21 September 2021

Research China

The Evergrande situation and what we expect

Bottom line: We expect the turmoil related to Evergrande to get worse before it gets better. But we believe the Chinese government will eventually intervene as the alternative could be a financial crisis with very severe effects on the Chinese economy and the Chinese people. The government needs to strike a balance between on the one hand show that irresponsible behaviour has a price and reduce moral hazard issues in the credit market and on the other hand not allow a financial crisis to unfold. The Chinese mini-crisis adds another headwind to Chinese growth this autumn.

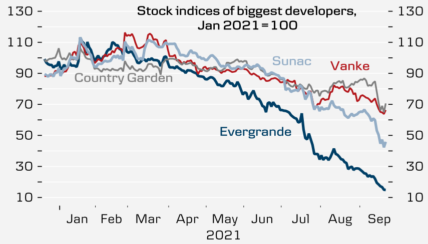
Background:

- **The Chinese property sector is around 25% of Chinese GDP** if both directs effects from construction as well as indirect effects from upstream and downstream industries included. The developer market is highly fragmented with many players. Evergrande is the second largest developer but only has a total market share of 4%.
- **Some developers, including Evergrande, have very high debt levels after many years of expansion** and some of the companies used very creative financing tools as supplement to normal debt and bank loans. Most of the debt is domestic but offshore bonds have also been issued. Evergrande has debt worth USD300 bn equivalent to 2% of Chinese GDP.
- **After many years of growing debt levels, China put fighting financial risks on top of their agenda five years ago**. In 2020 they tightened rules for developers putting limits on the debt and increasing requirements on liquidity (the so-called "three red lines" regulation).
- **The new regulation has created challenges for the most leveraged developers.** Evergrande is one of them. When the housing market cooled down significantly this year after policy tightening, Evergrande has faced a liquidity crisis. For more info on Evergrande see box below.
- **On top of bank loans and issuance of bonds some financing for developers are through Wealth Management Products sold directly** to Chinese citizens. There is a rising risk that they will start redeeming their money when possible and thus cut off a funding channel. Losses on these products could also lead to widespread protests.

How bad are markets hit?

- **Chinese stock markets have taken a big hit** with offshores equities trading close to lowest levels in six years. Developer stocks have declined significantly over the past week and high yield financing costs are the highest in a decade at 14%. We believe the domestic contagion has reached a point where intervention from Beijing is needed to stop the snowball that has started to roll.
- **Until this week contagion to global markets has been limited** but in recent days global risk sentiment has been hit. S&P500 dropped 1.7% on Monday.

Contagion to other developers accelerated over the past week



Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Bloomberg

China high yield market taking a very big hit raising financing costs for companies

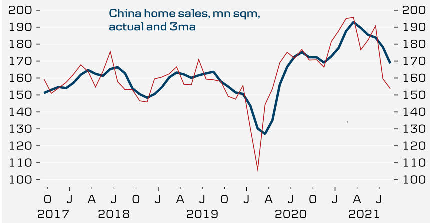
Note: Past performance is not a reliable indicator of current or future results.
Source: Macrobond Financial, Bloomberg

Chief Analyst
Allan von Mehren
+45 4512 8055
alvo@danskebank.dk

What do we expect to happen?

