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The Great Reckoning—Reflecting on the Evergrande Saga

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China's economic growth deceleration, triggered by a zero-COVID policy and multi-faceted regulatory tightening, has been of increasing concern to global markets. The Evergrande crisis, an epitome of China's great reckoning following its go-go growth days, has brought these worries to a flashpoint. We do not believe Evergrande is a black swan event— it has been brewing for several years, eliminating the element of surprise. Instead, it could be a "grey rhino," a highly probable event with a potentially profound impact, if not handled with caution in a timely manner. Evergrande has a large footprint, including multiple business lines, a vast number of stakeholders, and thousands of upstream and downstream partners. Further complicating matters are the opaqueness of its shadow lending and the intertwined financial web linkages. The key risk is whether policymakers can contain the impact of an Evergrande default to avoid a broad-based credit/liquidity crunch. Otherwise, the potential ramifications may include a significant loss of confidence, economic downturn, or financial instability. The People's Bank of China (PBOC) has been injecting liquidity into the system to prevent a market liquidity squeeze. Shoring up investor confidence is critical. The refinancing of other property developer bonds will be challenging if this rout is not stopped in an orderly manner.

Shift of policy focus

The trade war and COVID-19 have necessitated that Chinese policymakers consider a shift in policy to pursue more self-sufficient and sustainable growth. The top three priorities for the Chinese government are:

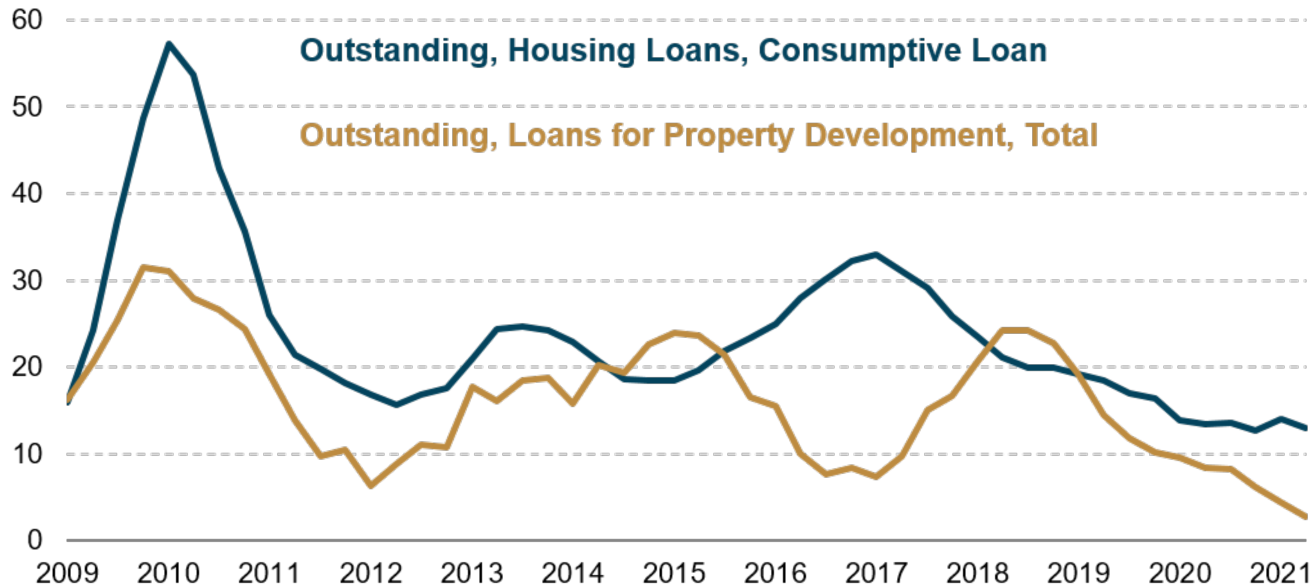
1. Tackling high levels of debt
2. Arresting deteriorating demographics
3. Boosting labor productivity

High property prices have been squeezing the middle class, discouraging fertility, and widening the wealth gap. Meanwhile, the introduction of China's "three red lines" deleveraging campaign in August 2020, aimed at improving the financial health of the real estate sector, has been the inflection point that exacerbated Evergrande's woes. However, property market tightening could achieve a trifecta: tightening credit to property developers and mortgage lending, stabilizing property and land prices as well as price expectations, and channeling capital away from the unproductive property sector to more productive sectors (see Chart 1).

