

Asian Fixed Income Kaisa default and Chinese property crisis

Asian Fixed Income | January 2022

Summary

- The China property market crisis is a self-engineered, policy induced liquidity crisis. Thus, we are confident the government will not allow a collapse in the property sector, which remains a key contributor to China's GDP growth. When this deleveraging process is completed, we believe it is actually positive for the long-term credit profile of the Chinese property sector.
- We believe the defaults in Evergrande and Kaisa and likely a few other developers will be managed in an orderly manner via debt restructuring, which we expect to last for around 2 years. We also expect the recovery value to be significantly higher than the current bond prices.
- There are clear signs of an easing in policy stance in the recent months by the Chinese government. We believe this should boost sentiments and if sales figures improve from here, we do expect a strong recovery in bond prices from the current depressed levels.
- The Chinese for 'crisis' is 危机. 危 (wei) means danger while 机 (ji) means opportunities. In other words, it means opportunities will emerge amid a crisis. We believe we will see further easing of policies in the months ahead and with bond prices at depressed prices, this presents a great opportunity for longer-term investors to invest into Asian bonds and ride on the eventual recovery of the Chinese property sector.

Three red lines policy

In order to fully understand why Kaisa defaulted on its bonds, we first need to get a good grasp on the deleveraging policy called the three red lines. Following years of debt-fueled growth in the property sector during which home prices surged six-fold over the past 15 years, the Chinese government decided to rein in excessive credit took on by property developers to avoid Japan's mistake in the 1990s, which eventually led to long-term damage to growth.

In August 2020, The People's Bank of China (PBOC) and the Ministry of Housing (MOH) came up with new financing rules to govern real estate companies. Developers wanting to refinance will be assessed against the three red lines, which include a 70% ceiling on liabilities to assets, excluding advance proceeds from projects sold on contract; a 100% cap on net debt to equity; and they must have a cash to short-term borrowing ratio of at least one. Developers will be grouped based on how many limits they breach, and their debt growth will be capped accordingly. If all three are breached, the company will not be allowed to increase its debt in the following year.

RISK FACTORS

This is a financial promotion for The First Sentier Asian Fixed Income Strategy. This information is for professional clients only in the UK and Switzerland and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Credit risk:** The issuers of bonds or similar investments may not pay income or repay capital when due.
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Charges to capital risk:** The fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Single country / specific region risk:** investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Below investment grade risk:** Below investment grade debt securities are speculative and involve a greater risk of default and price changes than investment grade debt securities due to changes in the issuer's creditworthiness. In periods of general economic difficulty, the market prices may fluctuate and decline significantly.
- **Interest rate risk:** bond prices have an inverse relationship with interest rates such that when interest rates rise, bonds may fall in value. Rising interest rates may cause the value of your investment to fall.
- **Emerging market risk:** Emerging markets tend to be more sensitive to economic and political conditions than developed markets. Other factors include greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Regulatory policies continued to tighten and in January 2021, PBOC and the China Banking and Insurance Regulatory Commission (CBIRC) jointly announced a cap on bank's overall property-related loan exposures as well as mortgages.

Since then, Chinese property developers have taken steps to sell down assets and improve their credit quality. Nevertheless, Evergrande, with liabilities estimated to be around US\$300 billion came under scrutiny as market became skeptical whether the firm can ever reduce its enormous debt. To make matters worse, Evergrande has other off-balance sheet liabilities in the form of trust loan and wealth management products, making an accurate analysis of its financial health arduous, if not impossible.

As the housing market started to slow amid the deleveraging, pressure started to mount on Evergrande as slower sales impaired its ability to refinance its upcoming maturity debt. This led to sharp decline in their bond prices, effectively shutting the door for offshore financing given the high interest costs. Risk sentiment headed further south as we saw further policy tightening, with the real estate sector named as one of the 'three mountains' (along with education and healthcare) in July 2021, followed by the expansion of the real estate tax pilot program in more cities in October 2021.

Evergrande default

Evergrande's liquidity woes started surfacing since 3Q 2021, notwithstanding S&P revising its rating outlook from negative to stable in April 2021 on the back of a 20% debt reduction during the H1 2021.

