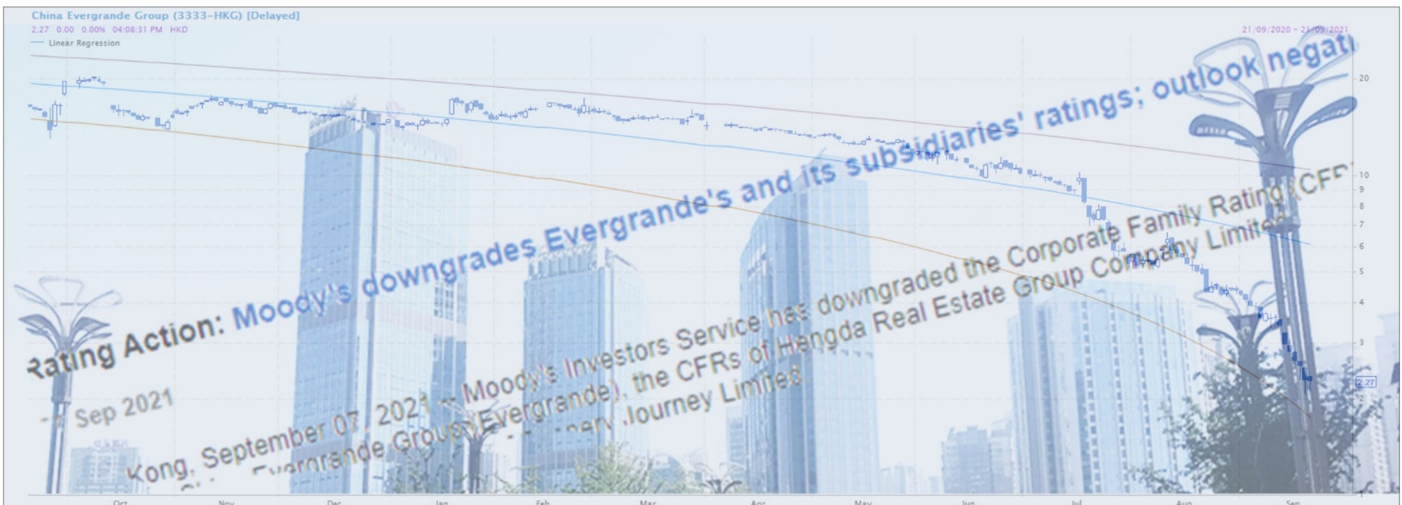
Be it ever so grand, a castle still needs financing

by TriLake Partners' resident moat cleaner



It's been called the world's most indebted property developer, a 300-billion-dollar time bomb, and—in many stakeholders' hopeful minds—too big to fail. And it is now the focus of investors' attention as the Typhoid Mary of a possible contagious conflagration in the emerging markets and beyond: Can the problems of China Evergrande Group snowball into something more serious that will affect regional and global capital markets and economic growth?

The short answer: Nobody knows for sure.

Pundits have pointed out a few similarities between the Evergrande problem and other high-profile episodes like Long-Term Capital Management, the Asian Financial Crisis, Lehman Brothers, the Global Financial Crisis, etc. And while Evergrande has some financial subsidiaries and widely distributed wealth management products, it is primarily a real estate development group. We don't expect the same apoplectic shock where credit stopped flowing from fear of counterparty failure. The lifeblood of capital markets continue to flow.

While the ripple effects around the world may not come close to the aforementioned crises, we are definitely feeling the anxiety engendered by the impending default—or at the very least, restructuring—of China's second-largest property firm. Pre-Covid, real estate accounted for 10% of China's GDP. That number doubles if we add construction and other related industries. In turn, China accounts for over a quarter of the world's annual GDP growth. Evergrande may not derail the nascent economic recovery as many countries start the transition to living with Covid but it certainly comes at a fragile time. So why now when we've known for years of Evergrande's excessive leverage?

Why now?

China was the first major economy to return to pre-Covid GDP levels around this time last year. The government embarked on a series of regulatory

tightening that affected most private sectors of the economy. Cleaning the rain gutters while the sun shines, I suppose. Focussing on the property sector, the government sought to put a lid on the growing debt of real estate companies. Debt is of course a way to finance your company growth, often cheaper than equity or bank borrowing. But the degree to which Chinese developers could keep borrowing now had to pass the so-called “three red lines” simplified below:

- A 70% limit on (debt/assets)
- A 100% limit on (debt/equity)
- A 100% limit on (short-term debt/cash)

Evergrande found itself in a liquidity crunch and started offering discounts of up to 30% to property buyers. It also started selling off assets and spinning off subsidiaries. Ironically this aggressive deleveraging may have weakened Evergrande. As the economy slowed down over the last year—much of which was engineered by the government—demand for property also abated, further compounding Evergrande’s woes.

What now?

It is a guessing game as to what extent, if any, the government intervenes. Finding a white knight at this time is not likely. Country Garden just “helped out” Guangzhou R&F by buying some its core assets. (At a Bloomberg Twitter event, Matthew Brooker likened it to JPMorgan buying Bear Stearns while Lehman collapsed in 2008.) It’s worthy to note that state-owned enterprises like Yongcheng Coal, Huachen Automotive, and Tsinghua Unigroup have been allowed to default this past year.

Evergrande founder and chairman Xu Jiayin, promised to repay all maturing wealth management products on time. He could be left with nothing, he said, but not their investors. Brave words at a time when many creditors are trying to maximise any possible recovery. They must fall in line behind employees who were practically forced to put a percentage of their compensation into those products, contractors and suppliers needing to be paid. Some might accept proposals to take property in lieu of payment or drawn-out cash instalments.

The Chinese property industry may see some consolidation and the healthier companies may even benefit in the longer term. Reducing Chinese investors’ obsession with property would also be beneficial. President Xi Jinping has declared that “housing is for living, not for speculation.”

Banks with significant exposure to the weaker players in the sector may be punished with wider spreads. And if borrowing costs rise and stay elevated, this could lead to more defaults that may not be confined to the property sector. For now there is scant evidence of such credit issues.

While China may not be deviating from the path towards a market-driven economy (yet), that path has shown more potholes over the last year. The impetus to curb excessive debt, wealth and income inequality, the concentration of power in a few corporate giants in certain private sectors and the drive to “common prosperity” may all be well and good. But we are also served a reminder that there is only one thing that is too big to fail in China and that’s the Party. They have shown their willingness to let the debt go bad and only step in when they deem the troubled firm to be economically important as they did with Huarong Asset Management. Will the Party deem Evergrande as economically important as Huarong? The market is betting against that.

Credit rating agency S&P Global does not expect any direct support from the government and believe that “the Chinese banking sector can digest an Evergrande default with no significant disruption… It is not too big to fail.”

Disclosure: TriLake Partners has no exposure to any debt or equity securities issued by Evergrande or its subsidiaries. Our investee funds do not have Evergrande exposure either, although one fund reports a small—less than 1%—investment in bonds of four large Chinese firms that are primarily in the real estate sector.

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