

September 21, 2021

Evergrande's heavy debt burden weighs on global sentiment



Markets began the week tangibly stressed about the liquidity crisis facing Evergrande, China's second largest property developer, and the prospect of contagion to other areas of the economy. The company has a debt burden of over \$300 billion, largely owed to contractors, investors and homeowners with important repayments due in the coming days. If the company was to default, the extent that this could slow growth momentum remains unclear but given that real estate makes up 29% China's GDP, we believe that the Chinese authorities will intervene to stop the situation spiralling out of control.

REGULATORY CONTEXT

Before explaining the Evergrande case, it is first helpful to understand the context. For some

years, soaring property prices have been a source of social discontent in China. In 2017, President Xi Jinping famously said at the 19th party congress that "*houses are for living in, not for speculation*". Under his leadership, the CCP has sought to control market risks in the sector, for example, in 2020, rules to rein in the borrowing costs of developers were introduced. Those measures placed a cap on debt in relation to a company's cash flows, assets and capital levels. This year, with Beijing honing in on its goal of "common prosperity", regulations were implemented around condominium transactions with the aim of containing speculative and illegal deals within three years. Measures included the introduction of eligibility rules for property purchases and intervention in the second-hand market in big cities to prevent price inflation.^[1] Those linked to the industry and investors were growing anxious that Beijing could go as far as to compel listed real estate groups to cut the costs of housing in mainland China and Hong Kong.

EVERGRANDE'S TROUBLES

In recent years, Evergrande's debts ballooned as it borrowed to finance its various pursuits including many outside of its core business – a soccer team, electric vehicles, groceries, bottled water and theme parks...

Concerns about the sustainability of the Evergrande's balance sheet came to international newswires in August 2021, when the Financial Times reported that the Group was facing a record number of cases filed by contractors in Chinese courts. Lately, the walls have been closing in on Evergrande, as pressure mounts on the company's executives to reduce its \$300bn in liabilities, including around \$100bn in debts. Ratings agencies have repeatedly downgraded the firm, citing its liquidity problems and in mid-September 2021 it was reported that the company was in danger of being unable to make payments on loan interest, something the company itself has since come out and stated.

Evergrande is due to pay \$83.5 million interest on September 23rd for its March 2022 bond. It has another \$47.5 million interest payment due on September 29th for March 2024 notes. Both bonds would default if Evergrande fails to settle the interest within 30 days of the scheduled payment dates. If the company goes under, it has been estimated that around 1,500,000^[2] customers could lose deposits on Evergrande homes that have yet to be built. Street protests have already been reported in Shenzhen.

MARKET STRESS

As the debt deadline looms, Evergrande's Hong Kong-listed shares closed around 10% lower on Monday - their weakest level since May 2010. Exchanges in mainland China were closed for a public holiday mid-Autumn festival that spans 20-21 September.

With global capital markets now so inextricably intertwined, losses were not contained to the

company, the sector, nor the country and the situation is uncomfortably reminiscent of 2015 when fears about Chinese debt prompted a broad-based market correction.

Property developers and financial institutions appeared to be at the epicentre of the turmoil in Hong Kong trading. The Hang Seng Property index, which tracks a dozen listed developers, fell by almost 7%, to its lowest point since 2016. Broader Asian indexes declined and European and US markets followed with Wall Street's fear gauge, the VIX, recording its highest reading since May. The US dollar, a typical safe haven, firmed.

China sovereign credit default swaps (CDS) jumped to their highest level since early October, while those of other emerging markets, including Brazil and Turkey, also rose to multi-month highs.

Metal prices fell on fears that a pullback in the wider Chinese property market could dampen demand for commodities. Mining stocks as far away as London saw their share prices hit.

FINDING A SOLUTION

No silver bullet to help the company to ease its liquidity stress seems to be forthcoming, rather a patchwork of half measures are being attempted. According to Reuters, one of Evergrande's main lenders has made provisions for losses on a portion of its loans to the developer, while some creditors are planning to extend repayment deadlines. On top of that, Evergrande said on Sunday it has begun repaying investors in its wealth management products with real estate.

If a default scenario does come to fruition, Evergrande will need to restructure its bonds but analysts expect a low recovery ratio for investors. Further, Evergrande's mix of dollar bonds issued by both the parent company and a special purpose vehicle, means restructuring could differ between the two sets of bonds and the process could be long and arduous.

Evergrande has already hired advisers for what could be one of the country's largest-ever debt restructurings.

GOVERNMENT INTERVENTION?

Chinese regulators are cognizant that Evergrande's \$300 billion of liabilities could spark broader risks to the country's financial system. Already back in August, the People's Bank of China, its central bank, and the nation's banking watchdog already summoned Evergrande's executives in a rare move and warned that it needed to reduce its debt risks and prioritise stability.

However, it seems that the government is reluctant to step in as a lender of last resort and bail-out a large private-sector company such as Evergrande (as it recently did for Huarong, a heavily indebted state-owned asset manager). As of now, we have seen indirect help from Beijing, such as telling Evergrande's major lenders to extend interest payments or rollover loans.

We believe that if the situation worsens, Beijing will step in with further measures (perhaps bringing strategic investors to the table or actively coordinating asset sales) in order to ringfence the incident and prevent China's economic recovery from being derailed.

If Evergrande does default, we do not think this event, in isolation, will cause a credit crisis in China: Problems would come if other indebted developers began defaulting in unison. Moreover, for international investors, contrary to some headlines, the crisis does not stand to be as bad as America's 2008 sub-prime mortgage crisis. Often in China's property market, buyers pay the full price upfront rather than relying on mortgages and as such, we expect the snowball effect to be limited.

[1]

<https://asia.nikkei.com/Business/Markets/Property/China-cracks-down-on-property-speculation>

[2] <https://time.com/6099000/china-evergrande/>

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