

Title: Wrinkly Reading

Author: disoriented_llama

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So, Evergrande is a big story right now, and there's a bunch of speculation, both informed and not about it running rampant. As someone with a bit of experience with how Chinese businesses run, I figured I'd share that with the group. (my MBA is in International Business, with an emphasis on China, and I did a fair bit of it at Tsinghua University in Beijing, whether that means I know what I'm talking about is up to you to decide)

This is flared "OPINION" because this is mostly background knowledge I already have mixed with research I've been doing into the Chinese market for the last few months, it's not at a level I'd be comfortable labeling "DD"

TL;DR China's going to do some sort of Evergrande bailout, but because they have radically different incentives that western politicians it's going to look very very different, and hedgies r extra fuk.

Ok, so first, let's talk about the \$300B in debt Evergrande has by comparing it to Lehman Brothers, not really a fair comparison for a lot of reasons, but it's something on everyone's minds, so let's begin there. When Lehman collapsed in 2008, they had \$619B in liabilities (debt) which is more than twice what Evergrande has. So that means this is way less of a big deal, right? Wrong. Lehman also had \$639B in assets (money) which means even though they went bust, they were still slightly net positive at the time.

Evergrande.. is NOT net positive. And they've got a lot more than just \$300B in debt. \$300B is just their outstanding bonds. Some of that debt is unknowable because it's hidden in China's shadow banking system and state banks, or it's owed "off the books" to employee's and their families. There's also a whole pile of debt owed to suppliers and subcontractors, which we also don't have numbers for right now. Finally, since you really, really, really can't trust official numbers about anything in China, the problem is likely worse than what they're telling us, and again, this is an unknowable unknown.

But there's another component to that debt that we do have a number for, and that's 1.6 million apartments. See, real estate in China doesn't work remotely like real estate in the USA does. For one thing, state benefits are based off of where you officially live, so an address in a big city is valuable as a lot more than just a place to sleep. (this is also why there are huge tenement slums outside of all the big cities despite the building boom, without permission to move or an address, rural workers basically have to camp out and lack access to all state benefits, like health care) For a second thing, if you're buying property in China, there's not "zero down and a teaser APR", there's not even "20% down and a mortgage", it ranges between "50% down and full price in cash", no loan. That upfront money paid is going to be super important later, so keep it in the back of your head while I go through this next part.

Now we need to talk about how Evergrande financed and ran its massive expansion over the last couple of years. First, they would buy up land well above market price, finance it with debt offerings, then take deposits from potential buyers and start building apartments, and sell the remaining debt in bonds, sort of similar to how the USA did with MBS and related securities from "The Big Short". Well, the thing is, the numbers never actually added up completely, and the whole thing was always sustained by using revenue from pre-selling the next project to pay for the current one. Unfortunately this also didn't quite add up after the executives skimmed their cut, so it then turned into using revenue from the next project to pay for the debt on the project one or two buildings previous. This kept escalating every time things cycled through until it all fell apart like a bunch of Jenga blocks.

If that process sounds familiar, it's because it's the same scam Bernie Madoff ran for years - a Ponzi scheme, where the new money pays for the "profits" of the earlier investors and it only works as long as exponentially more new money is coming in all the time. When that inflow stops, or even slows, you get the bad kind of boom. A few years ago the CCP got alarmed about the amount of leverage (debt) and speculation in the domestic housing market and tried to bleed it out slowly with the "one person one

house" policy. Unfortunately for them, the problem was already so bad that even slowing down the inflow of new money was going to detonate things. And that's what's happening now to Evergrande, which will be the first of many to fall like this.

Ok, so now you're caught up on what's happening and why, here's why things have escalated so quickly that executives are being taken hostage. Remember when I said to pay attention to where the upfront money for the new projects came from? Yeah, unlike in the US where people lost some rent, a place to live, and maybe some equity or a down payment, in China, it's people losing the entire purchase price of the building. And not big bankers, it's individuals losing their, and often their extended families' entire life savings. Because they spent it all for an apartment that hasn't been built yet with a company that's currently being liquidated.

And that's the second debt that needs to be paid here, not just the money and bond parts, which is all the western media understands or cares about, but the apartments and better lives and opportunities that these people and their families dumped their generations of savings into. 1.6 million apartments. And that's just from Evergrande. It's been less than a week and they're already taking executive's hostage. Next up the chain is Party officials, and that's when the tanks come out and things start getting really bad.

So, moving on, that's why Xi's response to this is going to be so different that what everyone here in the West is used to with financial crises. Because the main, or at least most reliable, motivation for basically all politicians is to gain and stay in power. In the West, that means keeping rich donors happy, which means screwing over the little guy, printing money, and preserving the wealth of the wealthy and the integrity of the international finance system and banks. In China, that means keeping society stable and prosperous enough not to have revolution in the streets.

So any focus or potential bailout that the CCP initiates isn't going to focus on international institutions or banks or bondholders debt, it's going to focus on the apartments debt. The debt to the tens of millions of Chinese citizens who got taken by Evergrande, and possibly hundreds of millions who got wiped out on unbuilt buildings by the time this is all over.

Another key thing to remember here is what happens to countries with debt to other countries experiencing a financial crisis that aren't the USA. A prime example is what Germany did to Greece after the 2008 crash. Things in Greece got so bad that unemployment was well north of 25% and people were starving to death. The people elected what were effectively communist, then fascist governments back to back in an effort to find a way out - that's how bad it got.

Now think about the fact that China, through its "Belt and Road" initiative has been lending out money all over Asia, Africa, and Eastern Europe. All of those countries, who took on debt to China to get infrastructure work done by Chinese construction companies, and had been enjoying having that debt laid off in exchange for political influence.. they're about to get some very harsh lessons in which people the Chinese government values more than them.

Finally, no, China can't "call on US debt" because they have to keep buying treasuries to keep their currency cheap, if they stop, or worse, start selling, then the Yuan quickly appreciates to the point that their exports aren't competitive anymore and their entire economy collapses.

Also, save some prayers for Western Australia, their mining industry just got obliterated by the new lack of Chinese demand.