China

The Evergrande Crisis

The ongoing crisis at the debt-ridden real estate giant Evergrande has not only roiled global investors, but also raises doubt if China's real estate construction boom is over.

As of now, the saga of China's imploding real estate giant Evergrande remains on everyone's lips. 1.5 million home buyers across China are left in the lurch. Overseas investors have their fingers severely burnt. Worries of contagion multiply as building contractors, suppliers, lenders, and others in the banking and financial services sector remain jittery. Suspicions of underhand dealings are rife. Fear of a possible Lehman Brothers moment begins to surface. Regulators in many provinces are on high alert. Beijing is sourly rattled.

What is Evergrande, and how has it got so big?

Evergrande, like some of China's post-reform trail-brazing entrepreneurs, is something of a rags-to-riches story, but with an uncertain ending. It is one of China's largest real estate developers and is part of the Global 500, meaning that it is also one of the world's biggest businesses by revenue. Based in the southern Chinese city of Shenzhen and listed in Hong Kong, it employs about 200,000 people. It also indirectly helps sustain more than 3.8 million jobs each year. Founded by Chinese billionaire Xu Jiayin, also known as Hui Ka Yan in Cantonese, who was once the country's richest man, Evergrande made its name in residential property and boasts that it "owns more than 1,300 projects in more than 280 cities" across China, but its interests extend far beyond that. Other than housing, the group has invested in electric vehicles, sports and theme parks. It even owns a food and beverage business, selling bottled water, groceries, dairy products and other goods across China.

The behemoth's founder Xu Jiayin (*Hui Ka-yan* in Cantonese) was born in a village in Gaoxian, a town of fewer than 50,000 residents in central China's Henan province. Raised by his paternal grandmother, he studied metallurgy at the former Wuhan Institute of Iron and Steel, before finding work in the local steel mill.

Inspired by Deng Xiaoping's reform policies, he quit his steel job in 1992 and headed for the "el dorado" in southern China, where he rode the rising tide of entrepreneurship, replacing communal ownership with private properties.

In 1996, Xu founded Evergrande in Guangzhou, building and selling high-rise apartments in a frenzied housing market barely 10 years old. The market

Why Would It Matter If Evergrande Collapses?

There are several reasons why Evergrande's problems are serious:

- Firstly, many people bought property from Evergrande even before building work began. They have paid deposits and could potentially lose that money if it goes bust.
- There are also the companies that do business with Evergrande. Firms including construction and design firms and materials suppliers are at risk of incurring major losses, which could force them into bankruptcy.
- The third is the potential impact on China's financial system."The financial fallout would be far-reaching. Evergrande reportedly owes money to around 171 domestic banks and 121 other financial firms," the Economist Intelligence Unit's (EIU) Mattie Bekink told the BBC.
- If Evergrande defaults, banks and other lenders may be forced to lend less.This could lead to what is known as a credit crunch, when companies struggle to borrow money at affordable rates.
- A credit crunch would be very bad news for the world's second largest economy, because companies that can't borrow find it difficult to grow, and in some cases are unable to continue operating. This may also unnerve foreign investors, who could see China as a less attractive place to put their money.
- The very serious potential fallout of such a heavily-indebted company collapsing has led some analysts to suggest that Beijing may step in to rescue it.

Courtesy: BBC

was dominated by large state-owned developers with capital and access to the best locations. But their apartments were large and priced beyond common affordability.

Xu kept his focus on affordable housing. As latent explosive demand for private housing was unleased, he borrowed relentlessly to build quickly at low costs, pre-selling his apartments off-plan to the nation's burgeoning property-hungry middle class, and using the high turnover and readily-available borrowing to generate a reservoir of cash-flows to fund rapacious growth.

Relying on binge borrowing or what seemed a license to print money, Evergrande operates in 170 cities across many provinces, including Guangzhou, Tianjin, Shenyang, Wuhan, Kunming, Chengdu, Chongqing, Nanjing, Zhengzhou, Luoyang, Changsha, Nanning, Xian, Taiyuan, and Guiyang.

According to the *South China Morning Post*, as early as 2017, Evergrande became the world's biggest property developer by sales, surpassing its long-time rival Vanke. Its total assets were estimated at $325 bn. Xu topped the *2017 Forbes China Rich List*, with his wealth estimated at $42.2 bn.

