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Which U.S. Corporate Sectors Will Feel The Chill From China's Cooling Growth?

Primary Credit Analysts:
Jennelyn U Tanchua, New York (212) 438-4436; jennelyn.tanchua@standardandpoors.com
David C Tesher, New York (1) 212-438-2618; david.tesher@standardandpoors.com

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Which U.S. Corporate Sectors Will Feel The Chill From China's Cooling Growth?

China's economic slowdown and financial market turbulence are having a limited overall impact on U.S. corporate sectors, in Standard & Poor's Ratings Services' view, but some sectors are more affected than others. The potential for adverse rating actions is particularly concentrated in the metals and mining sector, where China has an outsized presence because it essentially has been the only source of growth for industrial metal demand over the past decade. Technology, autos, chemicals, capital goods, and aerospace issuers have significant exposure to China, but we believe their size and flexibility will likely cushion them against China's economic woes. Meanwhile, consumer-focused companies are seeing some slowdown in China-related revenue growth, but that hasn't yet led them to pull back from their growth strategies in China because they continue to see the country as a long-term opportunity.

Overview

- Some U.S. issuers are feeling the pinch from China's economic slowdown, but most remain relatively unscathed.
- The metal and mining sector is being pressured the most as the downturn in China's metal-intensive infrastructure, construction, and heavy industries continues to trim demand and prices.
- China's oil demand will likely grow at a slower rate, but this risk is small compared to that posed by the industry's excess supply.
- We don't expect U.S. corporate issuers to suffer meaningful credit impact directly from China's woes, although the slowdown will continue to create headwinds for the technology, autos, chemicals, capital goods, and aerospace sectors.

China's Slowing Economy Has Unwanted Side Effects For U.S. Companies

China is the world's second-largest economy, and its performance has direct and indirect repercussions for growth, financial markets, sentiment, and risk globally. Before it emerged as a source of global market volatility this summer, we'd identified its slowing economic growth and high debt burden as among the top credit condition concerns globally (see "Credit Conditions: An Improving U.S. Economy Reduces North American Credit Risk, But Some Headwinds Remain," published March 31, 2015, on RatingsDirect).

However, the "China risk" has increased in recent months as the country's economy continued to lose momentum and investors worry that its financial market turmoil would hurt its domestic economy and also spread to the rest of the world. Still, our economists believe these concerns are a bit overdone. They are less uneasy about the current state of the Chinese economy and more concerned about its continued use of debt to support growth, which doesn't bode well for prospects over the next few years. Our baseline scenario is that Chinese real GDP growth will slow to 6.8% in 2015, 6.3% in 2016, and 6.1% in 2017, down from the above 7% growth in 2012-2014 and following the 10% average growth in 2000-2011.

Metals and mining is hurting the most

China's slowing growth weighs most heavily on the U.S. metals and mining sector, particularly industrial metals, where China plays an outsized role in demand. As the largest consumer of industrial metals globally, China accounts for about half of the world's demand, and its consumption of industrial metals expanded fivefold over the past 15 years. Indeed, China has been the only source of demand growth for the past decade, with the rest of the world's consumption remaining relatively flat since 2000 (see chart 1). We believe the downturn in China's metal-intensive infrastructure, construction, and heavy industries will continue to keep demand and prices slack as supply continues to expand. Additionally, China's iron ore demand is still on a weakening trend, with its import volumes barely increasing in recent months (see chart 2).

