

China Debt Dynamics

Evergrande: A Result of China Deleveraging and What Next

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China Evergrande Group, China's most heavily indebted property developer, is expected to default on its bonds sometime in the near future. Markets have been preoccupied with the question of whether Evergrande will receive a bailout, and if not to what extent might a default destabilize the financial system, roil credit markets, and slow the broader economy. When we look behind the current debacle to its ultimate catalyst, we see that Evergrande is simply a starkly visible symptom of what ShoreVest has for over a year been highlighting is the cause of China's significant increase in distressed and special situations opportunities: Beijing's resolve to de-risk and de-lever.

We believe the authorities are unlikely to bail out Evergrande. At the other extreme, it's also unlikely that Evergrande will formally undergo bankruptcy proceedings. Instead, we expect that Evergrande will enter into a government-led restructuring process, one that will utilize both market and state resources. It may be a long and messy process, but one that is designed to prevent financial sector instability, avoid social unrest, and minimize disruption to the economy. ShoreVest's view is that China's resolve to incur Evergrande forms of short-term pain (instead of the easier China 2009 approach or US 2020 approach of flooding the market with cash) will achieve a healthier long-term financial system. China will likely use Evergrande as an example of how well its form of government can manage the deleveraging process.

This is not a Lehman moment. Evergrande itself doesn't threaten to freeze-up China's banking system or to contract China's economy. For the most part the consequences to both the broader economy and financial system will be minor. However, it might ultimately prove a very costly exercise for both bondholders and local authorities. While we are positive in our broader outlook that Evergrande's restructuring will be good for the system, we do not believe every holder of unsecured debt (such as bonds) can rest easy.

The following report is our attempt to explain the significance of Evergrande and how it arrived at this point; what the restructuring process will likely look like; and what the implications for the economy are likely to be.

Why does Evergrande matter?

Shenzhen-based Evergrande is one of China's biggest property developers, accounting for about 5% of annual contract sales of residential housing. It has more than 800 projects spread among cities of all sizes throughout China. According to the New York Times, about 1.2 million home buyers have bought Evergrande apartments in advance of their completion and expect to take delivery of them in the next few years.

Evergrande is also the world's most heavily indebted developer. At the end of June, Evergrande had 571.8 billion yuan worth of interest bearing debt outstanding, and more than 900 billion yuan worth of payables, and mix of funds owed to suppliers and contractors, and money raised from homeowners by selling apartments prior to completion.

On August 31, Evergrande published its 1H 2021 earnings report in which it warned that if it doesn't raise new debt or sell enough assets it might not have sufficient cash to pay its debts.

"The group has risks of defaults on borrowings and cases of litigation outside of its normal course of business," it said. "Shareholders and potential investors are advised to exercise caution when dealing in the securities of the group."

In April, the Chinese press started to report that Evergrande was having trouble paying its contractors and suppliers on time and in full. Consequently, many contractors have declined to continue working for Evergrande until they get paid. Caixin recently reported that construction has stopped on more than 500 of Evergrande's housing projects. Given that the completion of some projects now looks uncertain, would-be homebuyers are unwilling to purchase unfinished apartments from Evergrande. That is further complicating life for Evergrande. Presales are a vital source of financing for the developer, and they have been declining month-on-month since May, despite steep discounts.

"If the relevant projects do not resume work, there may be risks of impairment on the projects and impact on the group's liquidity," Evergrande said in its earnings.

Since publishing its earnings report, Evergrande has defaulted on about 40 billion yuan worth of maturing wealth management products (WMPs). It had issued the WMPs to retail investors – mainly its own employees – and partially used the funds to finance its projects.

To deal with its increasing list of unpaid obligations, Evergrande has resorted to barter. Since the end of June, Evergrande has paid suppliers and contractors 25.17 billion yuan by compensating them with unfinished apartments. It has also offered WMP holders apartments in lieu of cash.

Investors have been predicting Evergrande's demise for at least a decade. It has a reputation for financial engineering which has allowed it to expand – and stay afloat – beyond what might otherwise be possible. Additionally, it has diversified into a bizarre array of unrelated businesses – electric vehicles, bottled water, online car sales, and an amusement park – in which it has no expertise, but has at times helped with fundraising.

