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Evergrande: A canary in the coalmine?

While systemic fallout may be limited, the long-term implications are significant

Summary

We don't believe a potential default of Evergrande is China's 'Lehman moment'. Instead, we would argue that the property developer's distress has occurred by design. Far more crucial than Evergrande itself, however, is how policy makers manage the deleveraging of the indebted corporate sector in the future, as this will likely have far reaching implications for the economy and foreign creditors. In this respect, Evergrande could very well be a canary in the coalmine.

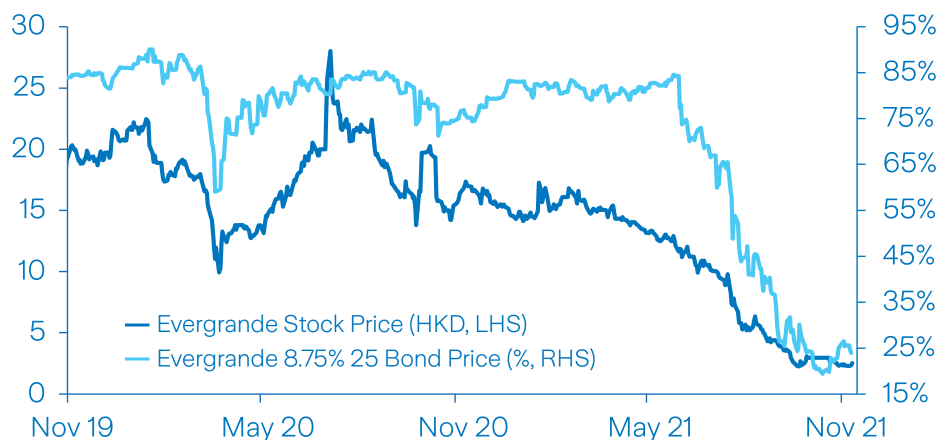
Outline

In this paper, we discuss why we don't think Evergrande's distress represents China's Lehman moment and how it may have occurred by design. We then discuss the long-term implications of the deleveraging process on Chinese credit markets and credit investors, as well as on the macro-economy.

Evergrande is not Lehman

Evergrande, the biggest Chinese property developer by assets and the largest issuer in the Chinese high yield market, as per Bloomberg data, has been in the headlines as it approaches a likely default on its bonds. With around USD 300bn in liabilities, based on the company's 2021 interim report, investor angst has been elevated around a potential Evergrande credit event representing China's 'Lehman moment'. We believe this fear is unwarranted as the systemic fallout should be far more contained than that of the Lehman Brothers bankruptcy. Our view is driven by the expectation that a managed restructuring of Evergrande's liabilities is more likely than a hard liquidation of assets.

Evergrande's default is unlikely to be China's 'Lehman moment'



Source: Bloomberg

Note: Evergrande Bond price around 24% indicates these bonds are trading at 24% of face value

A managed restructuring of Evergrande appears to be the most likely scenario due to four key reasons.

First and foremost, a disorderly liquidation of assets would harm both the Chinese property market and the Chinese banking sector, adversely impacting the macro-economic prospects of the Chinese economy. It would also cause a negative price spiral in the USD 50tn property market (property market size as per Goldman Sachs Research) which would hamper property investment and have ripple effects on banks. Indeed, based on data from Citi Research, about 30% of China's GDP is exposed to property and adjacent sectors, while land sales made up 42% of local government's revenues in 2020. A slowdown in property investment would therefore be a drag on economic growth that would be difficult to compensate, particularly given other impediments to growth. With respect to exposure of banks and other lenders, borrowing collateralised by real estate currently accounts for 63% of China's total bank loans and 36% of domestic debt securities outstanding, according to statistics from the Ministry of Finance. This has been facilitated by rapid credit growth, with outstanding mortgage loans as a percentage of disposable household income rising from less than 1% in 1997 to 55% in 2020. Property loans accounted for 19% of all new loans in the first half of 2021. This is a sizeable proportion, despite it being far less than the over 50% share five years ago, based on data from Citi Research. Given the importance of property as an investment driver for the economy and as collateral for banks, a disorderly liquidation seems unlikely to be a preferred option for policymakers.