Chart 1

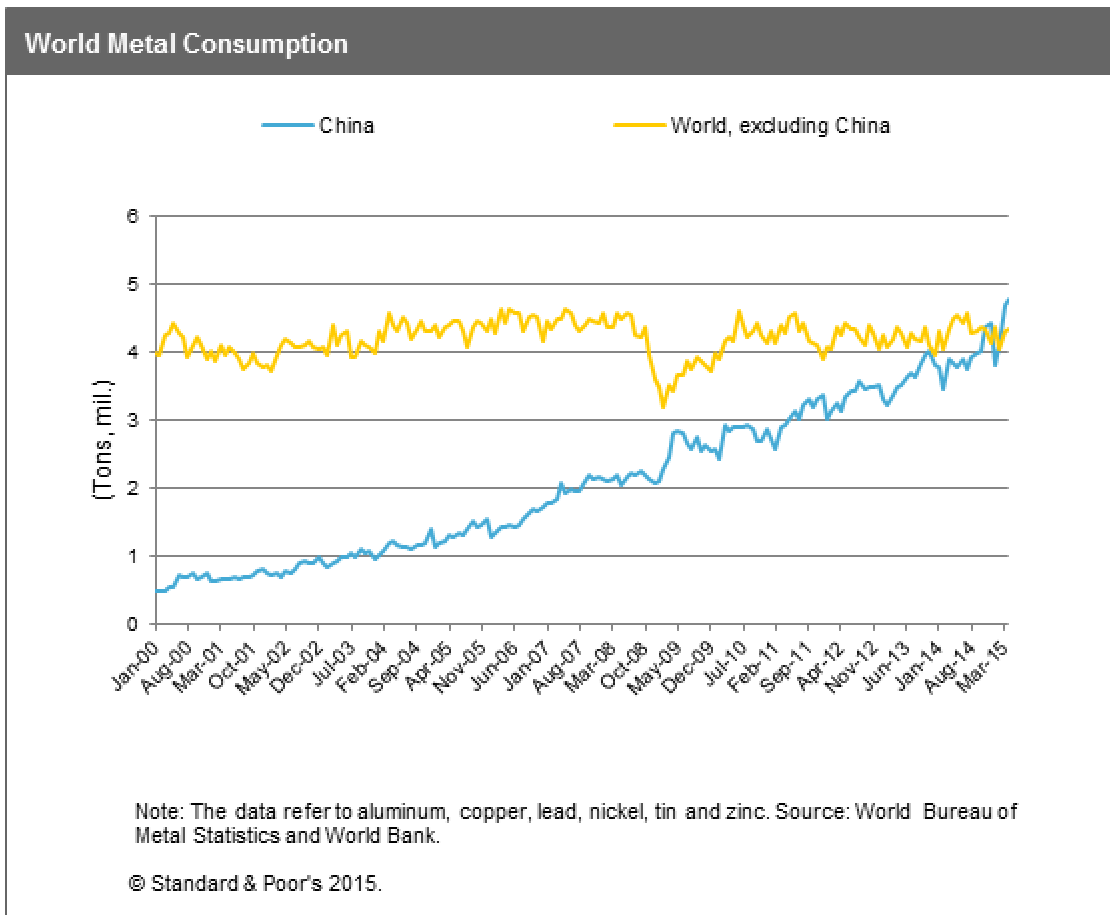
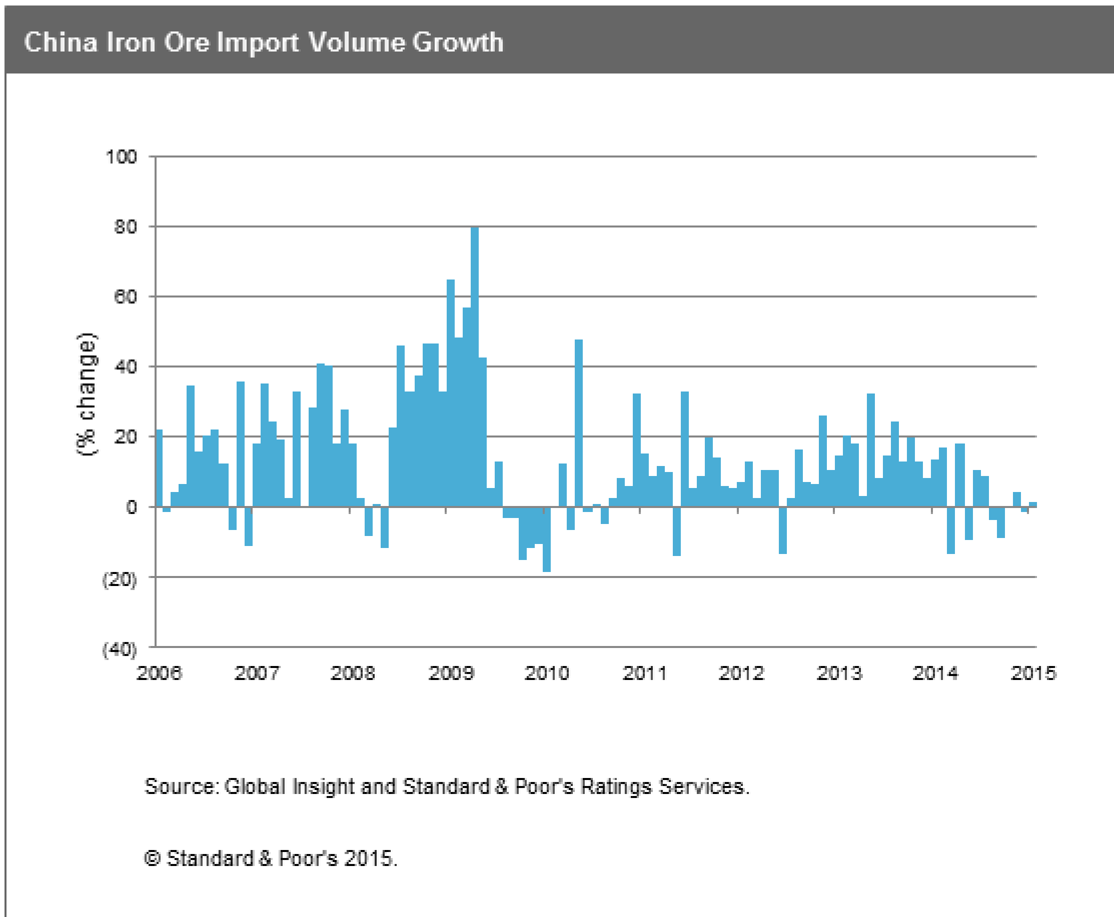