Evergrande is finally facing a reckoning due China's new policy measures introduced in August 2020 designed to deleverage the property sector. The measures established three "red lines" – three different measures of debt – that developers aren't permitted to exceed. If a developers' debt levels exceed all three red lines then they aren't allowed to increase their debt holdings. Evergrande was in violation of all three red lines. That meant that it was no longer able to borrow more to managed interest payments on its loans, but would have to service its existing financial obligations from the income generated by its assets – something it's subsequently failed to do.

What will happen?

We don't expect Evergrande to be bailed out. Government policy has precipitated this moment and there's little about Evergrande as a corporate entity that the authorities regard as being worth saving. However, we anticipate that the authorities will do everything in their power to preserve Evergrande's projects and ensure that they're completed. Not only do the projects support an ecosystem of contractors and suppliers throughout the country, but with so many homebuyers having already paid Evergrande for housing, the projects' completion is essential for social stability.

To achieve that goal, we expect that the authorities – most likely the Shenzhen, Guangzhou or Guangdong government – will play a role similar to a bankruptcy administrator but without Evergrande formally filing for bankruptcy. There's talk that the authorities will divide Evergrande into a number of entities and deal with them individually – separating the core

real estate business from the peripheral subsidiaries – which is not unlike how they've dealt with HNA Group. We think that's a feasible approach. However, the real challenge will be restructuring the property business.

First, under the authorities' direction, Evergrande will sell off as many of its projects as possible to other developers. That will have the advantage of generating cash for Evergrande which it can use to fund construction on its remaining projects. The authorities will prefer sales to proceed on a market basis, but in some cities it's likely that interested buyers won't emerge and that local authorities will mobilize their own state-owned developers to acquire Evergrande properties. However, not all projects will be worth buying. Some projects will be so heavily indebted – from bank loans, presales to homebuyers, and unpaid bills to suppliers – that there is no economic value left. These projects will remain on Evergrande's books. Eventually, at the end of the restructuring process, a strategic investor – most likely a state owned firm – will take over what remains and inject sufficient capital to allow the company to complete its existing projects and start new ones.

Given the size of Evergrande and the complexity of its financing arrangements, this is likely to be a long, drawn-out process. It won't be until the authorities are able to unravel the depths of Evergrande's problems that they will be able to even estimate how much capital will eventually need to be injected. But until that happens, the authorities will focus their efforts on preventing financial sector instability and minimizing economic disruption.

So, who gets paid?

Politically in order to minimize social unrest, the authorities will prioritize ensuring that homebuyers get what they paid for, and that Evergrande employees get paid their wages – although probably not what they invested in Evergrande WMPs. Additionally, authorities will probably strive to ensure that suppliers and contractors get paid most of what they're owed.

If each of Evergrande's assets was liquidated tomorrow, senior secured creditors – primarily the banks and trusts – would get paid in full. Chinese banks are typically allowed to lend no more than 70% of the value of completed residential properties, 60% of completed commercial or industrial, and for construction loans no more than 60% of the original value of the land. These loan-to-value (LTV) limits are further reduced by other metrics, such as the borrower's creditworthiness and the property's projected cashflows. This means that even under fire-sale conditions most banks should be able to recoup the entire value of their loans from selling the underlying security.

However, the authorities don't want Evergrande to be liquidated – they want it to complete its projects. The authorities have already told banks to hold off on enforcing their collateral claims. We expect that senior secured creditors that have lent to projects that remain as part of Evergrande will be asked to restructure their debt. That will involve extending the maturity of the loans – perhaps in exchange for partial repayment up front – as well as a short-term moratorium on interest repayments. Some banks – most likely those with the greatest exposure to Evergrande – might also come under pressure to swap some of their debt for equity in the restructured company.

Bondholders, on the other hand, are unlikely to get paid in full – and holders of Evergrande's offshore dollar-denominated bonds even less likely. Bond defaults don't threaten social stability in the same way that unpaid employees or out-of-pocket homebuyers do. Moreover, they don't have a secured claim to Evergrande's assets like banks do. Therefore in Evergrande's current crisis, unsecured bondholders are in one of the worst positions.

Offshore bondholders are even more exposed (see the box below). However, assuming that Evergrande doesn't formally enter bankruptcy, if Evergrande ever wishes to access international capital markets again then we don't anticipate offshore bondholders will walk away with nothing.

