

Market Commentary

Evergrande is not China's Lehman moment

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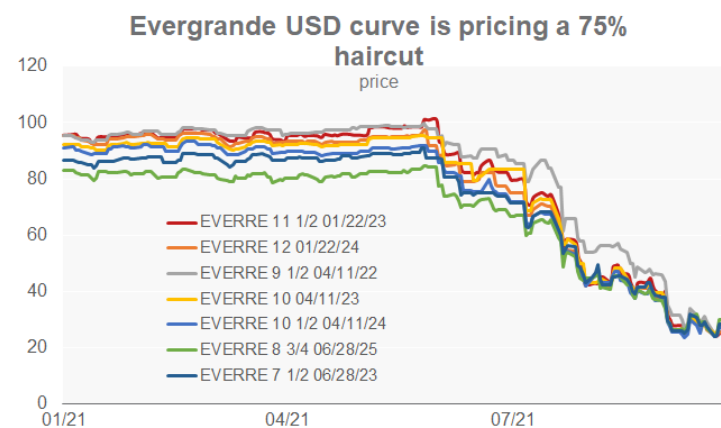
- Evergrande has missed a coupon payment on an USD bonds this Thursday 23rd of September. It is now entering a 30-day grace period to potentially pay the amounts due, otherwise the coupon miss will trigger a technical default on the offshore debt. Sentiment is likely to remain weak until a solution emerges. Dollar bonds are currently pricing a 75% haircut, in line with a debt liquidation scenario while a debt reprofiling (maturity extension, debt to equity swaps) appears more likely to us and would imply higher bonds prices.
- Evergrande is not a Lehman moment: As much as we believe Evergrande's equity and bondholders will bear the brunt of the burden, we view it as unlikely that this would trigger a global and systemic crisis, given the nature of its activities are less systemic than that of the financial sector. The amounts to be written-off look manageable.
- The Evergrande story adds to the risks of a sharper cooling of the real estate sector and the overall Chinese economy. Beijing's introduced several policies to deleverage the real estate sector. The main tools are the "Three-Red-Lines" approach and lending caps by the PBoC.
- The Chinese government wants a/ credit risk to be better priced, b/ to cool down property speculation and prices and c/ protect homebuyers. But it wants to avoid a property crash that would reverberate through both households (wealth effect) and the financial system (bad loans) and make the crisis systemic. So, bond holders will bear some pain, but China will work hard on avoiding detrimental chain effects.

We believe the likely default of Evergrande will not have the same systemic impact as the Lehman bankruptcy as:

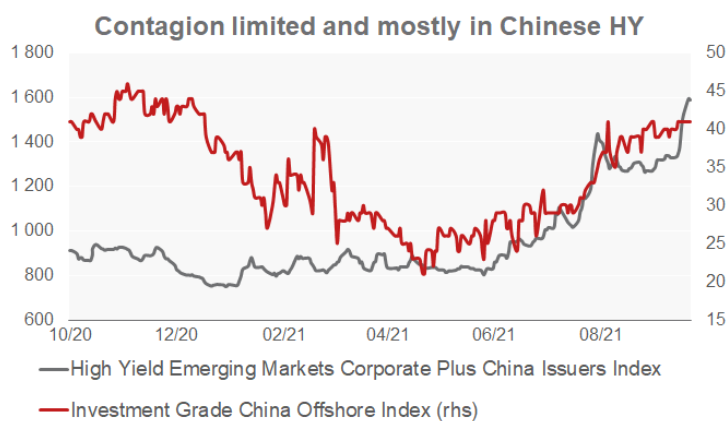
- First, Property developers are less systemic than banks, the amounts due by Evergrande are much easier to identify and are mostly due in China, where the banks are largely under control of the government. The debt amounts to just above USD300bn, of which slightly more than one third is interest-bearing debt including USD19bn of USD denominated bonds. While in the case of Lehman the debt was disseminated around the global financial system in the form of structured products, in the case of Evergrande, the creditors are easier to identify and mostly Chinese. According to S&P the Chinese banking sector can digest an Evergrande default with no significant disruption. With total debt, including onshore and offshore bonds, of about RMB571 billion at the end of June 2021, Evergrande is small relative to Chinese banks' total loans of about RMB160 trillion (0.35%) and total assets of RMB280 trillion (0.2%).
- Following the technical default triggered by the non-payment of the coupon on the USD 2022 bond, the company has a 30-day grace period to potentially find a solution to pay the coupons. Nonetheless, the most probable outcome is a resolution of the company rather than a liquidation. The company remains managed on a going concern and has rather a liquidity issue rather than a solvency issue. Moreover, in China liquidation type defaults are extremely rare cases and occur only when companies have absolutely no assets to sell which is far from being the case of Evergrande. The liquidity problems stems from the difficulty to fire sell assets, given that the property sector has already colled down and other developers are under significant regulatory constraint to contain leverage. We can expect negotiations between creditors deciding on either a debt reprofiling or a debt-to-equity swap.

