



On 22 September, China Evergrande (“Evergrande”), a property developer in China, announced that it had negotiated an agreement with onshore bond holders to meet a scheduled interest payment.<sup>1</sup> Meanwhile, its US dollar-bond interest payment due on 23 September remain unfulfilled.<sup>2</sup> Overall, weakening liquidity conditions among real-estate developers still pose numerous challenges for the sector moving forward. In this investment note, Fiona Cheung, Head of Global Emerging Markets Fixed Income Research, and Judy Kwok, Head of Greater China Fixed Income Research, explore the implications of recent market volatility for real-estate credits. They highlight the need for careful research and robust credit selection to identify potential long-term opportunities in the sector and broader high-yield space.

## China credits: A challenging outlook for real estate

### Looking beyond a single event: the implications for the sector

Evergrande is a real-estate developer with a significant operational footprint in China. It is the second largest in the country (by sales)<sup>3</sup>. The firm holds both onshore (CNY) and offshore (US dollar) debt obligations. Amid deteriorating liquidity conditions over the past few months, the issuer recently failed to make scheduled interest payments to banks, and, at the time of writing, still faces the risk of a potential default.<sup>4</sup>

Although uncertainty still exists regarding this company’s fate, we believe the market’s base case (according to current pricing of its bonds) is likely a default. Thus, the main issue is whether the default process will be orderly or disorderly. We think the nature of the potential default should then be a key

driver of China’s real estate sector outlook, which should evolve over time.

**Short-term:** Property developers, in general, will continue to experience tight liquidity conditions. Although we do not believe banks will call in existing loans, they are unlikely to extend further credit under current conditions. In addition, property developers could find it difficult to issue new bonds, both in the onshore and offshore markets.

**Medium-term:** Over a longer timeframe, the specifics of a potential default should be critical as operational issues come into focus. If the default is orderly, supply-chain disruptions could be minimised. Under a disorderly scenario, spillover from weakening liquidity may seep into supply chains. This will lead to increased financial stress among upstream suppliers making it more difficult for developers to deliver projects.

Regardless of the scenario, we expect accelerated industry consolidation during this period, and polarisation should deepen as stronger property

<sup>1</sup> Nikkei Asia, 22 September 2021. The agreement was reached through negotiations with creditors “off the clearing house”, meaning the specifics of the agreement have not been made public yet.

<sup>2</sup> Nikkei Asia, 24 September 2021. China Evergrande misses bond payment deadline and has 30 days to catch up before considered in default.

<sup>3</sup> Due to the highly fragmented nature of the industry, Evergrande only boasts around 4% of total market share, Fitch Ratings, 14 September 2021.

<sup>4</sup> Bloomberg, 22 September 2021. Nikkei Asia, 24 September 2021.

developers could purchase development projects from financially-weaker competitors.

**Long-term:** The deleveraging of the property-development sector should continue as one of the benefits over the longer term. Since the release of the “Three Red Lines<sup>5</sup>” policy in August 2020, the Chinese government has actively sought to reduce the level of debt used in the sector. Although there will likely be a significant and painful transition period, we believe that the industry should ultimately emerge stronger into an era of sustainable growth, i.e., with developers boasting lower debt levels, more stable cash flows, and more sustainable business models.

### **Broader implications: Mitigation of systemic risk and upholding social stability remain top policy priorities**

Overall, we believe a potential default scenario should be manageable for the affected financial counterparties and the broader economy.

The Chinese government has dealt with numerous high-profile and complex financial issues in the past, including the bankruptcy of Baoshang Bank and the restructuring of HNA.<sup>6</sup> In addition, the amount of affected bank and trust loans is not significantly high,<sup>7</sup> with many of the lending banks (particularly state-owned) well-capitalised. For instance, the People’s Bank of China has conducted comprehensive annual stress-testing exercises for banks, including a recent testing of the banks’ specific exposures to property developers<sup>8</sup>.

We think there may be potential second-order impacts if there is any disruption to the delivery of properties to homeowners, or supply-chain issues that lead to an uptick in unemployment at the local level. However, in these circumstances the People’s Bank of China is likely to step in with short-term liquidity, as the Chinese government has it made

clear it will mitigate systemic risk and uphold social stability.

### **Opportunities: Careful credit selection in the sector and high-yield space remains key**

As seen in financial markets last week, the situation is fluid and volatility remains elevated. According to ICE Bank of America High-Yield Emerging Markets Corporate Plus China Issuers Index, credit spread-to-worst versus government debt was 1581 basis points (bps) on 22 September 2021, higher than the 1436 bps on 30 July 2021 when the market was concerned about this entity’s potential default.<sup>9</sup>

In such an uncertain environment, we believe that the remainder of 2021 should remain volatile for the Chinese property sector both from a fundamental and market perspective. Therefore, we believe that careful credit selection and investment timing will be key to outperformance.

Indeed, as part of Manulife Investment Management’s credit selection and review process, we continually research credit names on an array of financial metrics. We have recently taken an analytical deep-dive into the liquidity levels and cash flow ratios of regional property developers, as liquidity concern is known to be a key contributing factor to default.

For investors interested in the sector, they should take a comprehensive look at the fundamentals of any property developer, focusing on the medium-term impact we described earlier. Generally, we still prefer developers with decent scale and a robust financial buffer to ride through different market cycles. These firms tend to have ample land reserves, either nationwide or in major economic clusters, where they hold leading market positions. In addition, we favour real estate developers with access to diversified funding channels in both onshore and offshore markets – this is critical to the

<sup>5</sup> The People’s Bank of China and the Ministry of Housing and Urban-Rural Development released the “Three Red Lines” policy in August 2020. The three red lines are: 1) Liability-to-asset ratio (excluding advance receipts) of less than 70%; 2) Net gearing ratio of less than 100%; 3) Cash to short-term debt ratio of more than 1x. If selected property developers cross any of the red lines, they will face restricted access to debt financing.

<sup>6</sup> [HNA Group to be broken into four independent units as Chinese conglomerate’s restructuring enters final stretch](#). South China Morning Post, 20 September 2021.

<sup>7</sup> J.P. Morgan estimates the troubled property developer accounts for 0.15% and 2.66% of system bank loans and trust loans, respectively.

<sup>8</sup> Reuters, 14 April 2021, and Straits Times 9 June 2021. The People’s Bank of China began stress-testing exercises in 2009 and has gradually expanded its scope to 4,024 banks in its 2021 exercise, compared with just 1,550 institutions in 2020.

<sup>9</sup> Bloomberg, as of 22 September 2021.

developers' liquidity positions as well as their long-term success.

### **Conclusion: Real estate is part of the larger structural-reform agenda**

Overall, we believe investors should view potential changes in the real-estate sector, such as deleveraging, as part of a more significant policy focus in China on substantive structural reforms.

Indeed, over the past few months we have written on [significant policy changes in the education and internet industries](#) aimed at lowering costs for families and improving workers' pay and treatment. The same analytical lens should likely be used for real estate. Although the sector has traditionally been used as a driver for economic growth via leverage, we believe the government envisages a more sustainable and equitable real-estate market. In our view, this is good news for investors seeking long-term opportunities in China.

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