Follow the Money: The State Financial Sector & the Aluminum & Steel Overcapacity Crisis

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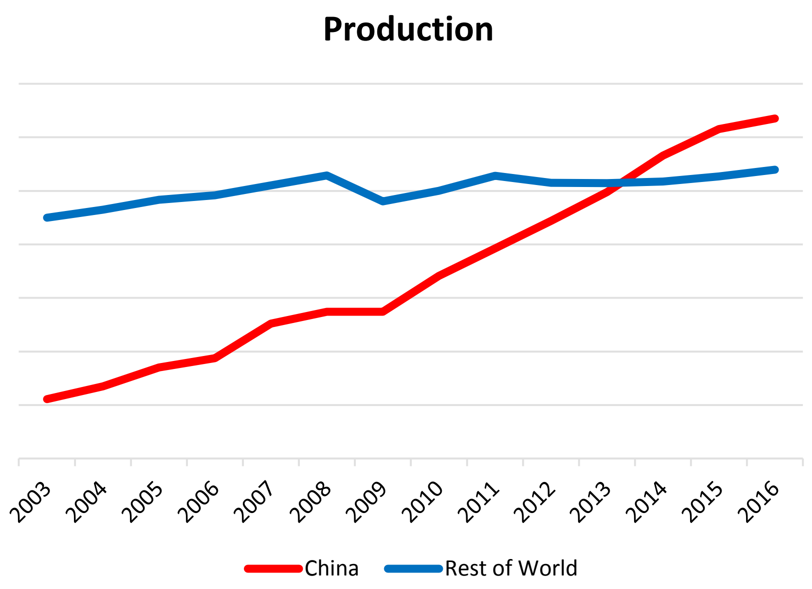
Where SEs Dominate, Overcapacity Follows

- The consequences of state enterprises in competitive industrial sectors are a global problem
- But not all countries are equal causes…
- The phenomenon is particularly acute in China’s traditional, pillar industries, *e.g.*, steel and aluminum

Steel and Aluminum in China: Which is Which?

Metal # 1



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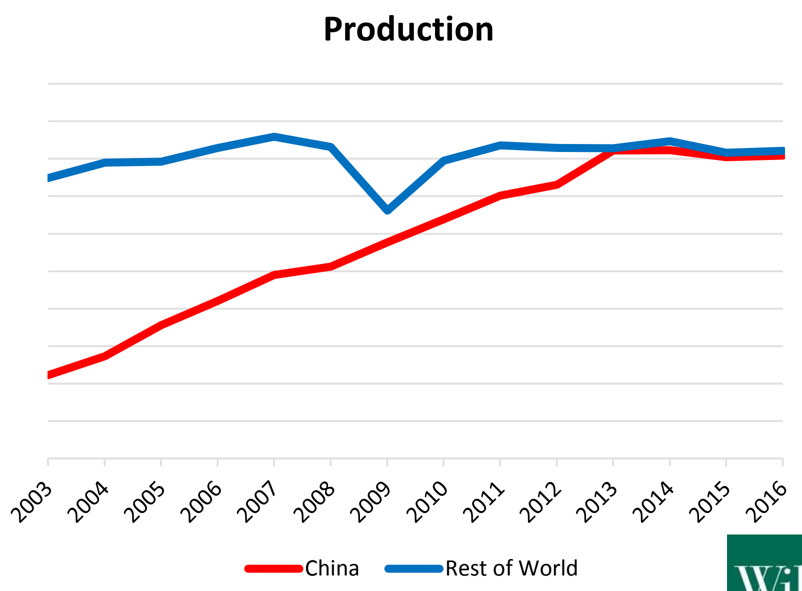

Expansion in China is Not Market-Based

- The overcapacity numbers are staggering:
  - Steel – at least 350 million tons, almost five times total U.S. production in 2016
  - Aluminum – at least 9 million tons, more than 10 times U.S. production in 2016
- "Blind expansions," to quote the Chinese government, have occurred despite:
  - Falling prices
  - Poor firm performance
  - Lack of comparative advantage
- Why?

