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Emerging Markets Debt | Global Investing

China Property: Evergrande May Just Be the Canary in the Coal Mine


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Boston - What seemed like an isolated credit event for Evergrande has now sent shockwaves across China's real estate economy. We think international investors should keep a close eye for potential risks of contagion stemming from the Chinese housing sector to global financial markets.

"We strive, as always, to search for mispriced securities in every corner of our investable universe. China property is no exception. We are leveraging our research and network to build a better mosaic as the situation evolves."

Intended and Unintended Consequences

Even before the crisis, President Xi's hawkish remark in 2017 that "housing is for living, not for speculation" made sense. China's property sector is massive, even for a country of 1.4 billion people, and was responsible for a significant share of the country's GDP compared to most other economies. China has an estimated 500 million households and annual housing sales amounting to 1.5 billion square meters.

However, we believe these statistics greatly exceed the underlying housing demand by approximately 30%. A combination of easy credit and stable home prices, and a lack of investment alternatives elsewhere, led to years of excess housing demand beyond annual household formation.

Onshore banks were the first to answer Beijing's call. Major policy banks began reducing real estate exposure, tightening mortgage availability and increasing borrowing costs, particularly for buyers with existing homes. Every rung of the government from the Ministry of Finance to local municipalities followed suit: Down payment requirements for new purchases went up, and new property taxes would make it financially onerous to own property. The government's intent was clear.

China implemented the *Three Red Lines* policy in 2020, giving regulators and investors a fresh set of tools to rank developers by credit quality. Although Evergrande had a reputation for the liberal use of its balance sheet, its total liabilities were seldom scrutinized by the outside world. With the Three Red Lines, Evergrande's liabilities became a conspicuous concern for regulators, creditors and homebuyers.

As news broke that Evergrande was not delivering homes and not paying suppliers on time, the real estate sector took an abrupt turn in the second half of 2021, despite record presales in the first half. It did not take long for investors and homebuyers to point out other developers that, like Evergrande, failed or barely passed the Three Red Lines test. The slowdown in presales from weak demand put financial stress at the project level, which led to a negative spiral of ratings downgrades and a sell-off in bond prices. The property sector faced a classic liquidity crunch.

According to the most recent data, presales for the top 200 developers were down 40% year-over-year in January. Could this be the bottom? Or will this be the new norm as originally intended by the policymakers?

Policy U-Turn for 2022

In fall 2022, the Communist Party National Congress will elect new leaders for the country, including the president. With President Xi now legally eligible for reelection, there is every incentive to fend off an economic downturn this year.

Since last December, we have seen a coordinated effort by Beijing to reflate the housing sector: The central bank cut the benchmark interest rate for mortgage originations, bank regulators made it easier for developers to obtain loans for M&A, and the housing ministry allowed developers to access presale deposits held in escrow accounts to unleash liquidity. At the municipal level, local governments began supervising project completions and M&A to guarantee final delivery to homebuyers. The macro stars have lined up for the sector to rebound.

Challenges (and Opportunities) Ahead

What seemed like an isolated credit event for Evergrande has now sent shockwaves across the Chinese real estate economy. Within a span of six months, developers, policymakers and homebuyers have pivoted from the best of times to facing the greatest challenge of their lifetimes. International investors should keep a close eye for potential risks of contagion stemming from the Chinese housing sector to global financial markets.

Global investors are still treading carefully, as evinced by the pervasive stress in the credit markets today. A complex web of implicit (and hidden) liabilities onshore make it difficult for offshore investors to estimate a reasonable recovery value for distressed developers. Evergrande's restructuring case has so far confirmed that offshore creditors are indeed structurally subordinated to onshore stakeholders as they await for instructions from the onshore credit committee.

At this stage, it seems to us that there will be a large number of defaults in the sector in addition to the few large developers that have already defaulted. Most of these defaults will likely result in distressed exchange offers, and investors will subsequently have a large universe of exchanged bonds to choose from when deciding where to invest.

Bottom line: We strive, as always, to search for mispriced securities in every corner of our investable universe. China property is no exception. We are leveraging our research and network to build a better mosaic as the situation evolves. As investors with a longer-term investment horizon, we are looking at the directional change for the Chinese property sector, and we are beginning to discover value beyond today's headlines.

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