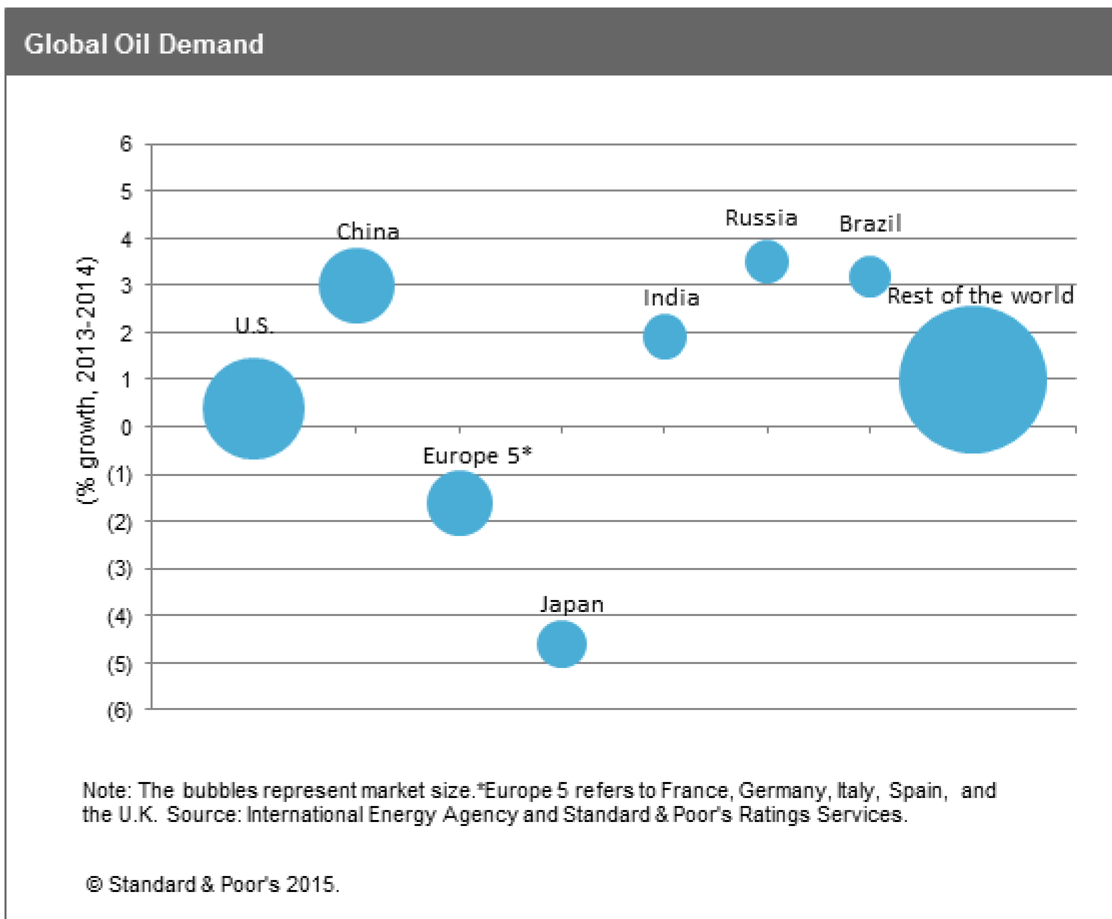
Chart 2



The oil sector is relatively unaffected

China's oil demand will likely grow at a slower rate as its economy continues to downshift. But this is a minor factor relative to the excess supply plaguing the industry because the oil market's demand composition is more balanced and relies less heavily on one country. In 2014, China accounted for 10% of global oil usage, which was less than its 15% share of world GDP and half the U.S.'s 20% share of oil consumption, though China's oil demand grew faster than that of the U.S. (see chart 3).

