Press Release

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Euler Hermes study: Issues for China in the Year of the Monkey

- Payment discipline in China worsens by a further three days in 2016; insolvencies up 20%
- Government seeks targeted structural reform away from low-cost manufacturing
- Given the structural reform in China, the manufacturing sector faces major challenges on the back of high debt levels and low margins – a snowball effect on the supply chain
- Foreign direct investment down, capital flight ramps up to USD 504 billion in 2015

PARIS - 1 MARCH 2016 – In the Year of the Monkey, many Chinese believe that everything is possible – and, indeed, everything is changing. In its study: "China: Monkey forces for the Year of the Monkey", Euler Hermes, the worldwide leader in trade credit insurance, analyzes what the Year of the Monkey has in store for the Chinese economy. Euler Hermes economists predict that in 2016 volatile markets, a relaxed monetary policy, increased payment defaults and insolvencies, rising capital flight and lower investment in R&D, falling export revenues in US dollars with major consequences for China's supply chain and a downward currency trend will affect both China and its trading partners.

Worsening payment discipline, increasing insolvencies, high debt levels

"The monkey is considered to be agile, cunning, flexible and good at solving problems, but in 2016 he also faces big challenges," said Ludovic Subran, chief economist at Euler Hermes. "This applies to the economy, the capital market, politics, currency turbulence, investment, capital costs and not least companies themselves. According to our estimates, payment discipline has worsened by a further three days and now stands at 84 days.* Insolvencies are expected to rise 20%. This trend comes as no surprise: Chinese companies are deep in the red and non-state banks already reported a sharp rise in loan defaults in the second half of 2015."

However, China's situation is not just about slightly weaker economic growth of 6.5% in 2016 and 6.4% in 2017, but is also strongly driven by political decisions. The leading credit insurer's economists attribute this mainly to two reasons.

Reason 1: Government seeks targeted structural change away from low-cost manufacturing

"The Chinese government has set itself a goal of targeted structural reform," explained Subran. "It wants to move up the value creation chain and away from being a cheap manufacturing country, to an economy shaped by services. As a result, the state's strategic focus is no longer on many sectors which were subsidized in the past – and the government is no longer afraid of letting them go bust."

The construction, metal and steel, mining and lower-end manufacturing industries now find themselves in a completely different environment, for which many companies are not equipped. High levels of debt and the now relatively high wages in China mean that many businesses are no longer sufficiently competitive to hold their ground without state subsidies. Prospects are healthier in the consumer goods sector however - electronics entertainment, food, and IT/computer, for example. The outlook is also better for sectors of strategic importance to the government, such as the automotive industry, aviation, information technology, telecoms services, and the transport sector -- and these should present somewhat lower levels of risk

Snowball effect: Chinese companies are failing and taking their supply chains down with them

The failure of the manufacturing sector is creating a snowball effect and the downward spiral is sweeping away the suppliers of the manufacturing businesses, whether based in China or in neighboring countries like Hong Kong, South Korea and Taiwan. However, service companies that work for and in production workshops are also feeling the impact - for example cleaning services, maintenance businesses, IT service providers. Transport and logistic companies, traders and brokers that market, ship or resell products in hubs such as Singapore are also affected. Some headquarters of companies that operate production workshops in China are based in Singapore, and are also impacted by the downward spiral.

Reason 2: Battle against shadow banks results in more restrictive access to credit

Secondly, the Chinese central government is also taking firmer action against shadow banks, and more rigorous discipline is also noticeable in local government spending. This in turn leads to reduced liquidity at companies and often develops into a vicious cycle. Difficult access to bank credit or alternative financing options has caused a growing number of companies in China to turn to supplier credit. Extremely long payment targets are more commonplace, and in some cases end in payment default. In a vicious cycle situation, this also leads to a rise in insolvencies.

Payment terms in China increased by an average of 27 days* between 2007 and 2015; they are expected to rise by a further three days in 2016. Companies are now forced to wait around a month longer on average for payment than a few years ago. The longer the payment terms, the greater the risk of default.

Foreign direct investment falls, capital flight ramps up to US 504 billion in 2015
Growing risks for companies, a weak business climate and continuing overcapacities lead in turn to a slowdown in investment growth – below 5% for the first time in 25 years. Financial investment faces challenges as investor perception remains negative. Foreign direct investment fell significantly, halving in Q3 2015 vs the previous quarter. The total amount of international capital pulled out of China in 2015 was USD 504 billion.

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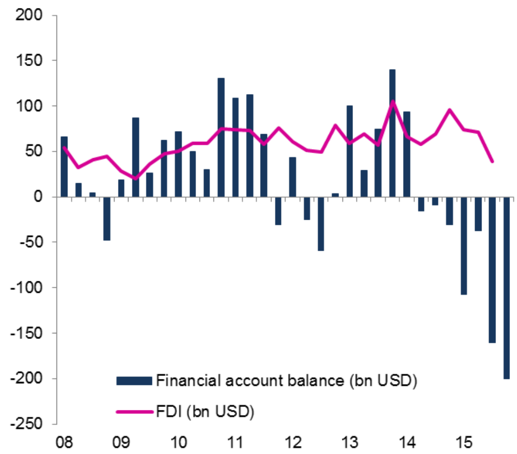
***Calculation based on days of sales outstanding (DSO) of listed companies. DSO is the period between billing and settlement of the receivable. In China this period is estimated to have increased by four days in 2015, from 77 to 81 days. In 2016 Euler Hermes expects DSO in China to worsen by a further three days to 84 days. In most industrial countries, the DSO trend is positive and companies pay as quickly as or even faster than they did last year.

To read the current Euler Hermes study "China: MONKEY forces for the Year of the Monkey" (English) go to: http://www.eulerhermes.com/mediacenter/Lists/mediacenter-documents/Economic-Insight-6-reasons-monkey-economics-china-fev16.pdf

To read a study on the Chinese economy and insolvencies "China: Great Wall, Great Mall, Great Fall? Not really…" (English) go to:
http://www.eulerhermes.com/mediacenter/Lists/mediacenter-documents/Economic-Insight-China-Sept15.pdf

Graph: Financial account balance and foreign direct investment (USD billion) in China



CONTACTS

Euler Hermes Group Media Relations
Remi Calvet +33 (0)1 84 11 61 41
remi.calvet@eulerhermes.com

Publicis Consultants
Romain Sulpice +33 (0)1 44 82 46 21
romain.sulpice@mslfrance.com

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