: Longer delays as growth falters

The Chinese economy experienced some challenges in 2018. Corporate bond defaults in US dollars quadrupled, reaching an amount of USD 16 billion, while the number of bankruptcy cases settled through the Supreme Court of the People's Republic of China spiked to 6,646. Deleveraging efforts led to tighter liquidity conditions during the first half of 2018. This coincided with an escalation of trade tensions between the United States and China, which eroded consumer sentiment, resulting in weaker domestic consumption. Reflecting these adverse conditions, a majority of respondents believe that it is unlikely that growth will improve in 2019 (59% vs. 33% a year ago). This is the first time that this result has been recorded since Coface started conducting China payment surveys in 2003.

This context has led to pressure for Chinese companies, who have resorted to using longer payment terms to sustain business. According to our survey of 1,500 Chinese companies, average payment terms increased to 86 days in 2018 – up from 76 days in 2017 and in line with a trend that began in 2015 – with terms being longest for the automotive and transportation sectors, followed by construction and energy.

Payment delays also deteriorated in 2018: 62% of companies experienced payment delays in 2018, with 40% reporting that they recorded an increase in 2018, much higher than the 29% registered in 2017. More worryingly, the proportion of respondents experiencing ultra-long payment delays (more than 180 days) exceeding 2% of their annual turnover increased to 55% in 2018 from 47% in 2017. According to Coface's experience, 80% of ultra-long payment delays are never paid. When these constitute more than 2% of annual turnover, a company's cash flow may be at risk.

Additionally, on the high-risk end of the spectrum, the largest proportion of respondents experiencing ultra-long payment delays exceeding 10% of their annual turnovers was in the construction sector (28%), followed by automotive (27%), and ICT (25%). The pharmaceutical sector recorded the lowest proportion (7%), ahead of the agri-food sector (12%). Further aggravating matters, almost 60% of respondents admitted to using banker acceptance drafts and/or commercial acceptance drafts in place of cash for payments. These represent hidden cash flow risks, which may prove problematic as growth continues to slow in 2019.

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1 PAYMENT TERMS: PRESSURE TO EXTEND TERMS FURTHER AS MARGINS TIGHTEN

Chart 1:
Average credit terms (days) increased

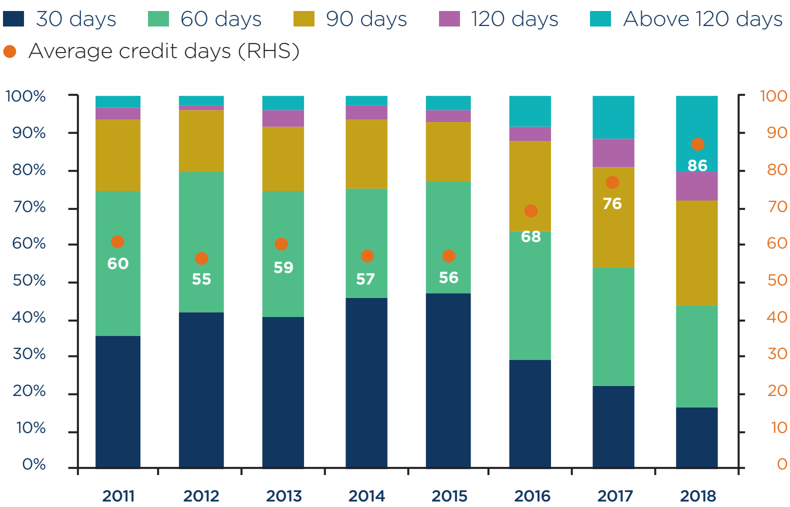


Chart 2:
Reason for offering payment terms

- 2018 proved to be a slightly more challenging year for China, with growth slowing to 6.6% from a revised 6.8% a year earlier. This meant pressure for Chinese companies, who resorted to extending longer payment terms in order to secure business. Average payment terms[1] increased from 76 days in 2017, to 86 days in 2018, in line with a trend that commenced in 2015.

- Corresponding with weaker growth momentum, most respondents cited market competition (40% in 2018 versus 31% in 2017) and tighter liquidity (19% in 2018 versus 14% in 2017) as the main reasons to offer longer payment terms. On the plus side, a larger proportion of respondents stated that they have more confidence in their consumers (36% in 2018 versus 32% in 2017).

