

For professional investors - Marketing communication - March 2022

# WHAT THE CHINESE POLICY PIVOT MEANS FOR ASIA CREDIT



**BNP PARIBAS**  
**ASSET MANAGEMENT**

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## EXECUTIVE SUMMARY

- With the US Federal Reserve (Fed) embarking on rate normalisation, many investors are concerned about the outlook for fixed-income markets. Our view is that certain pockets remain extremely attractive from a valuation standpoint and continue to offer a low correlation with wider fixed-income markets. We believe that the recent dislocation in Asian spreads offers a great investment opportunity that can also provide diversification benefits for global portfolios and asset allocators.
- Asia's credit markets have been under price pressure on account of the conflict in Ukraine. In our view, this is primarily due to a generalised flight to safe-haven assets rather than issues related to the longer-term credit fundamentals. Relative to other regional emerging market debt markets (e.g. Europe), we see the Asia credit opportunity as more idiosyncratic and less exposed to the consequences of the conflict in Ukraine. The ongoing uncertainty with regard to the future repercussions of the situation in Ukraine, reinforce our conviction about the extent of the coming Chinese policy pivot. That is to say, we anticipate more fiscal and monetary support from China's policymakers than would have otherwise been the case.
- Despite nearer-term volatility, we see light at the end of the tunnel for Asia high-yield credit. Given the recent price action, we think investors have already priced in the risk of a worst-case (and unlikely) scenario of insufficient government support to restore investor confidence.
- We are already seeing macroeconomic policies in China becoming more supportive of real-estate developers as Beijing is forced to deal with the economic slowdown caused in part by the Omicron Covid wave. While we do not foresee a policy U-turn, in our view, the level of policy support is likely to increase and lead to spreads normalizing in the Chinese real-estate sector.
- Furthermore, we believe private developers will continue to be an integral part of the overall market given the limitations faced by state-owned enterprises (SOEs) and local government financing vehicles (LGFVs). There will be no 'nationalisation' of the real-estate sector.
- Lastly, it is important to bear in mind that Asian high-yield credit is not solely comprised of Chinese real-estate firms; it is a large and well-diversified asset class in which we are continuing to identify compelling, high conviction ideas.

We discuss our viewpoints in greater detail below, where our China economist, Chang Liu, delves deeper into the policy shift we are currently seeing in Beijing, followed by an in-depth analysis of the Chinese real-estate sector and the wider Asia high-yield complex by the EMFI team.

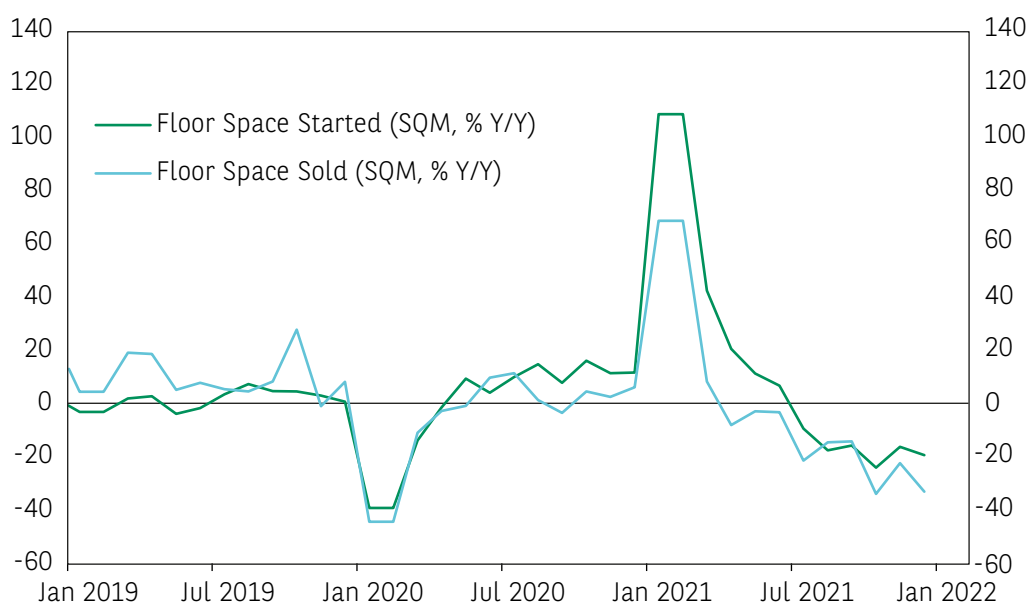
## POLICY SHIFT TO EASE STRESS IN CHINA'S PROPERTY SECTOR

After a tough year for China's property market, there have been recent signs that Beijing's policy stance is now turning more supportive for the sector. Although a repeat of the massive stimulus of 2015/16 is unlikely, we now expect the contraction in real-estate activity to start easing in the coming months on the back of moderate policy stimulus and further tweaks to property controls.

### Officials to step up support in the face of weak sentiment and rising Omicron risks

China's policymaking in 2021 was marked by a shift in focus towards tackling the country's medium-term structural problems and away from supporting short-term economic growth. A key aspect of this was a campaign to reduce financial risks by imposing strict controls on China's debt-ridden property sector. As a result, both construction activity and property sales have slumped in recent months, which has in turn led to a rise in defaults among developers.

