



## Is credit the new king for Asian corporates?

*Asian companies are once again borrowing more, but it's not yet time to worry.*

by Edward Russell

Asian companies have earned a reputation as cautious users of credit in recent years. From 2002 to 2007, leverage among non-financial corporates in Asia fell by a quarter, according to Morgan Stanley.

This wasn't voluntary. After businesses spent the 1990s going crazy with their credit cards, the Asian financial crisis put a stop to unrestrained corporate borrowing and forced banks to tighten their lending policies. As a result, many Asian companies learned how to grow using, of all things, cash.

"The trauma of being shut out of credit markets when it was most needed changed companies' views," wrote Viktor Hjort, an analyst at Morgan Stanley, in a report on the credit strategy of Asian companies since 1997. He added that even when credit was available, companies in the region simply chose not to access it.

Low leverage and ample cash prepared Asia well for the latest economic upset. This time around, the problem was in the West, where millions of dollars were borrowed without solid backing. Niche brands like Crocs and Krispy Kreme ended up with retail outlets spanning the globe, in locations as unlikely as Dubai and Nanjing. Now, a good number of Western retailers similar to these are more likely to be found in Salon.com's brand graveyard than in a glassy Asian shopping mall. Cash has taken on a new importance among those left standing.

"Cash is always king," said Quah Ban Huat, chief financial officer (CFO) of Singapore-based Rickmers Maritime. A fact he said he learned from his years working in investment banking.

But despite everything, Asian corporates are increasingly borrowing. From December 2007 to December 2009, outstanding loans to non-financial corporations in China were up 51%, according to the People's Bank of China; outstanding loans to business enterprises in Malaysia were up 20%, according to Bank Negara; and those to non-bank business customers in Singapore up 20%, according to the country's monetary authority. By comparison, in the US, one of the hardest hit regions in the 2008 crunch, outstanding commercial and industrial loans fell 16% during the same period, according to the Federal Deposit Insurance Corporation.

If the lesson of the past two years was to grow on cash, why are Asia's companies doing just the opposite -- growing on credit?

### **Credit to grow**

"Asia is driving a lot of the growth globally," said Sanjeev Chatrath, Asia-Pacific region head of client sales management at Citi global transaction services. Growth is one thing Asia certainly does not have a problem with -- China's economy expanded 8.7% and Indonesia 4.5% in 2009, according to government statistics and the UN estimated that India's grew 7.2% in the fiscal year ending March 31.

"What this means is [for businesses] to grow in Asia, they require a lot of investment in infrastructure, in capital that needs to be put up, in factories and so on," continued Chatrath. He said both Western and Asian multinationals are investing, the former to make up for shrinking or stagnating home markets and the latter to maintain the growth rates they have become accustomed to during the past decade.

As long as economic growth continues, borrowing makes sense wrote Morgan Stanley's Hjort. He said "higher revenues and profits require a higher capital base" and estimated that companies measured by the MSCI Asia-Pacific

ex-Japan index of non-financial corporates could increase their debt by as much as \$1.2 trillion by 2015 without increasing their leverage.

"Nobody borrows just because interest rates are low," said Chatrath. "You've got to have a business rationale to do it."

There are many examples of rational borrowing in Asia. For example, the Keppel Corporation spent S\$1.2 billion (\$849.7 million) on acquisitions and operations last year; including the S\$462 million purchase of the Senoko Incineration Plant in Singapore in August.

"All borrowings reported are made by companies within the Keppel Group, and they have varying requirements in terms of borrowings in the course of their business operations," said Paul Tan, group controller at Keppel. He added that low interest rates did influence the company's decisions to borrow in order to enhance shareholder value. The company's overall debt fell 14.4% year-on-year to S\$2.4 billion at the end of 2009, but short-term debt was up 272.6% to S\$840.8 million.

Mergers and acquisitions, many of which require financing, are also up. According to Dealogic, overall deal value for Asia ex-Japan in the first quarter of 2010 was \$123.2 billion, the highest since the second quarter of 2008, when M&A deals totalled \$124.4 billion.

One cannot forget government-stimulated borrowing. "The increase in borrowing is probably really driven by infrastructure spending and part of the governments' overall fiscal stimulus to the economies," said Clara Lau, group credit officer for Asia-Pacific corporates at Moody's. China is probably the best example. Of the country's \$585 billion stimulus package, CLSA estimated that as much as \$421 billion went into infrastructure, a move that resulted not only in major projects being brought forward, for example the Beijing-Shanghai high-speed rail line is now slated to open in 2012, a year earlier than originally scheduled, but also in suppliers and contractors borrowing to ramp up their construction capabilities to fulfil their government contracts.