- The increase in credit terms was brought about by a sharp rise in very long maturities, with fewer respondents offering credit terms below 30 days. Specifically, the percentage of respondents offering average credit terms exceeding 120 days increased to 20% in 2018 from 12% in 2017.

- Differences were also apparent across sectors. Average payment terms were longest for the automotive and transportation sectors, with the latter experiencing an increase of 13 days. Construction came in third, followed by the energy sector – one of the few that experienced a contraction in payment terms, together with the chemical sector.

86
DAYS
payment terms increased in 2018 compared to 76 days in 2017

1 Payment term: the time frame between when a customer purchases a product or service and when the payment is due.

• On the other end of the spectrum, the agri-food sector, despite a 4 day increase, continued to be the sector with the shortest payment terms, with respondents offering 59 days on average in 2018. Retail and chemical followed, with the latter registering an 11 day contraction in 2018. The textile, paper and wood sectors all offered payment terms below average in 2018.

Table 1:
Payment terms differed amongst the different sectors covered by the survey

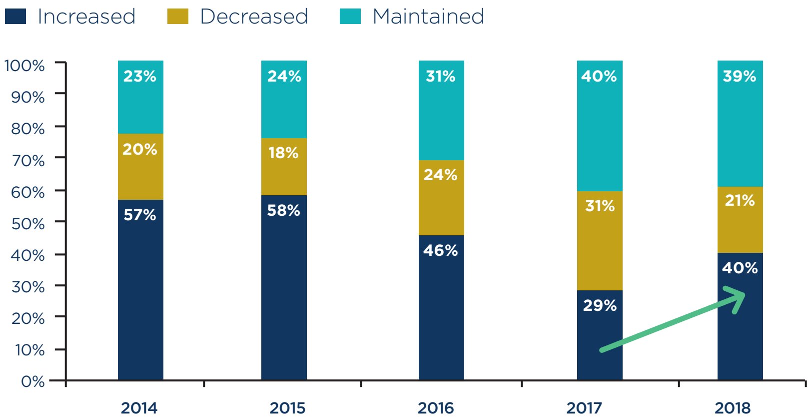
Sector	Average terms 2018	Difference vs. 2017 (days)	% offering credit terms	Coface Sector Risk Assessment[2]
Automotive	99	13	67%	High
Transport	98	13	79%	Medium
Construction	94	5	57%	Very High
Energy	92	-12	70%	High
ICT	89	4	67%	High
Metals	88	10	73%	High
Pharmaceuticals	87	-3	57%	Low
Textile	81	19	69%	High
Paper	75	13	79%	Medium
Wood	75	15	50%	High
Chemicals	73	-11	77%	Medium
Retail	66	-4	66%	Medium
Agri-food	59	4	59%	Medium

2 PAYMENT DELAYS[3]: LONGER DELAYS EXACERBATE CASH FLOW RISKS

The situation relating to payment delays also deteriorated. 62% of companies in China experienced payment delays in 2018, with 40% of respondents reporting that they recorded an increase in payment delays, much higher than the 29% registered in 2017. In line with this finding, a smaller number of respondents recorded a decrease in overdue amounts in 2018 compared to 2017 (21% versus 31%).

A larger proportion of respondents stated that payment delays did not exceed 90 days on average (61% in 2018 vs 50% in 2017). However, the proportion of those experiencing payment delays exceeding 120 days increased to 31% in 2018 from 26% in 2017. The transportation and construction sectors recorded the highest payment delays in 2018, lengthening by 34 and 31 days respectively in 2018. The chemical sector recorded the lowest payment delays, followed by agri-food. In both cases, payment delays shortened by 8 and 16 days respectively relative to 2017.