Despite making every effort to honor its maturing debt and raising as much as US\$8.0 billion during 2H 2021, Fitch placed the company in its restricted default category on the 9 December after Evergrande failed to pay its bondholders 3 days after the deadline. This category of default means the company has formally defaulted but had yet to enter into any form of bankruptcy filing, liquidation or other processes that would stop its operations.

Evergrande said it would 'actively engage' its foreign creditors to come up with a plan for restructuring. They also said officials from several state-backed institutions are forming a risk committee to help the company restructure itself.

Kaisa default

Kaisa reported a set of improving 1H 2021 financials, which included a satisfactory liquidity ratio of 1.9x cash to short-term debt. Nevertheless, following troubles at Evergrande, Kaisa along with other similarly rated bonds were sold down relentlessly as they continued to face a liquidity crunch affecting its ability to refinance.

Downgrades by rating agencies exacerbated the company's refinancing woes. This led Kaisa to launch a bond exchange in late November, with the company seeking to exchange their US\$ 400mn bond with a maturity date of 7 December 2021 into new notes that mature in 2023. However, the bond exchange proposal failed to receive sufficient bondholder support leading to an eventual default. The company has started work on restructuring its offshore debt of US\$12 billion.

Our views now

Since the onset of this crisis, we have maintained that it is a self-engineered deleveraging process by the Chinese government in order to rein in excessive credit growth. In other words, the government has the levers to ensure the process is carried out in an orderly manner and if needed, they can always relax some of their policy measures. We also believe the large developers including Evergrande and Kaisa will likely go through an orderly debt restructuring but not liquidation. Currently, the bond prices are pricing in a default rate of more than 40%. However, we believe the actual default rate would be lower should developers continue to pursue distressed debt swap or exchanges, combined with likely policy relaxation in 2022.

The property sector accounts for more than 20% of China's GDP growth. Hence, the government will not allow the ongoing crisis to persist for too long. We have assessed the implications on the banking sector to be low, noting China banking sector's exposures to property developers are well manageable at 7% of sector loans.

On the other hand, we view other industries who provide raw materials such as cement and steel, could be negatively impacted should the slowdown persists. Rising unemployment and social unrest are some of the factors the government will have to take into considerations too. We believe Chinese regulators will look to strike the right balance between short-term stability (i.e. avoiding contagion default risk of property developers) and the long-term policy target (i.e. lower reliance on property sector and more affordable housing).

This crisis remains a regulatory-induced liquidity crisis and when it is over, we believe the sector as whole will emerge stronger and more stable. While we believe short-term policy easing could be introduced, we expect the recently introduced micro-prudential measures such as the three red line policy and lending cap on banks will likely stay to promote developers' continued deleveraging and higher operating efficiency.

Recovery value analysis

1. Kaisa

Our base case scenario is that Kaisa will pursue debt restructuring, similar to its previous restructuring back in December 2014. It is worth highlighting that Kaisa's previous restructuring took about 30 months, and it featured 1:1 exchanges with tenor extensions, where the principal recovery for bondholders was closer to 100%.

	Lower end	Higher End
FSI estimates	US\$35	US\$100
Market estimates	US\$38	US\$61

2. Evergrande

Our base case scenario for Evergrande is that it will continue to work on a feasible debt restructuring outcome, with coordination from the provincial government.

	Lower end	Higher End
FSI estimates	US\$35	US\$100
Market estimates	US\$40	US\$70

Recent developments

We started seeing early signs of credit easing towards the end of 2021, where the latest policy measures included targeted relaxation of banks' lending, exclusion of M&A loans from the three red lines and facilitating mortgage loan approval process. The regulatory tone has also started to soften with both the Politburo and MOH recently highlighting the importance of reasonable housing demand and stable growth, as well as containing risk by enhancing the market confidence.

The government of Guangdong has dispatched a working group to Evergrande to ensure "normal" operations. Evergrande has also announced the establishment of a risk management committee featuring senior managers from the Guangdong provincial government and mainland state-owned enterprises.

