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Investment Strategy Bulletin

Restructuring Evergrande: Controlled demolition

Investment Solutions

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The turmoil surrounding China's property developer Evergrande is reaching fever pitch with the company set to skip two bond interest payments on 23 September. In our view, the company's restructuring is a foregone conclusion given its well-known fragilities as a highly indebted developer, heavily dependent on unsustainable, short-term financing. The company's status as a private enterprise precludes any direct state intervention to make the current bond and shareholders whole. Debt restructuring is coming.

The key question for investors is whether the company's restructuring can trigger contagion to China's financial markets, or even the wider world. Having brought the price of Evergrande's USD bonds below 30 cents on the dollar, markets appear to be shifting focus to these contagion risks. Other non-investment grade names in China's real estate sector have seen their USD offshore bond prices decline significantly in past few weeks, and a few insurance companies and commercial banks with higher exposures to the sector are facing pressures. Equity markets across the world experienced a sell-off on 20 September after holding steady until the end of last week. Investors are asking if this is China's 'Lehman moment.'

Our answer is a clear no. In our view, Evergrande's situation is a 'controlled demolition': **the company will be restructured, but the systemic implications are limited**. Even if markets are volatile in Asia's relatively illiquid mid-autumn festival season, prices should stabilise once Beijing's decisions on the troubled property developer become clear. There are three reasons for our conclusion.

Reason 1: Evergrande as an outlier

The first thing to note about Evergrande's situation is the company has been in a category of its own in terms of extremely aggressive financing tactics. Under the new leverage test, launched by the People's Bank of China (PBoC) and the Ministry of Housing in August 2020, developers need to keep their liabilities-to-assets ratio below 70% (excluding contract sales before completion or 'pre-sales'). In addition, net debt-to-equity ratio should remain below 100%, and firms must maintain cash coverage of short-term debt above 1 before they are allowed to increase their overall liabilities. Evergrande failed all three tests (commonly referred to as 'three red lines') in 2020, and it was barely able to bring its net gearing below 100% after months of painful deleveraging.

Even as it struggled to meet the government's deleveraging expectations, Evergrande maximised its loan allowances from banks (even acquiring a small bank for that purpose), used pre-sales as a de facto financing channel, and increased dependence on short-term commercial bills to nearly 30% of its liabilities. The company is also known for other financial ruses, such as floating news of a potential public listing for its subsidiaries in non-core businesses such as bottled water, electric vehicles, and infant formula.

This unusual history is why many market participants monitoring China are not surprised by Evergrande's troubles. Despite the company's best efforts to reduce leverage, the fundamental unsustainability of its financing model and thus need to restructure debt, have become even clearer this year. For this reason, Evergrande's likely fate should be thought of as an enduringly fragile name experiencing predictable turmoil, rather than an unexpected insolvency.

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Evergrande's outlier status also matters for our assessment of contagion risk, as the magnitude of the problem is not as severe for other property developers that are frequently grouped with the troubled firm. Guangzhou R&F, another B-rated developer in breach of all three of the government's leverage thresholds, has total liabilities just one fifth of the size of Evergrande's. SUNAC, another business that was in breach of the government's three red lines, has improved its ratios and compliance substantially over the past year and is now in a position to increase its debt by 10%, if needed. Six other developers who were in breach of at least one of the three red lines are now fully compliant and their dependence on short-term funding is materially lower. Simply put, the entire industry has stronger leverage ratios and cash levels than Evergrande's.

Reason 2: Prominence of pre-sales in Evergrande's liabilities and political risks of angry homebuyers

Another unique aspect of Evergrande is that marketable debt securities are just a small part of its overall debt burden. More than half of its liabilities, totaling around RMB 2 trillion, are account payables and trade acceptance bills tied to pre-sales. Of its liabilities, 14% have been repackaged and sold to retail investors as 'wealth management products', but Evergrande's guarantee for these appears mostly limited to those bought by employees and their families and friends. In addition, bank loans are a little more than 10% of total liabilities, but banks have seniority during the restructuring process with collaterals covering some of the loans. Even if all the banks' uncollateralised loans to Evergrande are lost, the Chinese banking sector as a whole will maintain its capital adequacy ratio around 11%, which is higher than the regulatory minimum of 9.5%. Commercial papers that form a key part of Evergrande's problematic short-term debt financing could affect banks unevenly in the case of default, but the authorities can quickly suppress any stress between banks. Tradeable bonds account for a meagre 9% of the total liabilities.