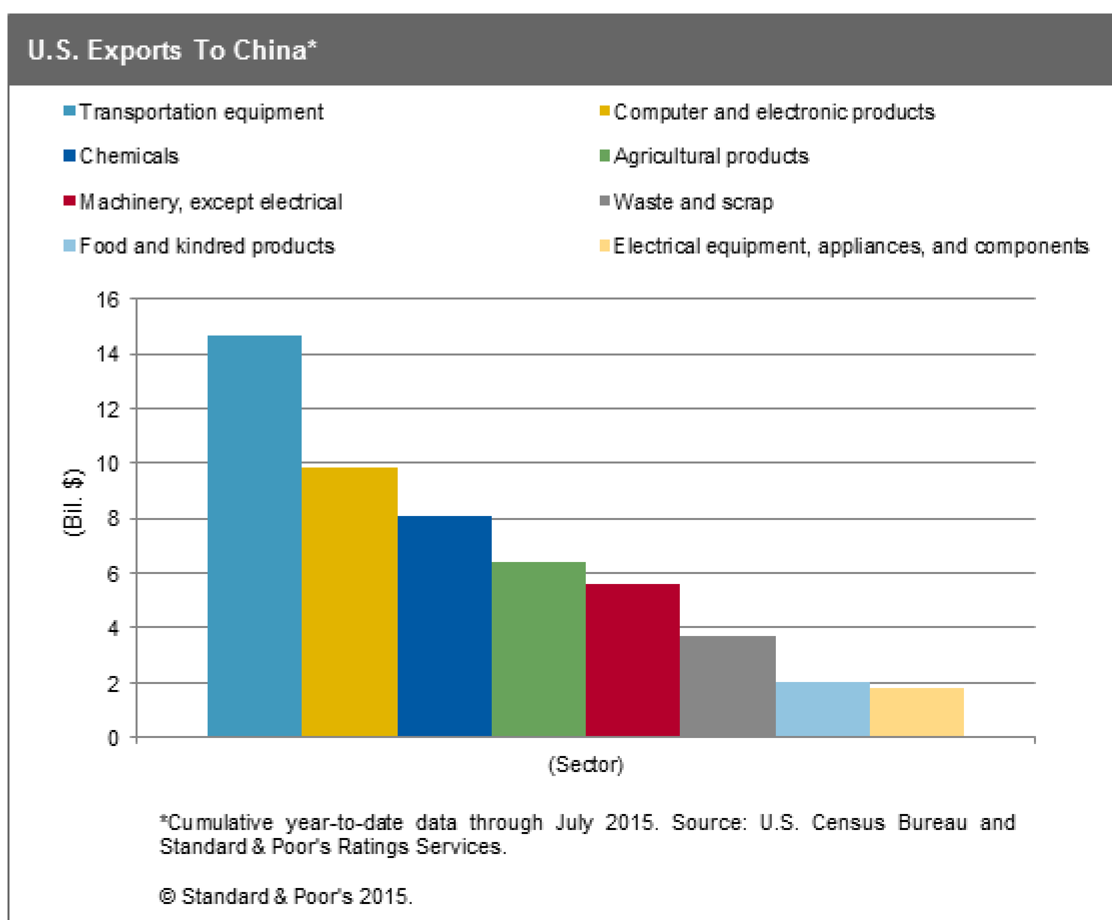
Chart 3



Exporters aren't immune

U.S. exporters and multinationals with substantial sales to China, such as technology, autos, chemicals, capital goods, and aerospace, also face headwinds from China's weaker economic conditions. Although China is a small export market for the U.S., accounting for only 7% of total merchandise exports, large U.S. corporate exporters' exposure to China could be much more substantial. Transportation equipment, technology products, and chemicals are the largest U.S. exports to China (see chart 4). Still, we don't expect China's slower economic growth to have any meaningful credit impact on many of those exporters and multinationals for now because of their size and flexibility. For example, approximately 20% of Boeing Co.'s deliveries are to Chinese airlines, but Boeing's long order backlog allows it to manage increased cancellations or rescheduled orders.

Chart 4



China is the world's largest automobile market, and its production is slowing while competition is increasing. However, U.S. automakers' participation is mostly through joint ventures with Chinese companies, rather than via exports. Despite the size of China's local market and its long-term growth prospects, North America still far outweighs China as a source of earnings for U.S. automakers.

