Manulife Investment Management

Portfolio Insights

Asian Credits: The rising importance of governance factors

Q4 2020

Overview

The COVID-19 pandemic has roiled global asset markets, including those in Asia. In this difficult economic environment, the region will not be immune to the general trend of credit deterioration.

Nevertheless, we believe Asia is structurally better positioned than its global counterparts, and in our view there are significant opportunities available for investors in credit selection. To fully extract value, incorporating a robust Environmental, Social, and Governance (ESG) analysis – and particularly the "G" factor (Governance) in Asia - will be increasingly integral in this difficult climate.

In this latest issue of Portfolio Insights, we explore the Asian credit environment and the growing importance of governance factors in credit selection. We demonstrate how Manulife Investment Management is well-placed to help investors add value in Asian credits – not just through our people and process, but also through our fully-integrated ESG approach. In fact, we have avoided all 61 "fallen angels" in Asia (ex-Japan) to date and have not registered a single default in our regional pan-Asian fixed-income holdings over the past 12 years[1].

Finally, through three illustrative case studies, we exemplify how our proven approach to credit selection and emphasis on governance issues has steered us away from potentially problematic names.

[1] Manulife Investment Management, Standard and Poors, Moody's, JP Morgan Asia Credit Index (JACI).

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The current Asian credits landscape

- Over the next few years, security selection will become critical as credit rating downgrades and defaults proliferate. We believe ESG considerations, particularly the "G" analysis (Governance) in Asia, will be increasingly important in this difficult pandemic and post-pandemiceconomic environment.

- In our view, the most significant opportunities in Asia lie in credit selection, as credit quality remains comparatively high, while corporates generally benefit from a broad array of diversified funding channels. In this section, we share our observations on key developments in the credit markets of China, Indonesia and India.

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The Manulife Investment Management difference: Our people, our process and a targeted ESG focus

- We boast an impressive track record: We have avoided all 61 "fallen angels" that occurred in Asia (ex-Japan) and have not registered a single default in our regional pan-Asian fixed-income holdings over the past 12 years[1]. This is a result of our commitment, as active managers, to safeguard investors from potential capital loss and credit write-offs, through a rigorous investment process and an unwavering focus on governance issues.

- The unique combination of art (our diversity of experienced analysts across the region, language ability and local on-the-ground familiarity) and science (our technical knowledge, deep expertise and ESG framework) drives Manulife Investment Management's strong track record in credit selection.

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How emphasis on the "G" in ESG is critical in Asia

- Quite often, qualitative factors in assessing Asian credits are overlooked. We believe that a more holistic credit assessment framework, integrating both quantitative and qualitative factors, is critical as there should be no room for any benefit of doubt when assessing Asian credits.

- In this section, we detail two atypical factors that are often picked up by our multi-faceted due diligence process: i) lack of formal governance structures; ii) related entities and transactions.

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Case Studies: Our track record underscores a robust ESG process

- In this section, we illustrate how, by integrating a robust ESG process into our credit selection, Manulife Investment Management's Asian Fixed Income Team has effectively steered away from credit problems arising from three well-known names.

