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Condo clearance sale

The largest property developer in China, the most indebted property developer in China and the largest junk-bond issuer in Asia are one and the same company. Reports two Thursdays ago of a liquidity crisis at China Evergrande Group bludgeoned that behemoth's stock and bond prices. Management's denials prompted not only a share-price reversal but also more confusion. The meaning of these systemically important eruptions is the topic at hand.

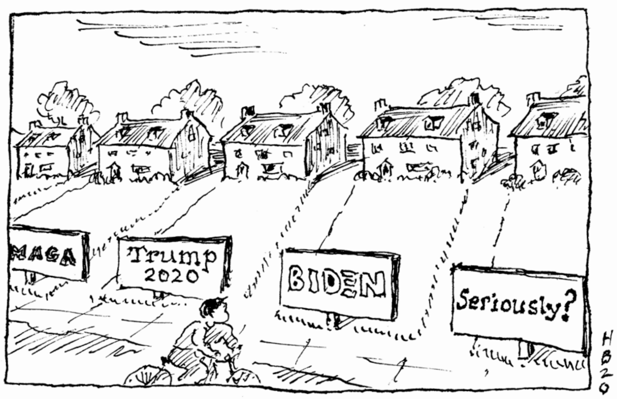
Constant readers will not have forgotten the conglomerate designated No. 3333 on the Hong Kong Stock Exchange. A bearish June 2, 2017 *Grant's* analysis concluded that Evergrande's name was bound for the history books, much like "Bank of United States" or "Hindenburg." The problem was the immensity of its on-balance-sheet debts and the serpentine nature of its off-balance-sheet obligations—"partnerships, third-party guarantees, ballooning pre-sales, forced loans from construction companies to which it owes money and myriad other hidden means of obtaining the ever-widening flows of cash needed to meet maturities of current debts," as we quoted Anne Stevenson-Yang, co-founder of J Capital Research, as saying. To which she added: "It is a company that would send most financial managers running for their blood-pressure pills."

Beyond real estate, Evergrande's operations encompass electric vehicles, movie theaters, property management, life insurance, professional soccer, health care, internet services ("HengTenNetworks Group Limited is a platform thinking-inspired asset-light internet service integration operator") and theme parks, including Evergrande Water World, Evergrande Fairyland and Evergrande Healthy Land.

What landed Evergrande in the news was the digital disclosure of a Sept. 24 S.O.S. message, purportedly from the front office, begging the Guangdong government for help to allay a near-term liquidity crisis. Beyond denouncing the message as a fake, management promised steps to deal with its superabundant debt.

As of June 30, the developer-conglomerate carried total debt (including leases) of Rmb 841.8 billion ($123.4 billion), equivalent to 11.2 times trailing earnings before interest, taxes, depreciation and amortization. And on that date, cash weighed in at just half the value of short-term maturities. No cash-flow statement accompanies first-half results, but a Rmb 37.7 billion rise in debt over the first six months implies, notes CreditSights, that free cash flow over the period was negative.

To capitalize on the generally higher equity valuations prevailing in the People's Republic compared with Hong Kong, Evergrande in 2016 began preparations to list a few of its Chinese operations in the mainland through a reverse merger. As part of that strategy, Evergrande raised Rmb 130 billion in fresh equity from outside investors. To date, the company has not received permission to complete the merger (hence the letter to Guangdong). Unless the listing is completed by Jan. 31, Evergrande must repay that Rmb 130 billion investment on top of maturing debt.



"It seems pretty obvious to me that this is a leak," Stevenson-Yang advises colleague Evan Lorenz by email. "The document itemizes Rmb 835.5 billion in outstanding loans as of June 30, slightly more than were reported by Evergrande, with the name and amount extended by each bank and non-banking institution—stuff that a third party would not know. It provides the name of each institution that invested in Evergrande's Rmb 130 billion private-equity round that was done prior to a 2017 planned reverse merger with a Shenzhen-listed company called Shenshenfang—that reverse listing which has still not been approved. This looks very much like those investors clamoring for liquidity."

