What does China's regulatory crackdown mean for EM corporate debt?

Omotunde Lawal, CFA
Head of Emerging Markets Corporate Debt

Chinese corporates are experiencing growing pains as fines and restrictions rain down on sectors like tech, real estate and education. However, while the new regulations have caused credit spreads to widen significantly, they may also represent a path to long-overdue reforms in various parts of the Chinese economy. Additionally, debt investments, unlike their equity counterparts, are not necessarily dependent on long-term growth prospects—rather, performance is often a function of a company's balance sheet strength and its ability to repay its debt. Against this backdrop, the current environment may prove to be a buying opportunity, particularly for long-term investors with the ability to identify companies with solid fundamentals.

The not-so-idiosyncratic crackdowns

While the recent government regulations may appear idiosyncratic in nature—taking the real estate, tech, consumer and education sectors in isolation—longer-term trends become apparent when viewed through a reform-minded lens.

Real estate

In an attempt to prevent housing prices from rising too quickly and to maintain affordability, the Chinese Communist Party has continued with a tightening policy bias on the real estate sector. In addition to credit tightening via mortgages and construction loans, this has included curbs on pre-sale permits for developers, a tightening of rules around home buyer qualifications, and mandated balance sheet deleveraging through the "Three Red Lines." While these measures do create short-term challenges for the thousands of real estate developers in China, they could ultimately be seen as positive for longer-term investors in the sector—as the crackdown may result in the strongest developers acting as consolidators and capital being allocated more efficiently.

Technology

An onslaught of regulations targeting China's tech industry over the last year—from the blocking of ANT Group's initial public offering to the $2.75 billion fine on Alibaba for anti-competitive behavior—has raised concerns about the sector's investment prospects. While the crackdowns and fines have resulted in market volatility, considering them through a long-term lens suggests the situation may be more nuanced. In particular, breaking up the monopolistic grasp of the tech giants could prove to be an important step toward fostering new startups, creating an environment for competition to thrive, and improving the efficient allocation of capital. That said, investors in the space must remain cognizant of potentially less altruistic motives behind the crackdowns, which may include a desire to neutralize the power that tech titans have gained in recent years.

Data and consumer privacy

Big data has also come under scrutiny, evidenced by the recent measures taken against consumer-based apps, particularly in the health care and food services sectors. For instance, investors recently watched in bafflement as the Chinese government cracked down on ride-hailing company DiDi, suspending its ability to sign up new customers and removing it from China's app stores. Beyond the ongoing concerns regarding the storage of sensitive consumer data, the government has also been making efforts to establish better labor standards and wages for the gig/contract workers that app-based companies employ. While challenging in the near-term, these regulations do seem aligned with the government's longer-term goals, specifically its pledge to promote social fairness, justice and common prosperity.

Education

The private, after-school tutoring and test-prep coaching industry is one of the most recent sectors to find itself in the government's cross hairs. Following the recent ban on these companies from making profits, raising capital or going public, the prices of China's biggest education sector stocks and bonds dropped precipitously. However, despite the short-term pain this has caused for investors, the government's action could be interpreted as a bid to level the playing field by improving social equality and the affordability of basic needs, in this case education. But like many of these changes, critics have pointed out potentially less altruistic motives here as well, which in this case may include a desire to limit Western-based ideologies permeating the Chinese educational curriculum.

Short-term pain, long-term gain?

The debt market's reaction to the regulatory moves has been nothing short of significant. Even so, Chinese corporate fundamentals remain strong overall, and most companies appear well-positioned to satisfy their debt obligations going forward. In the tech sector, for example, many of the impacted companies are investment-grade rated, with strong balance sheets, high net cash positions and low amounts of debt—which should provide some cushion against the fines imposed by regulators.

Additionally, while these regulatory actions have created volatility, we believe they stem largely from the government's desire to strengthen economic and social stability. That said, for sectors like education, the changes will greatly affect the ability of companies to attract investors, as firms are being forced to change their business models. For other sectors, however, the severe restrictions that have been imposed over the past year could bring long-term benefits—whether that means stronger balance sheets in the highly leveraged real estate sector or a breakup of monopolies in the tech sector.

Regarding the ongoing headlines around Evergrande—while the company is one of China's top-three developers, the residential property market is highly fragmented, and Evergrande's market share in 2020 was only around 4%.[1] In light of this, we would not expect a default to put significant pressure on housing prices, unless the restructuring or liquidation of the company's assets becomes disorderly. Although policy changes and recent headlines—and the associated contagion to other issuers in the real estate sector—are creating near-term volatility, our long-term fundamental view has not changed. Ultimately, we expect the government's focus on deleveraging the sector to result in greater consolidation among the stronger, larger developers, with smaller developers more likely to exit.

Key takeaway

Regulatory risk is an ongoing concern that must be carefully monitored and evaluated when investing in emerging markets. As we closely watch the direction of regulatory policy in China, acknowledging the many risks that exist across the landscape, we expect buying opportunities to emerge as well—particularly when spreads widen beyond what fundamentals would suggest. However, in times of heightened uncertainty, rigorous, bottom-up credit analysis plays a critical role in navigating risks that a change in the regulatory environment can create.

FOOTNOTES

1 Barings. As at December 2020.

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