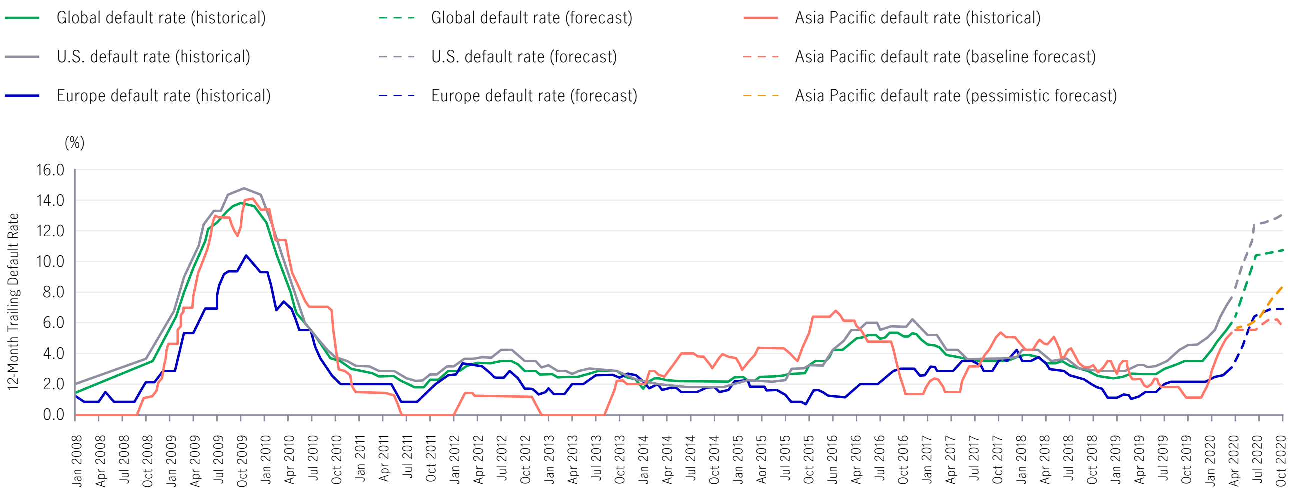
The current Asian credits landscape

The arrival of the COVID-19 pandemic has not only caused significant human loss but also roiled global asset markets, leading to significant volatility and dramatic drawdowns. Unprecedented fiscal and monetary stimulus, coupled with virus containment measures, have since somewhat stabilised markets. Nevertheless, individuals and corporates alike are still adapting and settling into this "new normal."

Global credit markets, particularly developed markets, have been hard hit by the downturn. Through the first half of 2020, the third highest year-to-date number of fallen angels (34) and second highest rated debt volume (US $323.1 billion) were recorded, primarily in the US and EMEA[2]. We believe that Asia will not be immune from the general trend of credit deterioration; rating downgrades and defaults are expected to rise gradually over the next two years, although at likely a relatively lower level than other regions[3]. The risk of fallen angels in Asia, although present, should also be more subdued when compared globally[4]. The impact of credit fundamentals on Asian issuers should start to emerge, and we may see a gradual uptick in rating downgrades and defaults in the later part of this year and into 2021.

Still, it is important to note that the defaults will be gradual – or potentially deferred – due to the active easing measures by governments and state-owned banks. These include forbearance programs, extended grace periods, as well as increased liquidity injections into financial systems to ease stress.

Chart 1: High-yield default rate (January 2008-June 2020 year-to-date)



Source: Moody's Investors Service

[2] Standard and Poor's, as of 30 June 2020. Fallen angels were concentrated in the automotive, oil and gas, and transportation sectors

[3] Moody's baseline scenario predicts a trailing 12-month APAC high-yield nonfinancial corporate default rate of 6.0% in 2020, up from 1.1% in 2019.

[4] Standard and Poor's, as of 30 June 2020. APAC only recorded one fallen angel thus far through the first half of 2020.

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In this rapidly evolving environment, we believe that the most significant opportunities in Asia lie in credit selection. For one, the region should be better positioned than its global peers, as credit quality is high, while corporates benefit from a broad array of diversified funding channels, ranging from local banks to bond markets.

Here's what we have observed in the key Asian markets of China, Indonesia and India thus far in 2020:

China: Increasing divergence in credit quality

We believe that credit quality in the Chinese bond market is diverging, with stronger corporates still having ability to rely on state support, while less robust names may default. Even then, some reasonably healthy companies may still see challenges with onshore bond issuance, given that their debt is now trading at roughly double-digit yields. This is particularly true for the property sector, where the tightening of the onshore bond markets, coupled with the People Bank of China's efforts to limit debt of the property sector, may put further stress on developers with high leverage and high refinancing risks[5].

With a high number of bonds maturing next year, many firms are also facing a considerable maturity wall that might challenge their ability to secure funding. As a result, we may potentially see an increase in credit events, as more companies try to restructure their bonds in a challenging environment.

Nevertheless, given the Chinese government's firm control over the financial system, it can direct stimulus into different sectors of the economy. Signs are pointing towards the authorities targeting support at areas that will primarily benefit key government goals.

For example, the government has redirected some support away from the property sector towards areas that are facing growing challenges, including renewables, infrastructure and manufacturing.

Indonesia: High yields under pressure

In Indonesia, tough economic conditions have put the high-yield market under pressure, with marginal names most likely to see distress. Notably, "B" and "CCC" rated property developers have been downgraded further, mainly due to refinancing concerns.

Furthermore, Indonesian banks are having challenges providing support to some high-yield credits. For companies, this inability to refinance through normal financing channels adds pressure. This contrasts with China, where there is a greater level of support in the local loan market for distressed names.

Before the pandemic, we had raised the issue of refinancing concerns with some key names. But with the new challenges brought along by the pandemic, these companies will be pushed to adopt a more focused approach to corporate governance and risk management.