**Exhibit 1:** China Floor Space Started and Sold



Source: CEIC. As of 31 December 2021.

Despite the slowdown in activity, the authorities held back from loosening controls on the sector for most of 2021, reflecting a higher 'pain threshold' compared to previous cycles. But even this higher limit appeared to have been reached by early December, when policymakers signalled a pro-growth shift at the annual Central Economic Work Conference (CEWC), with economic stability being raised to the top of the policy agenda.

Admittedly, a wholesale reversal of property controls is still unlikely as the phrase 'houses are for living in, not for speculation' continues to anchor policy even now. But the CEWC statement specifically called for more support for the commercial housing market and an increase in the construction of affordable housing.

Since then, we have seen a modest stepping-up of policy support for the sector. A number of city and provincial governments have announced policies aimed at promoting property sector activity in their respective regions. The People's Bank of China (PBoC) has also called on banks to support the sector by extending M&A loans to developers to allow healthy firms to acquire projects from struggling ones. State media report that these loans will not be classified as debt in the 'Three Red Lines' assessment. In addition, financial media outlets suggest that regulators are planning to relax rules on developers' access to proceeds from property pre-sales, which would help to ease their liquidity problems.

The measures announced so far are still not enough to resolve the problems in the property sector and, for now at least, the government remains hesitant to loosen controls more substantially. But we think the increasing risks of an Omicron outbreak could convince officials to act more decisively in the coming weeks.

DATE	SOURCE	POLICY/NEWS
17 Dec.	City Governments	Local media report more than 10 cities have announced measures to support home-purchases, including vouchers for developers and consumption coupons for buyers
20/21 Dec.	Heilongjiang Gov.	Heilongjiang's housing department published a notice on supporting growth of the real estate industry, including more measures to promote property sales and meet demand. This was removed a day later
22 Dec.	Jilin Government	Jilin government encourages cities and counties to offer housing subsidies to enable rural residents to purchase apartments in urban areas
30 Dec.	PBoC	A senior official called on financial institutions to create a better financing environment for property market mergers and acquisitions to help firms reduce debt and resolve risks
5 Jan.	State Media	Cailian reports that some banks in Shanghai have accelerated their issuance of mortgage loans. Many banks' personnel said regional branches had cleared the backlog of mortgages
6/7 Jan.	State Media	Shanghai Securities Journal reports that, according to industry sources, the government will no longer count M&A loans by major property firms as debt under the 'Three Red Lines' policy
18 Jan.	PBoC	Official says property sales financing is steadily returning to normal, and vows to keep continuity, stability in property financing and maintain basically stable mortgage loans
19 Jan.	Financial Media	Outlets including Reuters report that regulators are planning to relax rules on developers' access to funds from property pre-sales (currently held in escrow accounts)

DATE	SOURCE	POLICY/NEWS
20 Jan.	PBoC/Banks	Following a 10bp cut to policy rates by the PBoC on 17 January, the 1-Year LPR falls 10bp and the 5-Year LPR falls to 5bp. The latter is linked to the pricing of mortgages
24 Jan.	State Media	China Securities Journal reports that some local governments have eased policies on lending through their housing provident funds, with loans for home purchases jumping in January
8 Feb	PBOC/CBIRC	Announced that public affordable housing development loans will be exempt from rules limiting banks' exposure to the property sector
10 Feb.	State Media	Cailian reports that regulators will relax rules on developers' use of pre-sale funds
11 Feb.	State Media	China Securities Journal reports that the PBoC, CBIRC and SASAC* met concerning supporting M&A in the real-estate sector, including encouraging larger companies to acquire projects from struggling developers.

Source: Various China government agencies and media (as highlighted above). \* CBIRC = China Banking & Insurance Regulatory Commission; SASAC = State-owned Assets Supervision and Administration

Indeed, the government is widely expected to set a GDP growth target of 'above 5%' or '5.0%-5.5%' for 2022 at the annual meeting of the National People's Congress (NPC) in March. This is unlikely to be achieved without either a rebound in consumption or property investment (GDP growth in Q4 2021 fell to just 4.0% year-on-year (YoY)). Local governments have already unveiled their ambitious growth targets for 2022, with a median 6.5%, signalling their determination to stabilise activity in the coming months.

2022 GDP GROWTH TARGET	NO. OF PROVINCES	PROVINCES
Above 7%	8	Hainan, Tibet, Anhui, Jiangxi, Hubei, Yunnan, Guizhou, Ningxia
6% or 6.5%	13	Hunan, Henan, Fujian, Gansu, Guangxi, Sichuan, Shanxi, Hebei, Zhejiang, Shaanxi, Inner Mongolia, Jilin, Xinjiang
5% or 5.5%	10	Jiangsu, Shandong, Liaoning, Guangdong, Heilongjiang, Shanghai, Chongqing, Qinghai, Tianjin, Beijing

Source: Various China local government websites. As of 31 January 2022.

