Evergrande's Debts

China in August

In August, Chinese equity markets showed signs of stabilising despite investor sentiment in the offshore market remaining weak. More industries were hit by new regulations and policies – the latest recipients being online gaming (limiting children's playtime) and Macau casinos (inviting greater oversight by the government).

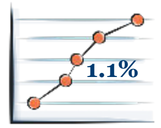
These measures are in line with the state's objectives of social stability and common prosperity, which we have discussed in previous editions. For August, the MSCI China index was flat and the MSCI China A Onshore index was up 1.1%.

At the macro level, economic activities in the summer were negatively impacted by floods in central China and pockets of Covid-19 lockdowns. This was partially offset by exports continuing to do well. The slowdown in the property sector and power shortages in some provinces caused by a lack of coal supply will weigh on growth for the remainder of the year, although it should be manageable. There is a growing expectation of policy reflation very soon.

The Evergrande situation

The complexities of the Chinese financial system are best demonstrated by the imminent collapse of Evergrande, one of China's largest property developers. Investors globally are worried that a default of its USD300bn debt could create a systematic risk.

"Overall, RisCura's portfolio is neutral to slightly underweight to the directly and indirectly impacted sectors compared to the benchmark. An overweight to property management companies, construction materials, machinery and whitegoods is offset by an underweight to banks and property developers."



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$300bn

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The stress on the country's property developers is partially due to government policy in the first place. Out of a perpetual fear of a "housing bubble", regulators have been systematically tightening rules on all aspects of the housing sector for a long time, from land sales and construction to developer financing and home purchase restrictions. These efforts, however, have yielded limited results, and home prices have continued to surge.

Due to the potential for systemic risk, it is expected that the state will intervene to resolve the situation at Evergrande. Contrary to western countries, China's financial system is mostly state-owned or state-controlled. The Chinese authorities have the tools and motivation to minimise the systemic impact, and have done this on multiple occasions in the past when financial institutions have been at risk or collapsed. The Chinese central bank has recently injected $18.6 billion short-term funds into the market to address liquidity. That being said, the Evergrande problem will have a short-term impact on economic growth and profitability of banks and other related industries, and volatility of share prices will continue for a while longer.

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"Whilst a debt burden of USD 300bn is large in absolute amounts, and certainly very large for a single company like Evergrande, it is small when compared to the USD 16 trillion of total assets of the real estate industry, or the USD 45 trillion of total assets of commercial banks including a loan book of USD 30 trillion. Evergrande's US dollar bonds of approximately $20bn are approximately 1% of the total Hong Kong-China US dollar corporate bond market."

In one manager's words, "Evergrande is badly run, by bad people making bad decisions. But the industry as a whole looks nothing like Evergrande." Over the past 10 years, the overall outstanding debt in China has doubled, the real estate sector has grown by around five times, however, Evergrande's liabilities grew by nearly 25 times. Evergrande's aggressive management of its balance sheet particularly after 2014 stands out as an outlier when compared to the wider industry.

$18.6bn

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Concern over Evergrande has created panic among international investors and share prices have fallen across the board. However, looking at the domestic A-share market, where share prices are driven mainly by domestic retail and institutional money, the picture looks a bit different. The largest property developers there, Poly Development and Gemdale, saw their share price bottoming in late July. They have since been recovering and exhibiting a completely different trend than Hong Kong-listed Chinese developers.

In summary, like any major default Evergrande will create some difficulties but it is not expected to trigger any systematic risks. And the resulting market volatility creates investment opportunities for skilled active managers.

We are grateful to Alliance Bernstein for allowing us to share their insightful views on Evergrande with our readers this month.

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