In all, the challenging operating environment has led to refinancing difficulties of certain high-yield credits, and we expect higher default rates in the market into 2021, given the debt-maturity profile of many issuers.

India: A cautious outlook ahead

Meanwhile, the credit situation in India remains fluid as the government and corporations deal with the fallout of COVID-19. We have certainly seen the non-bank financial companies (NBFCs) face persistent liquidity issues. Still, the Reserve Bank of India has been cutting rates and using an array of unconventional monetary tools to inject liquidity into the credit market.

Indeed, many NBFCs have access to onshore bonds, and the bank loan market has improved considerably. That said, some businesses with fundamentally weak corporate governance controls will still see a challenging outlook ahead.

[5] People's Bank of China, 23 August 2020. http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4075935/index.html.

On a macro level, with concerns over slower growth, coupled with a higher fiscal deficit, we believe India has limited headroom to cushion further downturns. Still, the country boasts several positives, such as relatively low reliance on external funding, and a possible narrowing of current account deficit this year due to improving trade terms on lower oil prices.

Depending on whether the government meets growth and debt targets, as well as the stance of credit rating agencies, India sovereign and quasi-sovereign ratings could be exposed to fallen angel-risk. Given India's latest borderline investment-grade rating, we are monitoring this situation closely.

Governance issues rise in importance

One thing is clear from our observations in Asia credit markets: as the global economy enters a rough patch, which is expected to last over the next few years, security selection will become critical as credit rating downgrades and defaults proliferate. ESG considerations, particularly the "G" analysis (Governance) in Asia, will be increasingly important in this difficult environment.

In the next two sections, we examine how Manulife Investment Management is well-placed to help investors add value in Asian credits – not just through our people and process, but also through our fully-integrated ESG approach.

The Manulife Investment Management difference: Our people, our process and a targeted ESG focus

Strong credit selection is an integral part of any successful Asian fixed income strategy. More than just identifying the right securities, it is also about knowing which propositions to avoid.

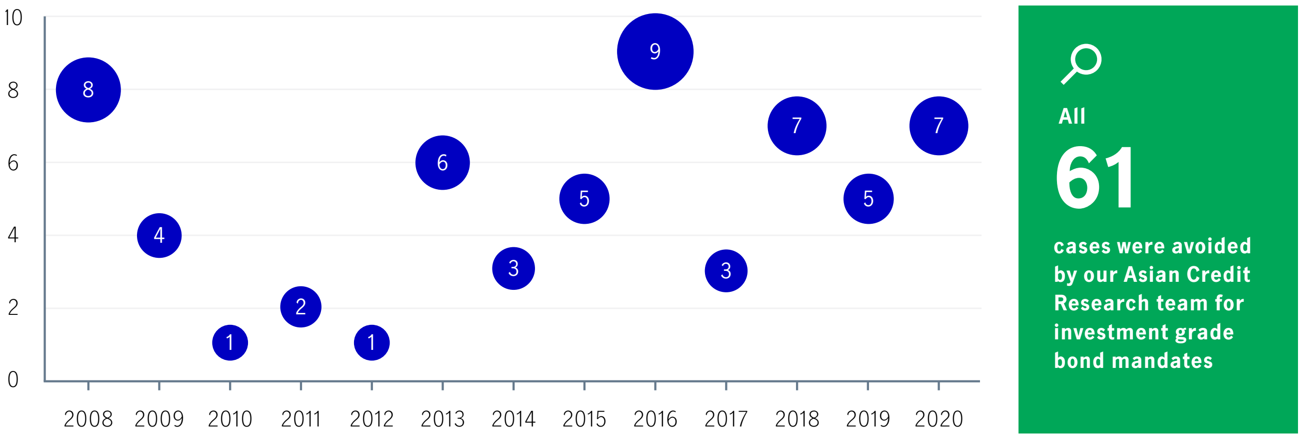
Manulife Investment Management's strength and track record in the asset class have bolstered our ability to create value for investors.
At the heart of our credit selection is a highly experienced analyst team, propelled by a rigorous proprietary research process, as well as a strong integration of ESG analysis.

Our track record: How we have avoided defaults and fallen angels

Since 2008, there have been 61 "fallen angels" – issuers whose investment rating had been cut from investment-grade to non-investment grade status by Moody's or S&P – within the Asian (ex-Japan) credit space. Yet, we have avoided **all** of them in our investment-grade bond mandates. Furthermore, we have not registered a single default in our regional pan-Asian fixed-income portfolio holdings over the past 12 years[6].