- **Evergrande needs to pay interest payments on Thursday including a coupon worth USD83.5 mn**. Rating agencies generally expect Evergrande to default on these and have downgraded the company over the past week. The company has USD669 mn coupon payments remaining this year. We believe a default could trigger further contagion in Chinese markets with some spill-over to global markets. A circuit breaker is needed, in our view, to calm investors and stop the current negative spiral.
- A key question is: when are things bad enough for Beijing to step in? And how will it be done? One scenario is that Evergrande ends up in bankruptcy but that the government will try to ringfence the company to avoid contagion. This might be done by ordering state banks to buy high yield bonds in the market and at bond issuances by other developers. And that state banks lend developers money enough to avoid others from defaulting. A cut in the reserve requirement ratio could free up more liquidity in the system for banks to buy bonds. Once the government shows its' hand in the market, other investors will probably step in and buy credit bonds again. A big gain could be made if credit bond yields decline subsequently from current high levels. Much like investors started by Spanish and Italian bonds when the ECB said they would do "what ever it takes" in July 2012, which basically ended the euro debt crisis as it removed the refinancing and default risk for periphery countries.
- A worse case scenario is that Beijing does not intervene. That could lead to a severe crisis as domino effects would lead to a financial crisis. A middle scenario would be that they intervene but very late and that global financial markets and global economy will take a big hit before things turn around again.
- Our baseline scenario is that Evergrande defaults this week and that things will get worse before it gets better. The timing of when it gets better is very difficult, as it depends on 1) how bad markets develop and 2) Beijing's patience before stepping in.

Housing has cooled sharply this year in China



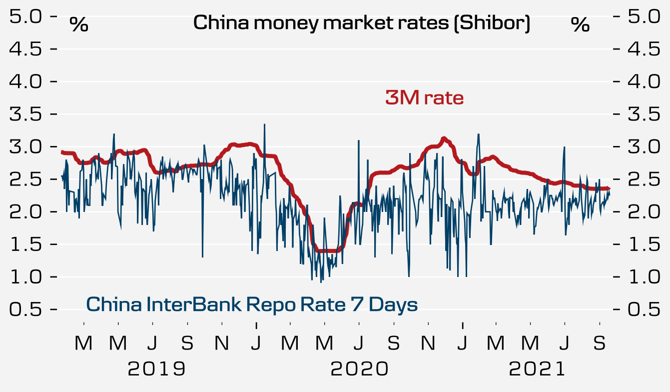
Source: Macrobond Financial, Bloomberg

Box: Facts on Evergrande

- Second largest developer by sales
- Based in the southeastern province Guangdong, China's most populous province.
- App. 4% market share of Chinese developer market.
- Debt estimated around USD300bn equivalent to 2% of Chinese GDP
- More than 200,000 employees.
- More than 8,000 upstream and downstream business partners.
- More than 800 projects under construction, around half halted due to the cash crunch.
- Has been selling assets at discounts of 30-40% (land and property) to raise liquidity to pay interest payments.
- Depends on short-term commercial paper with interest rates of 15-16% to pay construction partners and suppliers.
- For bank loans, executives and employees are often required to put in own money as well. Internal crowdfunding has taken place with names like "super return treasure" offering 25% return.
- The company also raised money through Wealth Management Products (WMP) to Chinese people and construction partners offering 5-10% return with minimum investment of 100.000 yuan (15.000 dollars). 40 billion yuan of WMP's are now due.
- End of June it had assets worth 2.38 trillion yuan and liabilities of 1.97 trillion yuan. It has big off-balance sheet debt as well through different financial structures.

Source: Caixin Global, Bloomberg, South China Morning Post

No stress in money markets yet (note markets been closed Monday and Tuesday due to Chinese holiday)



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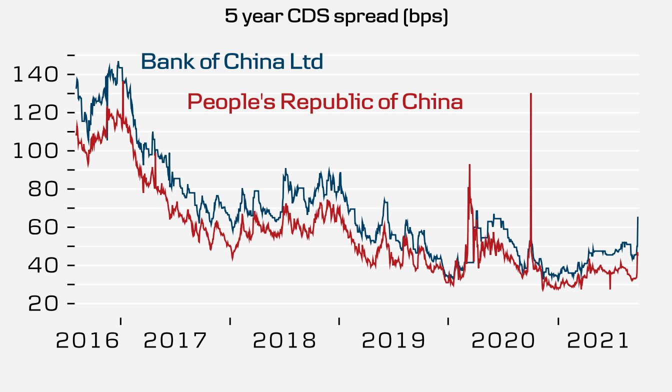
Source: Macrobond Financial, Bloomberg

CDS spreads on major banks and the government have not increased a lot



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