Since then, the provincial government and Evergrande have been working to resume activity at construction sites, to finish projects and to ensure that apartments are delivered to consumers. In late December 2021, the company reported that it had resumed work at 92% of its projects across China.

Kaisa has also been working with the Shenzhen government on a proposal to repay its onshore wealth management products. The developer is planning to sell RMB82 billion worth of assets in Shenzhen by the end of 2022 to raise funds.

Our portfolio positioning and performance

Asian Quality Bond

The strategy's exposure to the Chinese property has always been restricted to just the higher quality investment grade names. Nevertheless, performance relative to the benchmark suffered during Q4 2021, following the downgrade of SHIMAO from BBB- to BB which resulted in sharp decline of its bond prices. We currently own around 1.2% of this issuer and this position continues to detract value after it got downgraded yet again to B- in January 2022. At a dollar price of around \$30, market is pricing in a default scenario for SHIMAO. We maintain that Shimao may still be able to avert a default, should they be able to sell down

some of their assets along with an improvement in liquidity conditions. Hence, we are holding on to the position for now while closely monitoring its development. The remaining Chinese property exposures stands at 4.4%, largely in names like China Overseas Land, China Jinmao, China Resources Land, Vanke and COGARD.

For the full year of 2021, the strategy returned -0.72%. In comparison, the average return delivered by most of our peers fall in the -2.5% to -3.5% range on a gross-of-fees basis. Key reason for this relative to peers' outperformance has been our philosophy of protecting clients' capital and at the same time delivering consistent risk-adjusted returns.

Asian Strategic Bond

Being strategic in nature, the strategy added exposure to Chinese high yield as the sell-off worsened during 2021 on the back of attractive valuations and expectations that certain companies like Evergrande will likely go through debt restructuring instead of liquidation. We also believe recovery value could be significantly higher than what the depressed bond prices are suggesting. The timing of our purchases unfortunately has not been great and we certainly did not expect Evergrande's struggle to have a contagion effect on the more stable investment grade names.

The portfolio currently holds around 20% in Chinese high yield property names, which includes 0.9% in Kaisa and 0.6% in Evergrande. We are prepared to hold on to these positions and sit through the debt re-structuring process in anticipation of recovery a value than is higher than the current bond prices.

For the full year in 2021, the strategy returned -9.46%. In comparison, the average return delivered by most of our peers in the Asian High Yield space fall in the range of -14% to -15% on a gross-of-fees basis. Key reason for this out-performance relative to peers has been our more measured approach towards our allocation to high yield as we have been cautious towards the Chinese property sector before the crisis started.

We are of the opinion that in 6-9 months, we should be able to see a recovery in the Chinese property sector, which will allow our strategy to claw back a significant amount of 2021's drawdown and deliver strong returns for investors.

Important Information

This material is for general information purposes only. It does not constitute investment or financial advice and does not take into account any specific investment objectives, financial situation or needs. This is not an offer to provide asset management services, is not a recommendation or an offer or solicitation to buy, hold or sell any security or to execute any agreement for portfolio management or investment advisory services and this material has not been prepared in connection with any such offer. Before making any investment decision you should conduct your own due diligence and consider your individual investment needs, objectives and financial situation and read the relevant offering documents for details including the risk factors disclosure. Any person who acts upon, or changes their investment position in reliance on, the information contained in these materials does so entirely at their own risk.

We have taken reasonable care to ensure that this material is accurate, current, and complete and fit for its intended purpose and audience as at the date of publication but the information contained in the material may be subject to change thereafter without notice. No assurance is given or liability accepted regarding the accuracy, validity or completeness of this material.

To the extent this material contains any expression of opinion or forward-looking statements, such opinions and statements are based on assumptions, matters and sources believed to be true and reliable at the time of publication only. This material reflects the views of the individual writers only. Those views may change, may not prove to be valid and may not reflect the views of everyone at First Sentier Investors.

Past performance is not indicative of future performance. All investment involves risks and the value of investments and the income from them may go down as well as up and you may not get back your original investment. Actual outcomes or results may differ materially from those discussed. Readers must not place undue reliance on forward-looking statements as there is no certainty that conditions current at the time of publication will continue.