1

China's Property Sector Has Slowed Due to Bank Lending Squeeze

% YoY, As of Q2 2021



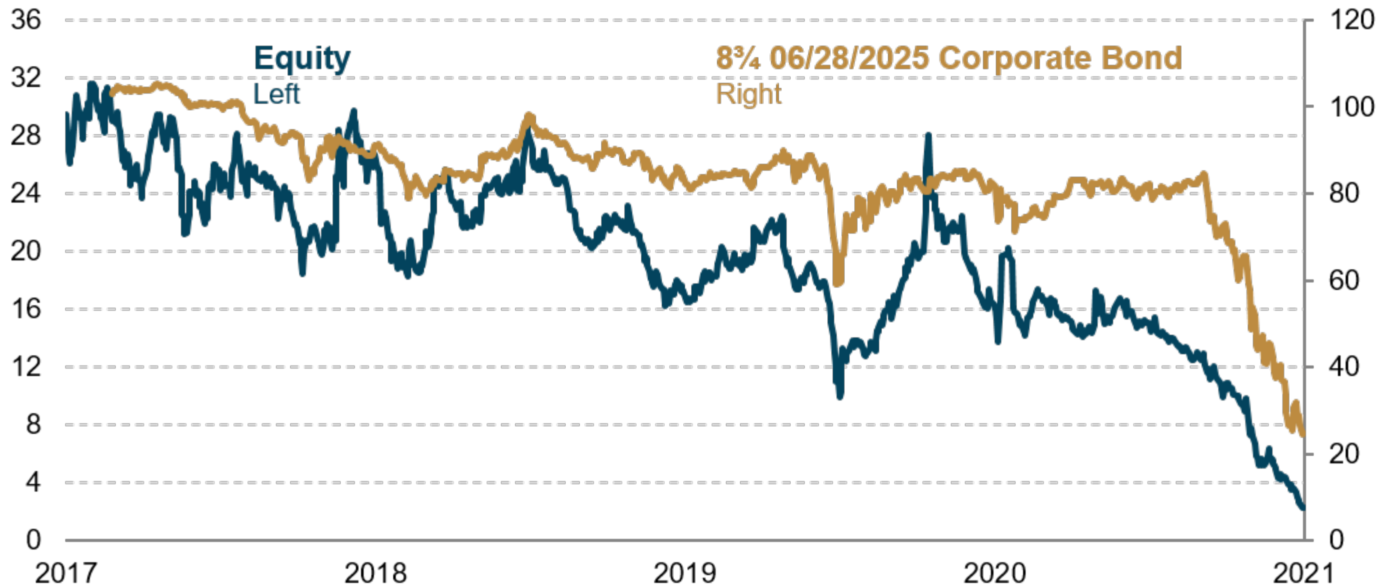
Source: Brandywine Global, Macrobond, PBOC

Evergrande expanded aggressively since the early 2000s to become one of China's largest and most levered property developers. Currently, it has over RMB2 trillion ($300 billion) in liabilities on its balance sheet with very limited cash. However, Evergrande's credit woes are not news. Its stock price has been on a downtrend since its peak in 2017. Since February 2021, the deterioration accelerated as the "three red lines" regulations intensified (see Chart 2). Now, Evergrande is experiencing acute liquidity risk with difficulty meeting its operational obligations and coupon payments.

2

Evergrande Equity and Bond Prices

Last Price, As of 9/21/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP)

Contagion risks

There are multiple possible contagion effects that investors must assess. A disorderly credit event related to Evergrande could lead to the broadening of social and financial risks.

