Rathbones
Look forward

Review of the week

20 September 2021

# Evergrande, nevermore?

**China's largest property developer is all but bust, throwing the market into disarray. Back in the UK, skyrocketing gas prices have the government scrambling to shore up energy retailers.**

Property has a nasty habit of causing financial trouble. It's the one investment that most people seek to make, at least once in their lives. It also tends to be irrevocably linked to debt, which is perhaps the problem. When a market that is so large - national property markets tend to dwarf bond and equity markets - and so debt-fuelled, it easily creates momentum that carries people away and outpaces a government's attempts to rein it back.

China has been battling a dangerously inflated property boom for many years now. Developers borrowed heavily from investors all around the world, using the cheap debt to finance countless apartment blocks and houses thrown up all over China. Demand for these homes, both as abodes and investments, was huge. However, many companies overstretched themselves, repaying maturing debt with ever more debt as they chased sales growth. This has finally come to a head with Evergrande, China's largest real estate company, sending a very public mayday call after new government rules stipulated that over-leveraged developers must repay old debt before issuing any more. The government is trying to stop runaway price inflation in homes and encourage developers to become more financially responsible. It seems to have had the desired effect on property prices, but it may also destroy developers rather than bring them to heel.

Evergrande is drowning. Its share price is sinking fast (down 85% year to date), yet it is still worth about $4.4 billion. The reason for the plunge? Debts in the realm of $300 billion. It has an interest payment due on some of its dollar-denominated bonds this week. Some investors think it won't be able to drum up the money without the state's help. If it doesn't stump up the cash the company will fall into default and yet more fear will ripple through China and anyone who has ploughed money into its real estate. A large amount of Evergrande's debt has been packaged up into investment products and sold to households too.

Concerns about Evergrande and its aftermath have hit the Hong Kong stock market the hardest. The satellite market - which used to be the largest in China and is typically used by overseas investors - came off worse following the government's recent crackdowns on technology and education businesses as well. Over the past six months, the Hong Kong index is down about 12%, while the Mainland index is up roughly 5%. Part of it could be foreign investors cutting and running, but the difference in flavour of the indices is the dominant reason. Half of the Hong Kong market by value is made up of financial companies, while another 20% are property businesses. In contrast, the Mainland sports about 25% financials and 2% property. In the short-term, it also helps as well that the Mainland stock markets are closed Monday and Tuesday for the Mid-Autumn Festival.

Property is crucial to so many people's lives. There are the builders, architects and tradesmen whose livelihoods are erecting the buildings, fixing them, modifying them, renovating them. It is the single-largest investment most people make and the place that keeps their family safe. This psychological impact should never be downplayed. The wealth effect for owners is real: people sitting on property that has gone up tend to be happier and they spend more, two big positives for society and the economy. However, that also works in reverse: people in negative equity become fearful and slash spending to repay their loans, something that causes economic turmoil when writ large. Concerns about the Chinese property market have already had an effect: the price of iron ore has plummeted more than 20% since the beginning of September. Any slowdown in Chinese construction would significantly reduce the global demand for steel, which is made from iron ore.

Evergrande isn't the only shaky mountain of debt threatening to cause havoc in China's financial landscape either. There's also Huarong Asset Management, which actually started life as a bad bank following the Asian financial crisis of the 1990s, before its managers got a taste for expansion, layering on the leverage to buy all sorts of other businesses. After much discussion at the top of the government, it was decided that Huarong was too big to fail. It is to be rescued by a consortium of other state-backed lenders.

Market opinion is divided on whether the government will rescue Evergrande or let it fail as a warning to the rest. There are so many more developers in a similar position, if Evergrande turns into a messy blow-out, the fallout would likely bury them as well. Not only that, but most of the creditors are local construction companies, subcontractors and Chinese citizens who have put up hefty deposits to secure homes off-plan. Letting those people down would be a political nightmare. All of this will be weighing on the minds of government officials this week.

### Money, it's a gas

The UK government has found itself in emergency talks of its own. The price of natural gas has risen rapidly this year all over Europe; however, it is most acute here in the UK, where the gas price is four times what it was at the beginning of the year. At one point this month it was 85% higher than the last record high posted in 2008.

The European gas crunch has been driven by several factors. A cooler summer meant more gas was used than expected, sending stockpiles lower heading into winter. The pandemic reopening has also bolstered demand for energy, carbon credits and raw materials.

In the UK, almost 40% of natural gas is used to heat homes, with another 30% used to generate power for the grid. So a large increase in the gas price has a significant effect on energy costs for British households. The UK's drive to increase competition in the retail energy market has created a plethora of fragile players in what is traditionally an oligopoly that sports just a few huge businesses. This has led to very keen pricing to attract customers, yet a raft of small, badly hedged businesses have gone bust in recent months as prices got away from them. More are expected to fold soon, potentially affecting millions of customers.

The government is now in talks with the industry to flesh out a plan to ride out the crisis. Reportedly, the larger players are asking for a multi-billion-pound support package from the taxpayer, and a 'bad bank' to take on the customers from the failed retailers. These companies will have locked in a per-unit power price with customers that is now well below what it costs to buy power in the wholesale market, so surviving retailers will be loath to take them on.

And you can't blame them. They would be taking on loss-making customers who will only be disgruntled and move as soon as their fixed-term price runs out and their price adjusted to a profitable level!

It's not just the power market that could be affected by the natural gas crisis either. The company that supplies 60% of carbon dioxide used in UK food production and preservation has shut down its two British factories because of the soaring cost of natural gas. If the plants do not resume production, more shortages are expected in British supermarkets. Not only that, but the factories also make fertiliser, so a protracted shuttering could lead to higher costs for farmers, hurting food production higher up the chain.

*If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.*


Julian Chillingworth
*Chief Investment Officer, Rathbones*


Rathbones
Look forward

rathbones.com

rathbonefunds.com

## Important information