Evergrande's Troubles Predate China's Crackdown on Capitalism

By: Emerging Markets Team | September 22, 2021

Boston - We have followed developments related to Chinese property developer Evergrande since fall 2020, even more closely since April. With the further deterioration in prices for Evergrande's outstanding securities and the increasing likelihood that the company could declare bankruptcy and default on debt soon, here's an update on what we think.

Evergrande's particular situation

The current situation Evergrande faces comes as no surprise to us, especially after the changes in policy we have perceived in China — specifically that "housing is for living, not for speculation," and that "too big to fail" is no longer the case.

Several years ago, the founder of Evergrande took a leveraged bet on the property market by borrowing extensively from onshore and offshore lenders to amass as much of a land bank as possible. In the meantime, the Chinese government initiated a host of measures to reduce leverage in the industry and to limit the rapid increase in property prices.

In particular, a rule of "three red lines" — namely, thresholds on liability to asset, net gearing and cash to short-term debt ratios — was introduced to standardize debt metrics across developers. Evergrande scores very poorly on these measures, and this — along with some company-specific events — precipitated a loss of confidence in the creditworthiness of Evergrande.

Today, Evergrande finds itself sitting on hard-to-liquidate real estate assets and many bills that are quickly coming due. The company cannot sell its assets fast enough to meet these payments, and the financial markets and suppliers are unwilling to extend them any more credit. Absent significant government intervention, which we think is a low probability event, Evergrande is likely going to default on its debt obligations.

Contagion across the real economy

The knock-on effects on the real economy from Evergrande's troubles are hard to predict. In a worst-case scenario, the Chinese public could go on a buyer's strike out of fear of future price declines, and this would shut off the most important funding channel for the industry.

However, we think the government — recognizing the critical role that property plays in the savings of the public and in its contribution to the economy — will likely prevent this contagion from happening. Weak developers will be allowed to default, and large developers could consolidate their position in what will increasingly become an oligopolistic market comprising only a few large, well-capitalized players.

Investing in China generally

More broadly, we have become concerned that the recent changes in the direction of policy in China may cause assets in the country to continue to underperform. The alarm in the Chinese Communist Party (CCP) over the influence of capitalism has been expressed through regulatory crackdowns in multiple sectors, including property developers, technology and for-profit education.

We expect additional industries may see more regulations, a bigger role for the state in many areas, higher taxes and a less friendly environment for the private sector — all in the CCP government's effort to better align the economy with social goals. That has led us to believe that potential investors may be wondering "what's next" and prefer to look elsewhere. In short, we believe investing in China now requires even deeper analysis.

Bottom line: As we have frequently expressed in our blogs, we like to see policy embracing free-market ideology. In our view, that approach has historically tended to result in better economic outcomes, improved quality of life for citizens and declining risk premia across assets.

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