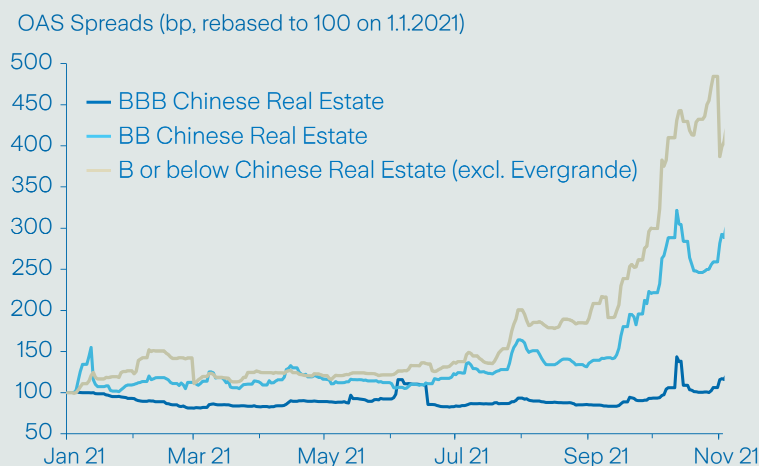
Secondly, a liquidation would likely depress consumer confidence. Falling property prices can reduce consumers' willingness to invest in property, and while this may be a tail risk currently, it is a risk with significant impact were it to occur. There seems to be an inherent belief amongst the public that residential property is not only a 'store of value', but an asset that continuously increases in value, resulting in not only extensive second-home buying, but also in buying property purely as an investment vehicle. This ideology likely caused President Xi to state that 'housing is for living, not for speculating' at the most recent National People's Congress. There are currently around 90 million empty apartments in China, which theoretically, assuming an average three persons per household, could easily accommodate all UK, German, French, and Italian inhabitants – a thought that illustrates the sheer volume of the issue. Given that about 60% of household assets are invested in property, a liquidation scenario with downward spiralling property prices would badly hit consumer confidence. This would result in dire consequences for the economic trajectory and the labour market.

Thirdly, the risk of social discontent is not trivial in a liquidation scenario. Around half of Evergrande's liabilities are to suppliers, based on the company's 2021 interim report, with another 14% towards domestic investors through wealth management products, as per Barclays Research. Recent protests have been reported due to fears that Evergrande will not be able to hand over houses or apartments that have already been almost fully pre-paid. **Around 90% of new residential properties were pre-sold in China during 2019 as per PricewaterhouseCoopers (PWC). Furthermore, as per PWC, the proceeds of these pre-sales are not necessarily protected in Escrow accounts, as is normally the case in other countries.** This leaves homeowners vulnerable in the event of developers falling into distress. Unsurprisingly, similar protests were reported a few years ago when fears erupted around falling house prices, after promises had been made by property sales offices that property is an ever-appreciating asset. We remain confident that the government is determined to avoid any uprising to maintain stability. It seems likely pre-paid property will be delivered as agreed, with potential help from state owned enterprises and local governments. It will be essential to tackle fears about a property crisis at an early stage and to cushion the impact on domestic customers, suppliers, and investors. We believe that maintaining public stability during the upcoming Plenum of the Communist Party this autumn, a gathering of over 300 members of the Central Committee, will be key.

Last but not least, the cost of recapitalising banks is likely to be greater in a liquidation scenario than in an orderly restructuring, with the domestic banking sector being relatively more exposed to Evergrande than international banks.

Hence, the costs of a disorderly liquidation seem far greater than the benefits and hence, an orderly restructuring of Evergrande's liabilities is our base case expectation.
Investor angst is heightened around the fate of bonds and associated spillover effects should there be an Evergrande default. So far, Evergrande has met its coupon obligations for the USD bonds (albeit within the grace period) and negotiated an agreement on domestic bonds. However, given the coupon and principal payments due this year and next, it faces a difficult liquidity situation. Even within a managed restructuring, we believe a full-fledged bailout of bondholders is unlikely. Policymakers seem to be wary of giving the impression that they would be willing to bail out all borrowers. The bond liabilities of Evergrande total only about USD 28bn, out of which around USD 20bn, including debt of subsidiaries, are denominated in US dollars, as per the company's 2021 interim report. The international bonds are currently trading at a price between 23% to 30% of face value, having risen slightly after the payment of the USD coupon, as per Bloomberg data, which implies investors expect heavy haircuts already despite the recent coupon payment. The transmission of losses to the global equity and credit markets is likely to be limited however, with many international banks having little credit exposure. In terms of the broader impact from a bond default, stress is more likely to be concentrated in domestic property developers, which have already seen a rise in their funding costs. Beyond this, a contagion of risks to both Chinese and developed world markets is unlikely and hence there seems to be little incentive for a bond bailout, but also little reason to be overly anxious. **Therefore, within a managed restructuring, Evergrande's bonds are likely to see a default but the spillover impact should be limited.**

