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Economic Watch

China | Will the fall of Evergrande lead to a systematic breakdown?

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Chinese property developers have long been famous for their high profitability and high leverage. The Evergrande Group is one of best representatives in this respect. Implementing extremely bold strategies of borrowing, the Evergrande managed to grow up to one of largest property developers in China over the past ten years. According to its financial report, the total debt of the Evergrande group stood at 1.97 trillion RMB (USD 300 billion), which is even higher than that of Huarong Asset Management, the largest failed Chinese financial intuition thus far.

Similar to Huarong, Evergrande issued a large amount of bonds in offshore markets which are now seriously discounted in the market. To a certain degree, Evergrande is the victim of the regulators' ever-tightening efforts to clamp down the property market bubbles. In particular, China's regulators imposed the so-called "Three Red Lines" limit on all the property developers in August 2020, in a bid to force the developers to reduce their debt as well as to accelerate their property development and housing sales.

The contents of "Three Red Lines" are as below:

- a 70% ceiling on liabilities to assets, excluding advance proceeds from projects sold on contract;
- a 100% cap on net debt to equity;
- a cash to short-term borrowing ratio of at least one.

Due to its "high-growth, high-leverage" business model, Evergrande became one of three property developers which failed on all three Red Lines. Starting from early this year, Evergrande found it increasingly difficult to meet their short-term liquidity needs, including both debt payment and business operation. Moreover, the diversification strategy of Evergrande doesn't help either. Its subsidiaries in other fields such as wealth management, electric vehicles and hoteling met liquidity problems as well. Many people believe that Evergrande was in fact using these subsidiaries as the vehicles to borrow more debts rather than developing their own businesses independently.

Market challenges were exacerbated by a number of more recent issues, including a court order freezing one of its bank deposits, and the halting of projects by local authorities. Evergrande, which relies heavily on prepayments from customers and the issuance of commercial bills to contractors, is on course to face record numbers of legal cases in the courts this year.

Under all these circumstances, Evergrande's own stock shares are down roughly more than 70% year-to-date. It also has strong adverse spillover to the equity and bond market in China. Concern on contagion impact from Evergrande led to some difficulty in bond issuance onshore due to the declining demand and offshore mainly due to the elevated cost. The contagion effect will also go to the global financial markets, as Evergrande counts big

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international asset management companies among its investors, including Allianz, Ashmore and BlackRock etc. A default is likely to have spillover effects on global markets, where many investors have historically anticipated Chinese government support at times of distress.

How large is the default possibility?

Investors are confronting the growing possibility of Evergrande's default. In their business model, Evergrande develops real estate projects and then sells the flats to customers who typically pay in advance before completion. It has 778 projects under way in 223 cities in China. On the other hand, Evergrande's payments to suppliers often rely on the issuance of commercial bills. The company announced that its liquidity issues, including delayed payments to suppliers and construction fees, mean that some ongoing projects were being suspended. It is rushing to sell assets to generate cash but some companies have refused to accept Evergrande's commercial paper now.

Thus, it is exposed to a vicious cycle in which it does not have enough cash to complete its projects and generate further proceeds from sales, which fell 26% in August from the same time a year earlier despite heavy discounts. The company needs that cash not only to service, but also to reduce its debts. That means, obviously, as we mentioned above, the "three Red Lines" imposed by Chinese authorities about a year ago that forced big Chinese developers to reduce their borrowing are one of the main reasons that pressure has mounted on Evergrande in the past year.

Altogether, we do expect a default scenario for Evergrande, that means, it is not "too big to fail", unless there is an unexpected positive development for the company such as selling their valuable assets. However, even if the central government finally chooses to let Evergrande default rather than bail it out directly, the move which would align with perceptions of a shift towards a more market-orientated approach, Chinese authorities are still likely to be involved in coordinating the continuation of projects of the company that employs large amount of population and their housing constructions are linked to billions of households. Moreover, property developers in China typically also have large amount of borrowings from the country's largest state-owned banks, that means, a pure market-oriented type of default without any support of the authorities is not anticipated.

What will be the authorities' reactions?

Although the market gave much stronger reactions to Evergrande than Huarong Asset Management previously, we don't believe that the authorities will bail out Evergrande as what they did to Huarong for a number of reasons.

First, Evergrande is a property developer, not a financial institution. As a financial institution, the fall of Huarong could immediately lead to uncontrollable contagion among the financial sector which could finally result in a full-fledged breakdown of the entire financial system. This is alike a Lehman Moment in the US leading to the beginning of the Global Financial Crisis back to 2007-2008. By contrast, a fall of a property developer like Evergrande, albeit with a bigger size than Huarong, has a much smaller chance of spilling over to the entire financial system. More importantly, it should be noted that China's financial sector is in essence state-owned. Investors' confidence in the financial sector, which is supposed to be reinforced by the recent bailout of Huarong, will limit the contagious risks of Evergrande to the financial sector.

In theory, there is another contagious channel in that the fall of Evergrande drags down most of property developers first and then sunk the entire financial sector via their huge exposure to the housing sector. But it seems very unlikely too. It is true that the stock prices of many other developers plummeted in tandem with Evergrande. However, the real estate developers differ quite a lot. To some degree, the implementation of "Three

Red Lines" is equivalent to conducting a stress test on all these developers. Evergrande is a failed one but most of others have passed. That means, eventually, the market will tell the good ones from bad ones.

Second, Evergrande is a private-owned company. The authorities cannot have legitimate reasons to bail it out with the use of taxpayers' money. Moreover, Evergrande still has valuable assets on its balance sheet, mainly its land reserve. At the current stage, it is still uncertain whether the Evergrande crisis is a liquidity one or a solvency one. Instead of directly bailing it out, the authorities will first push Evergrande to liquidate its assets and shed part of its debt. The authorities will surely help Evergrande to buy some time for it while there is a far cry from a direct bailout.

Last but not least, China's authorities continue to consider the clampdown on the housing market as a policy priority. Squeezing property developers is integral to this priority. At this moment, bailing out Evergrande is likely to make other property developers believe that this round of policy tightening is a toothless tiger, which could nullify all the previous policy and regulatory efforts to clamp down the housing market.

In sum, Evergrande is unlikely to be bailed out directly. Instead, the authorities will likely to form a debt-payment committee composed of government representatives and important debt holders. Under this debt-payment committee, Evergrande will liquidate its good assets to meet its debt obligation.

In such a process, the equity holders of Evergrande will take the final loss. Indeed, they are very likely to be wiped out. Meanwhile, the debt holders will be treated differently. That being said, the retail debt holders, mainly the homebuyers who paid the developers in advance, will be fully protected. Meanwhile, the institutional debt holders will share the loss which is not covered by the equity part. In this respect, we don't believe that the offshore bondholders of Evergrande will receive any favorable treatment than their onshore counterparts.

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