Finally, low interest rates have increased the attractiveness of debt refinancing. "Companies have been borrowing for refinancing," said Lau. "Also to repay some of their long-dated bonds by taking advantage of the better environment in the second half of last year." At the time of publication, China's one-year deposit rate was 2.25%, Hong Kong's base rate was 0.5% and Malaysia's overnight rate was 2.5%.

"Corporates are seen actively borrowing to refinance and reposition their funding structure," said Peter Wong, chairman of the International Association of CFOs and Corporate Treasurers in China. "With Hibor [Hong Kong interbank offer rate] so low, you can achieve your borrowing below 2% for under three years. That's a pretty good deal."

Despite the confident outlook among bankers and CFOs on the state of Asian corporate balance sheets, higher levels of debt are still no laughing matter.

### **On guard**

"The very rapid growth in credit in the first half of 2009 in both China and India could indicate trouble ahead in the quality of loan portfolios," wrote Charles Roxburgh, a director at the McKinsey Global Institute, in a report on debt. "There is historical correlation between past rates of loan growth and future non-performing loans, as credit underwriting standards slip when new volumes are very high."

Lau reiterated this perspective. "Increase in leverage is something you always have to watch out for," she said.

Treasurers, while not necessarily responsible for the borrowing decisions themselves, should take precautions in case good credit turns to bad. First and foremost, they must be ready for uncertainty.

"The main challenge for treasurers are the unexpected sharp U-turns," said Tom McCabe, global head of transaction banking at DBS. "When you look at the wide range of shocks in the economy over the last several years, many companies have thrown out their strategic plans and just focused on managing their day-by-day working capital." Preparedness remains especially important as economic prospects in Europe and the US remain uncertain -- a fact that was reinforced by Greece's bailout last month.

Treasurers also need to be able to quickly adjust their liquidity requirements. When credit markets closed in late 2008 and businesses faced operating difficulties as a result of the economic downturn, inter-bank credit spreads spiked and treasurers faced a sudden scramble to meet the working capital needs they thought they could count on banks for. Some borrowed at unfavourable rates while others had to tap alternative sources due to the lack of available bank financing.

"We went out and drew down on all our available loan facilities," said Rickmers Maritime's Quah. "When money is tight we'd rather have money on our balance sheet and in our bank account." At the end of 2009, the company had cash and cash equivalents of \$110.7 million, up nearly 1,000% compared to the end of 2008.

Other issues experts said treasurers should keep in mind as debt rises and national economies continue to grow include watching the cost of borrowing (central banks will eventually increase rates, it's just unclear when), carefully evaluate counterparties (this includes banks, buyers and suppliers) and not placing all their financial eggs in one basket -- or with one financial institution.

"Treasurers learned from the current crisis that managing liquidity risk is always a top priority," said Wong. "Also, there is no certainty that there will not be a double-dip recession. As a result, on the one hand, they are beefing up their balance sheet, increasing their working capital inventory, but they also have to be very careful about managing the credit risk of counterparties they do business with."

### **Sound, for now**

At first glance, Asia's new appetite for credit appears sound. The region is attracting investment at an impressive clip, economic growth and outlooks are positive and businesses are bullish on their prospects but behind it all, threats still lurk.

First, China's rapid expansion may be in for a correction. While the country does have a lot of economic growing room, the year-on-year increase in the consumer price index for food and housing already exceeds the government's alarm level of 4% -- the former was 5.9% in April and the latter 4.5% according to the National Bureau of Statistics -- and the general consensus among economists is that national inflation will exceed the 4% threshold for the year. Overall, CPI was 2.8% in April.

Second, already cheap and plentiful liquidity may get cheaper and more plentiful. Experts are concerned that Europe's recent €750 billion (\$955 billion) bailout plan could further boost credit in the region as the continent's lenders funnel additional capital to their profitable franchises in Asia. European lenders provided \$1.15 trillion in loans to the region, up 9.5% year-on-year, and more than three times that of US banks who lent \$357 billion last year, according to the Bank for International Settlements.

But even with the threats, the mood, while not bullish, is positive. "The environment in China is different than the US as the regulators can respond much quicker and they have more levers to use to slow down lending," said McCabe. "I am not concerned that the rates of growth and levels of borrowing in China are causing the same risks as in the US and Europe."

"More and more investment will be placed in China, it's a big place," said Quah on the still enormous growth opportunities in the country, especially in areas outside its largely developed coastal regions.

Corporate borrowing may be on the rise in Asia, but the region does not face the leverage issues of Europe and the US. Prior to 2007, the amount borrowed in the West often exceeded what was healthy based on corporate revenues and economic growth; here the debt is an integral part of the development and growth of the region. Having been through their own financial crisis, the dot.com bubble and Sars in little more than a decade, Asia's treasurers have, at least until now, demonstrated that they understand the importance of balancing debt and cash.

Let's hope they keep it up.

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