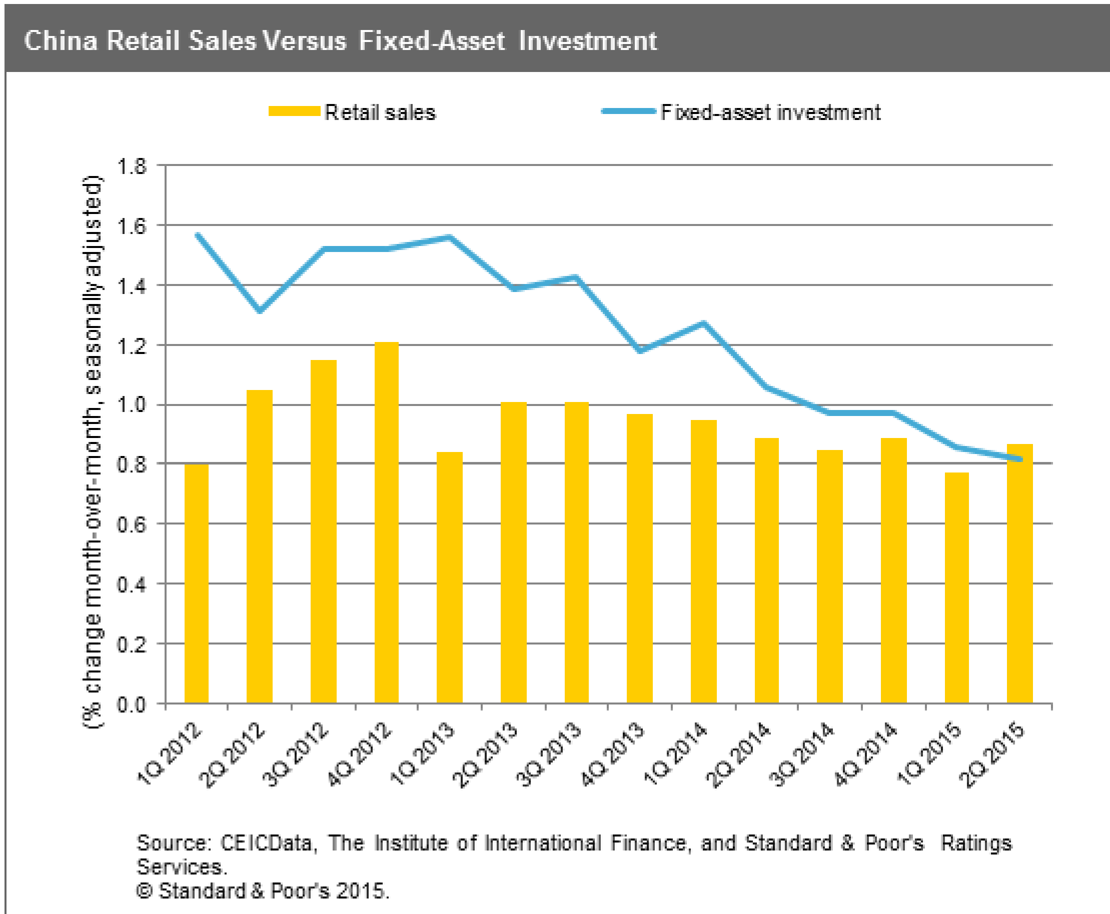
In the technology sector, global semiconductor sales growth forecasts for 2015 have been lowered to flat from 10% amidst lower demand from China. As a result, Intel Corp. and semiconductor foundries have sharply reduced their capital expenditure budgets.

Consumer products' revenue growth from China slows

China remains an important avenue of growth for U.S. consumer multinationals, given the low growth prospects for them in developed markets. We believe the country's economic slowdown could lead to softer revenue growth from the region for these companies. Some have already reported low-single-digit growth rates this year, compared with historical double-digit rates. Nevertheless, the region remains a significant source of growth for U.S. food and agricultural companies because China is the world's largest grocery market. In addition, the rising middle class in China and the resulting lifestyle and dietary changes will likely increase the appeal of Western products.

China's consumer economy has held up fairly well, and we believe a cooling in its consumer sector will likely be much milder than the deep slump in its industrial segments. As of second-quarter 2015, retail sales continued to grow at a steady pace, rising slightly below 1% quarter-over-quarter, compared to fixed-asset investment growth, which has halved since 2012 (see chart 5). Indeed, as China leans more toward becoming a consumption and service economy, consumer products, media and entertainment, airlines, leisure, and other consumer sectors stand to benefit the most. The current economic uncertainty could lead to scaled-back expectations for future growth and expansion, but many U.S. consumer-focused companies still see China as a long-term growth opportunity.