Overexuberance

Along came Xu's baubles and trophies. Evergrande bought a football team in 2010, spending lavishly to sign up international players. Guangzhou Evergrande FC, China's richest football club jointly owned by the Alibaba

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SBS, FRSA

Group, won seven consecutive tournaments in the Chinese Super League that year.

More than 90% of China's households own homes, 87% in urban and 96% in rural areas. As a quicker way to get rich, some through speculation, more than 20% of Chinese households own multiple homes, higher than many developed nations. By some estimates, while the $5 tn property market represents some 7.3% of China's GDP, the housing-related market—including real estate development and associated industries from steel to cement—accounts for 25 to 29% of GDP.

As the private-housing fever swept through China, homeownership has become a national norm, with urban property values rising continuously upwards. Urged on by status-conscious prospective in-laws, few young people dare getting married without securing a foothold on the housing ladder. Aided by shadow banks and other related financial or "wealth management" products tied to the property, speculation is rife.

Writing on the wall

The writing was on the wall at the end of 2016 when Chinese President Xi Jinping warned that "houses are for living in, not for speculation". This was followed by a continuous stream of measures and diktats to tighten the housing market and rein in speculative activities.

In 2017, Hainan Airlines and another property giant, Wanda, were forced to sell overseas assets and domestic investments in a deleveraging campaign to defuse financial risks. Some of the nation's property fever began to subside.

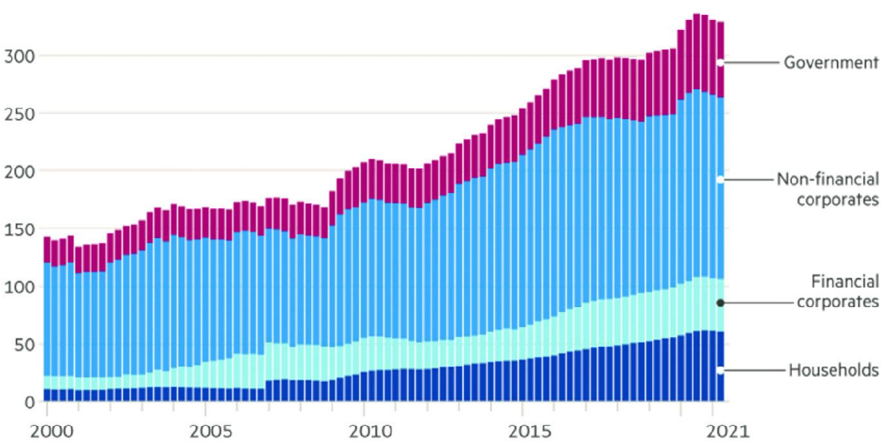
The last straw came in August last year in the form of Beijing's "Three Red Lines" for borrowing by property developers: liability-to-asset ratios of no more than 70%, net-debt-to-equity ratios of no more than 100%, and a cash-to-short-term borrowing ratio of at least one. This spells the end of the road for Evergrande's no-debt-too-large, fast-turnover, and pre-sold properties model.

Greed is blind

Still insensitive to the changing winds, the company branched out into the capital-intensive business of making electric cars through its China Evergrande New Energy Vehicle Group. Seven months later, when the bubble burst, with $75 bn of Evergrande's market value wiped out, the venture is yet to produce a single car.

The Debt Explosion That Followed the Global Financial Crisis

Chinese debt as a % of GDP, by sector



Source: Institute of International Finance
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According to Reuters, the company, which has more than $300 bn in liabilities, missed on October 11 the third round of interest payments on its dollar bonds in three weeks, triggering multiple credit-rating downgrades. It is now being dismissed as the world's most indebted property developer and is on the brink of collapse. On October 15, it failed to sell its $1.7 bn Hong Kong office tower to state-backed Yuexiu Property.

The situation of the entire housing market is grave. Developers have run up huge debts. Now home sales are down, Beijing is imposing borrowing curbs and buyers are balking at high prices. Contractors and suppliers are feeling the squeeze. Beyond Evergrande, China's property market faces a $5 tn reckoning, according to *The Wall Street Journal*, dated October 10.

Contagion worries are pushing China's spreads to record highs. Some fear a Chinese Lehman Brothers moment.