On Sept. 24–25, Evergrande shares plunged by 14.5%, only to recover that loss on Sept. 28. Creditors were not so easily mollified. The renminbi-pay unsecured 6.27s of 2023, for instance, dropped to 74 on Sept. 25 from 96.89 before the Evergrande management plea made its digital rounds. On Tuesday, the 6.27s rallied, but only to 85.78. The selloff has dealt a sympathetic knock to other property developers and suppliers to the

Like the Hindenburg?

source: The Bloomberg

construction industry.

The Evergrande saga plays out in the context of an uneven post-virus Chinese business bounce-back. "There's a recovery going on in China," Leland Miller, the CEO of China Beige Book, advises Lorenz. "It is not a recovery that is improving on last year's performance, as the Chinese government claims. There is not year-on-year improvement anywhere."

In the first eight months of the year, Chinese lenders extended Rmb 26.1 trillion ($3.8 trillion) in new credit, a 44.5% jump from the same period last year and a sum equal to 26.4% of 2019 GDP. Much of this borrowing, according to a Sept. 1 Rhodium Group report by Logan Wright and Allen Feng, has ended up in asset speculation as opposed to authentic business investment. "Official industrial profits data showed that revenue growth slowed to 0.8% [year-over-year] in July," Wright and Feng point out, "but profit growth accelerated to 15%, with stronger profit growth attributed to 'investment returns.'"

Remarkably, the credit blowout has proceeded in the teeth of Communist Party directives to tamp down lending and borrowing. Just as remarkably, the crackdown is calculated to bite the top Chinese asset class—property—the hardest. In late August, Beijing decreed that developers must pass a tripartite balance-sheet test: debt-to-assets below 70%, net gearing below 100% and short-term borrowings no greater than cash reserves. Those that pass all three parts may expand their liabilities per year by 15%, but no more; those that flunk may not expand their liabilities at all. Evergrande flunked.

"Property is the pillar industry of China's economy," Wright and Feng note. "These new measures are the most significant restrictions on developers' funding and growth ever proposed, as they target balance sheet growth directly, rather than financing channels. If enforced strictly, these regulatory limits will have two major economic implications: credit momentum will slow, and construction activity will decline."

In other words, Evergrande needs liquidity, and it's looking for it high and low. Its customers are one potential source. Through Oct. 8, you can have an Evergrande condo for 30% off, the steepest discount in company records. It's a classic example of the kind of debt-induced price deflation that the Federal Reserve seems to want no part of. On Friday, Evergrande received permission from the Hong Kong Stock Exchange to spin out and list its property-management business, a move that, in an optimistic scenario, could raise as much as HK$ 40 billion ($5.2 billion). On Tuesday, investors with stakes worth Rmb 86.3 billion out of that Rmb 130 billion that must be repaid by Jan. 31 agreed to postpone the due date, Bloomberg reports.

Evergrande's lenders may or may not choose to wait around. "[A]t least five Chinese banks and two trust firms held emergency meetings on Thursday night to discuss their Evergrande exposure and access to collateral, people familiar with the matter said," Bloomberg reported last Friday. "At least two of the banks that convened meetings decided to bar Evergrande from drawing unused credit lines, according to people familiar."

As a reminder, China's financial system is the largest in the world. As of June 30, mainland banks carried assets of $45.3 trillion, more than double the $21.1 trillion of American bank assets.

"The immediate issue with Evergrande may be solvable," Wright advises Lorenz by email. "But the news is highly significant because this risk has not emerged in a vacuum. It comes as credit risk has been accumulating in China's financial markets throughout the past year, and particularly in the past few months, with more frequent runs at smaller banks, defaults on shadow-banking investment products issued by trusts and defaults by major local government companies, when local governments themselves cannot provide support to key firms within their jurisdictions (Tianjin in particular)."

A failure of Evergrande "is the type of event that can cause investors to question Beijing's capacity to maintain financial stability, along with the slow-burning buildup of debt and defaults within the financial system," Wright goes on. "China's rapid debt accumulation over the past decade is now showing its teeth and is increasingly unmanageable, particularly in some localities where credit growth has already slowed sharply. Beijing can manage the Evergrande problem, but not China's broader debt burden."

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