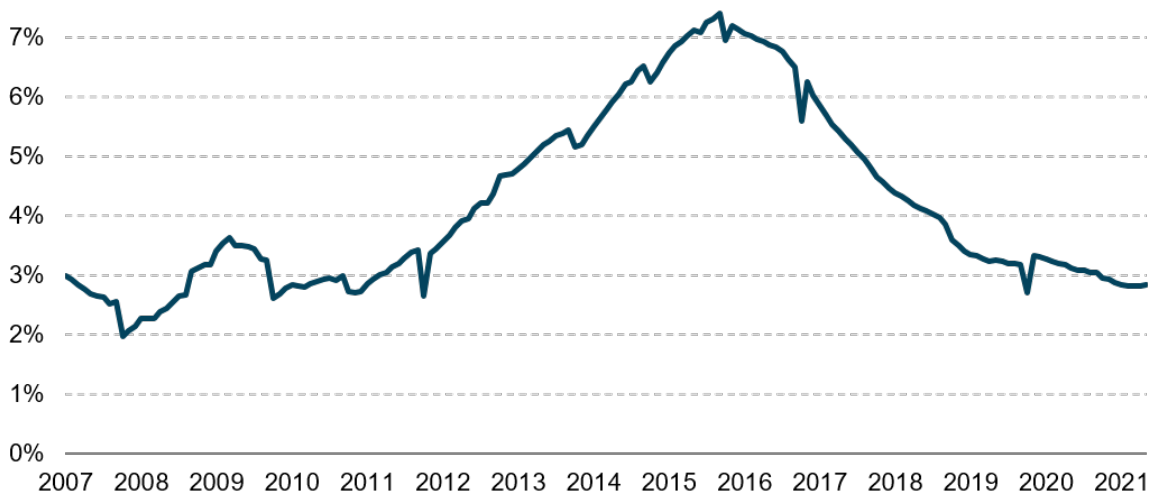
- The contagion effect on financial markets so far can be seen in the underperformance of equities and bonds of property developers. However, there is almost no sign of a liquidity squeeze in China's interbank market, with SHIBOR and 7-day repo rates very stable. The global selloff in risk assets on September 20, 2021, was a delayed broadening of the contagion risk.
- Another nuance of the contagion effect on financial markets is the exposure of China's banking system to Evergrande. Evergrande's liabilities represent around 0.6% of China's bank assets. National joint-stock banks, including Minsheng Bank, have larger exposure to Evergrande while China's Big Four banks have less exposure. Hence, a systemic banking crisis does not seem likely. However, policymakers need to ensure that they can quarantine the Evergrande crisis to avoid widespread default of other weaker developers.
- The social contagion effect relates to the ability to ensure ongoing project delivery to buyers and payments to project partners. Among Evergrande's RMB2 trillion liabilities, RMB1 trillion represents trade payables to more than 8,000 upstream and downstream partners. Defaulting on the payables could cause financial distress at these trade partners. Furthermore, unfinished projects in more than 220 cities and to nearly 2 million homebuyers present risks to social stability. Recent protests demonstrate the importance to social stability.
- The current crisis may cause homebuyers to delay home purchases, impacting the real economy by lowering property sales and prices, land sales and prices, and construction investments, and by weakening upstream and downstream industries as well as commodity prices. As Evergrande and other weak property developers try to sell assets quickly to raise cash and cover liabilities, property prices could take a further hit. Nevertheless, the macroeconomic impact from the worst-case contagion effect would likely be smaller than the 2014 - 2015 property downturn as current property inventories remain

low (see Chart 3). In the case of a sharper property correction, we would expect both fiscal and monetary policies to ease further, and there may be some modest adjustment in property policies as well.

3

Chinese Property Inventory Is Lower than in 2015

Unsold Floor Space of Residential Buildings, % of Total, As of 7/31/2021



Source: Haver Analytics

Policy options to contain the contagion

We need to keep in mind that the Evergrande crisis was intended by policymakers to rein in a reckless credit binge and punish bad actors in China's property market. Policymakers need to balance attacking the moral hazard of "too big to fail" with also containing systemic risk. We believe policy measures will be launched in the next few weeks to calm the market, arrest the sharp growth slowdown, and mitigate financial risks. Those measures could include injecting more liquidity into the financial system, more local special government bond issuance, reserve requirement ratio (RRR) cuts, fine-tuning property market tightening, loosening COVID restrictions, and easing decarbonization-driven production cuts, among other actions.

Investment implications

The Evergrande crisis is a deflationary shock to the Chinese economy, even though we do believe Chinese policymakers have the wherewithal to avoid a systemic risk. Our base case would be an orderly restructuring of Evergrande that potentially may include splitting the conglomerate into several parts. This restructuring may be followed by some state-owned enterprises (SOE) taking over unfinished projects and operational liabilities, combined with debt term extension and sale of assets to other developers. In times of default or distress, investors of offshore property developer bonds need to be cognizant of the payment pecking order. Obligations to homebuyers and suppliers will take priority, followed by claims by banks, onshore bondholders, offshore bondholders, and equity owners. Different claims of asset recovery and covenant structure between onshore and offshore bond holders are also very important.

China's policy easing is becoming more nuanced and targeted given its policy focus shift, and it needs to reserve some room for next year should the economy weaken more. The fiscal impulse is in the bottoming process with government bond issuance picking up in the third quarter. With that being said, there is always a risk that policymakers act too late or too little. In that case, the impact of the sharp slowdown on global growth and risk

assets could be quite negative until we see decisive easing measures in a timely manner. China-centric commodity prices will be under tremendous pressure. Chinese government bonds should still do well as a result of the flight to quality. The onshore renminbi (CNY) and the offshore renminbi (CNH) will experience some pressure from the growth slowdown and potential uptick in capital outflows. There will be more pain in the property sector with bouts of market volatility. It will not be an easy task to select winners from losers with the macro uncertainty and potential contagion risks, and the ride likely will not be smooth. However, the current environment presents a compelling valuation opportunity to take advantage of market dislocations, although we would emphasize that investors should be highly selective and focus on buying quality names.

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