EVERGRANDE’S PROBLEMS: NO SYSTEMIC RISK
STILL, THE COMPANY’S DEBT ISSUES HAVE REPERCUSSIONS FOR THE WIDER REAL ESTATE SECTOR, FOR CREDIT AND EQUITY MARKETS, AND FOR CHINA’S GROWTH MODEL

SUMMARY

› The group’s troubles cast doubt over the entire property sector, which accounts for over a quarter of China’s GDP. Recent events could weigh on sentiment and lead to a further slowdown in construction-related activity.

› We do not expect the authorities to ease their efforts to rein in leverage in the real estate sector, where liquidity has already been squeezed and credit problems have been rising. Despite official efforts to avoid contagion via injections into the financial system, ancillary sectors and companies are also under pressure.

› A small number of mid-sized financial institutions have some meaningful exposure to Evergrande, but the Chinese banking sector’s exposure in general appears manageable at this stage.

› In credit, yield spreads for Chinese real-estate companies have risen steeply, effectively closing many of them out of the market. Tensions have also risen in USD-denominated high-yield bonds in Asia more generally. But investment-grade credits are proving more resilient in China and in Asia at large.

› Real estate companies’ woes cloud the picture for China-related equity indexes. To become more constructive on Chinese stocks, we would need to see more transparency surrounding Evergrande and decisive government intervention. More generally, we need to see improvements in the credit impulse, which could indicate better momentum in Chinese growth.

Wide-ranging implications

The situation surrounding Chinese property developer Evergrande’s debt repayments continues to evolve rapidly. On 23 September, it was due to make a USD83.5 million coupon payment on one of its offshore US dollar bond issues, having already promised to meet the deadline for payment on one its onshore bonds (although whether this payment was in cash or assets is unclear) the day before.

With further interest payments fast coming into view, speculation has been mounting that the authorities will move to restructure Evergrande, with the most viable parts of the group’s business bought by rivals and debts underwritten by state-owned enterprises with support from the People’s Bank of China. Proceeds from the sale of non-core assets would be used to compensate creditors and decisions would also have to be taken on how Evergrande’s onshore and offshore assets and liabilities are distributed. Other reports suggest that the authorities in Beijing are reluctant to bail out China’s most heavily indebted property developer.

The Evergrande crisis has wide-ranging implications for the Chinese property sector of course, but also the financial sector, credit and equity markets, as well as prospects for the Chinese economy.

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Chinese economy

China’s economic growth has relied to an unusual extent on construction since the 1990s, with real estate accounting for well over a quarter of GDP by some measures. The government has been worried about leverage in the sector, leading it to impose strict controls last year (the so-called “three red lines”). But while the Chinese authorities may move to put a floor on real estate prices at a regional level, there is no sign that the government’s clampdown on the property sector nationally will ease significantly in the near term.

CHART 1: CHINA REAL ESTATE–LAND ACQUISITION, NEW STARTS AND PROPERTY SALES

The ongoing financial woes of some large developers will likely weigh on sentiment and lead to further slowdowns in home purchases and investment (chart 1). This, in turn, could put pressure on construction and industrial activities. While we are already seeing an increase in the pace of the issuance of local government bonds to prop up China’s flagging growth momentum, there might be a time lag before the economy reacts to this fiscal support. In addition, credit growth does not seem to have troughed yet.

We recently revised down our Chinese GDP forecast for 2021 to 8.7% from 9.0% on covid disruptions and weakening data. For the moment, we are keeping that forecast unchanged, but recognise that there could be further downside risk. The importance of the property sector to the Chinese economy may also warrant a revision to growth forecasts for 2022.
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Property sector

Due to the authorities’ efforts to control lending to the sector, property developers’ liquidity has been squeezed. The Evergrande situation means pressure on the Chinese property sector will likely continue, with non-performing loans potentially rising. Indeed, we estimate that almost one-third of listed property firms have cash/to short-term debt ratios of below 1 (this threshold was one of “three red lines” the Chinese government imposed on developers’ balance sheets last September).

As for Evergrande, some 60% of the company’s 800 outstanding projects (including 1.25 million unfinished homes) at various stages of completion have been put on hold and face an uncertain future. Of note, about half of the developer’s projects are located in tier-3 cities, on which it may have to accept significant haircuts in the case of fire sales. Suppliers are also in the firing line, with about half of Evergrande’s RMB2 trn in debt outstanding owed to subcontractors who are already feeling the impact of the authorities’ campaign to rein in the building sector.

