OUTCOMES

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PGIM QUANTITATIVE SOLUTIONS

DISTRESS IN CHINA'S REAL ESTATE SECTOR: WHOSE DEFAULT IS IT?

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Heightened regulatory scrutiny in China dominated headlines for most of 2021, forcing investors to navigate tumultuous waters and question the implications of investing in the world's second-largest economy. News surrounding the possible collapse of China Evergrande Group, once China's largest real estate developer, shined a spotlight on the property sector, a significant component of the Chinese economy. China represents over 30% of the MSCI Emerging Markets Index[1], so understanding the impact of regulatory changes on the real estate sector, along with how our investment process and models prevented the extreme losses realized in the sector, is critical for emerging markets investors.

The opening of China's economy in the late 1970s ushered in an era of unprecedented growth, which allowed millions to be lifted out of poverty. Sharply increasing demand for urban housing, driven by a quickly growing middle class, sparked concerns about overheated real estate prices. Decades of government policies to balance the objective of increased urbanization while controlling soaring property values have spurred countless debates around the probability of a bubble in China's real estate sector.

Growth is central to China's plans for a prosperous society. Although the government's goal was to shift the economy toward consumption-led growth, in part to deal with its shrinking workforce, growth during the last 50 years came predominantly from fiscal stimulus, leading debt-to-GDP levels to rise steadily. During this time, the government enacted a number of policy changes to spur economic expansion, including reducing requirements for multiple mortgage down payments. Increased credit access for developers and ease in securing residential mortgages were also introduced to speed up urbanization goals.

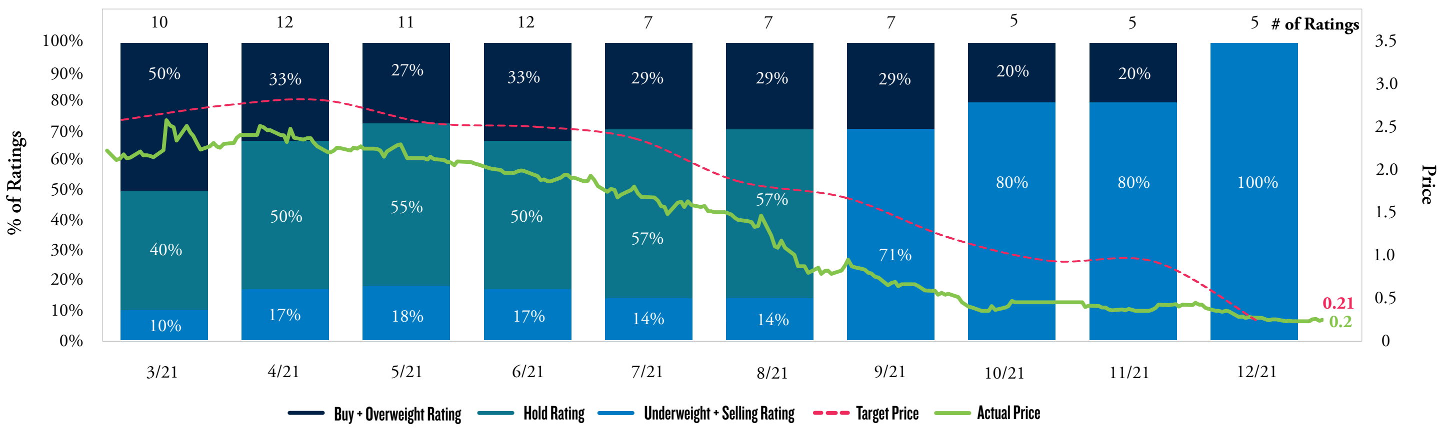
Policy easing helped China Evergrande Group, established in 1996, become one of the largest property developers in China. The company amassed astronomical debt developing properties to accommodate the growing middle class, although some of its investments were more unorthodox (e.g. a soccer stadium, which the government has taken over). In an effort to ameliorate extraordinarily high debt levels in the real estate sector, regulators introduced the "three red lines" policy in mid-2020. The policy outlined balance sheet stipulations developers had to meet in order to take on more debt.

Although real estate relies heavily on debt, brokerage firms turned notably negative on China Evergrande Group. The company became exceedingly expensive relative to its peers, with valuations peaking in June 2020 after China's stringent COVID-19-driven shutdowns. At the same time, the company's profitability was deteriorating and debt levels were increasing. A look at China Evergrande Group's long-term debt relative to EBITDA (seen in Figure 2) paints an alarming picture.

[1] As of February 28, 2022

While China Evergrande Group continued to operate, investor interest diminished. Missed bond payments and failed attempts at finding suitable buyers culminated into a dire situation. Downgraded debt and diminished analyst coverage (see Figure 1) have severely limited the company's access to capital markets, increasing the probability of default as liquidity evaporates further. Fears of contagion have heightened. China Evergrande Group's woes have reverberated throughout the property sector as real estate buyers retreat and investors stand on the sidelines. Supporting segments, like heavy industry products, are also feeling downstream effects.