We think the downside risk to consumption this year has increased in recent weeks as Omicron has started to spread locally in China, leading to a further tightening of rules around travel and testing. Although cases remain low for now, the country appears to be particularly vulnerable to the highly transmissible Omicron Covid variant due to the population's low

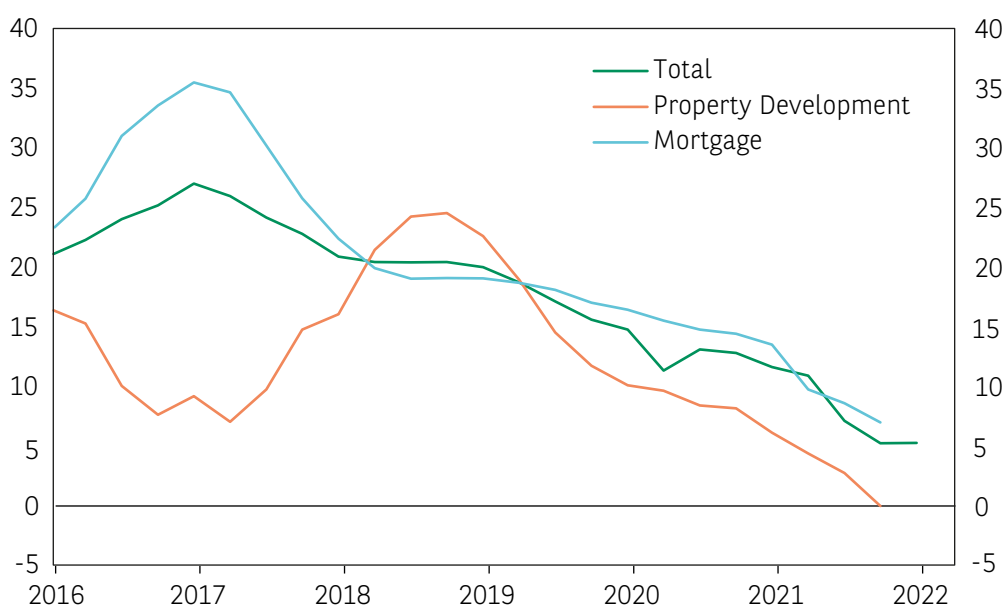
natural immunity, relatively low vaccine efficacy from domestic vaccines and limited primary care capacity compared to many advanced economies. If a wider Omicron outbreak led Covid restrictions to be tightened for longer and/or in more areas, it would further delay a recovery in consumption. Faced with that risk, officials may be left with little choice but to ease property policy further to shore up economic activity. After all, missing the GDP growth target would be embarrassing for senior officials ahead of a key Party Congress later this year.

### No substantial easing of property controls, but more measures to stabilise conditions in the sector

That said, with the broad policy stance of ‘houses are for living in, not for speculation’ remaining unchanged, we are not predicting a repeat of the massive easing seen in 2015/16.

Instead, we expect policies to continue to focus on lower-profile tools aimed at keeping developers afloat by increasing their financing and boosting their cash flows. These may include a further relaxation of rules on mortgages as well as measures to improve developers’ access to bank loans and the bond market (growth in real-estate loans have slowed sharply over the past couple of years). We could even see an extension of the transition period for the ‘Three Red Lines’ policy if conditions do not improve in the coming months.

**Exhibit 2:** Loans to real-estate sector (% YoY)



Source: CEIC. As of 31 December 2021.

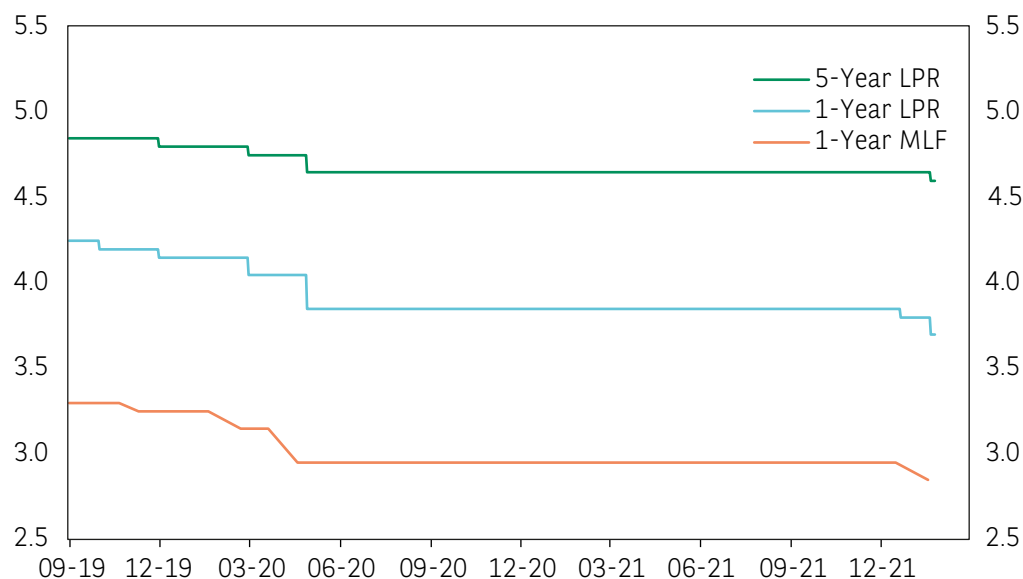
Although the broad tone on property controls is unlikely to change at the national level, we expect more local governments to tweak such controls in the coming weeks as the recent property market stress has deprived them of a key revenue source from land sales. Specifically, we anticipate a further easing in local purchase and price restrictions, adjustments to land supply and prices, and an increase in the construction of affordable and rental housing.