Chart 5



Sector Impact

The following sections provide further insight on the credit impact that Standards & Poor's credit analysts believe China's economic slowdown and financial market turbulence have had, and will have, on specific U.S. corporate sectors.

Aerospace And Aviation

Contacts: Christopher DeNicolo, CFA, Washington D.C., (1) 202-383-2398;
christopher.denicolo@standardandpoors.com

Philip Baggaley, CFA, New York, (1) 212-38-7683; philip.baggaley@standardandpoors.com

Among U.S. airlines, China is a small (less than 10% of revenues) but profitable market for United Airlines Inc. and Delta Air Lines Inc. So far, the strength of the dollar (and thus translation of revenues from tickets sold overseas) has been more of a drag on earnings than falling traffic to and from China.

China is a key market for Boeing, accounting for an estimated 20% of the company's deliveries in the first eight months of 2015. Therefore, a more significant drop in China's economic growth could affect orders from both Chinese airlines and airlines in Asia and elsewhere that have significant flights to the country. Indirect damage could also result as the economies of, and air travel from, countries that export commodities to China (such as Brazil) slow more sharply. However, there hasn't been any significant impact on air traffic in China so far, which grew a healthy 13.6% in August 2015. Boeing recently announced that a state-owned Chinese company has ordered 300 aircraft for use by Chinese airlines, though it isn't clear if these orders were already in Boeing's backlog. Boeing (and Airbus Group SE) routinely overbook orders, knowing that some airline customers will cancel or, more often, reschedule deliveries. Boeing's order backlog comprises about seven years' worth of production at current levels, with even longer waits for some popular models. Therefore, Boeing could accommodate even a material uptick in cancellations or rescheduling of orders, possibly only causing planned production increases to be trimmed or delayed.

Aircraft leasing is another aviation market with significant exposure to China. Asia-Pacific accounts for 25%-35% of many large aircraft leasing companies' revenues, of which a substantial, though undisclosed, portion is from Chinese customers. However, China's cooling growth so far has had little impact on this market.

Aviation is a high-priority development goal for the Chinese government, which is investing heavily in new airports and seeking to increase Chinese airlines' share of international traffic to and from the country. The major market hardest hit by China's slowdown has been Brazil because the sharply devalued real is hurting Brazilian airlines that borrowed to buy or lease planes in dollars. Still, aircraft lessors' business model is based on being able to take back and re-lease aircraft in a global market. They are, thus, set up to respond to potential further cooling demand from China and other developing countries. Furthermore, the aircraft lessors normally scale back capital spending, sometimes sharply, during downturns to conserve cash and avoid oversupply.

Autos

Contact: Nishit Madlani, New York, (1) 212-438-4070; nishit.madlani@standardandpoors.com

Several U.S. auto parts suppliers have significant exposure to Chinese original equipment manufacturers (OEMs), and General Motors Co. (GM) has a profitable joint venture with a leading Chinese automaker. The slowdown in production volumes as a result of slowing demand and increasing competition are putting pressure on prices and

lowering capacity utilization. Still, we don't believe these will have significant credit impact on U.S. automakers, such as GM and Ford Motor Co., and suppliers that have a product and geographic diversification.

In response, automakers are accelerating new vehicle launches and aggressively marketing these models to mitigate pricing pressure. Cost cutting, reduction of manufacturing inefficiencies, and increased dependence on local sourcing have helped mitigate any adverse impact on profitability targets in 2015. In addition, there is no evidence of any scale-back of long-term investments in China to support expansion of production (and should there be any, such cuts would likely occur in a phased manner). As local auto part suppliers become increasingly sophisticated or garner further government support, the resulting market share shift away from Western OEMs could create further problems for U.S. suppliers that lack relationships with Chinese OEMs. More mergers and acquisitions with potential Chinese acquirers could occur as a result.

Capital Goods

Contact: Sarah Wyeth, New York, (1) 212-438-5658; sarah.wyeth@standardandpoors.com

Few U.S. capital goods issuers have meaningful direct exposure to China, and we generally don't expect China's slowdown to have a significant credit impact on the sector. In many cases, business emanating from China is less profitable than in other regions and, thus, has less impact on earnings.