Figure 1: Analyst Ratings of China Evergrande Group

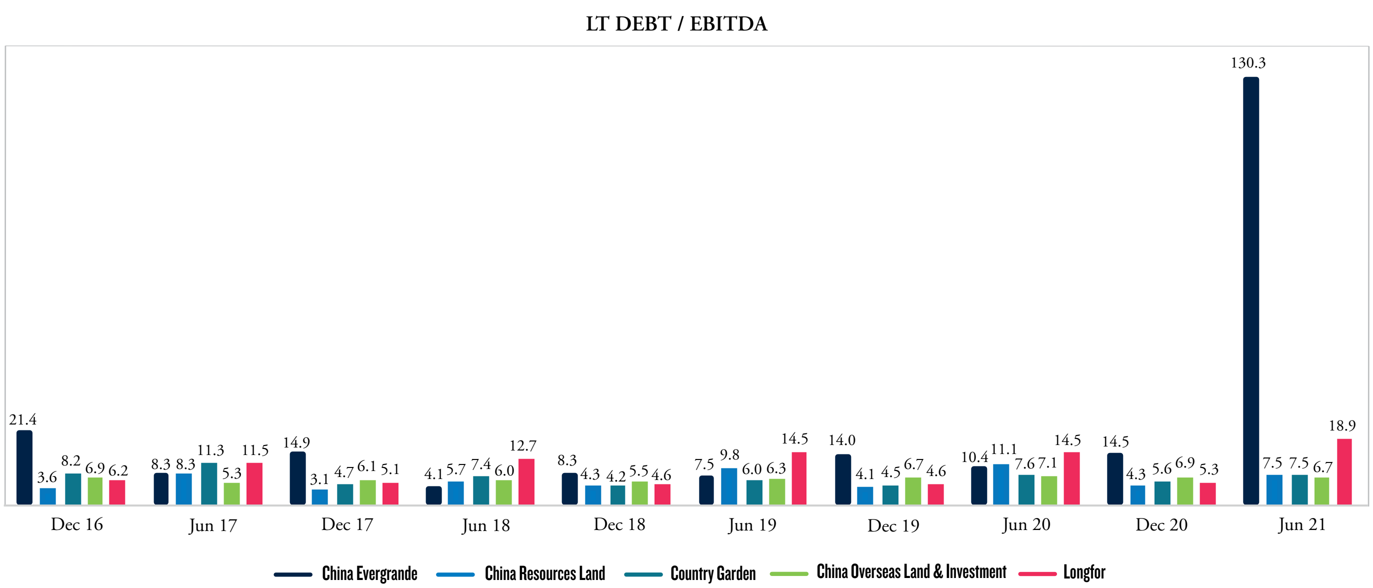


Source: FactSet as of 12/31/2021.

The extent to which the government is willing to remain passive is yet to be seen. However, real estate's contribution to GDP growth, not to mention all of its tributaries, is estimated to be sizable. We think it will be difficult for China's government to remain hands-off given its GDP growth targets, and urbanization plans. Furthermore, its goal of fostering "common prosperity," stressed in its latest 5-Year Plan, means housing prices must be tempered, which suggests government intervention is probable. With so much on the line, it is likely the government will facilitate liquidity versus embarking on a much more difficult path.

Within the MSCI Emerging Markets Index, China's real estate segment comprises over 1% of the benchmark, with real estate development making up the bulk of that figure. Figure 2 depicts some of the larger developers included in the index, revealing the extent to which the property sector's debt grew in a roughly five-year period. It should be noted that the Chinese government has a sizable stake in the industry.

Figure 2: Debt Levels of China's Real Estate Developers



Source: FactSet as of 6/30/2021.

Crises in emerging markets are not new: emerging markets equities are characterized by increased risks (ranging from political to liquidity risk, and anywhere in between) and higher volatility. Military coups and government intervention are par for the course. So, how do we manage the exposure to these challenging and risky markets in our portfolios?

Our systematic stock ranking process employs a proprietary blend of metrics, weighing the attractiveness of "cheap" stocks against the strength of their fundamentals and growth prospects, while limiting bets on any one country or sector. Although real estate stocks in China appeared cheap during 2021, our model revealed that the reward was not worth the risk. In the case of China Evergrande Group, the combination of unfavorable growth expectations and deteriorating profitability effectively muted any semblance of value as the stock price was sinking last year. As a result, we maintained a neutral position on China Evergrande Group (relative to the MSCI Emerging Markets Index) throughout 2021. The stock fell 31% in December to end the year with a decline of nearly 90%. China's economic growth, already revised down for 2022, is threatened by a renewed surge of COVID infections, which could continue to impact manufacturing and supply chains, and by extension, the real estate sector. Russia's invasion of Ukraine has sharply heightened market uncertainty and volatility and raised the stakes for China if it decides to back Putin's war. Western sanctions would likely ensue, leading to further pullbacks and complicating Beijing's maneuverability around its real estate woes. Therefore, clear understanding and management of risk remain critical to protecting assets amid a rapidly changing regulatory and market environment.

Notes to Disclosure

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