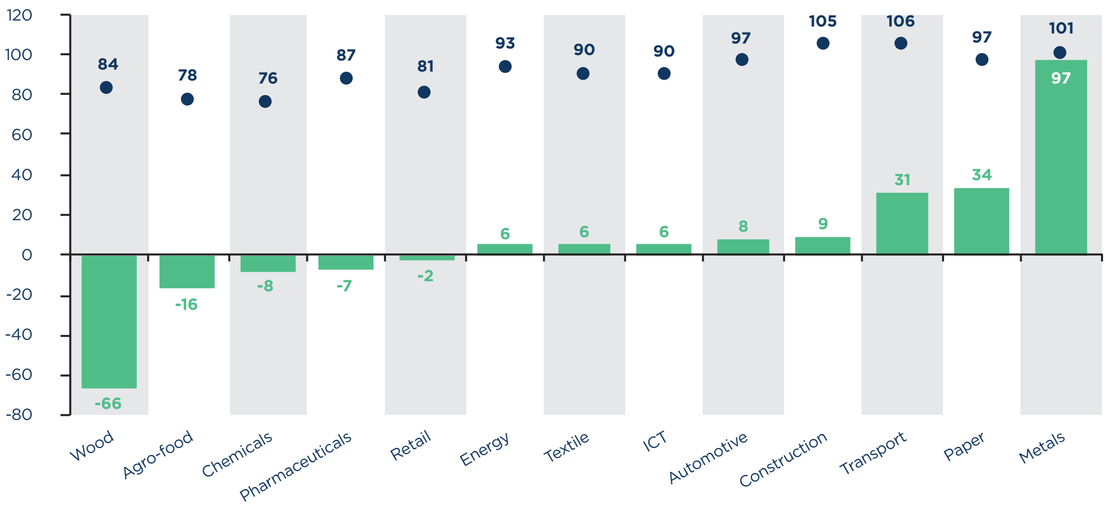
Chart 3:
Evolution of payment delays



2 Every quarter, Coface reviews the assessments of 13 sectors throughout 27 countries (representing approximately 87% of global GDP) in 6 major regions of the world. In order to assess these risks, Coface relies on its own methodology based on four cornerstones: an estimate of corporate defaults (by country) for the four coming quarters, payment periods recorded by buyers (aggregated by sector), forecasted financial results for the four coming quarters (aggregated by sector), and payment experience recorded by Coface for each sector. The sector risk assessment is on a 4-step scale: low, medium high, very high, in order of increasing risk.

3 Payment delay: the period between the payment due date and the date the payment is made.

Chart 4:
Average length and evolution of payment delays



- In order to gauge whether this deterioration is impacting cash flows, we look at the ratio of Ultra-Long Payment Delays (ULPDs, exceeding 180 days) as a percentage of total annual turnover. According to our experience, 80% of ULPDs are never paid. When these constitute more than 2% of annual turnover, a company's cash flow may be at risk – the higher the ratio, the higher the risk.

- The proportion of respondents experiencing ULPDs exceeding 2% of their annual turnover increased to 55% in 2018 from 47% in 2017. Most of this was on the back of a broad-based increase in the number of responses in the 2-5% range. On the high risk end of this spectrum, the proportion of respondents reporting that more than 10% of their annual turnover was tied up in such ULDPs remained stable at 21% in 2018, after surging in 2017. This is a telling sign that pockets of stress continue to be present in the Chinese economy, explaining a record number of defaults in 2018 (**see Insert**).

55%
The proportion of respondents experiencing ULPDs exceeding 2% of their annual turnover

- Differences were apparent across sectors. The largest proportion of respondents experiencing ULPDs exceeding 10% of their annual turnovers was in the construction sector (28% in 2018 vs. 32% in 2017), followed by automotive (27% in 2018 vs. 27% in 2017) and ICT (25% in 2018 vs. 22% in 2017). The pharmaceutical sector recorded the lowest proportion of respondents experiencing ULDPs exceeding 10% of their annual turnover (7%), before agri-food (12%).