The structure of Evergrande's liabilities therefore implies that it is a manageable problem as long as: (1) projects are completed and delivered to homebuyers; (2) obligations to employees and contractors are honoured in the process; (3) banks and trusts take some 'haircuts' as senior debt holders; and (4) both bond and share investors bear the brunt of the restructuring pain with others prioritised before them. Project completions will likely depend on other corporate entities (whether state- or privately owned) with healthy balance sheets acquiring them in exchange for Evergrande's land banks. We expect the government to provide liquidity and regulatory support to assist in completing projects.

Pre-sales have become a de facto financing channel for China's property developers. This is a byproduct of the government's increasing restrictions on official financing channels and the lack of standardisation in different municipalities for supervising pre-sales activities. Many aggressive property developers with ambitious growth targets, but lacking borrowing opportunities from banks or bond markets, resorted to contract sales. Many local governments then gave them significant discretion on the use of proceeds and the timing of project deliveries. Better yet, pre-sales are interest free. Drawn to these advantages, the industry as a whole has been increasing these contract sales and so freeing-up the liquidity tied to existing projects. If developers become insolvent, the result is millions of households who are potentially at the risk of receiving empty, unfinished houses.

We are confident that the government's post-default intervention will be effective, because the alternative is a scenario of millions of angry homebuyers. We estimate that approximately 1.3 to 1.5 million individuals have already committed their savings to Evergrande's unfinished projects via pre-sales. That number may of course rise if Evergrande's failure somehow creates broad contagion. Any failure to deliver the promised new homes to these investors could spark a politically destabilising event, especially when China's leadership is beginning to roll out the national agenda for their next term. We think the authorities' choice is obvious.

Reason 3: China's regulatory framework blocks negative feedback loops

China's regulatory framework makes negative feedback loops of industry-wide fire sales and mark-to-market losses leading to solvency crisis highly unlikely. The real estate market in China is not a free market. China's local governments have been strengthening their regulation of property transaction terms including 'price floors' at 15% of approved prices. Local governments are also empowered to suspend transactions on existing homes and subject new properties to a 'cooling-off' period of 4 to 6 years when re-selling is suspended. Regulators may block any attempt to unload a large volume of properties in inventory if deemed destabilising for markets.

Even if a developer gets approval to engage in a property fire sale, it is unlikely to find appropriate buyers to snap-up these properties. Since the introduction of three 'red line' thresholds, every property developer, including those with strong balance sheets, needs to ensure that leverage does not rise significantly to threaten its compliance. This prevents most developers from responding to the fire sales. Individual buyers also tend to pay the full price for a property via pre-sales, constraining their ability to absorb large volume of inventories.

Conclusion: Contagion unlikely though deleveraging will continue

Political necessity dictates that Evergrande's homebuyers are made whole at the expense of other creditors, and we expect this will force the government to participate in the coordination between creditors and developers. To ensure that its involvement is successful and economical, the government will do its best to limit the restructuring to extreme cases like Evergrande, taking a 'controlled demolition' approach by resolving risks one or two cases at a time, as the need arises. In Evergrande's situation, we believe that the recently reported framework, of local governments or corporates taking over the company's unfinished projects 'region-by-region,' makes sense. Should this materialise, Evergrande's land bank will be used as an incentive in the take-over. We anticipate that most projects will be delivered to homebuyers, and employees and contractors probably avoid significant economic penalties. Over-exposed banks or insurance companies may suffer losses via non-performing loans or equity wipe-out, but we do not believe this will cause any individual bank to suffer a major stress episode. Indeed, the onshore capital market remains relatively calm. Lasting and significant financial contagion is highly unlikely, and we believe that markets will see a relief rally once the government's plans become clear.

Some media reports argue that the government does not have the fiscal means to rescue the developers, but this is the wrong way of looking at the problem. What matters most for creditors is the credibility of isolated restructuring for these vulnerable property developers, because they are private entities that will not receive direct state support. It makes sense for the government to restructure the company and then minimise the fall-out through industry guidance and offsetting regulatory or macro policy easing. In that regard, we believe the government has ample means to achieve the relatively smooth restructuring of Evergrande. We note that the government approaches this episode with monetary and fiscal policy in a tight setting. The government has room to loosen policy further.

Evergrande remains a serious test of China's financial eco-system. The government's objective of industry-wide compliance with the 'three red lines' in the next few years looks demanding. It requires reducing the sector's liabilities, worth RMB 16-to-20 trillion. We suspect that the government could provide a more reasonable timeframe once the industry emerges from Evergrande's financial 'controlled demolition'. Nevertheless, the medium-term trend of deleveraging means that the sector will struggle to regain its allure as a destination for equity inflows, even though the firms that survive this process will attract investors looking for credit opportunities.

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