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CHINA FOCUS – A NOTE ON THE EVERGRANDE

The potential default of Evergrande has shocked the market globally. Its massive total liabilities of RMB2 trillion (~EUR260 billion) and potential chain effects reminisce the fall of Lehman Brothers. Our investment expert, Antony Cheng, China Desk would like to present our view and describe how large the contagion risk would be.

SHORT-TERM IMPACT

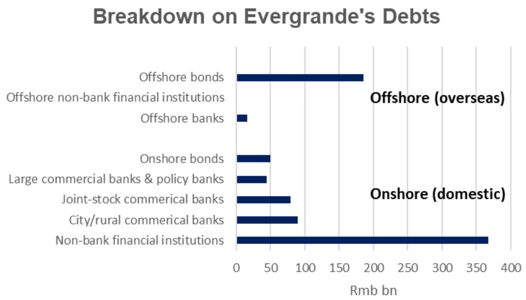
We think the shock to the economic growth and financial market is not over. With annual sales of RMB500bn (0.5% of China's GDP), and trade payable of Rmb950bn, there will be large impacts on the upstream and downstream of the property sector. Property prices will likely be affected too, leading to negative sentiment on consumption and investment. Already there are domestic-listed companies in construction and chemicals announced default because of Evergrande. The market is concerning if that could turn out leading to a chain default of even financial institutions.

But unlike Lehman Brother in 2008, Evergrande, if turns out default and collapse, has not been a big surprise to the market. The credit problem of Evergrande has been well-known as seen from its high cost of debt issuance in the past few years. Private banks in Hong Kong are helping it to issue ~11-13% coupon debts which is extremely high compared to issuers of similar size. So this is not Lehman Brothers which maintained a "A" rating just 6 days before the collapse.

HOW THE FINANCIAL SYSTEM WOULD BE SHOCKED?

Knock-on impact to the whole banking system is contained. Evergrande had long been a company that banks put special caution on. Therefore, large and listed banks have been limiting their exposure. The below chart shows Evergrande's breakdown on interest-bearing borrowing:

Breakdown on Evergrande´s Debt



Source. Media disclosure of Evergrande's letter to local government. Data as per 30.06.2020

There are a few points to note:

1) Impacts to large banks (i.e. the Big Four) are limited as they account for less than 5% of Evergrande's total borrowing. They would be able to absorb the contagion effects.
2) City/ rural commercial banks are heavily loaded on their size but they are mostly unlisted and owned by local governments, which means the central government would have final obligation to inject capital if needed.
3) Non-bank financial institutions means insurance and trust companies. Insurance in China is oligopolized and are the most healthy and solvent form of financial institution in China and they are heavily regulated; trust is a big concern as they are insufficiently capitalized and they package debts in wealth management products. This is called shallow banking in China but the size has been shrunken massively in recent years. Due to a high saving rate of individuals, there are still strong demand for such products that usually provide mid-to-high teens returns. If defaulted,

this could be a big social problem (the main concern of the government), but for financial institutions the shock would be limited.

4) Apart from private bank clients, foreign bond funds were also active buyer of Evergrande's offshore bonds. From Morning Star data, bond funds under BlackRock, HSBC and UBS were the major buyers. But those bonds only account for less than 2% of their respective fund size.

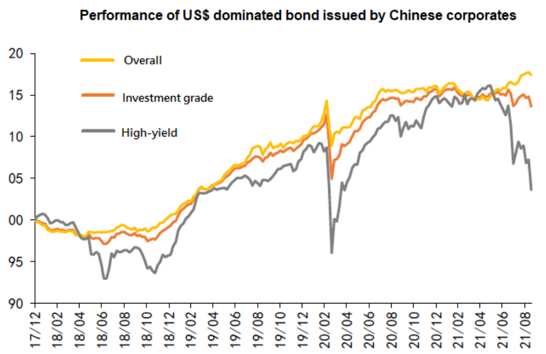
On more point to note, banks' direct loan to property developers have been declining since 2019, thanks to the "Three Red Line" policies announced last year (but that also partly led to Evergrande's debt crisis). Currently, from data on all listed banks, direct commercial loan to property sector accounted for only 6.2% of the total. Mortgage loan accounted for some 30%, but the equity ratio or downpayment ratio for that is very high, again very different from the US in 2008. At the end of 1H, NPL ratio of commercial banks in China stood at 1.76%, provision coverage ratio at 193.2%, and Core CAR at 10.5%, all has been on healthy trend in recent years.

Back then, Lehman's debt or packaged debt covered properties, equities and its business was large across major financial market globally. Further, it was ill-capitalized with only 3-4% of its liabilities, and more are off balance sheet. Evergrande's liabilities are visible on its statements, and institutional creditors are sufficiently aware of the risk, perhaps except individuals who bought the wealth management

MARKET RESPONSE NOT OVERLY NEGATIVE

While we knew that the global market was impacted, we notice some positive signs: Other indebted and sizable property developers like RF Properties announced injection of capital from its major shareholder, and was well-received, leading to a strong price rebound after the announcement; large and state-owned developers are actually outperformed the market as a whole, which hints that the market does not believe there would be a collapse in the property price in China. Also, offshore Chinese investment grade bonds are actually seeing increase in prices amid the turmoil, unlike early last year when the pandemic caused slump across all types of bonds. While it is too early to judge the ultimate market impact, but again it is not likely a Lehman-type of shock.

Bonds performance issued by Chinese corporates



Source: Bloomberg, Data as per 23.09.2021

HOW THE GOVERNMENT MAY DO TO MITIGATE THE IMPACT

The government has expressed the will to stabilize the long-term development property market. There has been pressure for Evergrande and local governments to deliver its contract sales. Therefore we do not foresee a sudden blackout. A series of actions are likely, such as maintaining its construction credit of its major banks, interest-free period of bank loan, short-term liquidity from policy banks/ government vehicles, or even bad debt company to take over the loan ultimately. Nonetheless, it is expected that the shareholders' interest would be placed the least as the government may take part in the shareholding at a deep discount.

WHAT WOULD BE THE IMPACT BEYOND THE SHORT-TERM TURBULENCE?

As said, the government has been in hard stance towards the property sector especially since last year. Going forward, it is unlikely to have more harsh policies on the sector. It is going to be hard for non-investment grade Chinese companies to issue bonds overseas. Yet, coupling with the slow-down economic data released early in the month, the Chinese authority is likely to pause its tightened monetary stance, followed by increasing infrastructural expenditure.

In fact, the People's Bank of China has massively increased the reverse-repo this week to raise market liquidity.