Impact of Evergrande's distress is most evident in lower rated developers



Source: Bloomberg

In summary, given the limited spillover from bond defaults and our expectation for an orderly restructuring, the parallels to Lehman seem overdone. Furthermore, the Chinese authorities have undertaken a number of macro-prudential measures to rein in an excessive build-up of hidden leverage, which was not the case in the United States during the period leading up to the US housing market crisis. Nonetheless, policy response is still crucial and investor angst is somewhat understandably amplified by policymakers' silence, as well as by their actions in other sectors such as the internet and educational companies, which are being increasingly regulated.

Evergrande's distress seems to have occurred by design

Evergrande's distress needs to be seen in the longer-term context of a managed deleveraging of China's indebted corporate sector. The rapid rise of corporate debt, along with an investor perception that all issuers are likely to be bailed out, has necessitated a policy tightening in general. The property sector has recently borne the brunt of this credit tightening.

Leverage growth has been tightened in the property sector with a roll out of the so called 'three red lines' in 2020 by The People's Bank of China (PBOC) and the Ministry of Housing. These three red lines define the credit metrics necessary for a company to achieve debt sustainability: The liability-to-asset ratio should not exceed 70% (excluding advance proceeds from projects sold on contract), the net debt-to-equity ratio should be below 100%, and a cash-to-short term liabilities ratio should be above 100%. Developers would be categorized based on how many limits they breach, and their debt growth is likely to be capped accordingly. By design, developers in breach of these red lines find it harder to raise liquidity. We believe the credit metrics defined by the three red lines are prudent, especially in the broader context of curbing leverage. Therefore, we believe that distress at Evergrande is a direct consequence of the deleveraging policy, rather than an accident.

Evergrande's woes stem from its lack of success in deleveraging and in this respect, it stands out among the top 10 property developers, with others such as Vanke faring better. Evergrande has breached all three of the red lines, as per several broker reports. It has also become a conglomerate with interests in electric vehicles, health and even a football club until recently. Furthermore, other property developers have shown progress towards deleveraging, which seems to have been more difficult for Evergrande. As a result of the liquidity crunch, Evergrande has reportedly been addressing funding shortfalls through measures such as the so-called 'pre-sales', in which homebuyers pay almost the entire house price upfront. Indeed, Evergrande's troubles stem from policy tightening that is also likely to impact other indebted property developers (as seen from the default of Fantasia and missed payment by Modern Land China). However, this shouldn't be extrapolated to less leveraged property developers and other borrowers in the Chinese credit markets, especially those who are prudent in managing their balance sheets.

Consequently, Evergrande's distress seems to us like a chapter in the book of managed deleveraging. It is the broader story of deleveraging that warrants greater investor attention than the credit event at Evergrande, something that we discuss next.

Long-term deleveraging policy implications are far more important for investors

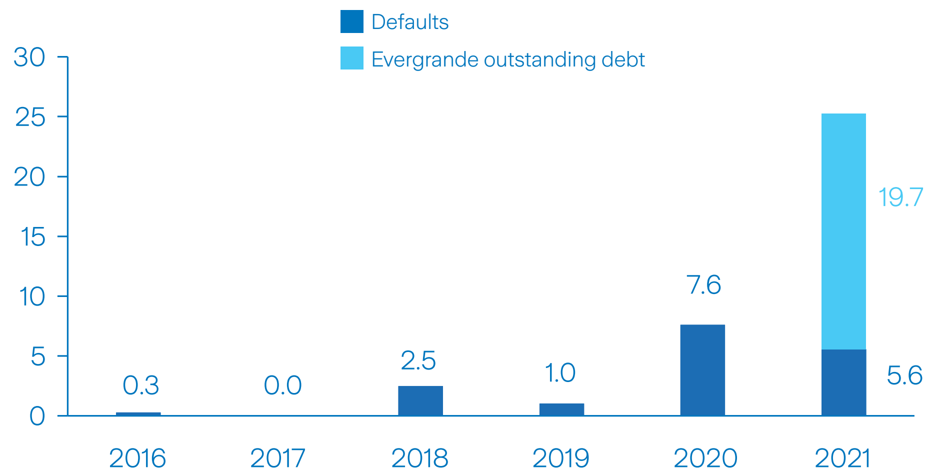
We believe there are three key consequences of the deleveraging policy that warrant investor attention: pricing dynamics in the Chinese credit markets, systemic risks around the deleveraging process and macro-economic implications.