Relaxing these sector-specific controls will also allow the property sector to benefit more from the broader monetary easing that we are expecting in the coming months. In January, the PBoC cut both the 7-day reverse repo rate and the one-year MLF<sup>1</sup> rate by 10bp, to 2.10% and 2.85%, respectively. This was then followed by a 10bp reduction in the one-year loan prime

1 Medium-term Lending Facility

rate as well as a 5bp cut in the five-year loan prime rate, the latter being a key reference rate for mortgage pricing in China. In addition, the PBoC last month clearly signalled further monetary easing will be implemented to stabilise economic growth. We think another RRR cut and further declines in the LPRs are likely in the months ahead alongside more targeted support, with an additional policy rate cut also possible.

**Exhibit 3:** China: MLF and loan prime rates (%)



Source: CEIC. As of 24 January 2022

While the scale of these easing measures is likely to be moderate and should not drive a sharp rebound in property activity as in previous cycles, we think they will be enough to ease the pace of contraction in property starts and sales over the coming months. This should help to alleviate some of the stress in the sector.

### March is probably the next window for major policy adjustments

In terms of timing, with the government emphasising that stimulus should be front-loaded this year and given the risk of a potential Omicron outbreak, we expect further easing to be announced in the weeks ahead.

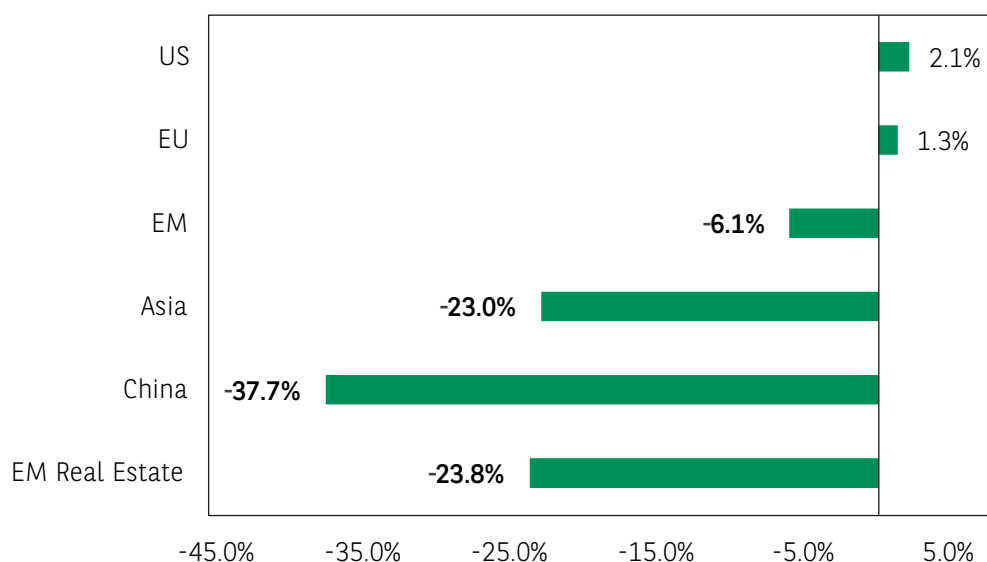
Potential triggers for further action by policymakers include persistent weakness in property sector data, data for related sectors (including steel and cement) and/or a further deterioration in sentiment that might lead to broader financial stress.

The second half of January offered officials a window to push through easing following the release of the Q4 GDP data and ahead of the Chinese New Year holiday. By contrast, February should be quieter as officials monitor the impact of the recent policy stimulus and because the statistics bureau will not release activity data in February (the data for January and February are published together in March to avoid the distortion caused by shifts in the timing of Chinese New Year). As a result, March is probably the next window for major policy adjustments, which may come as soon as at the annual meeting of the National People's Congress on 5 March.

## CHINA REAL ESTATE: SHORTER-TERM CHALLENGES PERSIST, BUT THE WORST COULD BE BEHIND US

Over the past year, Emerging Market (EM) High Yield (HY) corporate bonds have underperformed their US and EU peers, both of which have delivered positive returns. The underperformance of EM HY was mainly driven by Asia HY, which faced significant headwinds over the period. The main detractor within Asia HY was China, which almost exclusively and materially drove Asia HY's negative performance. This is further apparent when looking at the performance of individual sectors, where the EM real-estate sector (dominated by Chinese issuers) recorded significant underperformance.

**Exhibit 4:** 1-Year returns of high-yield corporate bonds (31 Jan 2021 to 31 Jan 2022)



Source: ICE Data Indices, LLC., BofA Global Research, MSCI, Bloomberg. As of 31 January 2022.

We recognise that the China real-estate sector is still likely to face shorter-term headwinds as some developers may encounter weaker sales and further refinancing and/or negative headline risk as sentiment in the sector remains weak. That said, looking at the fundamentals and longer-term prospects, we remain more optimistic about its future trajectory.

