China Corporates and Rising Input Costs

For Downstream Industries, Capacity to Pass on Higher Costs Will Influence Credit Effects

Key Points

- Fitch expects global commodity prices over 2021 will be higher than in 2020, on average, but consumer price increases will remain modest in China
- For downstream producers, the rating effects of higher input prices will depend partly on their capacity to pass on higher costs to customers
- Companies operating in competitive, highly fragmented industries will face greater difficulty in passing on higher input costs, which could depress profit margins

Raw material costs have risen sharply in recent months for Chinese companies, due partly to the domestic and international recoveries from the initial shock of the Covid-19 pandemic. Fitch Ratings believes that the rating effects of higher input prices for issuers in downstream industries will depend in part upon the capacity of companies to pass on higher costs to customers.

Producers Will Absorb Price Impact

We expect that China's downstream producers will, in aggregate, be forced to absorb much of the impact of higher raw material and manufacturing costs. This is evident in the sharp discrepancy between growth in the producer price index, which was up by 6.8% yoy in April 2021, and the consumer price index, up by just 0.9% yoy.

Producers' limited capacity to pass on cost increases reflects in part the fragility of consumer sentiment. Retail sales were up by 17.7% yoy in April, although the CAGR over the previous two years was just 4.3%, well below levels seen prior to Covid-19. In addition to the pandemic, high household debt may also dampen enthusiasm for spending.

Meanwhile, many industries remain intensely competitive, constraining firms' capacity to raise prices. There are also political pressures to contend with. Chinese media have reported that the State Council has called for measures to prevent commodity prices increases being passed on to consumers.

Some Firms May Have More Pricing Power

The industrial sector as a whole may absorb much of the increase in input costs, but we believe certain downstream producers will have more capacity to pass on costs. This should cushion the impact on profit margins, reducing potential downside pressure on ratings. Fitch-rated corporates, which tend to be larger and often have more negotiating power, may be heavily represented in this group.

We expect that companies with premium products and strong brand names, or those that operate within less fragmented sectors, should have a greater capacity to pass on higher costs of production to end-customers. In some industries, contractual provisions or favourable supply-demand dynamics may also ease this process.

Ratings Impact Depends on Multiple Factors

Cash flow and profitability are important factors in our assessments of companies' financial profiles, which feed into our ratings. Price factors may be a key driver of these for many issuers.

However, rating effects for individual issuers will ultimately depend on a variety of factors, such as the sustainability of any price-driven changes in cash generation, shareholder-return policies, adjustments to planned capex, and/or M&A policies.

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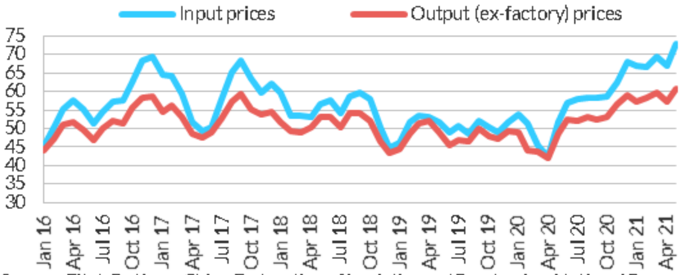
Price Trends Point to Margin Squeeze

Profits at large-scale industrial corporations in China rose by 57% yoy in April, according to China's National Bureau of Statistics. However, this has been driven largely by upstream producers, with midstream and downstream industries like consumer goods production facing challenges from higher costs.

Divergent trends in the headline producer and consumer price indices are illustrated in China's manufacturing purchasing managers' index (PMI). The PMI's sub-indices for input prices and ex-factory prices have diverged markedly since April 2020 as the economy recovered from the shock of Covid-19. This trend points to the potential for margin compression.

Input and Output Price Trends Diverge in China's PMI

Input and output price sub-indices (50+ shows positive monthly change)



Source: Fitch Ratings, China Federation of Logistics and Purchasing, National Bureau of Statistics, Haver Analytics

Outlook for Prices

Some of the upward pressure on input prices may ease later in 2021. The People's Bank of China (PBoC) has signalled that it expects producer price inflation to be lifted by imported commodity price increases in 2Q21-3Q21, but that it should stabilise as base effects associated with the pandemic shock in early 2020 recede, and as global supply catches up with demand.