We believe this reflects not just the experience and expertise of our team, but also our commitment — as active managers — to safeguard investors from potential capital loss and credit write-offs, through a rigorous investment process, sound risk management, and a strong focus on corporate governance.

Chart 2: Number of fallen angels in Asia ex-Japan (2008 – 2020 year-to-date)



Source: Manulife Investment Management, Standard and Poor's, Moody's JPMorgan Asia Credit Index (JACI)

Fallen angels — when S&P or Moody's downgrades the credit rating of the issuer to non-investment grade. The definition of investment grade bonds might differ for each bond mandate, depending on the specific investment guidelines.

[6] Past performance is not indicative of future returns. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Our proprietary credit assessment methodology: A unique blend of art and science

Our dedicated Asian fixed income team has an extensive on-the-ground network. Comprising 79 investment professionals of 18 different nationalities across 11 markets in Asia, the team speaks 14 different languages[7].

It is this unique combination of art (our diversity of analysts, language ability and local on-the-ground familiarity) and science (our technical knowledge, deep expertise and ESG framework) that drives our strong track record in credit selection.

I. Our people: Robust, open communication is key

Supporting our fixed income team is a tightly-knit 23-strong Asian credit research team that thrives in an open, collaborative environment. Robust and round-the-clock open communication within the team and with other local offices and desks – particularly the equity research desk – ensures timely exchange and analysis of topical news, as well as a rigorous assessment of company governance. We valued this exchange of ideas and information with equities desk because different asset class investors interpret information from different angles, providing for robust discussion and good cross reference when evaluating a company's credit profile.

In addition, we have a dedicated ESG team to fully integrate ESG assessment into our credit research process and ensure the investment team is equipped with the necessary ESG tools and skillset (see more in "**Our proprietary ESG framework**"). The ESG team works closely with the investment team by providing valuable insights on ESG risks in Asia credits, as well as analysis on green bond structures.

The dedicated ESG team regularly reviews external research providers and ESG data providers. It also organises training on specific issues which are recorded and added to a training video library. Key members of the Asian Fixed Income investment team (portfolio managers and credit analysts) are notably enrolled in Sustainable Finance / ESG executive programs with third-party providers such as Harvard Business School, NYU, and Cambridge University.

By sharing information and collaborating closely with our ESG analysts, the Asian credit research team is able to jointly review material ESG factors, which are critical in sieving out the "good" from the "bad". A full picture is then pieced together, before making a truly well-rounded investment decision.

More importantly, in 2018, the firm formed an ESG taskforce dedicated to our Asian Fixed Income portfolios. The objective of the taskforce is to ensure we execute on and track our progress in ESG integration via a collaborative and transparent committee. The taskforce is chaired by Singapore-based Deputy Head of Asian Fixed Income Murray Collis and consists of members from various functions: global ESG integration team members, Asian fixed income portfolio managers, client portfolio managers, and Asian credit research team members including Fiona Cheung, Head of Asia Credit.

II. Our process: Unique structure and methodology set us apart

Investment decisions are guided by our comprehensive in-house credit rating resources, led by the **Manulife Asia Credit Committee (MACC)**, under the guidance of our Head of Asian Credit, Fiona Cheung.

A dedicated committee of senior fixed-income professionals across Asia, the MACC ensures that each credit is rigorously analysed. During the credit analysis process, the MACC takes into consideration valuable local insight from the Asian credit research team. All credit issues are debated before being added to the investment team's eligible credit coverage universe.

The MACC holds weekly meetings to decide whether newly-issued bonds will be placed on a master "approved names" list. Credit analysis would include investment rationale and proposed internal risk rating in their credit thesis presented to Head of Asia Credit. The decision is binary: each bond is either approved or rejected for inclusion. If approved, each portfolio manager will then assess if the bond is appropriate for inclusion in their portfolios.

[7] As of 16 July 2020.

Unlike most credit research reporting structures, our analysts report to the Head of Credit, rather than Portfolio Managers who may have considerable influence over names to include in a portfolio. With full independence in conducting their analysis, our analysts engage in robust discussion and flag any governance issues directly to the Head of Credit.

Perhaps most importantly, we use a differentiated, holistic research approach compared to traditional rating agencies. While a rating agency's methodology relies heavily on information and data presented by management of the issuer to conduct credit assessment, we synthesise proprietary information from a range of sources: i) independent research of credit names identified by our research team; and ii) robust external due diligence by our team on-the-ground with their contacts.