Chart 5:
Ratio of ultra-long payment delays as a % of turnover

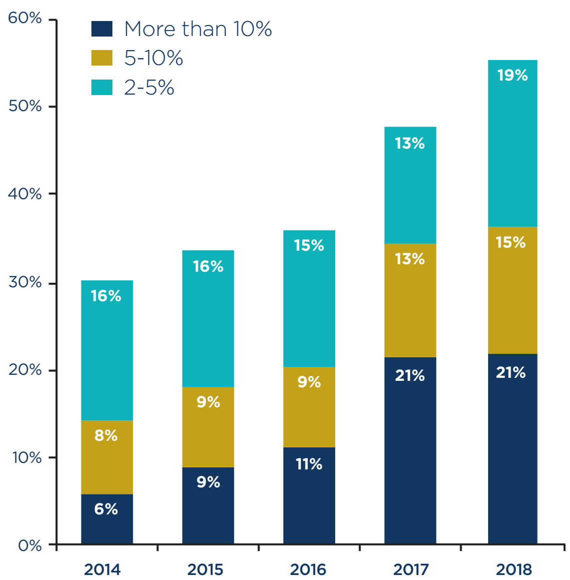
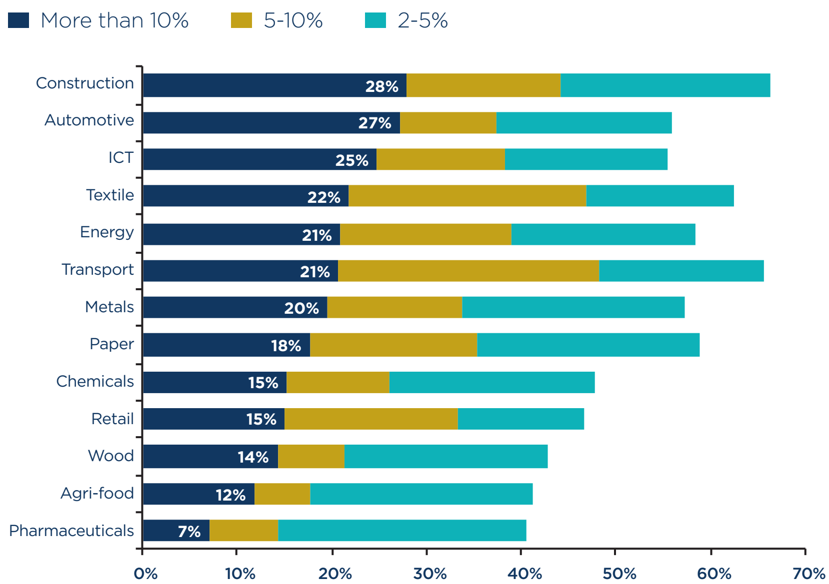


Chart 6:
More than 2% of total annual turnover in ultra-long payment delays



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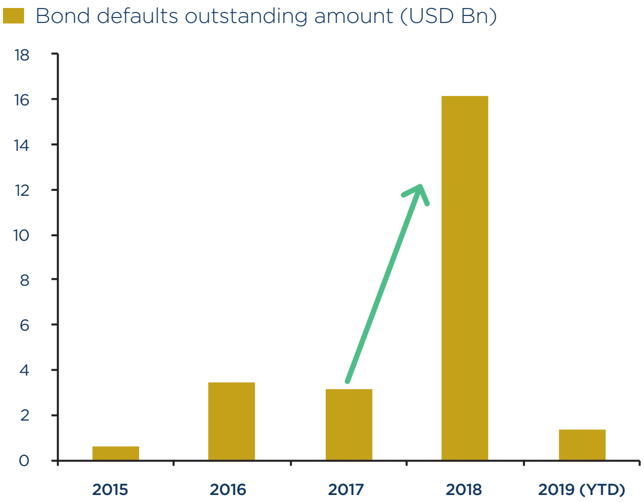
China experienced record corporate defaults in 2018

2018 proved to be a relatively challenging year for China. Growth slowed to 6.6% and is expected to decline further in 2019 (6.2%, according to Coface forecasts). This weaker growth momentum can be traced back to factors both domestic and external. On the domestic front, the need to reduce corporate leverage (total debt is about 260% of GDP) prompted authorities to tighten monetary conditions. This helped nudge companies to deleverage, in particular State-Owned Enterprises (SOEs). However, it also resulted in tighter liquidity, making it harder for companies to access financial resources, something that has been reflected in the results of our survey. On the external front, mounting pressures from trade negotiations with the United States have contributed to dampening domestic sentiment. Together, these factors contributed to deteriorating enterprise profits, which ended the year in contractionary territory (-1.9% YOY) for the first time in three years.