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The Causes are Actually Straightforward

- These industries are dominated by state enterprises, including strategically important, politically connected "private" enterprises, and…
- The government ensures virtually limitless financial support through the state-owned and -directed financial system
- This includes formal bank lending, bond markets, equity infusions, etc.

Money Flows Through the State-Directed Financial System

"SOEs have been the bulwark of government industrial policy, used to reach development and strategic goals. . . . The policy role of SOEs is enhanced by preferential access to financing. This includes financing provided by state-owned banks, but extends to other forms of borrowing. The privileged access has been underpinned by substantial land endowment . . . and implicit government guarantees."

IMF WP/16/203 (2016) at 7.

"China's commercial banks . . . are still expected to support policy objectives and align their strategies with the State's broad economic goals, and are frequently urged to do so. This suggests China remains a centrally planned economy despite financial reforms and effort at rebalancing the economy that had implied a greater role for market forces."

Fitch Ratings (2016).

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Beyond the Banks

- Bond Markets:
  - Implicit government guarantees distort credit ratings in favor of state enterprise issuers, while state financial institutions dominate the markets
- Shadow Banking:
  - A recent study by the Brookings Institution estimates that two-thirds of shadow bank funding is simply “bank loans in disguise,” predominantly by state-owned banks

Lavish Financing Despite Abysmal Financials in Aluminum

- Lending covers both operating losses and expansion of state enterprises, some of which operate below variable costs
- Profits have been created using asset sales to the government and related entities to avoid delisting
- Actual financial performance may be worse than it looks…

Aluminum Corp. of China (CHALCO)								
Ratio	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current	1.105	0.908	0.742	0.801	0.585	0.652	0.609	0.793
Quick	0.588	0.398	0.351	0.415	0.280	0.409	0.394	0.544
Debt-to-Equity	1.251	1.410	1.471	1.702	2.255	2.715	3.861	2.763
State Power								
Ratio	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current	0.264	0.302	0.326	0.390	0.387	0.373	0.356	0.423
Quick	0.205	0.229	0.240	0.280	0.271	0.275	0.268	0.337
Debt-to-Equity	4.597	10.180	5.602	6.059	5.494	5.443	5.331	4.680
Shenhuo								
Ratio	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current	0.491	0.560	0.684	0.606	0.521	0.495	0.500	0.497
Quick	0.388	0.425	0.513	0.456	0.403	0.346	0.345	0.347
Debt-to-Equity	2.681	3.099	3.348	3.679	3.379	3.650	4.628	5.767
Jiquan Iron & Steel Co. (JISCO)								
Ratio	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Current	1.351	0.954	1.192	0.861	0.705	0.730	0.655	0.334
Quick	0.730	0.532	0.744	0.569	0.446	0.452	0.452	0.213
Debt-to-Equity	1.904	1.656	1.743	2.610	2.632	1.969	2.180	2.656

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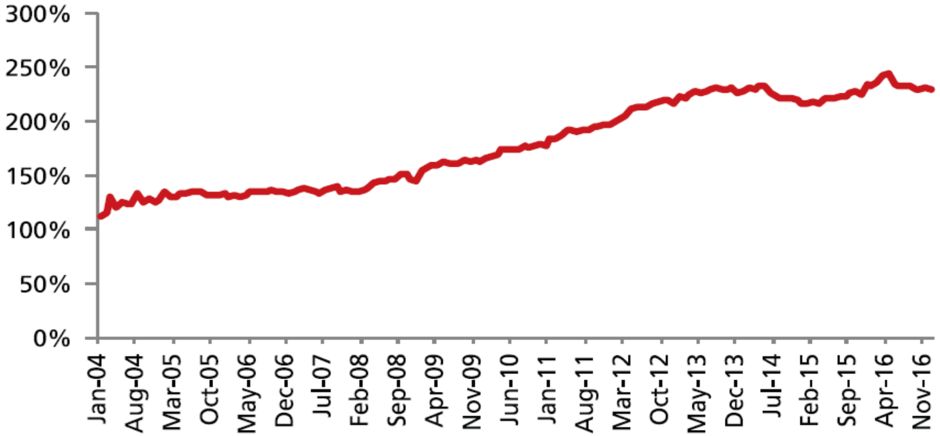
Lavish Financing Despite Abysmal Financials in Steel

According to statistics of CISA, the total debt-to-equity ratio of China's large and medium-sized steel companies was 229% at end-2016, versus 234% at end-2015. This compares with 149% during the 2004-2011 commodity boom and 222% during the 2012-2015 commodity doom.