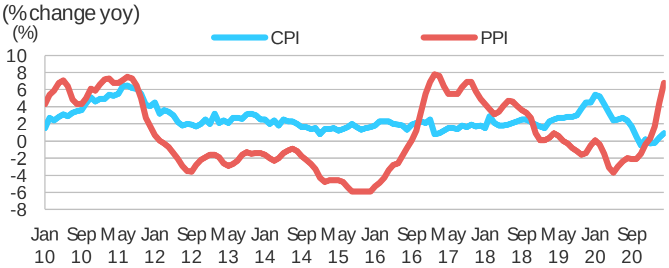
In addition to the State Council's call to prevent commodity prices increases being passed on to consumers, the authorities have recently signalled that they will crack down on market irregularities in the commodity sector. This may help to cool rises in raw material costs in China.

Fitch revised up its near-term forecasts for a number of key global commodities in May 2021. We believe costs for many raw materials will remain high in 2021, with average prices for most well above 2020 levels. We expect stronger pricing sentiment to spill over into early 2022, although our longer-term price assumptions for 2023 and beyond remain largely unchanged.

We see little indication of a pick-up in consumer price inflation. A cyclical downturn in pork prices, which has offset stronger increases in fields like education and transportation costs, has been one of the drivers of subdued consumer price inflation so far this year. However, core consumer price inflation (excluding food and energy) also remains low.

Historically Linkage Between PPI and CPI Inflation Is Weak

(% change yoy)



Note: CPI=consumer price index; PPI=producer price index, all industrial products
Source: Fitch Ratings, Haver Analytics, National Bureau of Statistics

Exchange-rate movements have served to cushion price increases for imported commodities so far in 2021, reflecting the renminbi's yoy strengthening against the US dollar. Any significant weakening of the currency could add to imported price pressures, but we do not believe this is likely. The authorities have signalled that they expect the exchange rate to remain "basically stable".

Cost Pressures More Apparent for Some

The upward pressure on producer input prices has been more evident for some sectors than others. Sectors with low levels of concentration and high competition may struggle to pass on higher costs to consumers.

Chinese automakers, for example, have been significantly affected by raw material cost inflation in 1Q21. The global supply shortage of auto chips has been a particularly marked factor, but prices have risen for many other important inputs as well.

Several listed companies attributed lower profit margins to the higher cost of parts. For example, Great Wall Motors' 1Q21 gross margin dropped by 2pp qoq, albeit driven partially by a higher sales contribution from its lower-margin Ora-branded mini electric vehicles (EV)s.

Some firms have managed to offset the effects of cost inflation on margins with product mix adjustments. Luxury brands, with their large order backlogs, are likely to have a stronger ability to pass on the higher costs to customers than mass-market brands.

However, it may be difficult in general to pass higher costs on to consumers due to fierce competition, in particular in the mature fossil-fuel car market. Despite higher raw material costs and production bottlenecks due to chip shortages, retail discounts offered by auto dealers have been largely stable year-to-date, according to the China Passenger Car Association. Some dealers have run promotions to offset longer wait times for new cars.

Fitch believes production disruption stemming from the chip shortage poses larger risks to Chinese carmakers' sales and margins this year than other raw material cost increases, which we view as likely to be more transitory in nature.

Chinese automakers should be relatively less affected by chip-related disruption than their global peers, given their more conservative inventory strategies and high flexibility to shift to local alternatives. Nevertheless, working capital is likely to deteriorate for many, due to their strategy of stockpiling parts and producing half-finished vehicles while awaiting chip supplies.

Higher raw material costs could also put further pressure on the profit margins of Chinese vehicle battery suppliers, although the impact will vary across different products and players.

Rising raw material costs have affected lower-priced LFP batteries more than ternary-cathode batteries, potentially narrowing the cost advantages of the former. The market share of LFP batteries rose to 39.8% in 4M21 from 32.5% in 2019, as automakers sought cheaper battery options for their mid- to low-end EVs.

Fitch expects China's dominant vehicle battery producer, CATL (BBB+/Stable), to use its bargaining power with automakers and its strong influence over upstream suppliers to limit the impact of higher production costs on margins. Smaller, low-end battery suppliers are more likely to face margin erosion, due to greater reliance on LFP products and higher customer concentration.

