

Over the last few weeks China's second largest real estate developer has made headlines as it failed to make payments on its debt and threatened to become the largest debt default in Asia. Markets sold off as investors questioned the potential impact on the Chinese financial system as well as the rest of the world.

PROPERTY MARKETS AND REGULATION

The excessive use of leverage by property developers has been a long-time concern for Chinese policymakers. Not only has the practice been viewed as a risk to financial markets but also a source of rising property prices. After years warning about property speculation, the government finally imposed the "three red lines" guidance in August 2020 to rein in borrowings by developers. Under these rules, property developers are being assessed against three thresholds:

1. Liability to asset ratio (excl. advance receipts) of less than 70%
2. Net gearing ratio of less than 100%
3. Cash to short-term debt ratio of more than 1x

Since then, many developers have started the process of divesting their assets to aggressively raise cash in order to meet these new guidelines. However, a selection of firms, including China Evergrande, were not only slow to react to this new regulation, but continued to invest in non-core businesses such as electric vehicles.

Prior to its default, the market believed that Evergrande was "too big to fail" and the government would step in to bail out the company at the first sign of distress. However, it seems that the government has a different agenda and wants to teach the market and developers a lesson that no company is too big to fail. As the Evergrande crisis has evolved, the government has pumped liquidity into the financial system through reverse-repo, but it has stopped short of directly providing funding to the company. It appears that the government believes the collapse of Evergrande will be under control.

THE IMPACT OF THE CRISIS AND CONTAGION RISK

The risk of contagion appears low as the government and regulators are in a strong position to control the current crisis. First, the Chinese financial system is largely closed with few foreign and private creditors. Second, the government is very powerful and able to order banks, most of which are state-owned, to provide liquidity to companies it deems systematically important to save. So far, China Evergrande does not appear to meet this qualification.

Perhaps the biggest question is whether the China Evergrande situation will lead to a financial crisis similar to how Lehman Brothers led to the global financial crisis. The short answer in our view is no. China's onshore bond market is the second largest bond market globally at \$15.5trillion. While China Evergrande's total debt is large, it only represents 2% of China's onshore bond market. More importantly, only \$20B or 6.7% of Evergrande's debt is offshore. Even if all the offshore debt were wiped out, the impact on currency markets would be minimal.

From investment perspective, it is highly likely that equity and offshore bond holders will be the biggest losers of the current crisis. We expect they would likely get very little, if any, of their money back in the recovery process. The company's equity is concentrated in the hands of the firm's founder Xu Jiayin and his wealthy friends. Meanwhile bonds are mostly owned by offshore private banks.

Chinese banks are also likely to face some losses, but the overall impact is expected to be limited. Most banks are state-owned enterprises and are able to extend the credit and absorb the bad loans over time as they have done in the past with the restructuring of companies such as Wanda Group, Anbang Insurance and HNA Group.

The current priority of the government is to maintain social stability. As such their aim is to ensure completion and delivery of Evergrande's current projects to buyers, most of which were paid in advance, and to pay off construction workers and suppliers.

Only then will the government likely start the restructuring of Evergrande. This restructuring will likely involve the large amounts of land owned by the company that are estimated to be worth as much as its debt.

From the perspective of the broader Chinese economy, the country's debt dynamics generally make it easier for the financial system to roll over the debt. While overall corporate debt remains high in China, exceeding 160% of GDP, most of this debt is denominated in local currency and owned by domestic banks (mostly state-owned) and investors. Further, China's high domestic savings, totaling to 45% of GDP, also make the situation less grievous.

Given the government's hands-on approach in previous crises, its calmness and relative inaction this time likely means the damage will be tolerable. While housing sales have weakened over the past 2 months, there is a chance that this outcome plays into the government's intentions and "common prosperity" agenda. The long-term goal of higher wealth equality and more affordable housing to boost birth rates is much more important than the short-term slow-down of the economy.

Make no mistake, consumption will likely decelerate in the coming quarters as the real estate sector directly and indirectly contributes to at least 15-20% of GDP growth. But other pillars of the economy including manufacturing and exports remain robust and China continues to run a large trade surplus with other countries. The Chinese central bank also has room to cut interest rates as the benchmark one-year loan prime rate has been kept at 3.85% since April 2020 and a cash reserve ratio of banks at 12% while CPI is only running at 0.8%.

In conclusion, a wide-spread financial crisis remains unlikely but a slowdown of the economy is more probable. With the MSCI China Index falling 30% from its peak in February and trading at less than 15x P/E 2021 (vs. 20x in 2020), it appears the market has already priced in many negatives. The current moment could be an interesting opportunity for long-term investors to increase their allocation to China.

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