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China property developer Evergrande's bond default imminent, is it too big to fail?

Evergrande is founded by Hui Ka Yan in 1996, the company has grown fast, and it has diversified into sectors from real estate, electric cars, soccer club, entertainment to wealth management. Evergrande Real Estate owns more than 1,300 projects in over 280 cities. It was committed to build the equivalent of about 1.4 million individual properties, according to Capital Economics.

Evergrande has been struggling with a liquidity/debt crisis and is saddled with more than $300 billion liabilities. A statement issued by the company also said that its cash flow was under "tremendous pressure" as it is not able to sell assets fast enough to service its liabilities. The announcement came just hours after protesters besieged the company's headquarters in Shenzhen on Sept 13. They called on the company repayment of its loans and financial products.

Bond downgrading

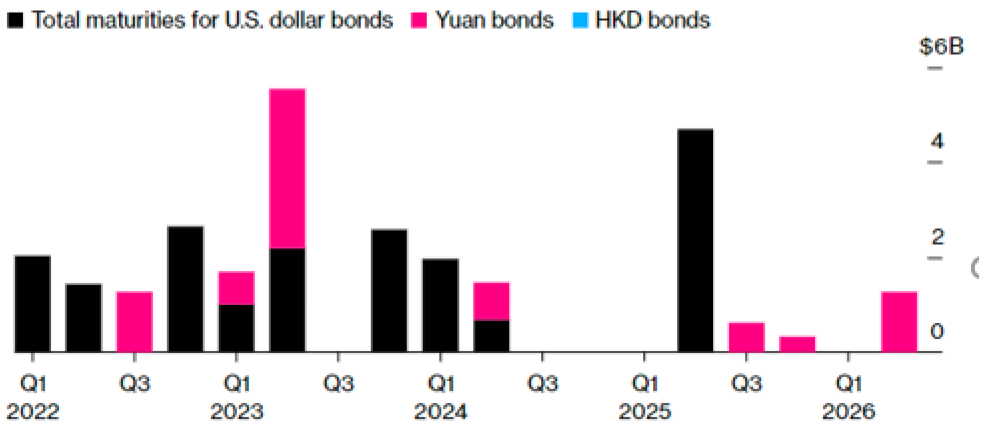
Evergrande, due to the concerns on its inability to repay its tremendous debts, have been repeatedly downgraded by ratings agencies as it has been almost impossible to raise the money needed to meet the repayments.

Evergrande was notified on September 15 from Chinese rating agency Chengxin International that the bonds' ratings had been downgraded to A from AA, and being put on a watchlist for further downgrades. Moody downgraded the corporate family rating (CFR) of China Evergrande to "Ca" from "Caa1", with a negative outlook. Fitch downgraded Evergrande to "CC" from "CCC+", flagging a "probable" default.

Chinese banks were warned by authorities earlier this month that the company wouldn't be able to meet interest payments on loans due Sept 20, according to several reports. Although the company has raised about $8 billion as of August 2021, by selling shares in its EV unit (Heng Ten), a Hang Zhou Property firm and a regional bank, it is still far from enough to repay all its current liability. The payment due could wrestle with a liquidity crisis and potentially lead to cross default in the property sector and the broader financial sector.

Coming Due

Evergrande needs to repay some $7.4 billion of maturing bonds next year.



Source: Bloomberg
Note: Totals for HKD and yuan-denominated debt converted into U.S. dollars as of Sept. 14.

Some analysts have suggested that the company's debt problems could pose widespread risks to the financial system, as hundreds of housing projects remain unfinished and more than a million people are waiting to move into new homes, payment delinquencies to suppliers. Another potential flashpoint is whether Evergrande can repay high-yield financial products that it sold to thousands of retail investors, including many of its own employees. The stock price has cratered and its bonds seemed to be defaulted. With $300 billion in liabilities and links to myriad banks, if Evergrande falls down disorderly, it could send shock waves through the financial system and the broader economy should calamity strike.

Any chance of government bailout?

Although we believe it is not very likely for the Chinese government to give direct support to Evergrande, after months and years spent trying to cool the country’s hot property market and force it to deleverage, we are quite sure that the Chinese government could step in to avoid any disorderly fall out of Evergrande as it may lead to significant risk to the financial market as a whole.

There is a market rumor that the Chinese government has instructed Guangdong provincial authority to map out a plan to manage the firm’s debt problems, including coordinating potential buyers to acquire its assets. There is also a market rumor that regulators in September signed off on a proposal to let Evergrande renegotiate payment deadlines with banks and other creditors, paving the way for another temporary reprieve.

In fact, China has been trying to cut down on the piling up debts in real estate sector, setting strict new rules on how developers find financing - 3 red lines deleveraging campaign to improve the financial health of real estate industry in China. The new policy seeks to ensure sustainable growth within the industry by setting caps on the amount of debt that can be held relative to the liability-to-asset ratio, net gearing ratio, and cash-to-short-term debt ratio.

Is it too big to fail?

The China government is in a dilemma, either a tolerance for risky bets in the belief that the state will always bail those default companies out. It might unwillingly signal a kind of acceptance of such risky behavior, and other companies can interpret the bailout as reassurance that government will bailout them eventually. Or allowing a big, interconnected company like Evergrande to collapse would reverberate across the financial system and also lead to sufferings of many millions of Chinese homeowners. Such pain could weaken the economic growth, endanger the financial stability and most importantly, stir social discontent.

YongCheng Coal, Huchen Automotive and Tsinghua Unigroup, all state-owned enterprises defaulted over the past years. Huarong Asset Management, one of the China’s big four stated owned debt collectors served as a prime example. The firm announced that it would delay to report its annual financial statements, which triggered collapse in bond prices. Huarong’s failure had the potential to send shock waves through the entire economy. After months of back-and-forth, a $7.7 billion bailout was arranged in which Citic Group and other state-owned investors would inject the company with liquidity. This has been the first clear case of a company that was “too big to fail.” Evergrande’s 300 billion liabilities exceed Huarong’s total liabilities of $238 billion.

Thus, we believe that Evergrande would be similar as Huarong’s situation. The China government will not let Evergrande to fall down disorderly. The China government will step in to prevent any crisis and also try to minimize the negative impact from the Evergrande fall down. However, it just means that the fall down of Evergrande will not lead to any financial crisis or economic recession to China, it does not mean that the China government will also bail out the investors who purchased the Evergrande’s equity and bond.

Fears over a potential contagion on Evergrande issues has triggered a selloff spreading across the globe on. Evergrande shares ended Tuesday's trading in Hong Kong plunged by almost 12%. The firm's shares have fallen by more than 80% after it outlined the extent of its financial problems

Source: Bloomberg

Source: Bloomberg, CNBC News, Reuters, Financial Times, Capital Economics

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