### Markets barely pricing any changes in policy direction from Beijing

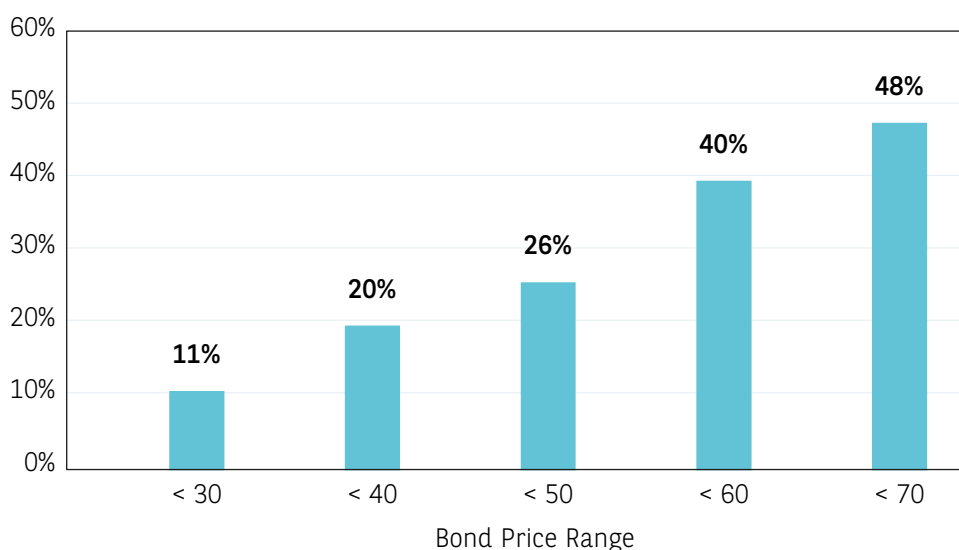
Since the second half of 2021, local governments in China have closely scrutinised pre-sales proceeds due to concerns over the risks of projects remaining unfinished. A large proportion of a developer's cash flow has to be deposited or re-deposited into the escrow accounts at the project level. As a result, the liquidity position of developers has deteriorated materially as most cash is now restricted and inaccessible for debt repayment.

At the same time, most refinancing channels are effectively closed due to heightened borrowing costs, while housing sales are sluggish as homebuyers adopt a wait-and-see mode amid market uncertainties. The only option that developers can rely on to replenish liquidity is to dispose of assets, since operating cash flow and financing cash flow are no longer enough for debt repayment.

Nevertheless, we believe the China HY property sector has priced in a worst-case scenario. According to research, the current HY bond price reflects an implied default rate of 26%, if we assume all bonds trading at <50 will eventually default, extend or restructure in 2022. This is in addition to the >30% default rate we had seen in the sector in 2021.

However, we believe the actual default rate in 2022 could be lower than the implied rate, given our assumptions that the Chinese government will develop more front-loaded supportive policies amid concerns over economic growth and the health of the real-estate sector. Our focus here is on whether developers can muddle through this difficult interim period, before the policy effects gradually stimulate housing demand and restore a more healthy liquidity environment and refinancing market.

**Exhibit 5: China property: High-yield default rate**



Source: Bloomberg, Goldman Sachs Research. As of 12 January 2022.

**We prefer sound developers of systemic importance to the sector, trading at attractive valuations following excessive market punishment**

The housing market in China has grown rapidly over the past few years. The total transaction amount increased to RMB 18.2 trillion in 2021 from RMB 13.4 trillion in 2017. Based on estimates, the property sector in China, including the upstream and downstream industries, contributes about 30% of the country's GDP.

It is therefore unquestionable that the sector will need to maintain a stable pace of development for China to achieve its targeted GDP growth of 5%-5.5% in 2022. The need to preserve economic stability has become even more striking recently, as the country is currently in the midst of coping with a resurgent pandemic wave caused by the Omicron variant. Given that the recent restrictive property policies have, in some ways, been successful in curbing debt and reducing risk in the sector, our view is that the government will continue to step in to provide support and restore normalcy.

That said, idiosyncratic risk remains the key risk area in the China property sector. We therefore take the view that, besides policy support, solid credit fundamentals are of utmost importance in this current environment – developers with better metrics in terms of a cash buffer, sales performance and multiple revenue sources, asset base, strong shareholder support and potentially easier funding access will fare significantly better than those without. Developers with these qualities that can ‘survive’ this round of market downturn are more likely to gain a competitive edge over their peers and emerge in better shape for the future.

We are of the view that Chinese policymakers want to draw a line in the sand and make sure that the sector can weather the storm while allowing some specific issuers to default when deemed unsustainable.

### Could the property sector be ‘nationalised’?

State-owned property developers are likely to benefit from this market downturn and gain market share, amid their satisfactory sales performance, continuous access to funding, and the favourable policy on M&A financing. According to the Financial Times<sup>2</sup>, SOEs and LGFVs had become the dominant players in the land market and acquired three-quarters of the land plots auctioned between August and October 2021. We expect this trend to continue given that most privately-owned developers are in a tight liquidity position. SOEs have also expedited project acquisitions from the weaker developers. Through M&A, SOEs can currently acquire quality assets at reasonable prices. In addition, this market-oriented approach is encouraged by the Chinese government to provide liquidity to the sector and the weaker players.