Financial sector

We estimate Evergrande’s total liabilities, including off-balance sheet items, to be RMB1.8-2 trn (about USD300 bn). A small number of mid-sized banks seem to have the largest single exposure, with a chance that they may have to raise capital to meet reserve requirements. Larger Chinese banks’ exposure to Evergrande is more limited, allowing them to safely pass stress tests. Western banks’ exposure would also seem to be contained. The People’s Bank of China nonetheless pumped RMB900 bn into the banking system this week in order to curb contagion risks.

As for Chinese banks’ involvement in real estate more generally, out of a total loan book of RMB185 trn (according to the People’s Bank of China), property-related loans account for 27% (of which about 8% is in the form of developer/property loans and 19% in the form of mortgages). After a period of rapid growth, the introduction last year of a regulatory cap on property-related loans means there is little potential for banks’ to expand their property loan books any further.

Credit markets

Recent weeks have seen a significant widening of spreads in Chinese high yield, with signs that sentiment might be waver ing at the lower end of the Chinese investment-grade universe too. At yields of over 20% and with refinancing concerns rising for a number of developers facing maturities on USD bonds, the bond market is effectively closed for many Chinese developers. The advance of restructuring plans has led to a short-term rebound in high-yield prices, but much depends on how Evergrande meets its offshore interest-payment deadlines. Of course, the details of restructuring plans and whether it happens in an orderly fashion will be essential for the future course of events, with the possibility that investors will be faced with hefty haircuts. Chinese investment-grade credits have proved more resilient, with investors showing a clear preference for quality and state-owned enterprises.

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Tensions have been rising in the USD-denominated high-yield market in Asia more generally. But Asian investment-grade credit in US dollars has resisted events in China, with limited signs of spread widening. High-yield spreads in India and Indonesia have been holding in. The potential return an investor may receive per unit of risk (the spread per turn of leverage) has been falling for Asian investment-grade issues and rising for Asian high yield (excluding Evergrande).

**Equities**

Chinese real estate’s travails have implications for equities, given the sector’s share of market capitalisation and earnings. Hong Kong is especially exposed in this regard, with real estate companies (developers, management companies and REITS) accounting for 18% of the MSCI Hong Kong Index’s market capitalisation and 27% of its total earnings (chart 2).

**CHART 2: REAL ESTATE’S SHARE OF MARKET CAPITALISATION AND EARNINGS IN CHINESE EQUITY INDICES**

The real estate sector has been expected to supply 12.5% of the expected growth in MSCI Hong Kong earnings next year, compared to 9% and 3.5% for the MSCI China and the MSCI China A onshore, respectively. In short, the larger the offshore component in China-related indices, the bigger the exposure to real estate. While the market should be able to stomach little to no earnings growth in the real estate sector next year, it could be a different story should current events significantly impact real estate companies’ bottom line.

In our year-end scenario published in early August, we argued that neither valuations nor earnings were likely to provide much support to offshore Chinese equities through to the end of 2021. This view was based on the state of the credit cycle in China, as well as the regulatory drive there and Chinese ADRs’ possible delisting from US stock exchanges. The risk of a systemic crisis, however remote, reinforces the relatively downbeat view we formulated in August.

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Going forward, the risk of contagion needs to be monitored from different angles. First, bond yields of over 20% in large parts of China’s real estate sector would be unsustainable if they last, hampering companies’ efforts to refinance and undoubtedly forcing the government to intervene. Second developments in the interbank funding market will tell us how much confidence major financial institutions have in each other. Third, while we do not expect a major correction in real estate prices, we have to be aware of its potential to trigger a sharp slowdown in China.

Although we do not see a major risk of broad contagion at this stage, the Chinese authorities have little incentive to act pre-emptively, given they have long sought to reduce excessive risk-taking in the real estate sector. In other words, they are likely to wait first and only intervene if it is truly necessary to ensure macroeconomic stability. Investors should therefore expect more bumps on the road to Evergrande’s probable restructuring.

To turn more constructive on Chinese stocks, we would expect clarification on Evergrande’s restructuring as well as signs of concrete government intervention (i.e. a clear backstop). Longer term, we would watch a rise in the credit impulse (currently at trough levels), indicating that the worst of the current credit cycle has passed.
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