Diagram 5. China's steel sector: Total debt-to-equity ratio of large and medium-sized steel mills



Source: CEIC, DBS Vickers

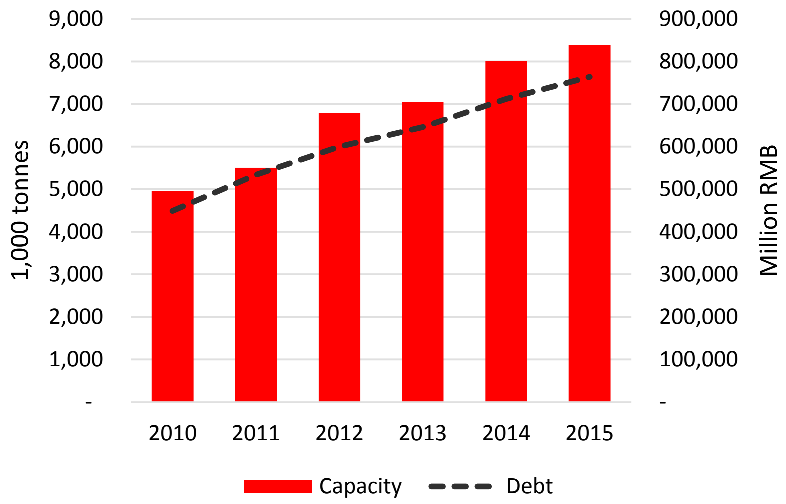
Source: DBS Group Research Asian Insights, "China's Steel Sector Supply Reform" (April 2017) at 12.

Debt Fuels Blind Expansions

- According to the IMF, credit growth has been driven largely by continued financing to non-viable enterprises in overcapacity industries
- Unsurprisingly, these are industries where state enterprises dominate
- Prices collapsed as state enterprises continued to operate and expand from 2011-2016

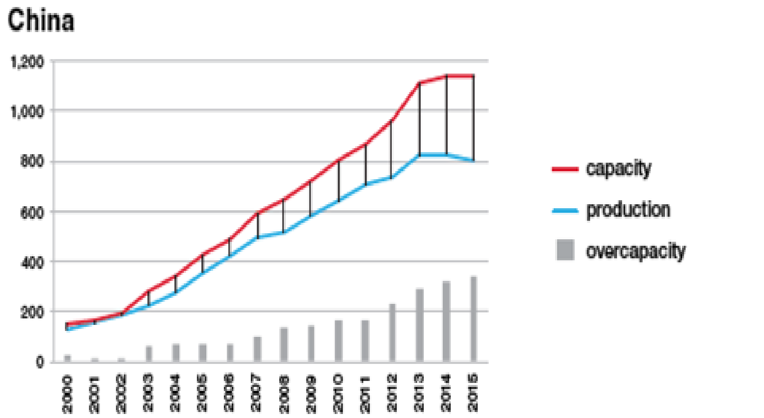
Debt Fuels Blind Expansions (cont'd)

