LOMBARD ODIER
LOMBARD ODIER DARIER HENTSCH

CIO Viewpoint

Evergrande prompts China to put its house in order

Investment Solutions

27 September 2021

Thirteen years after the great financial crisis, investors need no reminder that poor lending practices in one housing market can contaminate assets around the world. While fears of contagion from China Evergrande Group's lending practices and likely defaults are fading, the implications for China's property market and the country's growth are becoming clearer.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Evergrande was the world's biggest property developer, and with USD 300 billion in liabilities is now China's most indebted. It would be the biggest restructuring exercise that the Chinese state has had to manage, affecting as many as 1.4 million people invested in homes bought off plan. That may demand additional monetary and fiscal measures to prop up the country's growth in the short term.

Real estate activity and construction accounts officially for 14.5% of China's gross domestic product. Even that may minimise the economic importance of the property sector. Harvard professor Kenneth Rogoff and co-author Yuanchen Yang last week doubled that estimate by including indirect exposure such as financing, labour inputs and management. By this measure, the sector's share of GDP has tripled over the past two decades, they reported, adding that China's economy is more reliant on the property market than Spain and Ireland before the 2008 financial crisis.

China's property market accounts for a larger share of the economy than in most other countries, and is more expensive. The ratios of median home prices to median incomes in China's cities are as much as five times higher than European and US cities, according to cost-of-living database numbeo.com (see table, page 2). The price-to-income for Beijing and Shenzhen housing stands at 49 and 47 times respectively, more than double the ratio for Paris or London.

Evergrande's debt

On 22 September, Evergrande said that it had reached an agreement with bondholders for a coupon payment in renminbi due the following day, worth RMB 232 million (USD 36 million). The company missed interest payments on a second 'offshore' coupon worth USD 84 million. With little data, the market is trading the company's debt at a flat 25 cents to the dollar, suggesting that investors expect the company to default.

Key takeaways

- The immediate impact of Evergrande's failure looks contained, but illustrates the urgency to overhaul China's property markets
- China will likely restructure Evergrande and ensure retail buyers get their homes, without helping equity and bondholders
- Third-quarter GDP will suffer, but China is increasing liquidity and has the fiscal and monetary tools to avoid a major economic impact. We see full-year 2021 GDP growth at 8.5% and 5.6% next year
- By addressing the sector's excessive leverage, the episode should prove a necessary evolution of the Chinese economic model.

In total, Evergrande owes dollar and renminbi-denominated bond payments worth more than USD 1 billion over the next four months, according to Bloomberg data. China's banking limitations on lending mean that the company's business model also depended on selling financial products and it has missed payments to retail investors worth around USD 6.2 billion. It also owes USD 1.8 billion, sold through lenders known as trusts, before the end of this year, with another USD 4 billion due in 2022. Some of these trusts either have reimbursed their institutional clients and private investors or are negotiating extensions, Bloomberg reports.

Evergrande's problems have not surprised those watching its leveraged finance model. Ratings agencies have cut the company's debt scores this month. Fitch, for example, downgraded the firm three notches in three steps since 22 June. The latest, on 7 September, took Evergrande from B+ a year ago, to CC and the agency wrote that "a default of some kind appears probable."

'Red lines'

Despite working to reduce its leverage, Evergrande has failed all three 'red lines' that China introduced last year to limit property developers' risk. Under these tests, developers must maintain a liabilities-to-assets ratio of less than 70%, keep cash to cover short-term debt and have a net debt-to-equity ratio below 100%.

Still, the numbers may overstate the risks of contagion. As long as the default risks remain limited to Evergrande, China has the fiscal and monetary tools to avoid a major impact.

In July the People's Bank of China cut the amount of cash that banks have to hold in reserve, known as the 'reserve ratio requirement' (RRR). If the country's growth does slow, the central bank can further ease policy through another RRR cut in the last quarter of this year.

Local governments already planned to ramp-up bond issuance in the coming months and last week, the PBoC injected RMB 460 billion of cash into the country's banking system, ensuring that financial markets continued to function. The Shanghai stock exchange dismissed the week's earlier contagion fears to close 0.3% higher on 24 September and the Chinese government's benchmark 10-year bond yielded 2.88%, from a peak of more than 3.3% this year.

China's political priority will be to make sure that the firm's customers eventually see their homes built with local authorities managing the contracts through other developers. In the meantime, equity and fixed income investors on the other hand, will have to shoulder their losses.

Selected global cities	Median home price to median income ratio
Beijing, China	49
Shenzhen, China	47
Shanghai, China	39
Guangzhou, China	30
Moscow	22
Tel Aviv	20
Wuhan, China	20
Paris	20
Singapore	18
London	15
Frankfurt	12
Toronto	11
Geneva	10
New York	9
Zurich	9

Source: https://www.numbeo.com/

That would be in line with the government's ambition to discourage risky behaviour or moral hazard, and its efforts to reform bankruptcy rules, restructure inefficient companies and let them default. It has also engaged in a regulatory crackdown on technology firms and last week the PBoC outlawed cryptocurrencies.