However, it is important to note that SOEs account for only a moderate part of the sector and are not in a position to take the lead on a potential turnaround of the property market. Furthermore, SOEs and LGFVs also have their own constraints on expansion and acquisitions. Even if the loans for M&A do not count towards the ‘Three Red Lines’ calculation, SOEs usually have caps on their net gearing. Among China’s top-10 developers in 2021, state-owned firms claimed four positions and generated total sales of RMB 1.43 trillion. In contrast, developers that defaulted or went through distressed exchanges in the same period recorded sales of about RMB 1.5 trillion, an amount close to the pre-sales of the four biggest state-owned developers. Without materially increasing their debt leverage, it seems unlikely that state-owned developers can keep up their land banking and be the ‘white knights’ of the many distressed developers or assets.

Moreover, according to another report by Bloomberg<sup>3</sup>, state-owned banks have become more selective in funding LGFVs on property project development. In our view, using LGFVs to acquire lands from local governments and support fiscal revenues can only be a temporary solution. Eventually, the goal of the Chinese authorities is the de-risking and de-leveraging of the real-estate sector, rather than the transferring of the risk from the private sector to the government.

As a result, we believe privately-owned developers will continue to have an important role and market position. In our view, Beijing will have less tolerance for another round of large-scale privately-owned enterprise (POE) defaults as we saw in 2021. Since the second half of 2020, 19 property developers, mostly POEs, defaulted or went through distressed exchanges. About half of these distressed developers are among the top-50 players in the industry.

<sup>2</sup> Chinese State Developers Step Up Land Auction Activity to Rescue Local Governments, The Financial Times, published 14 November 2021.

<sup>3</sup> China Banks Restrict Property Loans to Local Government Firms, Bloomberg News, published 13 January 2022.

In our opinion, the property market in China will likely enter into another round of market consolidation. The outcome of that would likely be that quality developers – including both SOEs and POEs that emerge relatively unscathed from this crisis with healthier balance sheets and fundamentals – would gain the market shares of the distressed peers. While we expect SOEs to slightly increase their market share from the existing 30%-35% in 2021, we think POEs are still likely to maintain their dominant position given their better operating efficiency and project execution.

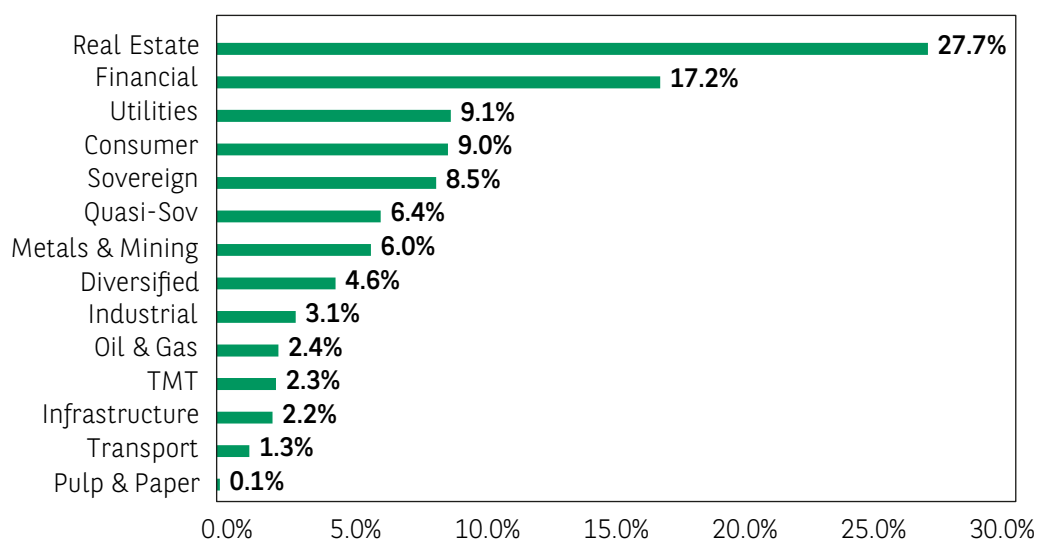
Given the importance of the sector and the willingness of policymakers to segregate the bad cases from fundamentally sound ones, we believe that we are at a turning point in terms of valuations in this sector, which has already seen too much pessimism priced in. From a medium-term perspective, we expect this sub-segment to attain a significant level of normalisation and recovery. We acknowledge this is a contrarian call.