Thus, our people and their expertise are critical in our success. Based on their experience, they design a set of bespoke analytical tools to each issue under consideration. We shall examine this leading edge in the next section.

III. Our proprietary ESG framework and tools:

As part of our overall credit assessment framework, our analysts use an internal corporate ESG scorecard to assign a risk-intensity ranking for every corporate issuer, based on each of the three factors. We are also guided by a proprietary ESG materiality map for each sector.

Our Asian Credit ESG scorecard

This scorecard aims at increasing transparency on how our credit analysts capture ESG risks when assessing a company's credit worthiness. Though ESG factors are already embedded into our internal risk ratings (as mentioned in "**Our process: Unique structure and methodology set us apart**"), the framework aims to quantify how ESG factors affect our credit rating decisions.

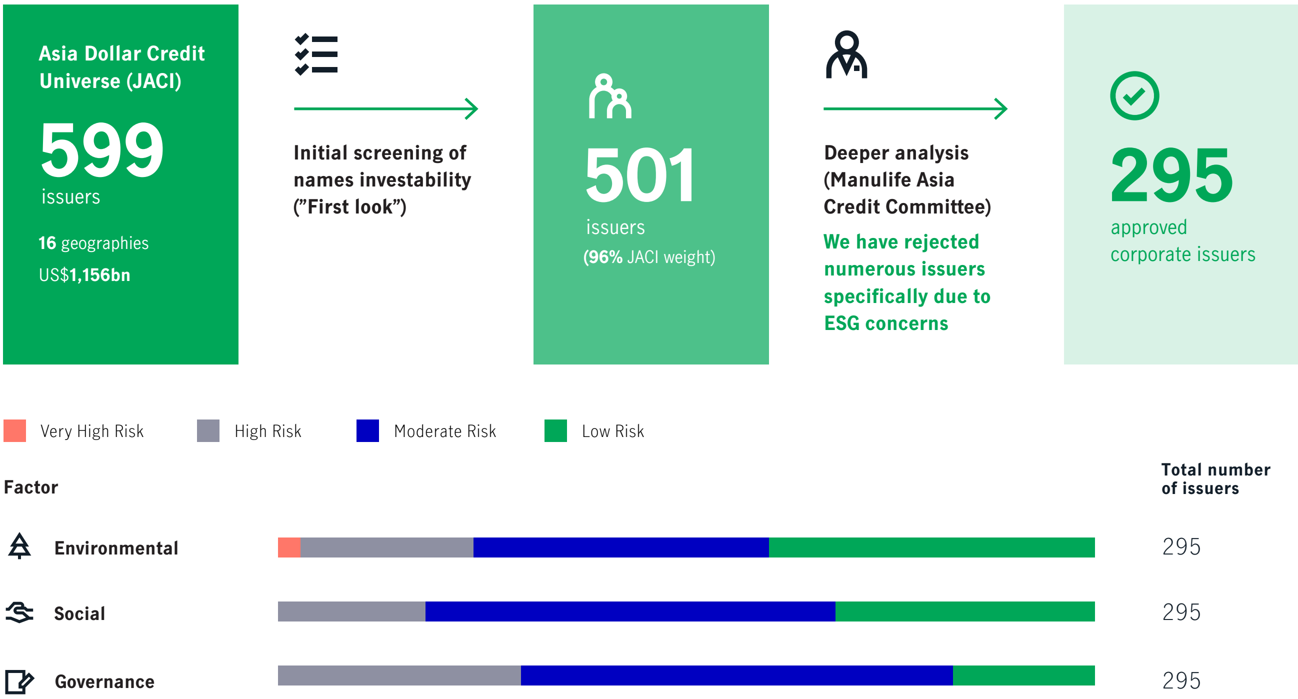
Each ranking corresponds to an estimated impact on the internal risk rating (in notches). Amongst the three factors, the greatest emphasis is placed on governance issues. An approve-and-reject system is in place to help us to steer clear of specific names, regardless of their price and yield. This systematic approach has helped us exclude numerous issuers, mostly due to governance concerns.

By utilising this scorecard, our credit analysts can categorise each ESG factor into intensity rankings based on various qualitative attributes. Credit analysts are empowered to determine if a different magnitude of notching is appropriate, when considering potential mitigating factors such as government support, business diversification and financial strength.

Our ESG Materiality Map by industry

Our dedicated ESG team developed a “Materiality Map” across different industries in order to support calibration of our internal risk intensity rankings, this provide two-fold benefits; to ensure credit analysts have considered all potential material E/S/G factors and align our approach across the entire credit team.

