UOB Investment Insights

Quick Note

22 September 2021

Chinese Real Estate Woes Hit Markets

- Global markets were hit by fears of potential bankruptcies of Chinese real estate developers as government tightening measures take effect.

- At this juncture, uncertainty surrounding China Evergrande's solvency will likely continue to weigh on market sentiment until a more conclusive outcome occurs. Stay cognisant of further near-term volatility and possible contagion effects.

- Overall valuations of Chinese equities remain attractive. We maintain our preference for the domestic A-share market to ride the China Megatrend.

What happened?

- Last year, the Chinese government rolled out tightening measures known as the "Three Red Lines"[1], aiming to rein in on financial risks among real estate companies. Some of these companies are known to be highly leveraged, hence the authorities' proactive policies to reduce risks.

- These measures require real estate firms to reduce their leverage before taking on more debt to run their operations. A further tightening of housing policies in recent months have led to poor sales, impacting the profitability of the sector and causing liquidity concerns among highly-leveraged developers.

- In particular, China Evergrande Group, one of China's largest and highly-leveraged developers, is facing insolvency issues and has around US$300 billion worth of liabilities. The developer accounts for around 4% of China's total property sales and has 123,000 employees and 3.8 million contractors. Markets are expecting the company to default on payments, with prices of its corporate bonds and equities plunging over the past few days.

- Fears over a potential systemic fallout across the industry's value chain, including banks and asset lenders, weighed on market concerns.

A big worry but unlikely a catastrophe

- Being one of the largest and most indebted, Evergrande's insolvency could negatively impact economic growth as the property sector may drastically slow down.

- Unlike the Lehman Brothers crisis back in 2008, the financial repercussions may be managed within Chinese High Yield bond exposures. Evergrande's highly leveraged woe was accelerated by the government's "Three Red Lines" imposed on developers and property lending limit imposed on the banks.

- The government is not without options and has policy tools to intervene and prevent a domino effect of collapses across the sector.

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[1] Three Red Lines:
  - Ratio of cash to short term debt should not be less than 1
  - Net debt ratio should not be greater than 100%
  - Asset-liability ratio (excluding prepayments) should not exceed 70%

- Additionally, the Chinese real estate market has a large influence on overall GDP, and many Chinese citizens have a large part of their net worth tied up in real estate. A fallout in the real estate market could lead to social instability, which is undesirable from a policy perspective.

- Thus, government intervention in a form of restructuring cannot be ruled out. Previous cases of reorganising systemically vital troubled institutions support this view. In fact, the Guangdong provincial government has hired advisors and started negotiations with the developer.

- With the policy focus on social welfare and common prosperity, it is likely that authorities will focus on protecting homebuyers who have purchased housing units from the developer but have yet to receive them.

- Events will remain fluid and uncertain. A restructuring to prevent a disorderly default is a possibility. **Until a clearer path or some form of meaningful resolution occurs, expect market volatility to persist.**

Prefer domestic A-Share equities for the China Megatrend

- In a previous writeup (Quick Note: Regulatory Concerns Weigh on Chinese Equities, but Megatrend Intact), the ongoing regulatory tightening across various parts of the economy remains a **short-term pain for longer-term gain**. Policy focus on social responsibility, national security and financial deleveraging seeks to create better quality of economic conditions.

- A decline in property sales and slowdown in construction activities prevent overbuilding. This dampens economic outlook on the shorter term but instils greater financial discipline for the longer term, which is a healthy development.

- Sectors and industries (i.e. decarbonisation, infrastructure) that are more in-line with government priorities are likely to fare better in the current backdrop. Boosting domestic consumption also remains a priority, where the rising income of China's middle class is a key pillar to the China Megatrend.

- Investors can continue to tap on the China Megatrend via domestic-focused onshore A-shares, focusing on opportunities in line with government priorities.

What should investors do?

- Invest in line with your **risk tolerance,** and maintain **adequate diversification** across asset classes, regions and market segments to manage market volatility should it persist. Our proprietary Risk-First approach can help ensure that you take the appropriate amount of risks in accordance with your risk profile.

- Investors holding on to Asian bond funds can note that they have minimal exposure to Evergrande and can remain invested. For those interested in Asian credits, balance sheet strength of companies will be vital at this juncture.

- Equities wise, investors with a **higher risk appetite** should adopt a **long-term perspective** when investing in the Chinese market. Investing through active professional investment managers may help to mitigate some of the risks as they will make portfolio shifts as the situation develops.

- **Consider investing in onshore A-shares and other tactical ideas** – Investors can consider the domestic onshore markets (A-Shares) as an alternative to continue tapping the benefits of China's growing domestic consumption. Other tactical ideas such as Megatrends (Sustainability, Global Healthcare) and High Conviction calls (US Financials, European equities) are viable alternatives for tactical holdings.

- Investors who are not currently invested in China but wish to enter can consider **investing in tranches** and **buying on market dips** to gradually accumulate positions in **China A-share funds** at cheaper valuations. Similarly, invest in tranches when accumulating other tactical ideas.

- Investors with **lower risk tolerance** can also consider increasing core holdings like growth-orientated multi-asset strategies such as Capital Builder.

- Please speak to your UOB Advisor to find out more.

All data are sourced from Bloomberg unless otherwise stated.

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