The Evergrande crisis is not only an idiosyncratic/micro risk but also has a macroeconomic background. To some extent, Evergrande's troubles have been caused by macroeconomic policies. China faces a balancing act. The Chinese government wants to deleverage the sector to put it on a stronger footing, to improve the price discovery mechanism and

pricing of risk in the credit market, and to stabilise property prices while protecting homebuyers. At the same time, it needs to avoid a property crash and a crisis which would negatively affect households and financial markets and could end up cooling growth too much. This balancing act has a range of dimensions:



Source: Bloomberg, GIAM



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- **The real estate sector is systemically important.** Together with upstream and downstream sectors, it accounts for about 25% of GDP. Moreover, the sector is highly diverse. Overheating effects and extremely stretched housing affordability in large cities (tier 1) coexist with demand problems in small towns. Beijing has thus increasingly refrained from global policies and leaves it to local governments to steer the local markets. The policies in place (see below) will likely slow the sector further. Given the size of the sector, any cooling needs to be handled with caution.
- **Beijing sees risks from the leverage in the real estate sector, implying also risk for the financial sector.** Evergrande is the poster child of but not the only developer with stretched leverage. Generally, the financial sector is heavily exposed to the real estate market. Property-related loans account for more than a third of total loans. In addition, real estate is widely used as collateral which is estimated to add another 10-15% of indirect exposure. Other funds have also been (hiddenly) channelled into the property sector. However, there are also stabilising factors for the banking sector. Down payments for first homes are typically as high as 30%. Thus, mortgage loans from banks have a sizeable buffer. The deleveraging of the property sector follows on the heels of the deleveraging of the shadow banking sector. This also already restrained credit access for some developers.
- **A stronger drop in prices could imply a negative wealth effect for consumers.** However, [a recent study](#) finds that for “normal” households the wealth effects are small compared to disposable income. Effects rise with additional (speculative) property buying. Deteriorating housing affordability has a clear negative effect on consumption.
- **To de-risk the sector and to limit the exposure of banks to the real estate sector, China has installed a range of policies.** First the so called “Three red-lines” approach limits debt expansion of developers according to certain criteria. In case none of the criteria will be met, the company must not increase its debt. Initially, these rules were only binding for the 12 largest developers (like Evergrande) but seem to de-facto have broadened to all developers. Second, the PBoC introduced caps on property lending and mortgage loans of commercial banks (effective on Jan 1, 2021). The quota for mortgages limits household demand for property. This is necessary to stabilize prices as the deleveraging of the sector tends to decrease housing supply (and may thus increase prices). Third, the Ministry of Natural Resources Land announced a land supply policy reform at least for 22 major cities which intends to improve land auctions and thereby the market functioning.

The “Three red-lines” and the PBoC quota policies contributed to cool the market. In August 2021, the floor space sold in value terms decreased by 5.6% yoy on a 3-month moving average basis. House price inflation (Reuters average, there is no official average inflation rate) slowed to +4.2% yoy of late. This cooling makes it more difficult for developers like Evergrande to manage the demanded deleveraging and secure liquidity. However, in order to achieve the target of a financially sound sector, **we do not expect the government to suspend these policies. Beijing seems also willing to incur some costs.** Macroeconomically, the sector deleveraging is estimated to cost about 1 pp of GDP over 2-3 years. That said, neither has Beijing an interest to run down the sector and induce a crisis. In case the current measures in place would prove too restrictive,

Beijing can recalibrate. Moreover, we expect China's central bank to prevent any liquidity squeeze in the financial sector. Recently injected funds have been widely interpreted as a support signal. **As Evergrande is not the only "weak" developer, more failures of property firms are likely.** Generally, Beijing will work to keep them as "smooth" a possible. Home buyers' deposits will be protected.

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