Chart 3: How we screen Asian credits via our ESG framework



For illustrative purpose only.

Source: Manulife Investment Management, JPMorgan Asia Credit Index (JACI) as of 27 October 2020.
* The figure 295 reflects the number of Asian corporate issuers approved by Manulife Asia Credit Commitee

Emphasis on the “G” in ESG is critical in Asia

Governance risks exist in every credit market, whether they are developed or emerging. However, the nature of governance risks and how they should be assessed differ significantly between these two types of markets.

In Asia, we believe that a more holistic credit assessment framework, integrating both quantitative and qualitative factors, is integral in fully understanding the risks. Quite often, qualitative factors are overlooked. In our opinion, this is risky as there should be no room for any benefit of doubt when assessing credits.

Lack of formal governance structures

Many Asian businesses tend to be family-owned, and as a result, the corporate governance structure and published financial statements may not tell the full story.

For example, corporate governance best practices typically state that a company must have independent directors on the board to serve as a check on management. In Asia, many publicly-owned family businesses meet this best practice – at least on paper. However, a closer examination of the relationship between the independent director(s) and the family owners, in certain cases, can reveal shared businesses or personal interests that might impair the directors’ ability to objectively supervise the business.

As such relationships are often hidden from scrutiny, our local on-the ground presence plays a key role in uncovering and understanding the dynamics of these companies.

Related entities and transactions

Another key issue in Asian credits is assessing related entities and transactions. While conglomerates exist in many markets, differing accounting and disclosure standards sometimes make it difficult to understand the real relationships between parent and subsidiary firms, including their financial dealings.

Credit risks in this area can manifest in numerous ways:

- “Loans” made between the parent and subsidiary
- Intra-group purchases of products and inventory
- Share pledges by the parent company to secure funding
- Key companies in the group are unlisted with no public reporting requirements

Although each of these factors pose different challenges and implications to understand, collectively they can create an opaque picture of a company’s and group’s financial health, potentially exposing investors to unanticipated risks.

Qualitative assessment of governance factors

Cognisant of these governance issues, our investment approach in key Asian markets such as China, Indonesia and India involve deeper due diligence, local reach and insight. This enables us to conduct more qualitative assessments.

When analysing governance, our focus is usually on the financial health of both the issuer and sponsor.
It is also important to examine related entities, as we have come across circumstances where the controlling shareholder tries to extract liquidity from an issuer in order to meet the financial obligations of a sister company.

In other instances, credit lines may be shared between the issuing group and the family’s other businesses. This means that any financial stress in one company could cascade into the healthier one.

Our due diligence therefore focuses on aspects such as related-party transactions and banks’ willingness to loan to an issuer. On-the-ground teams look at other factors like the reputation of the founding family or whether there is a reputable minority shareholder.

The importance of understanding these factors in Asia will be presented in three case studies, where analysis of credits governance played a key role in preserving investors’ capital.

Case Studies: Our track record underscores a robust ESG process

The three case studies below illustrate how governance factors have played a key role in our credit decisions that foresaw issues before they surfaced publicly.

Case study A[8]: One of the leading car rental companies in China

How its financial standing was affected by a subsidiary's woes

Company A is a leading car rental company in China. Despite its solid market position, we rejected the name for all our credit portfolios due to the 'G' factor.

Our research uncovered an increasing number of related-party transactions between Company A and its parent company. They included vehicle purchases, disposals and leases, where disclosures on the terms of transactions were limited. The parent company had also pledged its shares in Company A for bank loans, leaving it vulnerable to negative movements in Company A's share price.