Capacity and Debt of Four Major Aluminum SEs in China



Source: CRU; Company Financial Statements

China Steel Production & Overcapacity

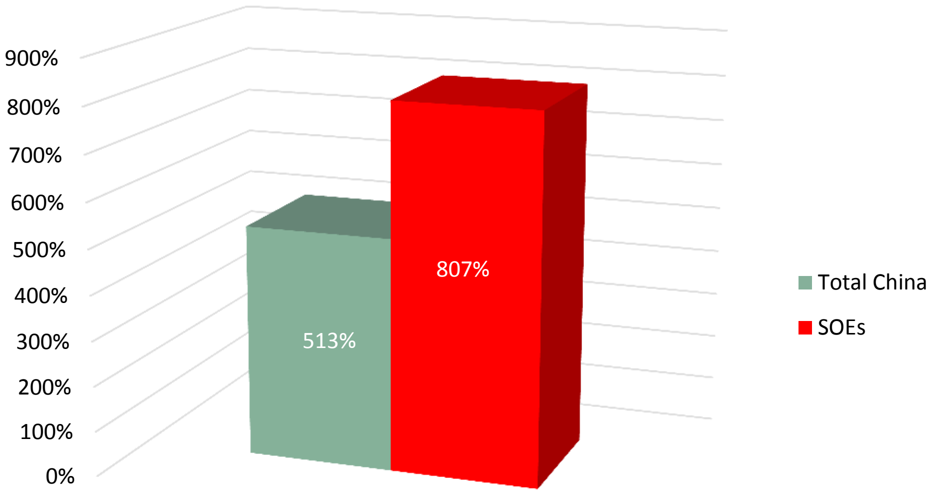


Note: figures represent nominal raw steelmaking capacity, production and overcapacity in million metric tons (MT) across the major steel producing regions in the world. Please note the difference in scale for China and all other regions.
Source: Duke CGGC, calculated from the German Steel Federation (capacity) and World Steel Association (production).

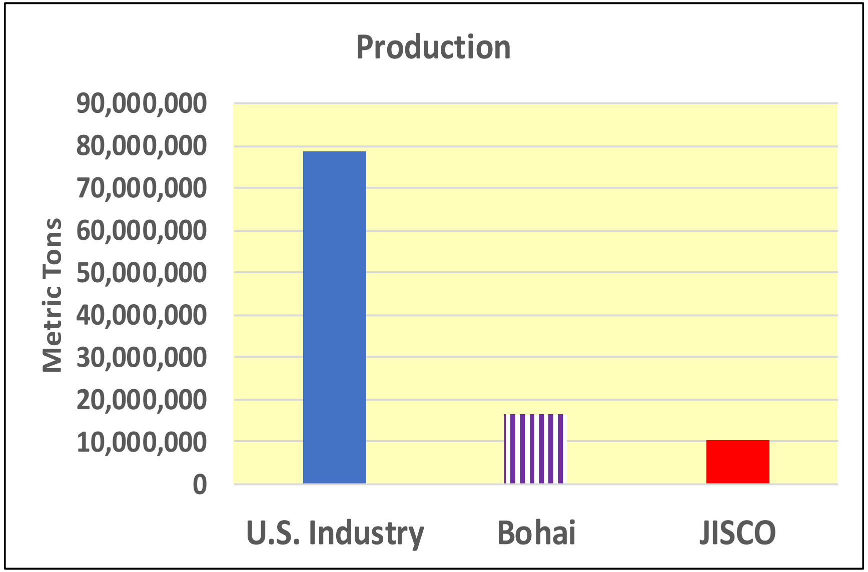
Benefits Flow Disproportionately to State Enterprises

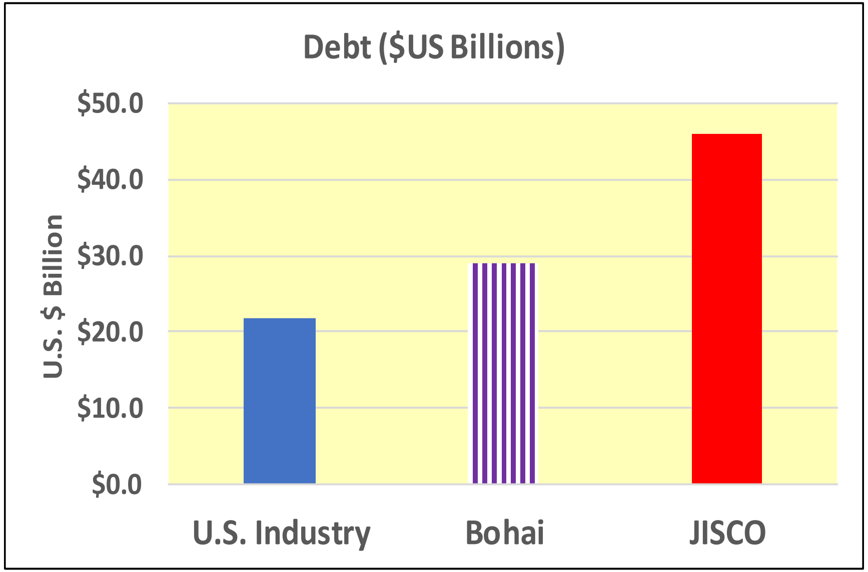
- As in the steel industry, preferential financing in aluminum is directed to state enterprises, so they expand faster than the industry as a whole

