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Does the Evergrande turmoil in China have implications for India?

Synopsis
Indian steel stocks, while no longer the best bets in the market, do not appear particularly bad either. We, however, prefer non-ferrous metals both in India and globally.

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Over the last few days, there have been a number of news stories on the **Evergrande** issue in China. Evergrande is a large property developer in **China**, which has been facing financial difficulties with possibility of default on its debt.

There have been questions like whether it is China's 'Lehman moment', meaning just as the collapse of Lehman Brothers triggered the Great Financial Crisis of 2008-9, will this trigger something far bigger than a single company default? How much of an impact does the property market in China have on prices of materials, particularly steel, around the world? Is there a cause for worry for the Indian markets and investors?

In this piece, we tried to dig a little deep into what these developments portend.

First off, how big a deal is that Evergrande has been having difficulties? To understand the context, China has been trying to clean up its bad corporate debts for years. The government has been making noises about more market discipline and a transparent process for letting firms default in order to prevent 'moral hazard'.

However, it has taken a caliberated approach for the same. The contrast can be seen in how it dealt with the large lender, Huarong, which was facing problems and a possible default a couple of months ago. In that case since it was state-owned and considered large & systemically important, the Chinese government essentially engineered a bailout and ensured that there was no default.

The Evergrande issue is different. In our view, the issue is part of a deliberate move by the Chinese Government to let a few businesses fail, if needed, to rein in a bigger problem, so they will not let it go out of hand. The situation is similar to a "controlled detonation". In a relatively controlled economy like China, this is entirely possible.

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Of course, for now, Evergrande has not defaulted on its onshore obligations, which form the bulk of its debt. It has probably come to some kind of deal with them, the details of which have not been made public.

Plus, for all practical purposes, a default of Evergrande has already been priced in, and not just its own bonds -- even overall high yield bonds in China/Asia -- have already reacted, so there's not much further downside there.

Besides, apart from real estate, tech and consumer discretionary, which have also been the subject of the government crackdown, other parts of the Chinese economy, continue to be robust. That is where we are placing our faith.

The primary casualty of the contagion, if any, will be the banking sector. As far as our global funds and portfolios are concerned, this is a sector we are anyway underweight on.

In China, we are in sectors which are more robust like clean energy, semiconductors, footwear & chemicals. We have not taken any direct exposure to the finance and property sectors in China. We also cut out the consumer internet/ tech stocks a few months ago after the government pressure increased in various ways on companies like Alibaba, Tencent etc. The way the Chinese government forced the pulling of the Alibaba affiliate, Ant Financials' IPO and thereafter moved against several other consumer tech giants showed that regardless of business potential, the Chinese government would not let any entrepreneur get 'too big for their boots'.

On the other hand, the Chinese government has put in a lot of effort and money behind many identified innovations and high tech areas from semiconductors to neuroscience to blockchain. Hence, the opportunities have to be properly sifted and identified.

We will be watching the developments very closely, but one way or the other, it is not going to affect our global fund/ portfolio materially.

While we don’t think anyone realistically sees Evergrande as Lehman, but we’ve also seen these periods of China deleveraging weakness before and they aren’t fun. We don’t need the 0.01% probability tail event to be concerned. However, given the amount of publicity it has already received, property developers and financiers have already seen credit spreads widen. For Evergrande effectively, a default risk is already built in with its bonds trading at 20-30 cents on the dollar.

Beijing wants to rein in the property sector, which has been highly levered for some time now. But Beijing does

not want consumers to suffer. So the only solution is restructuring and a slow burn in the property sector. As of June, Evergrande's inventory (composed of largely unfinished projects) accounted for about 60% of its total assets. Properties under sevelopment, in particular, ballooned to 1.3 trillion yuan ($202 billion), a 54% jump from three years ago.

If only Evergrande could offload some of these projects to, say, a cash-rich state-owned enterprise, its immediate liquidity crunch would be resolved. Beijing would then have some breathing room to gradually scale down this beast. While one can bet against Chinese private banks/NBFCs with high exposure to property-related sectors, we don't think PBOC will let big banks collapse.

The other possible risk area is investment grade names in the real estate space. The Bloomberg China HY USD index is 66% real estate. Hence, when you look at the aggregate index, it is mostly a real estate picture you get. So far, we think this a China real estate-specific problem. The contagion is likely to be very limited.

This leads us to the question if a Chinese real estate/ property area problem has wider implications? Especially for metals and other industrial commodities.

Steel and iron ore are already under pressure due to Beijing's 'Blue Skies' mission for Winter Olympics where they're restricting steel production in order to reduce emissions. Iron ore is trading around $100-110, less than half of its May 2021 peak. Australian miners can take a big hit and they already are.

As for implications for Indian metal companies: Metals, including steel, had been big winners in our India portfolio from the third quarter of 2020, but we had started trimming these a few months ago. One reason being that we estimated that the US would try to curb commodity inflation by strengthening the dollar, which actually happened.

China has been curbing its own steel consumption for environmental and other reasons. However, I think the primary impact of this has been and will continue to be on iron ore prices and stocks - especially, Australian miners.

Indian steel stocks, while no longer the best bets in the market, do not appear particularly bad either. We, however, prefer non-ferrous metals both in India and globally.

Meanwhile, our systems continue to monitor all macro & market variables for all major economies as well as industry-level data and, like a hare, we remain alert, scanning the environment and ready to change direction if the situation so warrants. As of now, we are not worried about contagion from this particular event but we continue to monitor potential risks.

(Harsh Shivlani contributed to this article)