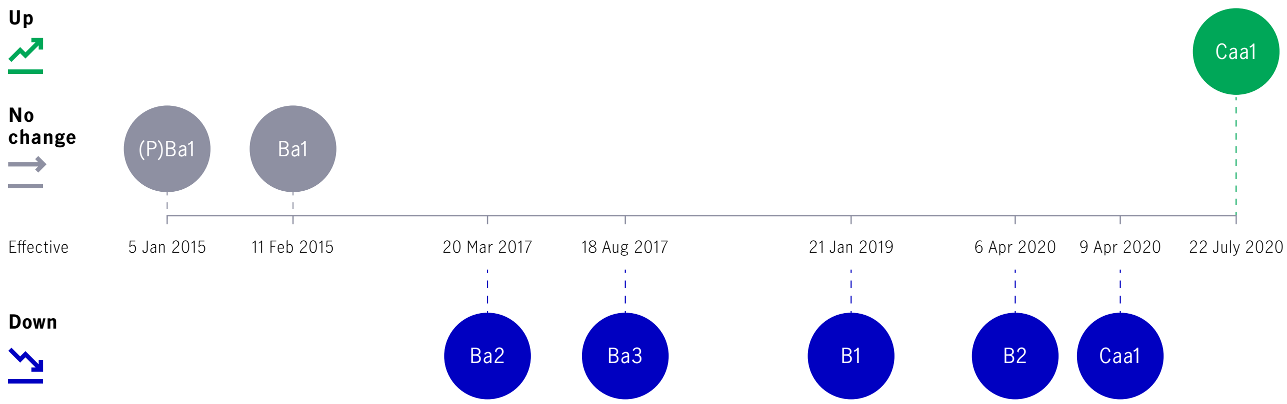
We noted that Company A's chairman and owner controls other business ventures, including a food and beverage (F&B) company whose reputation is closely linked to Company A. Several board members and senior management of the F&B company were also former employees of both Company A and the parent company.

Our governance analysis took all these factors, as well as the company's external links, into account.

A short-seller report on the F&B company soon brought up allegations of sales fabrications and related-party transactions, which were later confirmed. This caused Company A's share price to plummet, which in turn triggered margin calls for the share-pledged loan at the parent company level.

Company A subsequently announced a profit warning for its 1H20 results, expecting material write-offs on receivables from its parent company as well as other sister companies. The company is now seeking rescue from potential white knights.

Chart 4: Moody's rating history of company A



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Case study B[9]: One of the leading materials companies in China

How high cash levels may not always be everything

A debut bond issuance of Company B in 2017 saw strong investor interest, as well as a Ba3 rating by Moody's. However, we rejected the name due to what we observed were high governance risks.

There were red flags around its corporate governance, including poor disclosures of its high levels of related-party transactions, opaque customer and supplier relationships, as well as a high share pledge by its parent company.

Weak cash flow generation was recorded, despite its rapid growth in sales. The company also reported abnormally high margins, without convincing evidence of a clear edge in a highly competitive industry.

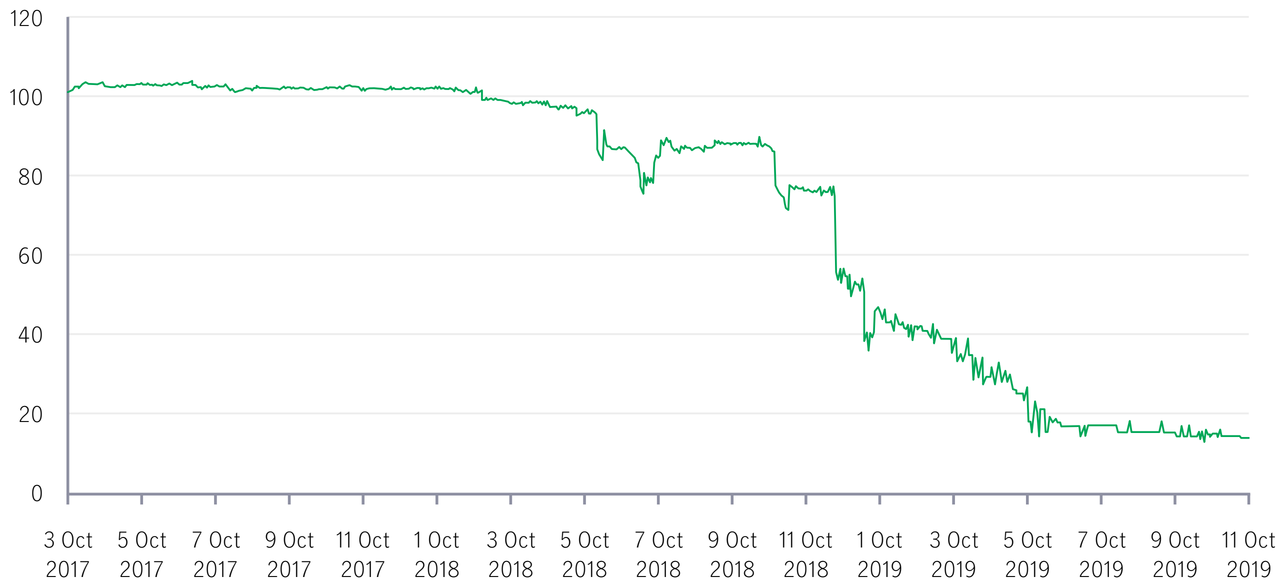
Most importantly, its parent company, which was an unlisted entity, had very limited disclosure of its financials.