2003-2016 Alu Capacity Growth



Chinese State Enterprises are Excessively Leveraged





More Money, More Problems

- State Enterprises account for 16% of value-added, but receive 50% of total bank credit in China
- Approximately 40% of new debt goes to pay interest on existing loans rather than productive investments
- The IMF estimates that 15% of current debt consists of loans “potentially-at-risk,” or loans to firms with insufficient earnings to cover interest payments
- These figures account only for formal bank lending and are likely higher considering all sources (bonds, shadow banking, etc.)

More Problems, More Money

- In late 2016, China announced a massive bailout program relying primarily on debt-to-equity swaps
- China’s state-owned commercial banks were directed to establish special asset management subsidiaries to hold the shares and to prioritize “creating a stable outlook, stable credit, and stable support” and “safeguarding the normal operations of enterprises”
- The asset management companies (AMCs) effectively bestow a clean financial slate at little to no cost to the borrowers, and the cycle repeats itself…

More Problems, More Money (cont'd)

- Approximately 70 state enterprises in heavy industries like metals, mining, and equipment have converted more than RMB 1 trillion into equity shares thus far
- According to recent reports, this includes ten steel enterprises in debt-to-equity swap agreements worth RMB 150 billion (US $23 billion), an estimated 4.3% of major steel company debt in China
  - Those identified in the report are state enterprises
  - Based on those figures, China's major steel companies are more than $534 billion in debt
- Bottom line – deleveraging is due to state support and not improved performance

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State Consolidation Perpetuates the Problem

- In 2016, China launched a $50 billion fund for SE restructuring as part of its "supply side structural reform" program
- State-directed reorganizations are often used to ensure that industrial assets continue operating rather than exiting the market and create even larger and more powerful state enterprises
- In 2016, struggling Wuhan Iron & Steel was merged with Baoshan Iron & Steel to create Baowu Steel Group, now the world's 2^{nd} largest steelmaker (70 mln tpy)
  - The Deal involved a $3.6 billion debt-to-equity swap between WISCO and China Construction Bank
- Chinalco recently suspended A share trading, suggesting movement on a rumored merger involving State Power Investment Co.

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State Enterprises Spared from Administrative Capacity Reductions?

- In 2016, 80% of steel mill closures reported by the National Development and Reform Commission were private mills
- Of nearly 5 million tons of recently identified "illegal capacity" in aluminum, only 7% was state-owned, and all capacity actually shut down thus far is private

Smelter	Ownership	Illegal Capacity ('000 mt)	Shut Down
Xinjiang Jiarun	Private	150	150
Xinjiang East Hope	Private	800	400
Xinjiang Qiya	Private	20	20
Xinjiang Tianlong	State	100	0
Shandong Xinfa	Private	1100	570
Shandong Weiqiao	Private	2050	1450
Huayun New Material	State	213	0
Jinlian Aluminum	Private	250	100
Total		**4683**	**2540**

Source: AZ China; CRU

Conclusions

- There is a clear relationship between state enterprises and the global overcapacity crisis
- State ownership of steelmakers is key, but their survival depends on the role of the state in the financial sector
- Distortions create a vicious cycle, as mainly non-state enterprises in the rest of the world shut down
- Those that have not shut down are unable to reinvest and are sliding towards shutdown or financial failure
- To find the source of the crisis, just follow the money

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