## ASIA CREDIT: MORE THAN JUST CHINESE REAL-ESTATE DEVELOPERS

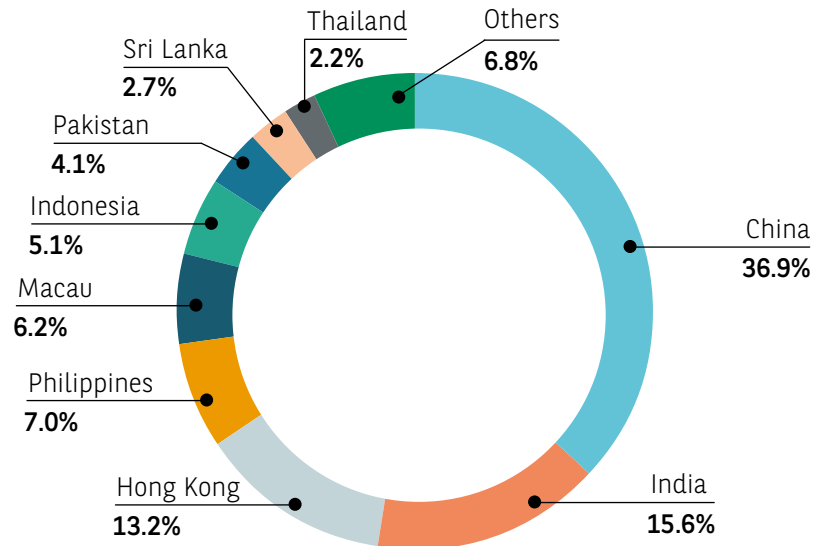
The high indebtedness within the Chinese real-estate sector has affected the credit metrics within Asia HY credit. Despite the shorter-term pain inflicted by Beijing's more recent debt clampdown, our view is that this will improve the sector's longer-term fundamentals with greater debt sustainability in the future. In addition, the current level of spread differentials between Asia and US HY makes the former segment very attractive from a valuations perspective.

We also conclude this paper by pointing out that while constituting a significant portion of the Asian HY universe (more than 20%), China real estate far from represents the entire opportunity set. We continue to find other meaningful and attractive investment themes within the Asia HY market.

**Exhibit 6:** Breakdown of the Asia USD non-investment grade bond universe by sector (%)



Source: JP Morgan as of 31 January 2022.

**Exhibit 7:** Breakdown of the Asia USD non-investment grade bond universe by geography (%)

Source: JP Morgan as of 31 January 2022.

#### Asia HY and China real-estate fundamentals: Shorter-term pain for longer-term gain?

Versus its EM peers, Asia HY does record weaker metrics, specifically higher net debt and short-term (ST) to total debt ratio. While these have been characteristics of this sub-sector since its debut in the USD offshore markets, it was coupled with the understanding that the sector was on an expansionary journey with the funding used to increase individual developers' land banks, which would in turn yield profitable developments.

	US HY	EM HY	LatAm HY	EMEA HY	Asia HY
<b>Net Leverage</b>	4.5x	3.0x	2.7x	1.9x	4.4x
<b>Interest Coverage</b>	4.5x	5.8x	4.6x	7.2x	7.6x
<b>Cash to ST Debt</b>	2.0x	1.1x	1.0x	1.5x	1.1x
<b>Cash to Total Debt</b>	19%	27%	16%	23%	36%
<b>ST to Total Debt</b>	9%	24%	17%	16%	33%
<b>LTM Capex to LTM Ebitda</b>	39%	34%	37%	33%	31%
<b>Gross Margin</b>	29%	29%	26%	43%	23%

Source: BofA Global Research, fundamental data as of 30 June 2021.

Policymakers were aiming to tackle the leverage and debt ratio with the introduction of the 'Three Red Lines' policy in 2020. As part of the 'Three Red Lines' scheme, property developers must submit detailed reports of their financing situation for evaluation by regulators led by People's Bank of China, China's central bank, and the Ministry of Housing and Urban-Rural Development, the state construction regulator. The regulators assess the developers' finance situation against three criteria, namely; (i) Liability-to-asset ratio excluding advance receipts of less than 70%; (ii) Net gearing ratio of less than 100%; (iii) Cash-to-short-term debt ratio of more than one. If the developers fail to meet one, two, or all of the 'Three Red Lines', regulators would then place limits on the extent to which they can take on more debt.

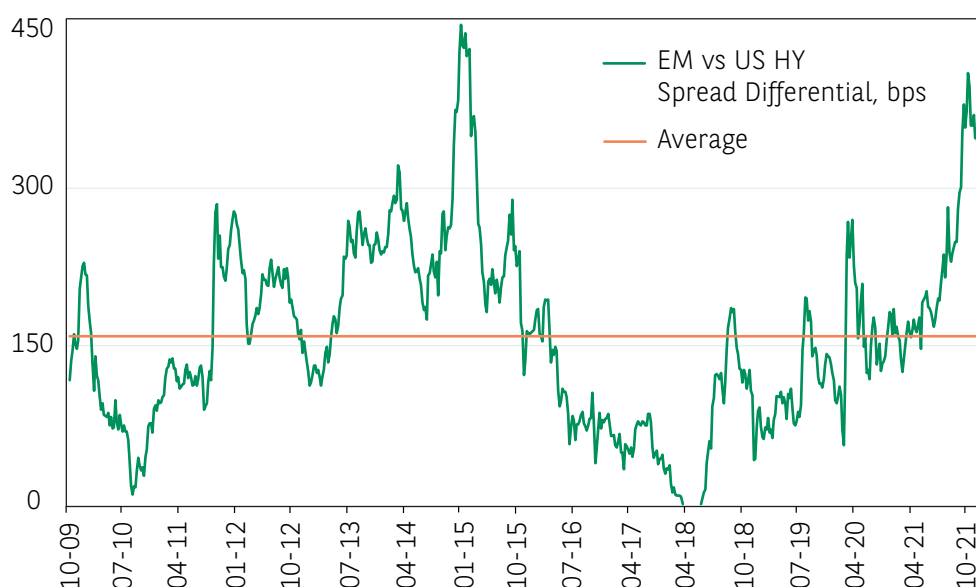
In our view, this initiative would have had a net positive outcome in the medium to long-run, resulting in healthier balance sheets across the sector. However, what followed was an overtightening of financial and, as a result, operating conditions, which resulted in fewer sales (and less development) and, in the end, liquidity constraints across both local and offshore funding channels. This presented the sector with a liquidity issue which resulted in the rise of defaults, distressed exchanges, extension and amendment requests and, more recently, more meaningful policy easing.