The Dangers of Structural Subordination on Offshore High Yield “Bonds”

For over a decade, we have been saying that investors in Chinese credit are ill-advised to think that rated bonds or other offshore debt (such as private loans invested by foreign funds in Hong Kong) are “safer” than ShoreVest’s onshore first-lien real estate-backed debt. Nonetheless, US dollar denominated high yield bonds by Chinese issuers dominate the Asian high yield market with over US\$150bn in issued value outstanding, which represents over [60% of the Asia high yield market](#). These securities have been popular amongst institutional and HNW investors because getting exposure in Hong Kong is easier than going onshore, and because of their attractive spreads relative to [similar rated instruments elsewhere](#). However these securities are gravely misnamed; in fact the bonds are more like preferred equity securities, being senior only to the offshore common equity in a liquidation event.

The logic is simple: For Chinese high yield issuers, the bulk of which are real estate developers, almost all the hard assets are onshore in the PRC. In the case of Evergrande, [~25% of its financial borrowings were denominated in USD and HKD but less than 5% of its real estate assets are offshore](#). As the Chinese legal system gives priority to onshore creditors in a liquidation, this serious mismatch in the jurisdiction of assets and liabilities (which is not atypical) puts offshore creditors in a risky situation. Onshore creditors (including creditors which are unsecured) may take most or all the value of onshore asset liquidations, while offshore bondholders are left with crumbs. Legal instruments like keepwell deeds have proven to be flimsy protection at best and entirely unenforceable at worst.

By contrast, onshore first-lien real estate backed debt (even defaulted debt such as NPLs) has long been prioritized by courts and Beijing. For example, in the last few years, ShoreVest has held the senior NPLs of two property developers that went into bankruptcy. In one case, in 2018 we purchased an Wuxi developer’s NPL, enforced it in the courts, and all the cash from the collateral auction was paid to ShoreVest in less than a year. In another case, our 2017 purchase of a Suzhou developer’s NPL resulted in full repayment of our mortgaged amount in thirteen months.

Therefore, in order to get safe exposure to Chinese credit risk, a prudent investor will seek to ensure they enjoy some form of onshore security, ideally on segregated collateral. This ensures that should the borrower default, there is direct recourse to onshore collateral and avoids the situation where onshore creditors take everything and nothing is left for the structurally subordinated bondholder.

What does this mean for China's economy?

Even though China's banks likely have sufficient collateral to cover the value of most of their loans, a significant portion of loans to Evergrande will have to be recognized as nonperforming loans (NPLs) – at least in the short term. This will mean that under current NPL recognition rules (which, [as we have written](#), have become more strict), banks will need to increase impairments which will mean some will need to raise fresh capital in order to meet minimum regulatory requirements.

Crucially, this process will not be destabilizing to the financial system because the process for recognition and disposal of NPLs has been in place for years. That said, there's been much discussion in the Chinese press that Liaoning province-based Shengjing Bank might need state support – not because of its loans to Evergrande, but because of a disproportionately large holding of Evergrande bonds. This makes Shengjing Bank an outlier. Most of China's banks hold very few corporate bonds on their own balance sheets. The majority of corporate bonds are held by bank-issued wealth management products (WMPs). As recently as a couple of years ago, banks routinely took responsibility for losses incurred by their WMPs. However, under new rules they are no longer able to do so.

Compared to the noise in the press, we believe the real impact on the economy is likely to be fairly muted. Clearly, it's unlikely that Evergrande will start any new projects over the next year, and it might struggle to resume work on some

existing projects for some time yet. But Beijing could conceivably make up from the decline in construction by approving more local government public works programs or other forms of support.

The impact on the housing market is harder to discern. A lot of China's developers are under financial stress because of the three red lines. Two other large developers have already defaulted this year and many others are clearly dealing with cash flow problems. If, because of Evergrande, Chinese consumers become less willing to pay for housing prior to completion, then more developer defaults are likely. Still, even without a default by Evergrande, many developers will likely be facing an extended period of stress.

Conclusion

We anticipate that the authorities won't bail out Evergrande. Despite its size, a default will cause only a muted disruption to the financial system and broader economy. Evergrande's crisis will, nonetheless, require extensive involvement on the part of local authorities to guide Evergrande's restructuring and deploy their own funds where necessary to ensure construction on projects continues. And unsecured creditors will be the ones to take a more significant hit.

Bigger picture, China's efforts to de-risk and de-lever its system shows a resolve to take short term pains in order to foster a longer-term health. Outside of Evergrande, other results of this deleveraging effort include last year's >3 trillion yuan of NPL disposals (twice the 2017 number), as well as the >20 trillion yuan reduction in the shadow banking system since 2016, each of which is producing opportunity for distressed and special situations investors in China.

ShoreVest Management

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