The company' subsequent failure to repay a bond triggered a cross-default on other issued bonds. This was despite having significant levels of cash on its balance sheet. The parent company's chairman was later arrested for alleged misappropriation of listed company funds.

This case highlighted the need for in-depth analysis to form a full picture of a company's overall financials. Prior to the default, Company B had a healthy cash position, but the money was channelled into the parent company to help with debt repayment.

This is a classic case of cash not always being king on company balance sheets.

Chart 5: Bond price movement of company B



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Case study C[10]: A leading retail company in India

How our on-the-ground research unearthed local knowledge

A leading retailer and supermarket chain in India, Company C issued roughly a half billion worth of bonds in 2020. The bonds were rated BB- by S&P and BB by Fitch. The new issue was well received, due to its strong market technicals and a general lack of non-renewable supply of high-yield bonds. The market also liked the fact that a substantial portion of Company C was held by a well-known global company.

Notwithstanding its good market position, we assigned the issue with a single-B credit rating. This was because Company C had high leverage, high inventory days outstanding, numerous related-party transactions and a tight liquidity position. Most importantly, corporate governance fundamentals were weak.

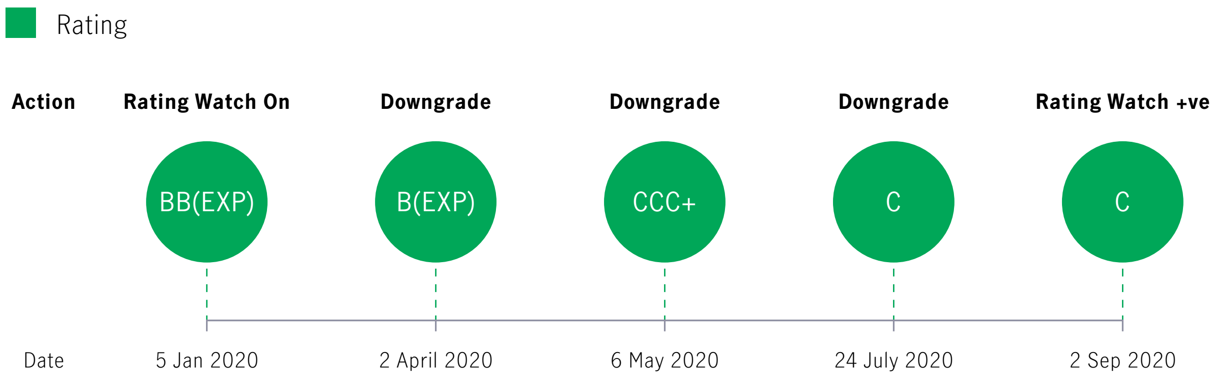
Our on-the-ground research also uncovered potential over-leverage by the promoter group, which had an unfavourable reputation for its top-down management style. Executions and payments were also slower than its industry peers.

The relatively high inventory days outstanding suggested a likelihood of channel stuffing by its main supplier, which was a sister company. In return, Company C enjoyed longer account payables days. While related-party transactions are generally justifiable, there is a need for close monitoring as they skew the financial disclosure of each entity.

In March 2020, the COVID-19 pandemic dented India's economic activities and stock market. On the back of concerns around the largest shareholder's financial health, the bond price plunged to 25 cents a dollar in April, before rebounding to around 60 cents in June on hopes of a white knight rescue.

More recently, Company C made an overdue coupon payment on outstanding USD bonds, while a white knight has since agreed to acquire part of the business.

Chart 6: Fitch rating history of company C



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Conclusion

ESG factors are important drivers of credit quality

As the world adapts to the new normal in a pandemic environment, businesses are bracing themselves for greater operational and compliance risks. In view of this, more stringent regulations are expected over the next decade.

As Asian markets mature, investors will increasingly place the spotlight on ESG matters. In Asia, all eyes are on 'G' as corporates navigate growing economic challenges. Pressure from investors to heighten governance standards and transparency will only increase.

Additionally, with geopolitics playing a more significant role in determining market movements, there will be increasing focus on the role of ESG, especially as the US blacklists overseas companies that are deemed non-compliant. Businesses with weak ESG profiles could then be seen as vulnerable and open to political exploitation.

Without a doubt, ESG analysis will play a key role in driving credit quality going forward. At Manulife Investment Management, we are well-placed to help investors navigate and add value in this new world.

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A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other pre-existing political, social and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment.

About Manulife Investment Management

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