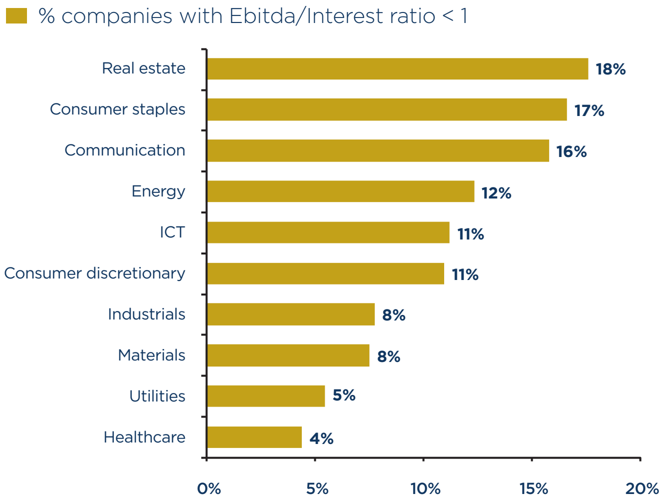
As a result, 2018 saw a record number and amount of corporate bond defaults in China. The amount (in US dollars) of bond defaults more than quadrupled, reaching USD 16 billion. While this is still a small proportion of China's massive USD 4 trillion bond market, it denotes an important shift in an economy that has not traditionally experienced defaults – the first ever bond default was Shanghai-based Chaori Solar in 2014. According to figures by Bloomberg[4], the size of bond defaults in 2018 was largest for refining (27%), coal operations (17%), distributors of consumer discretionary products (i.e. jewelry and automobiles, 16%), transportation and logistics (7%) and real estate (5%). Coinciding with the uptick in bond defaults, there was a spike in the number of bankruptcy cases settled through the Supreme Court of the People's Republic of China, reaching 6646 in 2018. The increase in bankruptcy cases fits in with the authorities' plans to expedite insolvency resolutions and clean up the debt of firms with excess capacity production or insolvent balance sheets by 2020. In other words, a higher default rate will become the new norm.

Chart 7:
Bond defaults soared in 2018



Source: Bloomberg and Coface

Chart 8:
Stress in debt service for some sectors



Source: Bloomberg and Coface

There is a strong association between the results of our payment survey, financials from listed companies, and the occurrence of bond defaults. For example, in the 2018 edition of our survey, 33% of energy companies experienced ULPDs exceeding 10% of their annual turnover, with almost 30% of all listed companies facing stress in debt service as measured by the interest cover (EBITDA/interest expense ratio below 1). Unsurprisingly, most bond defaults last year concerned companies belonging to the energy sector. Looking at the interest cover for over 3,700 Chinese listed companies in 2018, we see diverging trends by sector for 2019. Almost 20% of real estate companies reported insufficient earnings to cover their interest payments. This is in line with our survey, as these were the highest proportion of respondents experiencing ULPDs exceeding 10% of annual turnover. Consumer staples and communication equipment trailed closely behind, which is understandable in the context of slower domestic demand. On the other end of the spectrum, only 4% of healthcare companies are experiencing stress in debt service. The pharmaceutical sector experienced a decline in payment delays in 2018 and is also the sector with the lowest proportion of respondents experiencing ULDPs exceeding 10% of annual turnover.

4 Bloomberg bond default data uses the Bloomberg Industry Classification Systems (BICS). These vary relative to the Global Industry Classification System (GICS) and Coface's own sector classifications.

3 ECONOMIC EXPECTATIONS: HIDDEN RISKS AS GROWTH MOMENTUM SLOWS

- The slowdown in economic activity had a noticeable impact on payment delays. On the domestic front, deleveraging efforts led to tighter liquidity conditions during the first half of 2018. Not surprisingly, 49% of respondents stated that the main reason behind the payment delays was customer's financial difficulties. These were brought about by fierce competition impacting profit margins, a lack of financial resources, and slower growth in China. To make matters worse, deleveraging coincided with an escalation of trade tensions between the United States and China, resulting in weaker consumer confidence and domestic consumption – only 5% of respondents claim the reason behind customer financial difficulties was lower international demand.

- Reflecting these headwinds, a majority of respondents believe that it is unlikely that growth will improve in 2019 (59% vs. 33% a year ago). This is the first time this result has been recorded since Coface started conducting payment surveys in China in 2003, denoting that domestic sentiment has in fact deteriorated quite significantly. Expectations on the profitability and cash flow fronts were more muted as well, and, despite their views on the broader economy, most managers remain optimistic. 46% of respondents reported that their sales increased in 2018 relative to 2017, while 54% expect sales to improve further in 2019. The results were slightly more subdued for cash flows. Just 37% of respondents reported an improvement relative to 2017, while 47% expect cash flows to improve in 2019.