Building on growth

China's regulatory and credit tightening will translate into some slightly weaker full-year economic growth, led by the property sector. GDP for 2021 should be around 8.5%, although the third quarter will undoubtedly experience low or even zero growth. Next year, we expect China to post growth of 5.6%, in line with its longer-term average. The Chinese economy is adapting as it shifts to domestic-driven demand, slowly peaking urbanisation and an ageing working population.

Our portfolio positioning favours renminbi-denominated government bonds. Given that the Chinese property sector has looked fragile for some time, we have avoided vulnerable, high yield names. We increased our exposure to Chinese equities in August after their underperformance year-to-date, bringing our portfolio position to neutral. The Chinese currency should hold its value as most sovereign debt is financed in renminbi with high reserves of foreign currency. China's current account balance, along with foreign direct investment and portfolio flows, remain strong, underpinning the renminbi in the medium term. We see the Chinese currency trading around 6.45 against the dollar by the end of this year, and 6.35 per USD by the end of 2022.

We also continue to watch for any signs of onshore, or offshore, contagion. Specifically, we look at the health of the Chinese high yield market, where almost two-thirds of credit is tied to real estate, much of it trading at distressed values. In contrast, dollar-denominated investment grade fixed income continues to trade with no signs of contagion.

In time, China is positioned to stave-off the worst of the Evergrande fallout. Furthermore, by stamping out the worst excesses of leveraging practices, overall, we believe that this is a necessary evolution of the Chinese economic model.

Important information

This is a marketing communication issued by Bank Lombard Odier & Co Ltd (hereinafter "Lombard Odier"). It is not intended for distribution, publication, or use in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it aimed at any person or entity to whom it would be unlawful to address such a marketing communication. This marketing communication is provided for information purposes only. It does not constitute an offer or a recommendation to subscribe, purchase, sell or hold any security or financial instrument. It contains the opinions of Lombard Odier, as at the date of issue. **These opinions and the information contained herein do not take into account an individual's specific circumstances, objectives, or needs. No representation is made that any investment or strategy is suitable or appropriate to individual circumstances or that any investment or strategy constitutes personalised investment advice to any investor.** Each investor must make his/her own independent decisions regarding any securities or financial instruments mentioned herein. Tax treatment depends on the individual circumstances of each person and may be subject to change in the future. Lombard Odier does not provide tax advice. Therefore, you must verify the above and all other information provided in the marketing communication or otherwise review it with your external tax advisors. Some investment products and services, including custody, may be subject to legal restrictions or may not be available worldwide on an unrestricted basis. The information and analysis contained herein are based on sources considered reliable. Lombard Odier uses its best effort to ensure the timeliness, accuracy, and comprehensiveness of the information contained in this marketing communication. Nevertheless, all information and opinions as well as the prices, market valuations and calculations indicated herein may change without notice.
Investments are subject to a variety of risks. Before entering into any transaction, an investor should consult his/her investment advisor and, where necessary, obtain independent professional advice in respect of risks, as well as any legal, regulatory, credit, tax, and accounting consequences. The investments mentioned in this marketing communication may carry risks that are difficult to quantify and integrate into an investment assessment. In general, products such as equities, bonds, securities lending, forex, or money market instruments bear risks, which are higher in the case of derivative, structured, and private equity products; these are aimed solely at investors who are able to understand their nature and characteristics and to bear their associated risks. On request, Lombard Odier will be pleased to provide investors with more detailed information concerning risks associated with given instruments. **Past performance is no guarantee of current or future returns, and the investor may receive back less than he/she invested**. The value of any investment in a currency other than the base currency of a portfolio is subject to the foreign exchange rates. Exchange rates may fluctuate and adversely affect the value of the investment when it is realised and converted back into the investor's base currency. The liquidity of an investment is subject to supply and demand. Some products may not have a well-established secondary market or in extreme market conditions may be difficult to value, resulting in price volatility and making it difficult to obtain a price to dispose of the asset. **This marketing communication is not issued by the organisational unit of the Bank Lombard Odier & Co Ltd responsible for the production of financial research**, as defined under the Swiss Bankers Association Directives on the Independence of Financial Research. Consequently, it is not prepared in accordance with the provisions of the referred Directives or any other legal requirements designed to promote the independence of the production of financial research. Opinions expressed in this marketing communication may differ from the opinions expressed by other divisions of Lombard Odier, including Bank Lombard Odier & Co Ltd's Research Department. Nevertheless, if opinions from financial analysts belonging to the Research Department are contained herein, such analysts attest that all of the opinions expressed accurately reflect their personal views about any given instruments. In order to ensure their independence, financial analysts are expressly prohibited from owning any securities that belong to the research universe they cover. Lombard Odier may hold positions in securities as referred to in this marketing communication for and on behalf of its clients and/or such securities may be included in the portfolios of investment funds as managed by Lombard Odier or affiliated Group companies. Lombard Odier recognises that conflicts of interest may exist as a consequence of the distribution of financial instruments or products issued and/or managed by entities belonging to the Lombard Odier Group. Lombard Odier has a Conflict of Interests policy to identify and manage such conflicts of interest.
European Union Members: This marketing communication has been approved for use by Lombard Odier (Europe) S.A. in Luxembourg and by each of its branches operating in the following territories: **Belgium**: Lombard Odier (Europe) S.A. Luxembourg • Belgium branch; **France**: Lombard Odier (Europe) S.A. • Succursale en France; **Italy**: Lombard Odier (Europe) S.A. • Italian Branch; **Spain**: Lombard Odier (Europe) S.A. • Sucursal en España. Lombard Odier (Europe) S.A. is a credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg. In addition, this marketing communication has also been approved for use by the following entity domiciled within the European Union: **Spain**: Lombard Odier Gestión (España) S.G.I.I.C., S.A.U., an investment management company authorised and regulated by the Comisión Nacional del Mercado de Valores (CNMV), Spain.
Hong Kong: This marketing communication has been approved for use by Lombard Odier (Hong Kong) Limited, a licensed entity regulated and supervised by the Securities and Futures Commission in Hong Kong for the general information of professional investors and other persons in accordance with the Securities and Futures Ordinance (Chapter 571) of the laws of Hong Kong.

SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
The Bank is authorised in the UK by the Prudential Regulation Authority (PRA). Subject to regulation by the Financial Conduct Authority (FCA) and limited regulation by the Prudential Regulation Authority. Financial Services Firm Reference Number 597896. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority and regulation by the Financial Conduct Authority are available from us on request.
Lombard Odier Asset Management (Europe) Limited
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
Investment firm authorised and regulated by the Financial Conduct Authority (FCA register No.515393).

LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66, 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).

MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st. 2, bld. 1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
Credit institution supervised in France by the Autorité de contrôle prudentiel et de résolution (ACPR) and by the Autorité des Marchés Financiers (AMF) in respect of its investment services activities. Business permit No.23/12. Registered in Luxembourg · No.B169 907. Insurance intermediary authorised by the Commissariat aux Assurances (CAA) No.2014 CM002. The registration with the CAA can be verified at www.orias.fr.

AFRICA | AMERICAS | MIDDLE EAST

ABU-DHABI
Bank Lombard Odier & Co Ltd · Abu Dhabi Global Market Branch
Al Maryah Island · Abu Dhabi Global Market Square · Al Khatem Tower · 8th floor · P.O. Box 764646 · Abu Dhabi · UAE · abudhabi@lombardodier.com
Arranging Deals in Investments · Advising on Investment or Credit · Arranging Credit. Regulated by the ADGM Financial Services Regulatory Authority.

BERMUDA
Lombard Odier Trust (Bermuda) Limited
3rd Floor, Victoria Place · 31 Victoria Street · Hamilton HM 10 · Bermuda · bermuda@lombardodier.com
Licensed to conduct Trust, Investment and Corporate Service Provider Business by the Bermuda Monetary Authority.

BRASIL
Lombard Odier (Brasil) Consultoria de Valores Mobiliários Ltda.
Avenida 9 de Julho No. 3624, Torre DGN 360, 6° andar · Jardim Paulista · CEP 01406-000 · São Paulo · Brasil
sao.paulo.office@lombardodier.com
Supervised by the Comissão de Valores Mobiliários of Brazil.

DUBAI
Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

ISRAEL
Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
Not supervised by the Supervisor of Banks in the Bank of Israel, but by Swiss Financial Market Supervisory Authority which supervises the activities of Bank Lombard Odier & Co Ltd.

JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Superintendencia de Bancos de Panamá.
Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Superintendencia del Mercado de valores de Panamá. Licensed to operate as an Investment Adviser. Res. SMV No.528-2013.

ASIA - PACIFIC

HONG KONG
Lombard Odier (Hong Kong) Limited
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
A licensed entity regulated and supervised by the Securities and Futures Commission in Hong Kong.

SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
Regulated and supervised by the Financial Services Agency (FSA) in Japan. It holds a trust business license (FSA No.208) and is registered with Kanto Local Finance Bureau for Financial Instruments Business Operator (No.470).

[1] *Private bank and securities firm authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).*

[2] *Branch of Lombard Odier (Europe) S.A., a credit institution based in Luxembourg, authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.*