Calming the nerves

On September 23, Federal Reserve Chairman Jerome Powell reassured markets by confirming that the Evergrande situation is unique to China and has no parallel to the American experience. Powell further noted that major Chinese banks were "not tremendously exposed" and the Chinese government had put new structures in place for highly leveraged companies.

While Armageddon may be averted, market jitters linger. The Chinese government appears to have adopted a relatively low-key response, relying on the company's restructuring and coordination by local governments. Pain is expected all around as Beijing plans to take advantage of the crisis to finally rein in the market's excesses. To avoid moral hazard, Chinese authorities are loath to directly bail out Evergrande, but they are keen to prevent a complete collapse. Proven tricks are likely to be deployed, including debt roll-over, haircuts on assets, and emergency payments to vulnerable underdogs, to avert social unrest.

Evergrande has appointed US restructuring experts Houlihan Lokey and Hong Kong-based investment bank Admiralty Harbour Capital to help with its restructuring.

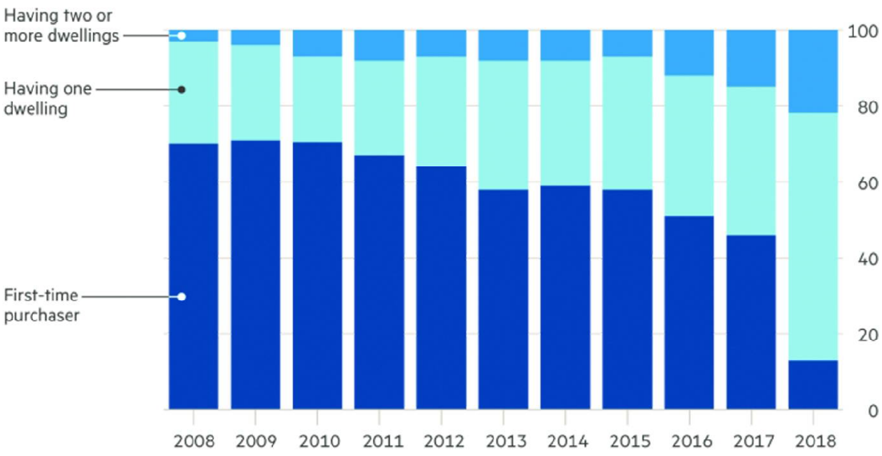
According to a research note by Natixis, a French bank, Evergrande's creditors would not be treated equally. Households will be the top priority for the Chinese government, followed by suppliers. Banks will probably be the next, followed by onshore bondholders, which are anyway small. Offshore bondholders are likely to be last in the queue.

Contagion fears

Meanwhile, signs of contagion are rearing their heads. According to the *South China Morning Post*, dated October 12, another risky Chinese developer, Sinic Holdings, has $694 mn in dollar bonds outstanding and has already missed domestic payments last month. Modern Land (China), a Beijing-headquartered developer with $1.35 bn of dollar bonds

Housing Has Become an Increasingly Speculative Asset

Dwellings already owned by buyer at time of new house purchase (% of new buyers)



Sources: Survey and Research Center for China Household Finance; Rogoff & Yang 'Peak China Housing' (NBER 2020)
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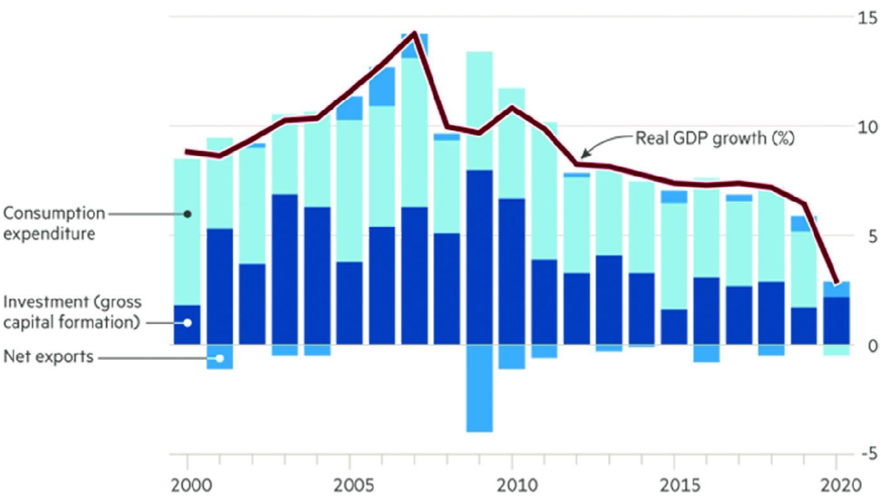
outstanding, is asking holders for a three-month extension to pay off a note due on October 25. Xinyuan Real Estate, which has $760 mn of dollar bonds, is proposing what Fitch Ratings considers a distressed debt exchange involving a dollar note set to mature on October 15. Property firms' missed payments have made up 36 % of the record 175 billion yuan ($27.1 bn) in onshore corporate bond defaults this year. Borrowing costs for dollar junk-rated debt, which is dominated by Chinese developers, soared to the highest level in about a decade with yields at 17.5%.