- Despite this deterioration in economic expectations, fewer than 20% of respondents declared using credit insurance or credit agency reports to mitigate their risks. The situation is worse for factoring and debt collection, with only 6% and 7% of those sampled reporting using these. Furthermore, almost 40% of respondents admitted that they use no credit management tools to mitigate credit risks.

- To further aggravate matters, almost 60% of respondents admitted to using Banker Acceptance Drafts (BAD) and/or Commercial Acceptance Drafts (CAD) in place of cash for payments. While this may help to improve balance sheets, these forms of payment effectively constitute a payment delay. When these delays do not appear on corporate balance sheets, they represent hidden cash flow risks. This might prove problematic as growth slows to 6.2% in 2019, potentially resulting in an even higher rate of defaults for some sectors.

Chart 9:
Growth will improve relative to last year

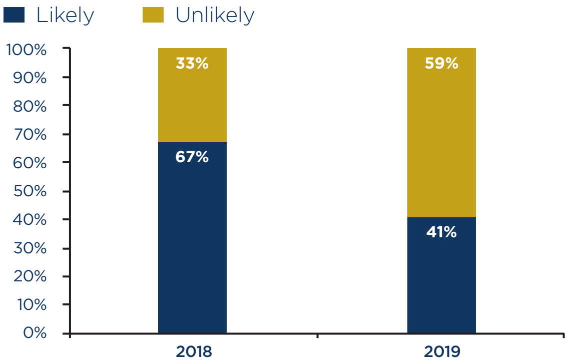


Chart 10:
Economic expectations (% respondents)

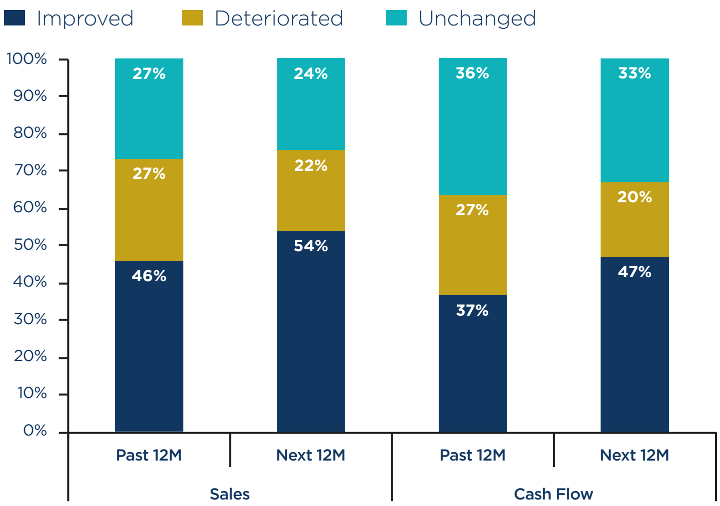


Chart 11:
Main reason for financial difficulties

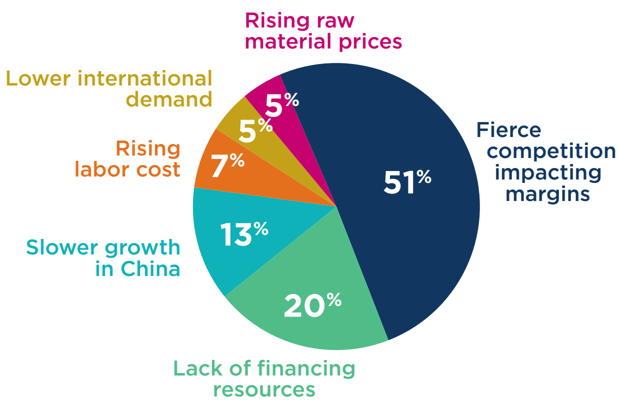
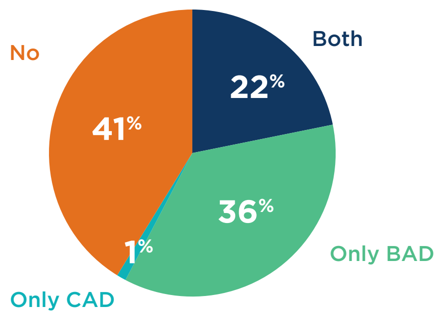