References to specific securities (if any) are included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. Any securities referenced may or may not form part of the holdings of First Sentier Investors' portfolios at a certain point in time, and the holdings may change over time.

References to comparative benchmarks or indices (if any) are for illustrative and comparison purposes only, may not be available for direct investment, are unmanaged, assume reinvestment of income, and have limitations when used for comparison or other purposes because they may have volatility, credit, or other material characteristics (such as number and types of securities) that are different from the funds managed by First Sentier Investors.

Selling restrictions

Not all First Sentier Investors products are available in all jurisdictions.

This material is neither directed at nor intended to be accessed by persons resident in, or citizens of any country, or types or categories of individual where to allow such access would be unlawful or where it would require any registration, filing, application for any licence or approval or other steps to be taken by First Sentier Investors in order to comply with local laws or regulatory requirements in such country.

This material is intended for 'professional clients' (as defined by the UK Financial Conduct Authority, or under MiFID II), 'wholesale clients' (as defined under the Corporations Act 2001 (Cth) or Financial Markets Conduct Act 2013 (New Zealand) and 'professional' and 'institutional' investors as may be defined in the jurisdiction in which the material is received, including Hong Kong, Singapore and the United States, and should not be relied upon by or be passed to other persons.

The First Sentier Investors funds referenced in these materials are not registered for sale in the United States and this document is not an offer for sale of funds to US persons (as such term is used in Regulation S promulgated under the 1933 Act). Fund-specific information has been provided to illustrate First Sentier Investors' expertise in the strategy. Differences between fund-specific constraints or fees and those of a similarly managed mandate would affect performance results.

About First Sentier Investors

References to 'we', 'us' or 'our' are references to First Sentier Investors, a global asset management business which is ultimately owned by Mitsubishi UFJ Financial Group (**MUFG**). Certain of our investment teams operate under the trading names FSSA Investment Managers, Stewart Investors and Realindex Investments, all of which are part of the First Sentier Investors group.

This material may not be copied or reproduced in whole or in part, and in any form or by any means circulated without the prior written consent of First Sentier Investors.

We communicate and conduct business through different legal entities in different locations. This material is communicated in:^[1]

- **Australia and New Zealand** by First Sentier Investors (Australia) IM Limited, authorised and regulated in Australia by the Australian Securities and Investments Commission (AFSL 289017; ABN 89 114 194311)
- **European Economic Area** by First Sentier Investors (Ireland) Limited, authorised and regulated in Ireland by the Central Bank of Ireland (CBI reg no. C182306; reg office 70 Sir John Rogerson's Quay, Dublin 2, Ireland; reg company no. 629188)
- **Hong Kong** by First Sentier Investors (Hong Kong) Limited and has not been reviewed by the Securities & Futures Commission in Hong Kong
- **Singapore** by First Sentier Investors (Singapore) (reg company no. 196900420D) and has not been reviewed by the Monetary Authority of Singapore. First Sentier Investors (registration number 53236800B) is a business division of First Sentier Investors (Singapore).
- **Japan** by First Sentier Investors (Japan) Limited, authorised and regulated by the Financial Service Agency (Director of Kanto Local Finance Bureau (Registered Financial Institutions) No.2611)
- **United Kingdom** by First Sentier Investors (UK) Funds Limited, authorised and regulated by the Financial Conduct Authority (reg. no. 2294743; reg office Finsbury Circus House, 15 Finsbury Circus, London EC2M 7EB)
- **United States** by First Sentier Investors (US) LLC, authorised and regulated by the Securities Exchange Commission (RIA 801-93167).
- **Other jurisdictions**, where this document may lawfully be issued, by First Sentier Investors International IM Limited, authorised and regulated in the UK by the Financial Conduct Authority (registration number 122512; registered office 23 St. Andrew Square, Edinburgh, EH2 1BB number SC079063).

To the extent permitted by law, MUFG and its subsidiaries are not liable for any loss or damage as a result of reliance on any statement or information contained in this document. Neither MUFG nor any of its subsidiaries guarantee the performance of any investment products referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk, including loss of income and capital invested.

© First Sentier Investors Group

¹ If the materials will be made available in other locations, seek advice from Regulatory Compliance.