However, some U.S. capital goods companies are experiencing sales declines in Asia amid reduced industrial capital spending and infrastructure development in China, as well as increased pricing pressure. Moreover, lower investment spending in China could also have repercussions in other regions and their demand for equipment. Additional drops in commodity prices from already depressed levels could add stress to companies that manufacture mining equipment and components, although companies most exposed to commodity prices have been facing headwinds for some time now. On the other hand, the commodity price slump could have a modestly positive effect in the form of lower costs.

Chemicals

Contact: Paul Kurias, New York, (1) 212-438-3486; paul.kurias@standardandpoors.com

The size of China's chemical market surpassed that of the U.S. a few years ago, and operating conditions in China have increasingly begun to influence U.S. chemical producers of global commodity products. A slowdown in Chinese demand combined with lower oil prices and a stronger U.S. dollar have contributed to lower prices and profit margins in several commodity chemicals. And while the precise impact of the Chinese slowdown is hard to quantify and varies across different commodity chemicals, it clearly has been a factor in lower commodity chemical prices.

As prices decline and profit margins dip, the overarching impact is negative for U.S. chemical companies' credit quality, even though a small number of producers that use these chemicals as an input have benefited. Capital spending and investment plans by U.S. and overseas chemical companies also appear to have been trimmed back. But this could be a modest, though temporary, positive for credit quality because it could push back the timing for a sector downturn that could result from the large capacity additions in some commodity chemicals.

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Consumer Products

Diane Shand, New York, (1) 212-438-7860; diane.shand@standardandpoors.com

U.S. consumer goods companies have been expecting slower growth in China, but they also recognize that its growth rate is still above those of developed markets. The companies generally continue to see tremendous long-term growth in China. Some companies have reported that growth has slowed to the low-single digits this year from historical double-digit rates. However, they've indicated plans for investing more in the region and to try gaining market share as others pull out. We don't expect the slowdown in China to affect our ratings on U.S.-based consumer products companies because most of them have a small exposure to the region, but we do believe it puts more pressure on the companies to reduce costs to offset slower top-line growth.

Leisure

Contacts: Emile Courtney, CFA, New York, (1) 212-438-7824; emile.courtney@standardandpoors.com

Melissa Long, New York, (1) 212-438-3886; melissa.long@standardandpoors.com

China's slowing growth could modestly affect mass-market gaming demand in Macau over the next 12 months, which could exacerbate that market's recent gaming revenue declines. However, we still believe the mass-market segment is more stable than the highly volatile VIP market over the longer term. Gaming development projects in progress in Macau are real estate-based and will likely be completed as planned, and we don't expect any significant changes in this strategy. The market still has good long-term growth prospects, given China's relatively good economic growth compared with other regions', the country's growing middle class and increased tourism, the improving infrastructure and transportation connectivity between Macau and China, and the new gaming projects that will be absorbed over time.

U.S.-based leisure goods manufacturers could experience lower input costs that may have a positive impact on margins. Lodging and cruise companies are not meaningfully affected by weakness in China due to their asset and customer diversity.

Media And Entertainment

Contact: Naveen Sarma, New York (1) 212-438-7833; naveen.sarma@standardandpoors.com

China represents a significant growth opportunity for U.S. media companies, primarily film studios, which view the Chinese box office as a growing opportunity. Studios could feel an impact to the extent that the economic issues affect movie attendance. But this is unlikely because box-office receipts primarily reflect the quality of the film slate and tend to be immune to economic cycles. The Walt Disney Co. has additional exposure through two theme parks in China: an existing one in Hong Kong and a new, massive park in Shanghai, which is expected to open in late 2016. If park attendance lags, especially at the Shanghai venue, it could have a modest negative impact on Disney's theme park

segment operating performance. But that would be unlikely to affect our ratings on Disney because Hong Kong is a very small part of its business, and Shanghai represents future growth.

Metals And Mining

Contact: James Fielding, New York, (1) 212-438-2452; james.fielding@standardandpoors.com

Metal prices have collapsed by 20%-45% over the past 12 months and are now close to, and in some cases below, the levels in early 2009. Although every commodity has its own supply and demand story, most have enjoyed soaring support from China in recent years. With the country now accounting for 40%-50% of the demand for raw materials, concerns over China's economic growth have been sending shock waves across commodity markets.

We recently lowered our metals price assumptions--our third downward revision in 2015. We took several negative rating actions on U.S. metal producers following our decision to lower price assumptions on copper, gold, nickel, aluminum, and zinc. We reviewed company-specific factors, including other rating assumptions, issuers' flexibility to adapt to lower prices by curbing capital expenditures and shareholder distributions, and their ability to maintain sufficient liquidity. We expect that prices will remain very volatile because the conditions in China have raised uncertainty, and we will continue to closely monitor the companies' ability to absorb shocks over the coming months.

