JK Capital Management Ltd.

# Week of 14th June 2021

What's on our mind this week?

## Evergrande bond volatility ramps up as negative media reports hurt investor sentiment

The past two weeks has seen a sharp drop in the price of bonds issued by Chinese property giant Evergrande. The benchmark 2025 issue has seen its price fall 14pts since May 26th while even shorter dated 2022 and 2023 issues have also seen significant price erosion. For Asian HY bonds this not only has a direct impact, given Evergrande is the largest single issuer in the market, but this has led to a poor sentiment across the Chinese property complex which has also traded weaker in recent days.

The recent softness appears to stem from a rash of media reports suggesting potential liquidity strains at the company. In late May, Chinese business magazine Caixin published a story suggesting regulators may be investigating illegal lending between Evergrande and an affiliated financial institution Shengjing Bank. It later emerged the property lending fines at Shengjing were small and something most banks within China face. In fact, brokers at BNP reported the size of the fines at Shengjing were just RMB5.5m compared to RMB2.3bn of illegal real estate lending related fines issued across the whole banking industry since last year. Nevertheless, this set a weak tone for Evergrande bonds for the subsequent two weeks. In early June onshore newspapers then reported one of Evergrande's project companies was late on commercial paper repayments (later resolved) while there were also reports the company was offering heavy discounts on certain projects to accelerate cash collection. Finally, Bloomberg news, citing unnamed insiders, said Chinese authorities had ordered domestic banks to stress test their exposure to Evergrande, something one would expect banks already do on a regular basis, but nevertheless this prompted one local rating agency to put Evergrande's AAA rating on review.

The market is certainly no stranger to Evergrande volatility. The 2025 bond, which was issued in mid-2017, has seen its price swing in a range of over 15pts every year since it was issued. This is unsurprising considering Evergrande is China's largest property developer by assets, operates a fast turnover high leverage business model and has made significant, and at times divisive, investments in many non-core industries. Reports predicting the imminent collapse of the company has been an annual ritual since Evergrande was first listed in 2013. Nevertheless, the recent frequency of negative media reporting on the company has certainly increased in recent weeks, even by Evergrande's own standards.

This raises the question is the market going through yet another seasonal crisis of confidence in the HY behemoth or should recent developments in the market suggest that the latest drop is more justified and sustainable? Certainly, taking the recent individual news stories in isolation these appear typical Evergrande noise that in the past years would have seen a bout of short-term market weakness followed by a sharp recovery.

It should also be pointed out that, despite all the negative market headlines, underlying fundamentals for Evergrande have actually been improving recently. Following the introduction of the three-red-lines lending policy in China last year, highly leveraged developers such as Evergrande have been forced to accelerate deleveraging through faster assets sales and slower capex. In 2020 Evergrande cut its Net Debt/Capital ratio to 61.5%, its lowest level since 2015 and has publicly committed to further reduce debt in 2021 to gain better compliance with the China red lines targets. Last week, Bank of America research estimated that even in a worst-case scenario the company will have sufficient cash flow to repay bonds and trust loans in 2021 even if new funding becomes curtailed which would result in a significant improvement in credit metrics by the end of the year.

However, underlying much of the past confidence in the company has been the combination of the company's almost heroic ability to constantly find new sources of capital and a general market perception that, as the largest property developer in the country with massive debt exposure across the Chinese banking system, there is no way the company would be allowed to fail, the implications would be just too disastrous.

In 2021 this assumption may be changing. The rash of China SOE bond failures in 2020, including university affiliated entities owned by the central Ministry of Education, demonstrated the government is highly committed in its intension to install increased moral hazard into Chinese financial markets, it does not want investors to believe any entity is "too big to fail". Even more serious in this regard is the situation with central government owned distress asset manager China Huarong AMC since February. The lack of government clarity on how Huarong's financial stresses will be resolved has left investors with only one of two conclusions. Either the issues are small and not the concern of government regulators or Huarong's problems are so material that the authorities realize extreme care must be taken to resolve its weak balance sheet without either creating a market panic or undoing all the work installing market financial discipline. Whichever the situation, the government's lack of urgency in providing market visibility on Huarong has clearly had a profound impact on overall investor sentiment and is likely to sustain price volatility on high beta names like Evergrande for the foreseeable future.