A) Pricing dynamics in Chinese credit markets

We think that many international investors historically had the belief that Chinese policymakers are likely to bail out every creditor in a distress scenario. It is evident from rising defaults that policymakers want to change such a perception so that risk premiums fairly reflect the underlying risks and less worthy borrowers are not able to access capital easily. Indeed, defaults in the Chinese corporate market have been rising for a few years, as data from Bloomberg shows in the chart below.

Chinese corporate defaults on an accelerating path

Chinese USD corporate debt defaults

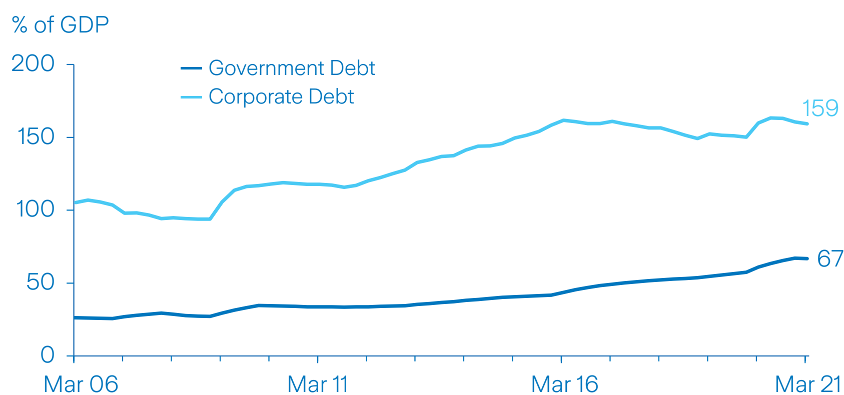


Source: Bloomberg

Note: Evergrande has not yet defaulted as per definitions of failure to pay

Defaults tend to be a means of achieving rapid, albeit painful, deleveraging. It is constructive in our view that the notion of blanket bondholder bailouts has been dispelled through the pickup in default volumes. This seems to be a healthy policy, not only allowing markets to allocate capital efficiently, but also to manage the perception of contingent liabilities on the sovereign. In this context, it is worth noting that the Chinese government debt-to-GDP ratio is only 67% versus around 100% for many developed countries. However, non-financial corporate Chinese debt-to-GDP ratio is 159%, compared to only around 85% for the US, as per BIS data from Q1 21. Chinese corporate debt has rapidly grown since the global financial crisis as the chart shows. Hence, a bailout of significant parts of the corporate sector can become a strain on government finances, without even considering local government debt burdens.

Chinese corporate debt far exceeds government debt



Source: Bank of International Settlements (BIS)

A key question on investors' minds should be how the deleveraging policy will impact credit markets. While the policy focus on managed deleveraging seems healthy in the long term, short-term pain is unavoidable, as has been seen in the property sector and particularly in the case of Evergrande and some others such as Fantasia. The bonds of lower rated property developers have been already hit by wider spreads since the news of Evergrande's distress made international headlines. That said, the better-quality property developers have not seen a significant rise in credit spreads and neither have other segments of the Chinese credit market. If Evergrande's case were to be a template, the deleveraging policy is likely to cause a repricing of those segments where leverage is perceived as being excessive by policymakers. Investors who have been expecting blanket bailouts will likely adjust their risk appetite towards issuers that are conservative, while shunning those who could come under scrutiny due to excessive leverage. **Therefore, it seems likely that in the long term, parts of the Chinese credit market that are at risk of being perceived as excessively leveraged by policymakers would see proactive repricing, although this should not diminish the growth of the market itself.**