Oil And Gas

Contact: Tom Watters, New York, (1) 212-438-7818; thomas.watters@standardandpoors.com

U.S. oil and gas issuers have few options available to mitigate the oil slump's impact. To preserve liquidity, many have already cut capital expenditure (capex) to maintenance production levels. Many are in the market to sell assets, though the transactions have been limited. Service costs for exploration and production companies have been reduced, with little room left for more cuts. Companies are hunkering down until prices rebound, and none can hedge with strip prices that are too low.

China's economic slowdown hasn't materially diminished its appetite for oil. Indeed, China's oil demand rose 10.2% in August to 11.2 million barrels per day (b/d), compared with a year earlier. China's net imports of oil products also surged in August, rising 131% year-over-year to 700,000 b/d. The country's total apparent oil demand averaged 11.14 million b/d through August, an 8.2% increase from the same period in 2014. According to Platts China Oil Analytics, China's apparent oil demand should remain steady at 11.1 million b/d for the remainder of the year. It would appear that the government stimulus measures implemented earlier in the year are having an effect. We believe China's oil usage will still grow--but at a slower rate--as the economy retreats from its robust levels.

Retail

Contact: Robert Schulz, CFA, New York, (1) 212-438-7808; robert.schulz@standardandpoors.com

In U.S. retail, with a few exceptions, China's cooling growth is primarily affecting companies' prospective rate of

expansion. Like many U.S. corporate sectors, large global retailers such as Wal-Mart Stores Inc. and The Gap Inc. have set their sights on the Chinese consumer market. Sharply lower growth rates in Chinese consumer spending would call into question current expectations for expansions, investments, and returns. For U.S. luxury retailers, the impact on their operations outside China would also revolve around how much less shopping tourism occurs among Chinese travelers. However, we don't expect the slower Chinese growth rates to affect our ratings on U.S. retailers. Very few retailers have a heavy presence in China. But for those that do, such as Yum! Brands Inc., the slower growth would have a significant impact on their revenues, profits, and, potentially, credit metrics. However, we already incorporate volatility from Chinese operations in our corporate credit rating on Yum.

Technology

Contacts: Andrew Chang, San Francisco, (1) 415-371-5043; andrew.chang@standardandpoors.com

John Moore, CFA, New York, (1) 212-438-2140; john.moore@standardandpoors.com

We expect that China's slowing economy and currency devaluation will trim U.S. technology exports into the country. China's share of global semiconductor consumption should continue to track its share of global GDP. However, revenues from Chinese PC hardware and software markets could keep declining over the next 12 months due to the continued stretching of product refresh rates and no compelling need to upgrade. Mobile device demand is likely to slow, but revenue growth should remain positive, given substantial product refresh activity in 2015 and weak foreign currency conditions. We expect that Apple Inc. will likely see a material cooling in demand after notching 80% growth from China during the past nine months due to its introduction of the iPhone 6.

We don't expect significant impact on large telecom equipment makers, such as Cisco Systems Inc. and Juniper Networks Inc., given their declining exposure to China, with market share gains already achieved by several Chinese-based companies, including Huawei Technologies Co. Ltd. We expect that the recent partnerships and investments certain U.S. enterprise hardware companies have made, including H3C Technologies Co. Ltd. and Dell Inc., will support their revenue stability in China. Telecom equipment demand should remain flat over the next 12 months due to spending curtailment that began last year, especially for base-station development related to 4G network infrastructure. This is partially offset by shared capex partnerships between carriers and national tower companies as well as network constraints, which are both helpful to demand. Other tech markets, including semiconductors, hardware, and software in industrial and automotive markets, should grow faster than the overall sector, given the increasing technology content in cars and the IoT (Internet of Things).

We see tech companies temporarily rationalizing capex partly due to lower China demand. For example, Intel and semiconductor foundries have dramatically reduced capex budgets because of now flat overall semiconductor growth forecasts for 2015, including lower semiconductor demand in China.

Related Research

- Credit Conditions: U.S. Economic Strength Is Largely Favorable For North America, But Risks Remain, Oct. 13, 2015,

- Credit Conditions: A Resilient U.S. Economy Shields North American Credit Conditions From Increasing Risks, July 14, 2015
- Credit Conditions: An Improving U.S. Economy Reduces North American Credit Risk, But Some Headwinds Remain, March 31, 2015

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