One of the drawbacks of a highly diversified fund is that spreading the portfolio over a large proportion of the market naturally increases the chances of unforeseen credit events affecting the investment. However, on the other hand, this does drastically limit the impact of such idiosyncratic events and when the asset class sees a significant drop in the largest issuer in the market, the value of a diversified equal-weighting strategy becomes very clear. At the start of 2020 bonds issued by Evergrande and its subsidiaries accounted for 6.4% of the Barclays Bloomberg USD HY Bond index. Even after recent declines that weight is still 5.8% the largest single issuer in the Index. The structure of the market and our portfolio dictate that irrespective of our fundamental view on the company, Evergrande will always be the among the biggest underweight positions in the fund and naturally the recent developments have seen the JKC Asia 2023 portfolio outperform the wider Asian HY market over the past week. While we believe Evergrande still has the flexibility and underlying asset base strength to resolve the current crisis, the impact on the fund of this single issuer will be contained as the direct exposure of the fund is of only 1% and, including all subsidiaries and associates, 1.9%.

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### Huawei's new smartphone operating system: Harmony 2.0

When the relations between the US and China started degrading under the Trump administration and Huawei felt the weight of sanctions, one subject appeared particularly problematic for the smartphone maker: its reliance on Google's operating system, Android. At the time, Huawei had announced it had an operating system (OS) ready should it no longer be allowed to rely on Android, although the company backtracked afterwards to say the said OS was not fully commercially ready and adopted Android's open-source OS, called EMUI, without GMS (Google Mobile Service) support starting September 2020 when the sanctions came in. Huawei has now released its OS, Harmony 2.0, which will be installed on all the Huawei phones freeing the manufacturer from any engagement to Google within the software system.

The release of the OS is quite remarkable as it shows the ability to replace key pieces of software with home developed quality ones. The Harmony OS system is not based on Unix or Android. It is completely independent. Some functionalities look very similar to some patented features of Android or Apple such as some logics, gestures features, or sequences and there could be patent-related uncertainty in the future, especially in the global market. But this is not overly critical at this stage. The most important element to make Harmony a success will now be the app-developer environment. Many applications will likely not work on this OS. Huawei does put forward its own emulator that can easily convert Android apps into Harmony apps, but users of the iOS emulator for the Android OS know the performance is hardly satisfying. The emulator can mechanically change the language, but it will not give it a nice commercial finish or an ergonomic feel. This is why app developers often need to double the efforts and the costs to release versions of their app for the different platforms. It explains also why, for PCs, there are fewer software available for the Mac OS then there are for the Windows OS. In the gaming world, Playstation and Xbox are the lead actors competing to bring more game developers to their platform. Relatively smaller players like Nintendo have a hard time competing and need to find their own niche in which to thrive without the contribution of many game developers.

Whether app-developers will start working in the Harmony OS environment is the key question. It all depends on how many end-users the Harmony OS will attract. If the market is deep enough app-developers will eventually invest to have products made for the platform. Many Chinese consumer-electronics companies such as Midea, Haier, Joyoung, and Fotile, have already agreed to use this OS on their consumer electronic devices like washing machines or ovens. However, smartphone makers like Oppo, Vivo, or Xiaomi haven't yet. If they do, at least for the domestic market, the Harmony OS may be a success.

Huawei's smartphone shipment has already dropped to 4% of the global market share in Q1 2021, from 20% at its peak. At this level, the challenge to launch an OS is very different. Huawei needs other Chinese smartphone makers to adopt it and they may request Huawei to abandon manufacturing altogether as a requisite for their move. But this would only solve the problem for the Chinese market. Globally, Apple's iOS and Google's Android are well implanted, and it is hard to imagine a third OS taking significant market share from them and attracting developers. Harmony may need to be something like Nintendo in the gaming world, a niche player with its own environment, features, followers and reasons for existence. Until then, although we salute the technical tour-de-force to have released a completely new and independent OS, it is not the "Get-out-of-jail" free card Huawei needs. At least not yet.