Buyers Exhibit Different Price Sensitivity

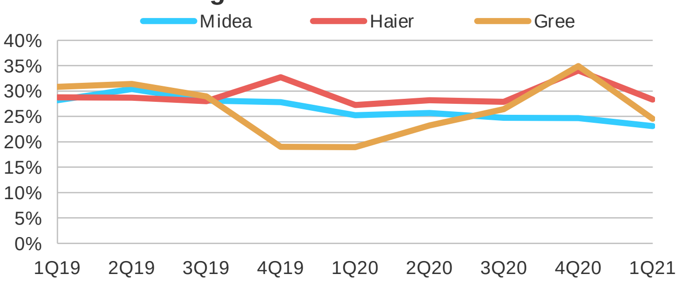
The importance of product and client mix in influencing firms' ability to pass on cost increases has been notable in the home appliance sector, where some firms have so far demonstrated greater leeway to pass on price increases to domestic consumers than to export clients.

Midea (A/Stable) has faced margin erosion in recent quarters, due partly to increases in the price of raw materials, which typically represent around 90% of its cost of goods sold (COGS).

Despite the fragility in consumer sentiment noted earlier, Midea has so far been able to pass on price increases to domestic consumers more easily than to overseas buyers that it produces for on an original equipment manufacturer (OEM) basis, helping to limit this erosion. This may be due in part to ongoing upgrading of its overall product range, though when OEM contracts are renegotiated that may also offer an opportunity to improve margins on the OEM side. Midea is also seeking supply-chain efficiencies to offset rising costs.

Recent performance may be an imperfect guide to future trends. Companies' ability to pass on price increases to domestic consumers could be impeded if rising political concerns about inflation causes policymakers to put pressure on producers to absorb higher input costs.

Grosss Profit Margin



Note: Fitch calculations. Midea reclassified some costs from selling, general and administrative expense to COGS in 2020, depressing gross profit margin
Source: Fitch Ratings, company reports

The impact of rising input prices on profit margins has been less clear for other appliance-makers like Haier and Gree (neither of which are rated by Fitch). In Haier's case, a shift towards premium products in both domestic and overseas markets may have served to support profitability.

Contractual Protection May Play a Role

Fitch believes that favourable supply-demand dynamics and contractual protection will enable issuers in some sectors to shoulder the impact of higher input costs better than others.

For example, among China's engineering and construction (E&C) companies, raw materials are an important driver of profitability as they typically account for over 30% of costs. Partly as a result, we expect recent steep increases in steel and cement prices to put short-term pressure on operating cash flow and profitability.

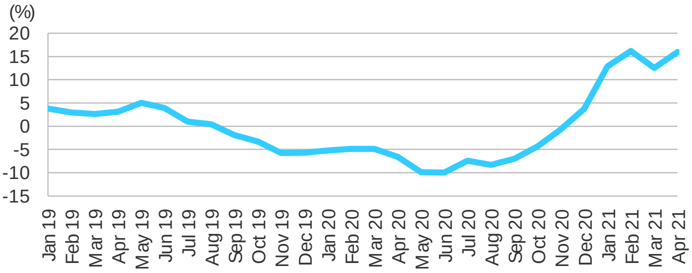
A prolonged period of rising materials prices could squeeze construction companies' margins and cash flow, particularly given that competition is intense and bidding prices are depressed.

However, we expect the overall impact to be manageable, as construction contracts are usually cost-plus-based and include terms for fluctuating building materials costs. In most cases, if the rise in building material prices exceeds a pre-set range, such as 5%, the construction party can transfer the extra costs to the project owner.

Leading construction companies, such as China State Construction Engineering Corporation Ltd (A/Stable) and China Communications Construction Company Limited (A-/Stable), may be better positioned to manage price risk due to their scale advantages and negotiating power as central state-owned enterprises.

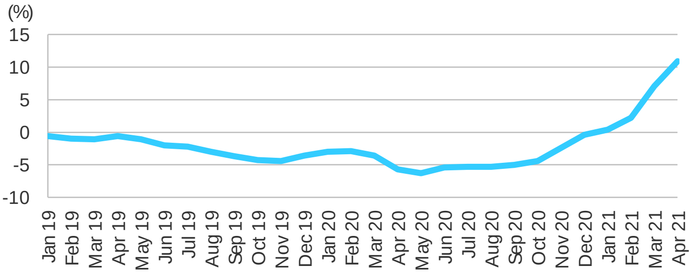
Appendix: Price Charts

China's PPI: Coal and Coking Coal Industry YoY
PPI: Coal and coking coal industry