On October 15, Moody's Investors Service said in a report that Chinese financial institutions' potential direct loss from the Evedrgrande fallout is manageable, though it could trigger a significant and industrywide deterioration in property developers' access to funding and property sales. On the same day, the People's Bank of China (PBOC), China's central bank, lambasted Evergande for its poor management, while reaffirming that any potential spillover effects are controllable.

How Investment Demand Drives Economic Growth

Contributions to China's GDP growth (% points)



Source: Haver Analytics
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It's an ill wind

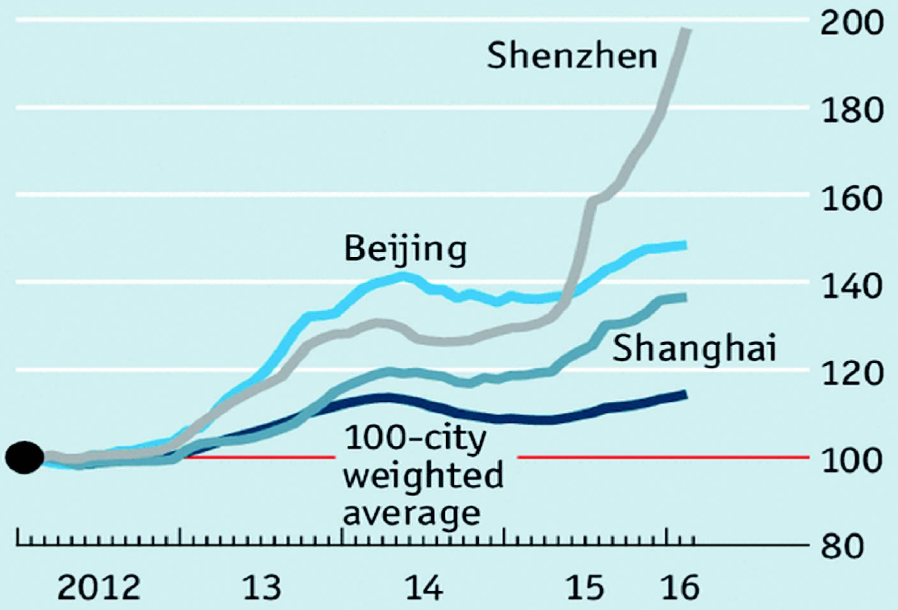
While greed is often blind, at the end of the day, it's an ill wind that blows nobody any good. Threats of a Chinese housing bubble have been around for a long time. While the sorry Evergrande saga is no Lehman Brothers moment, it is likely to inject much-needed caution and sobriety into China's over-heated and over-leveraged property market, involving developers, home purchasers, and regulators alike.

While Stephan Roach of Yale University laments China's perceived strangling of capitalistic "animal spirits", President Xi has made a clarion call to redirect China's enterprising spirit from relentless monopolistic profit-seeking towards such imperatives as self-reliant breakthrough technologies, innovation, domestic consumption and services, the green economy, ecological conservation, and an equitable quest for "common prosperity".

According to an October 2020 Credit Suisse report, the top 1% of households globally own 43% of all personal wealth, while the bottom 50% own only 1%. President Xi's call is instructive and timely, if such extreme social despondency dramatized by Korea's globally-popular TV series, *Squid Game,* is to be averted. ■

What could go wrong?

Chinese house prices, yuan per m2
January 2012=100



Sources: China Index Academy; SouFun

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