B) Managing the deleveraging process

The management of the deleveraging process is one that requires utmost caution from policymakers. An advantage for the Chinese economy is that most domestic lending is done by domestic banks, which can be used by policymakers to control distress situations. However, there is a very tight rope that needs to be walked in managing the deleveraging process of leveraged entities. A reluctance for blanket bailouts seems successful so far. However, the risk remains that a spillover of negative sentiment from defaults into either the banking sector or the credit markets is sizeable enough to create a vicious loop with systemic consequences. The policy differentiation between whom to bailout and whom not to has been logical so far. Indeed, the bailout of Huarong Asset Management is a good example of this and an orderly restructuring of Evergrande should be another one in the future. However, a disciplined approach on a case-by-case basis is required for this success to be maintained. Evergrande, for example, was the largest issuer in the Chinese high yield market by face value. Indeed, its bonds accounted for 12% of the outstanding debt by face value of the Chinese High Yield property developers, as per Bloomberg data. However, this does not make it systemically important enough to qualify for a bailout and the low price of the bonds reflect this. Systemically important entities on the other hand would likely need bailouts, and investors should factor this into portfolio construction.

The other side of the coin in deleveraging policy is to manage the perception of contingent liabilities. Given the size of corporate debt, policymakers cannot be seen as too generous. If investors perception of contingent liabilities changes for the worse, this will likely have a knock-on effect for investment in Chinese financial assets, which in turn would likely hit long-term macro-economic prospects.

Therefore, investors need to keenly watch policy developments around managing credit excesses. Too much generosity through bailouts as well as too harsh a treatment for profligate but systemically important issuers are key risks. Furthermore, we would expect investors to favour a larger share of systemically important issuers in portfolios.

C) Macroeconomic implications of deleveraging

Deleveraging typically slows economic growth and this has been on investors' minds recently as concerns have erupted around China's decelerating growth. Due to Covid related distortions in China's GDP statistics quarterly and monthly growth numbers have become very volatile, a rather unusual phenomenon. Following mixed growth in H1, China's economy has nearly come to a standstill in Q3, growing only at a snail's pace of 0.8% in sequential annualised terms according to national statistics. Some alternative growth measures suggest that the economy may even have contracted, which is devastating for an economy that is used to grow at least above the six percent range. Production cuts to meet energy intensity targets amid the power supply crisis as well as strict environmental targets, including ambitions to reduce pollution before the Winter Olympic Games, are already in the offing. Throwing in mobility restrictions amid potential further virus eruptions over the winter would add to growth risks, and we have cut our growth forecast accordingly. However, we believe the government is well aware of these risks and is preparing adequate measures to overcome hurdles to an adequate growth path in order to maintain social stability and China's status of a 'moderately prosperous society' going forward.

Reverberations of credit tightening in the property sector are already evident. The latest economic activity indicators show that weaker property investment, falling home sales along with slow retail sales have been major contributors to the growth slowdown in China. House price inflation has receded as well, which has been particularly visible in some major cities. Indeed, in September, China's 70-city average new home price recorded its first sequential contraction since April 2015, based on NBS data. While some short-term growth impediments may be overcome due to the policy stimulus that we expect in Q4, we need to watch the medium- to longer-term implications of problems in the property sector very carefully.

The credit impulse in China has been slowing due to the government's efforts to achieve a managed deleveraging. What is important is that this process ensures that not all sectors suffer deleveraging at once and it is the excesses that are being curbed rather than productive credit growth.

While long-term growth prospects for the Chinese economy remain decent, deleveraging will likely impact growth in the short term and any policy mistakes in tackling the leverage can be costly. The process will not be easy, however, and risks are high. Consequently, the managed deleveraging process warrants close investor attention.

China's credit impulse has been slowing

Source: Bloomberg

Note: Credit impulse measures the acceleration of credit versus GDP growth

Conclusion

Investor angst has been centred on distress in the Chinese property developer sector, most notably on Evergrande, whose impending default has led to fears of this being China's Lehman moment. We disagree with this outlook and believe a systemic fallout from Evergrande is likely to be limited. That said, Evergrande's distress should be seen in the context of the longer-term deleveraging strategy of Chinese policymakers, which we view as a healthy long-term strategy. In our opinion, it is the structural implications of deleveraging that are far more important than Evergrande for investors. Credit markets are likely to see increased differentiation based on credit fundamentals and investors are likely to avoid credits and sectors that are likely to attract policy attention for excessive leverage. Furthermore, systemically important issuers are likely to be favoured by investors. The economic impact of deleveraging, ceteris paribus, is normally slower growth to improve long-term prospects, but policy mistakes can be quite costly, and investors need to pay close attention.

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