

# Asian Fixed Income Kaisa default and Chinese property crisis

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## 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.

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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.

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