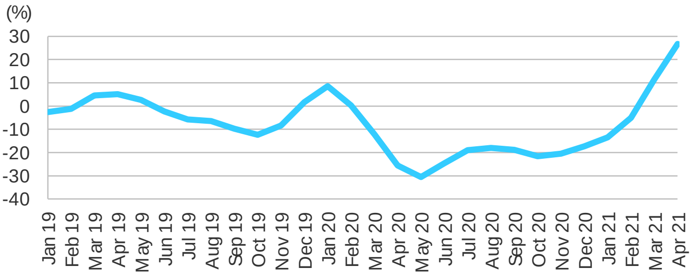
Source: Fitch Ratings, NBS

China's PPI: Chemical Industry YoY
PPI: Chemical industry



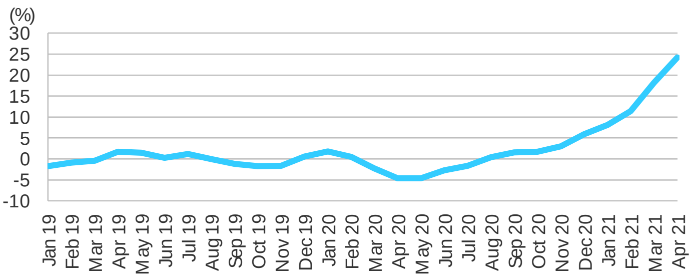
Source: Fitch Ratings, NBS

China's PPI: Petroleum Industry YoY
PPI: Petroleum industry



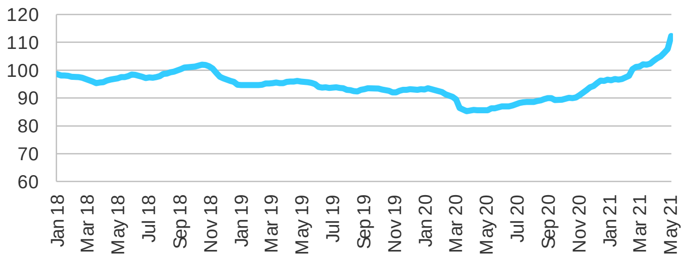
Source: Fitch Ratings, NBS

China's PPI: Matallurgical Industry YoY
PPI: Metallurgical industry



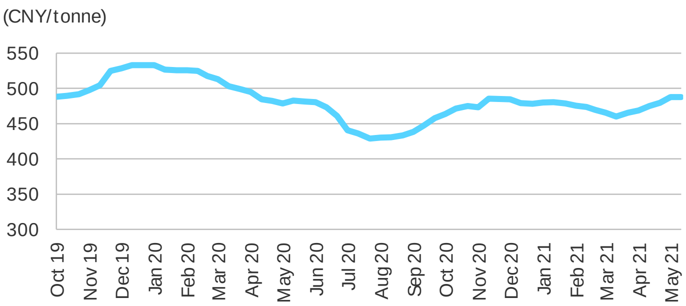
Source: Fitch Ratings, NBS

China's Production Material Price Index
Production material price index total



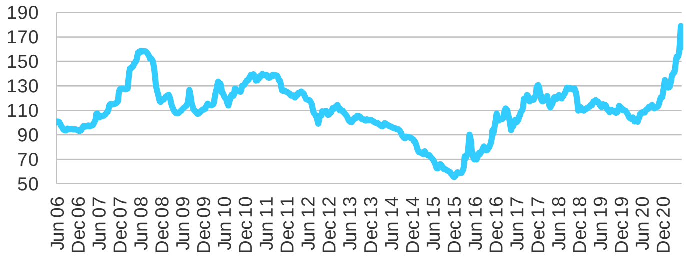
Note: December 2005 = 100
Source: Fitch Ratings, MOFCOM

Market Price: Cement: P.O42.5 Packaged:National



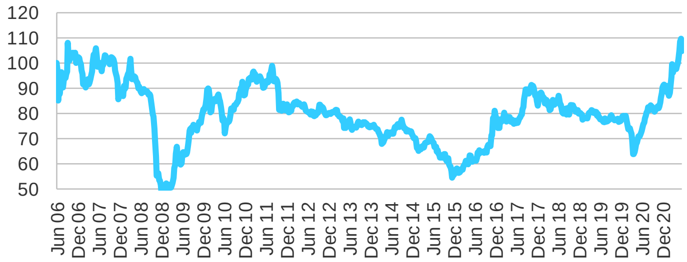
Source: Fitch Ratings, NBS

China Commodity Price Index: Steel



Note: Price index is calculated based on the price in June 2006; index =100 in June 2006
Source: Fitch Ratings, MOFCOM

China Commodity Price Index: Non-Ferrous Metals



Note: Price index is calculated based on the price in June 2006; index =100 in June 2006
Source: Fitch Ratings, MOFCOM

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