While we acknowledge that fundamentals might not look as strong as in other regions, to a certain extent, this is nothing new for the region, and we believe that given current valuations, the extreme pessimism surrounding the asset class is unwarranted. This underpins our contrarian view that the worst might be behind us.

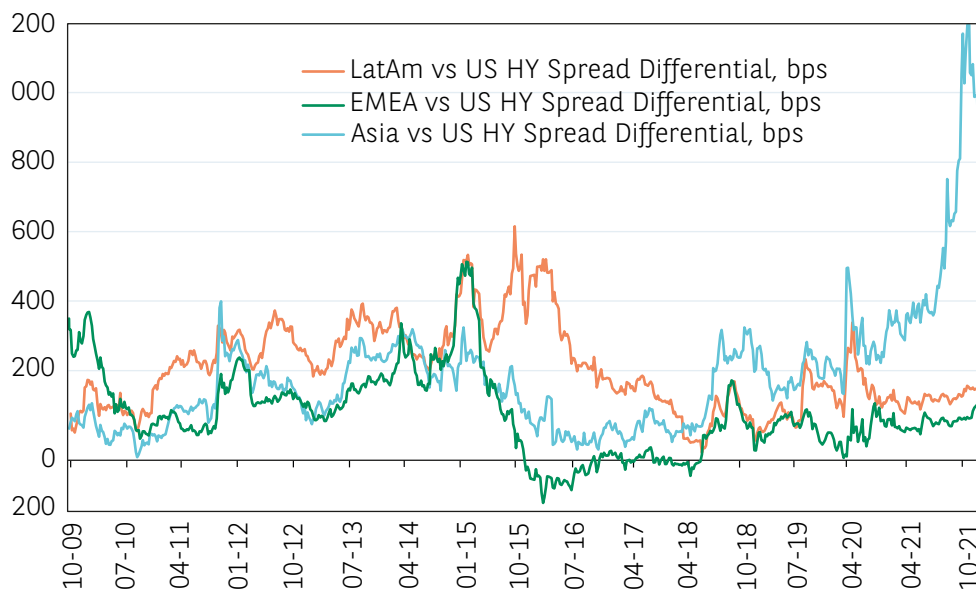
#### Asia HY credit spreads are currently trading at very attractive levels

Over the past 12 months, EM vs. US HY credit spread differentials have widened significantly at close to 136bp. This was driven largely by Asian HY spreads, with much of the underperformance coming from the Chinese real-estate segment. While both Latin America and EMEA HY underperformed US HY, their individual spread widening was relatively contained, at 21bp and 56bp, respectively. The spread differential between Asia and US HY on the other hand, widened to 504bp and is currently trading at more than 800bp.

**Exhibit 8:** EM vs. US HY Spread Differential (bps)



Source: ICE Data Indices, LLC., BofA Global Research, MSCI, Bloomberg. As of 31 January 2022.

**Exhibit 9:** Regional EM vs. US HY Differential (bps)

Source: ICE Data Indices, LLC., BofA Global Research, MSCI, Bloomberg. As of 31 January 2022.

The current level of credit spreads within Asia HY looks very attractive, particularly to high-conviction investors like us (the recent apparent tightening at the benchmark level was simply due to the exclusion of issuers in default). Asia IG is also attractive relative to other EM as well as developed markets IG, which in our view has not been the case for some time.

Looking ahead, we firmly believe that this will be the year of the great normalisation of Asia spreads. We believe that outsized returns are likely to be driven by Asia HY given its current attractive valuation levels and the potential for significant spread compression.

#### Asia HY: Compelling opportunities in other segments apart from China real estate

While China HY does dominate the Asia HY sector, we remain positive across other Asia HY sectors. In particular, we are excited about opportunities within Indian renewables.

The Indian renewables sector has grown recently and now accounts for 5% of Asia HY. While its need for investment and sponsorship remains high, it enjoys both strong sponsorship from leading global institutional investors and solid local policy support. We view this sub-segment as a core sector in the country. With the cost of renewables declining, the companies involved have more room to focus on the battery storage market, which is still in its infancy in India. We view this as a material growth opportunity for the sector. We expect these favourable conditions to be sustained even in adverse conditions.

## CONCLUSION

While acknowledging near-term challenges within Asia HY, we remain more optimistic about the medium to long-term prospects of the asset class. We have begun to see some policy support from Chinese policymakers for property developers, which remains a sector that is integral to both the domestic economy as well as the broader Asia credit market. Looking ahead, we also believe that China real estate will undergo another round of consolidation and that developers with healthy fundamentals that emerge successfully from this downturn will be in a better and more dominant position in the market. We see this recent dislocation in Asia credit spreads as offering a strong investment opportunity which should also provide diversification benefits for global portfolios and asset allocators.

The BNP Paribas Asset Management Emerging Markets Fixed Income Team  
7 March 2022



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