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Sectoral developments in China: Property and gaming

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Key points

- News about Evergrande Real Estate Group's US$300 billion debt triggered a selloff in the company's bonds. The issues of other B-rated property names in China also suffered.
- Despite this, at this current juncture, we do not expect contagion from the property space to spread across the broader Asian fixed income market. Yet volatility is likely to remain in the property sector and the broader China and Asian High Yield sector.
- The Evergrande situation can change rapidly as there are a lot of moving parts. A central government bailout of Evergrande is considered unlikely.
- 'Common prosperity' will remain a core government theme, with housing policy unchanged.
- Investors should also look through other regulatory activity, which is targeted rather than all-encompassing.
- The recent clampdown on Macau's gaming sector is an example of specific measures to rectify distinct issues.
- While valuations of China High Yield and Asian High Yield as an asset class remain attractive compared to US and European High Yield, volatility is likely to persist in both of them.

An overview of the Evergrande events

News about potential liquidity issues at Chinese property developer Evergrande Real Estate Group began to filter through in May 2021. Although its management team initially brushed this off as market noise, concerns persisted. This was followed by the downgrade of the company's credit rating by Fitch, and in mid-August when Hui Ka Yan resigned as Evergrande's chairman.

Further downgrades by other ratings agencies followed suit, coupled with news that the Guangzhou Intermediate People's Court would centrally coordinate lawsuits against the group. As at 20 Sep 2021, the group owes around US$300 billion[*] to suppliers, lenders, and overseas investors. Unsurprisingly, the price of Evergrande's bonds moved significantly lower, and its 8.25 per cent March 2022 bonds have traded at 26 cents in the dollar, while its 9.5 per cent March 2024 issue was at 26 cents in the dollar[**].

Keeping a watchful eye

Property developers which are highly leveraged with weaker cash flows and liquidity are likely to be tested and may experience aggressive pricing action.

Therefore, investors need to monitor the operations of property developers – particularly their onshore and offshore access to liquidity and refinancing arrangements. Market volatility means that any missteps in the execution of contracted sales, maintaining their cash collection rates or an inability to refinance could trigger a liquidity crunch.

That said, at this current juncture, we do not think that contagion from the property space will spread to other sectors – to the banking sector, for example. Most of the larger banks in China are reasonably well capitalised and broadly diversified in their lending commitments.

However, there could be potentially more risk associated with the smaller, local banks that may have lent to local developers, who are smaller in scale and operate with limited numbers of projects. As such, they could be impacted by the weaker sentiment toward property firms. Also, some insurance companies have been under pressure from a wealth management perspective, given an element of their underlying holdings are associated with property.

A central government bailout of Evergrande is also considered unlikely. The situation can change rapidly as there are a lot of moving parts. While a debt restructuring could be a possible outcome, the process and negotiations may take a longer period.

To turn sentiment around within Chinese equities, we are looking for an inflection point regarding monetary policy. Once reached, we may see some form of policy relaxation such as a reserve requirement ratio (RRR) cut. Policy uncertainty will likely further weigh on sentiment though.

From a positioning perspective, with its contrarian stylistic approach, our Fidelity China Fund is currently overweight the property sector. It focuses on state-owned enterprises (SOEs) with solid balance sheets. These are likely to be beneficiaries of any market consolidation.

Housing – The next moves

A core focus of the Chinese government is that of 'common prosperity' – affordable housing fits into this area of policy. From a broader macroeconomic viewpoint, property contributes around 28 per cent to China's overall economic growth[1], thus, to support the sector, monetary policy is likely to be loosened to some degree (also when taking into consideration weaker macro data in the second half of this year).

There are many moving parts at present, and the Evergrande dynamics are ever-changing, making them hard to predict. Despite this, government policy toward housing is likely to remain unchanged. There is less room for the regulator to tighten further from the current stance, though there may be some fine-tuning.

The broader policy direction still points at more affordable housing or rental homes for families. Margins for developers will inevitably move lower, and decreased leverage should be the trend as we move forward.

A market-driven economy

In the broader Chinese economy, we have witnessed a weakening in market sentiment, driven by high-profile, but targeted, regulatory action. Despite the recent changes in the oversight of the after-school services and online gaming sectors, it's important to note that the country probably won't deviate from the path toward a market-driven economy.

China's government is focused on three areas: security, the autonomy (or security) of supply lines, and fairness where it seeks to establish a level playing field for all companies. Ultimately, not all government policies are detrimental to all companies and sectors. And for investors, it's crucial to fully comprehend these policy changes before they can be successfully navigated.

The pricing of negative news flow

As it stands, much of the unfavourable news flow has been priced in by the market. But that's not to say all risk has been identified and managed, but people are perhaps overly negative at this juncture.

Suppose we take the recent news about a clampdown on Macau's gaming sector as an example. This is less to do with the casino sector and more about a technical issue pertaining to licencing within the gaming space. Even though further volatility is expected – there is unlikely to be further news until a public consultation is completed at the end of October – this is quite a different scenario from the recent government action on other market segments.

Notably, many of the targeted names in the recent market selloff did not report disappointing first-half earnings results. Some of the big tech players are looking attractive right now compared to their peers in the US, which still trade at stretched multiples.

High Yield remains attractive

Turning to market specifics, China High Yield bonds as an asset class maintain their allure. As of end August 2021, the China High Yield index yield[***] is at around 13-14 per cent. This compares to about 7 per cent for the Asian High Yield index and 3-5 per cent for Europe, and the US High Yield indices.

Although Asia is far from homogenous, the macroeconomic dynamics of China often have an impact on sentiment across the region. The recent weakening of sentiment toward credits of China's property developers has boosted investors' interest in Indonesian and Indian debt, although the stability of energy price has played a part too.

However, over the next few months, we expect to see volatility become a feature of China and Asia High Yield markets.

Liquidity is key

A final word on Evergrande, which, admittedly, has been trying to manage its debt burden. In the first half of the year, it reduced its debt by RMB145 billion (US$22.4 billion) to RMB572 billion with no more offshore maturities due in the remaining months of 2021. The crux of the issue is that the company's deleveraging happened so quickly that it created its very own liquidity crunch. As such, it remains vital to watch the liquidity and the refinancing plans of individual credits over the next couple of months, especially given the volatility in the offshore markets.

Reference:

** Total Liabilities as of 1H21 earnings report*

*** Prices are indicative given over the counter trading of bonds.*

*** Index Yield to Maturity

Source:

[1] Bloomberg, 31 August 2021.

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