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PAKISTAN
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Dissecting potential Evergrande fallout!

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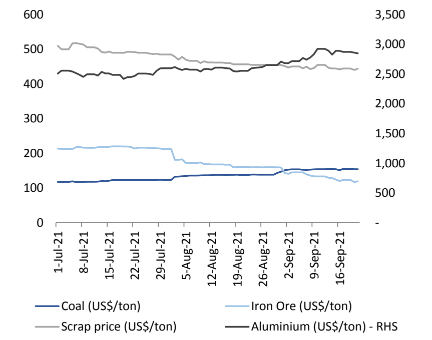
- **2021 marks significant regulatory changes in China under the banner of "Common Prosperity Initiative" - targeting companies in Tech space, Real estate, and Education. The negative near-term implications from such regulatory actions have become more visible lately with Evergrande calling for debt-restructuring facing a possible default threat.**
- **Financial distress at Evergrande has brought jitters in Emerging Market bonds — however, fortunately most of the impacts are limited to Chinese real estate bonds, where contagion from fall-out appears far-fetched. However, it compounded existing weakness precipitated by expected stimulus tapering by US Fed.**
- **Beijing is due to host Winter Olympics in Feb'22 where we expect climate curbs in the regions close to event sites — on a scale much larger than seen in 2008 Beijing Summer Olympics. Major industries which are likely to be impacted are, Steel and Aluminium producers, Refiners, and Coal miners.**
- **From Pakistan's vantage, volatility shall persist in EM bonds space in the near term, possibly resulting in local authorities realizing higher yields on planned US$1-1.5bn Sukuk issuance in Oct'21, to retire US1bn bond (previous 5y yield: 5.875%). That said, possible downward revision in certain commodities is materially positive for local steel players. For Cements, coal prices are likely to remain elevated in the near term however, lack of future investments in coal power plants by China is material positive.**

Commodities—Trend



Source: Investing.com & AKD Research

A year of regulatory changes in China: 2021 marks significant regulatory changes in China under the banner of "Common Prosperity Initiative" - targeting companies in Tech space, Real estate, and Education. The negative near-term implications from such regulatory actions have become more visible lately with Evergrande calling for debt-restructuring facing a possible default threat. Moreover, the Chinese authorities are further escalating efforts on climate front with the latest being the country ending its support for offshore new coal power projects — unlikely to have material implications on coal prices which in the near term should persist to be a function of unwavering demand — while further actions are plausible with Beijing Winter Olympics beginning in Feb'22 and on a much larger scale than seen in 2008 Beijing Summer Olympics. Regions close to event sites are likely to face stringent climate protocols which include Steel production hubs of Tangshan and Handan, Refiners operating in the province of Shandong bringing concerns on production of fuels to the fore, and lastly Shanxi, Shaanxi, and Henan — home to Coal mining with output curbs likely to further extend the rally in coal prices. Moreover, output caps of Steel and Aluminum manufacturing are likely to be extended.

Red flags raised on Evergrande's financial position: Evergrande — China's second largest real estate player — has found itself in financial distress with latest numbers suggesting outstanding debt totaling US$300bn. The company aiming to meet c`ompliance with new regulations which puts a cap on leverage of real estate companies has found itself grappling with liquidity shortfalls despite speeding up asset sales including listing of subsidiaries. This has triggered pressure on EM bonds (JPM EMB ETF down 1.1% in the past one week) compounding existing weakness as investors digest stimulus tapering by the US Fed. However, company's announcement of settling US$36mn interest payments on domestic bonds (due today) seems to have stabilized broader market jitters but only temporarily in our view, where clarity is still needed on US$83.5mn and US$47.5mn bond payments due today and next week respectively. Furthermore, we believe the aforementioned episode could result in liquidity implications across broader sector with a consequent impact on property development sales in the near term.

What does it mean for Pakistan? Evergrande's episode is unlikely to form a contagion, at least for now, where we see Chinese authorities mulling for an amicable resolution of the issue however, possibility of direct bailout is yet far-fetched. Hence, volatility shall persist in EM bonds space in the near term, possibly resulting in local authorities realizing higher yields on planned US$1-1.5bn Sukuk issuance in Oct'21, to retire US1bn bond. That said, spillover on commodities from the aforementioned developments is materially positive for local steel players where scrap prices have already spiraled down by 2.4% since the beginning of the month. For Cements, coal prices are likely to remain elevated in the near term however, lack of future investments in coal power plants by China is material positive.

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