Chart 12:
Use of acceptance drafts



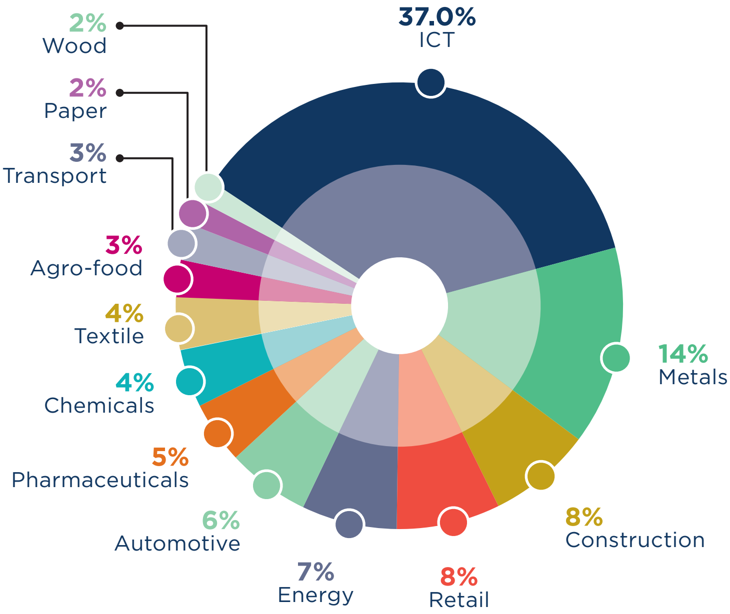
APPENDIX

A TOTAL OF

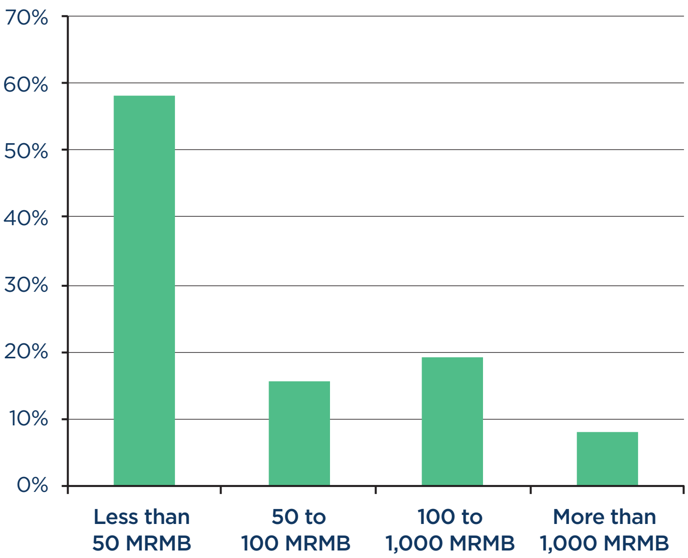
1,500
COMPANIES

PARTICIPATED
IN THE PAYMENT SURVEY

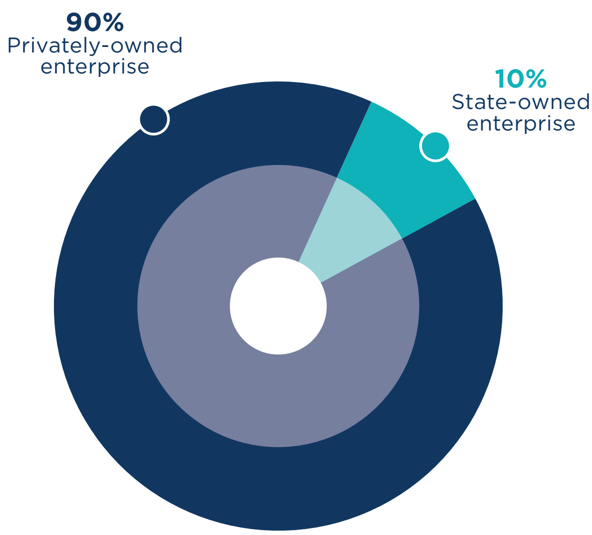
Which of the following best describes your company's industry?



For 2018, the total estimated sales revenue of your company will be:



Please state the nature of your company:



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