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Update on China

September 2021

While headlines surrounding a beleaguered Chinese property company have raised questions on the potential for broader contagion, we believe the situation is likely to be contained by Chinese policymakers. Portfolio Managers Warren Hyland and Christina Bastin discuss.

What's happening in China?

Recent concerns surrounding the indebtedness of Chinese property developer Evergrande have resulted in contagion fears to the broader property sector, as well as insurers and banks with exposure to Evergrande.

Evergrande is highly levered. Its liquidity issues have been in the spotlight for some time due to a slowdown in sales and increased regulations brought in to reduce debt and control prices in the property sector.¹

In August 2020, the Chinese government imposed the three red lines guidance - three debt metrics (cash to short term debt, debt to equity and debt to assets) developers must meet to increase borrowing. If a developer fails to meet one, two, or all the 'three red lines', the Chinese government limits their borrowing.

1. <https://www.ft.com/content/c1144ffe-30f9-41d3-b033-bb82eca258b4>

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Analysis

Christina Bastin Portfolio Manager



Christina joined Muzinich in 2013 and is an experienced fund manager with a distinguished career in corporate credit spanning 27 years. Christina holds a BA from the University of Oxford and an MA from the University of London. She was also awarded the Yamamuro Trust Foundation Scholarship for a 1yr International Politics programme at Keio University, Tokyo. Christina is fluent in five languages.

Warren Hyland Portfolio Manager



Warren is a Portfolio Manager at Muzinich and has 24 years of corporate credit experience. Warren has a BSc in Mathematics for Business from the Middlesex University London, and later received his MSc in Shipping Trade and Finance from the CASS Business School. He holds the Chartered Financial Analyst designation.

Every developer must improve these metrics over the next two years. Evergrande has so far failed on all three metrics.² Regulations have also been implemented to limit bank quotas on mortgages and loans to developers.³

How has the market reacted?

Evergrande is already trading at distressed levels, as if it has already defaulted.⁴ We are also seeing a bifurcation in price action of Chinese property developers by rating where B rated property developers have sold off more than BB and BBB rated issues.⁵

The rest of the China high yield market appears stable, and we do not expect a spill over into other Chinese industrial high yield names, unless the situation remains drawn out. So far, the banking sector appears stable; even the bank with the largest exposure to Evergrande is well capitalised and we believe can weather the hit.

Emerging market investment grade has also held up relatively well, which could be a sign contamination is contained within Asia.

What is the likelihood of broader contagion?

We believe the tighter regulatory environment is meant to encourage financial stability, not lead to a systemic collapse. If policymakers are willing to let Evergrande go into a managed default, we believe they should be equally willing to calm the market to avoid a complete collapse in confidence.

In our view, bank exposure to Evergrande is manageable and policymakers can deal with it. Some very exposed banks still have comfortable levels of capital and, while they may experience a drop in earnings, it is not likely to result in a capital event.

Nevertheless, we do expect some small Chinese leveraged developers could potentially default because the Evergrande situation has resulted in the closure of the offshore refinancing market.

Over time, property developers naturally delever if cash proceeds from asset sales are used to repay debt. The excess cash is usually used for land purchases, which is the normal course of business (to replenish the land bank). However, we expect all Chinese developers to continue to use excess cash to repay debt and to avoid land purchases for the time being. We believe the whole sector will continue to de-lever in the second half of the year.

In our view, the real estate sector is an important cornerstone for the Chinese economy. The direct economic input is 14% of China's gross domestic product (GDP) and indirectly as high as 25%.⁶ A protracted loss of confidence in the sector could lead to a collapse in land purchases, an important source of revenue for local government, along with a dramatic decline in the wealth effect on the Chinese consumer.

Policymakers want price stability in the sector, not a collapse in confidence and a downturn in the property market. As a result, we expect a positive response from policymakers to calm the situation.

What will continue to weaken the market?

In our view, further defaults, even if from smaller Chinese property companies, could have an impact. Nationwide September sales figures could also hurt the market, although a large drop is likely to precipitate a positive policy response as has been the case in the past. Disorderly Evergrande news such as more social unrest is another potential catalyst, although again, too much disorderliness is also likely to precipitate a policy response.

What will calm the global financial market?

There are a number of things we believe could calm global financial markets, including continued coupon payments, asset sales and capital injections from other property firms. We have already seen some positive news from Guangzhou R&F, a sizeable property developer, who announced receipt of US\$1bn in short-term financing.⁷

2. <https://www.bloomberg.com/news/articles/2021-04-12/evergrande-fails-china-s-three-red-lines-test-as-peers-improve>

3. <https://www.scmp.com/business/companies/article/3116718/chinese-developers-hit-tough-new-rules-bank-loans-could-weigh>

4. <https://www.bloomberg.com/news/articles/2021-09-12/evergrande-haircut-of-75-is-now-a-base-case-for-bond-analysts>

5. JP Morgan - China Credit, 20th September 2021

6. JP Morgan - China Credit, 20th September 2021

7. <https://www.reuters.com/business/guangzhou-rf-raises-25-bln-by-selling-unit-tapping-shareholders-2021-09-20/>

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Other positive news, such as the orderly unwind of Evergrande, could also help; even if there is a default at the bond level, the continuation of the company's existing projects is key.

In addition, a policy response from the government, either allowing banks to disburse mortgages, a cut in interest rate cuts or other short-term supportive measures, could help.

How are we positioning our portfolios?

Within our multi-asset credit portfolios, we have maintained an overweight stance in high yield globally, but with a bias for quality credits with short duration.

While this positioning could potentially have an effect on the portfolio in the short term, due to heightened market volatility, we maintain our constructive outlook on the asset class which is benefitting from global economic growth, a positive earning cycle and low interest rates.

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