# Chinese Corporate Financials Keep up Disturbing Trend of Deterioration

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Highlighting the deteriorating trend in Chinese corporate financials has been an annual feature our of this blog. This year, instead of looking at just the CSI 300 constituents, we chose to broaden our universe by using the FTSE All A Share Index, an index of about 2000 Chinese A shares. This should give us the most accurate read on the state of corporate China.

For at least the last decade Chinese corporations have levered up, both through debt and working capital, in an attempt to keep the music playing and without regard to stability or profitability. As we will see, 2016 was no different. As an aside, all of the data in this post show aggregated (summed up) metrics for all non-financial companies. For example, sales growth numbers show the sum total of 2016 non-financial constituent sales relative to the sum total of 2015 non-financial constituent sales. Aggregating the data in this way gives us a good top down view without having to control for outlier companies that may be small and irrelevant.

Starting with the balance sheet, one constant characteristic of Chinese corporate behavior has been their willingness to lever up. There are a number of ways to measure leverage, but one of our favorites is net debt as a percent of equity. From 2005-2016 net debt as a percent of equity increased 126%. From 2015-2016 along it increased by 13% to 143%, the highest on record. Meanwhile debt as a percent of capital ticked up again to 63% in 2016 – also the highest reading on record – while cash as a percent of total capital fell to its lowest ever reading of 9%. Luckily, financial leverage (assets relative to equity) remained constant at an egregiously high 6.9x.

| Balance Sheet Items | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Data Item** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
| **Net Debt % Equity** | 63% | 62% | 75% | 82% | 90% | 86% | 102% | 118% | 116% | 120% | 127% | 143% |
| **Total Debt % TC** | 45% | 44% | 50% | 51% | 54% | 53% | 56% | 59% | 58% | 60% | 61% | 63% |
| **Cash % TC** | 10% | 10% | 13% | 11% | 13% | 13% | 11% | 10% | 10% | 11% | 13% | 9% |
| **Cash % Assets** | 2% | 2% | 3% | 3% | 4% | 4% | 4% | 3% | 3% | 4% | 5% | 4% |
| **Financial Leverage** | 8.4 | 7.8 | 7.9 | 7.1 | 7.6 | 7.2 | 7.3 | 7.3 | 7.3 | 7.1 | 6.9 | 6.9 |

Moving on to some ratios of working capital metrics as a percent of sales, we can see that 2016 was just a continuation of an alarming decade-long trend of Chinese companies gutting corporate efficiency to finance sales. From 2005-2016 accounts receivable as a percent of sales has increased 173%, accounts payable as a percent of sales has increased 73% and inventory as a percent of sales has increased 86%. All three metrics increased to an all-time high in 2016.

| Mixed Ratios | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Data Item** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
| **AR % Sales** | 4% | 5% | 6% | 5% | 8% | 10% | 10% | 10% | 10% | 11% | 11% | 12% |
| **AP % Sales** | 8% | 9% | 10% | 10% | 12% | 12% | 12% | 12% | 12% | 13% | 13% | 15% |
| **Inventory % Sales** | 13% | 12% | 13% | 14% | 16% | 17% | 18% | 18% | 19% | 20% | 22% | 23% |

Building up one's working capital could be a strategy to manage exploding top line growth, but unfortunately that is not the case for Chinese companies. Sales and net income haven't grown since 2014 and net income actually contracted in 2016. Cash flow from operations also fell 18% for the largest year-on-year contraction since at least 2006. Plunging cash flow is an indication that the earnings decline of 1% could be painting too rosy a picture.

| Growth | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Data Item** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
| **Sales Growth** | | 30% | 40% | 38% | 6% | 37% | 29% | 14% | 14% | 7% | 0% | 0% |
| **Net Income Growth** | | 33% | 72% | -3% | 32% | 41% | 19% | 5% | 20% | 7% | 0% | -1% |
| **CFO Growth** | | 5% | 32% | -17% | 68% | 12% | 22% | 40% | -17% | 58% | 61% | -18% |

This brings us to something we like to call Chinese channel stuffing – or the tendency of corporate China to stuff the supply chain with accounts receivable and accounts payable so as to keep sales/sales growth at the desired level. Since 2012 both current liabilities and current assets have outpaced sales growth by between 2%-10% annually. In 2016 both metrics outpaced sales growth by 6%. This is to say, in order for corporate China in aggregate to have generated flat sales in 2016, they needed to grow working capital by 6%. In order for corporate China to have generated flat sales for two consecutive years they needed to grow working capital by a cumulative 16%.

**Chinese Channel Stuffing**

| Data Item | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Current Liability Growth less Sales Growth | | -9% | -10% | -12% | 21% | -13% | -6% | 3% | 2% | 3% | 9% | 6% |
| Current Asset Growth less Sales Growth | | -8% | -10% | -10% | 20% | -12% | -6% | 3% | 2% | 3% | 10% | 6% |

The good thing is that, if you can believe the earnings and cash flow numbers, margins have remained relatively healthy. Net profit margins have remained at the historical average of 8% while cash flow margins stood at a robust 27% in 2017.

**Margins**

| Data Item | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Net Margin | 8% | 9% | 10% | 7% | 9% | 9% | 9% | 8% | 8% | 8% | 8% | 8% |
| CFO Margin | 28% | 23% | 21% | 13% | 20% | 17% | 16% | 19% | 14% | 20% | 33% | 27% |

But, flat margins and growing balance sheets make for deteriorating profitability stats. In 2016 ROE dropped to an all-time low of 9%, ROA dropped to 5% and ROIC dropped to an all-time low of 4%.

**Profitability**

| Data Item | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ROE | 12% | 12% | 16% | 11% | 12% | 14% | 13% | 12% | 12% | 12% | 10% | 9% |
| ROA | 5% | 4% | 4% | 3% | 4% | 3% | 3% | 4% | 3% | 4% | 6% | 5% |
| ROIC | 7% | 8% | 9% | 6% | 7% | 7% | 6% | 5% | 6% | 5% | 5% | 4% |

There, unfortunately, are not a lot of positive things to say about the trends in corporate China. Much of the above is of course driven by SOEs at the behest of the government, but that doesn't make the trends look any better. No one knows what the tipping point is and how long this can continue, but it goes without saying that we'd like to see these firms align the growth of their balance sheets to the growth of their income statements as soon as possible.