Perspectives

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China: Evergrande and Another Move Down

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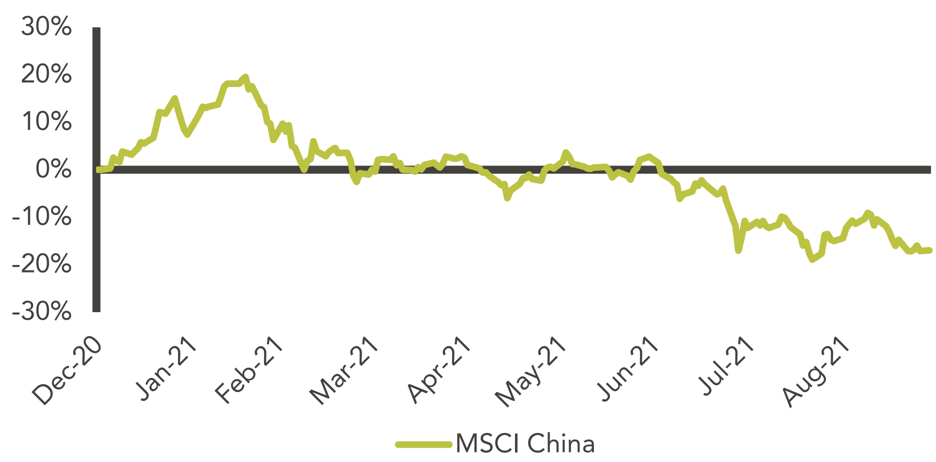
In August we released our newsletter China: From Leader to Laggard, in which we reviewed how China transformed from a top-performing country to a bottom-performing country between 2020 and 2021. We noted that increased regulation was a key reason for this change as new government policies have spooked investors. We highlighted that China has gone through these periods of regulatory change in the past and opined that the market would continue to be jittery over the next six to twelve months before recalibrating to the new environment. Since then, Chinese equities have continued to fall as global investors focused their attention on Evergrande Group (Evergrande), a Chinese property developer. In this newsletter, we will provide a synopsis of the Evergrande story and discuss the market risks.

Exhibit 1: MSCI China Index Cumulative Year-to-Date Performance



Source: Bloomberg through September 27, 2021

THE COMPANY AND THE ISSUE

Through August, the MSCI China Index was down 12.2% year-to-date. In September, the index lost another 5.6% through the 20th as investors focused their attention on Evergrande, the second-largest property developer in China. This Shenzhen-based company employs roughly 200,000 people and owns more than 1,300 projects across 280 cities in China. It totaled $110B in sales in 2020 and held $305B in liabilities. This company made news since it was in danger of missing debt payments of $83.5M and $47.5M in the second half of September.

HOW IT GOT THERE

In 1996 Hui Ka Yan founded Evergrande, formerly known as the Hengda Group. In 2009, the company went public and listed on the Hong Kong Stock Exchange raising $722M of capital. Over the next twelve years, the company took advantage of loose credit conditions and fueled its fast expansion by taking on debt as it aggressively raised loans to support its land buying. It also branched out into other industries including healthcare services, consumer products, and electric vehicles. Additionally, the company is the majority owner of Guangzhou Football Club and even invested in theme parks.

In China, periods of unchecked growth are often followed by increased regulation. In August 2020, China announced its "three red lines" policy aimed at the real estate industry. The policy provided three metrics by which companies would be evaluated:

1. Liability-to-asset ratio of less than 70%
2. Net gearing (debt to equity) ratio of less than 100%
3. Cash-to-short-term debt ratio of more than 1x

The purpose of this policy was to force deleveraging, improve financial health, and control housing prices. If a company breaches these red lines, regulators will place limits on its ability to grow debt. The more breaches the greater the limit imposed. At the end of 2020, Evergrande breached all three limits but was able to improve its debt-to-equity ratio by the second half of 2021. However, with the increased focus on debt levels and tightening credit policies, Evergrande faced liquidity challenges and earlier this year suggested it may not be able to meet upcoming interest payments due in September.

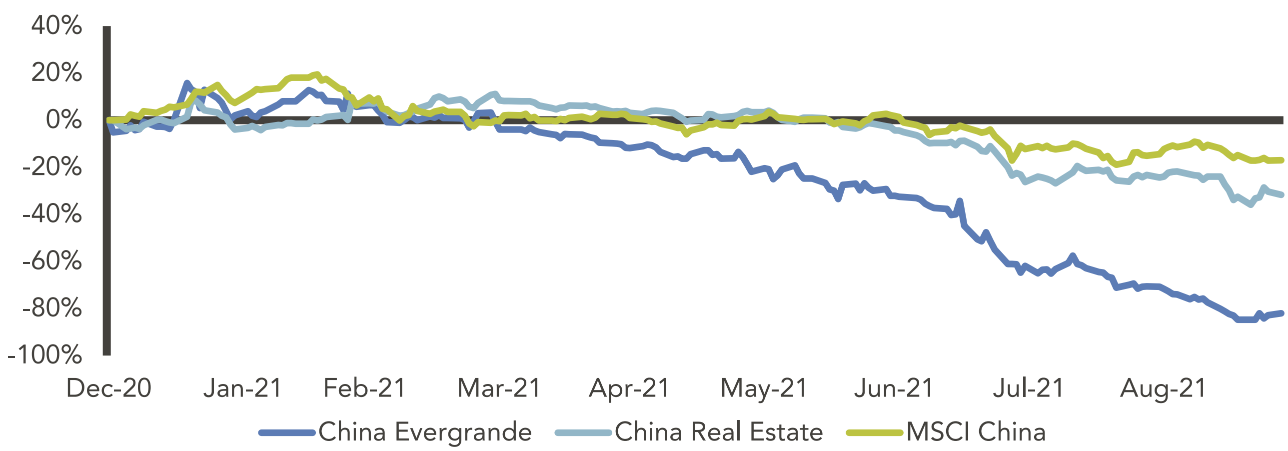
Exhibit 2: Evergrande Three Red Lines Data

	Liability/ Asset	Net Debt/ Equity	Cash/Short-Term Debt
2020	83.8%	131.3%	0.5x
2Q 2021	81.0%	99.8%	0.4x

Sources: GAM, Evergrande financials; as of June 30, 2021

PERFORMANCE IMPACT

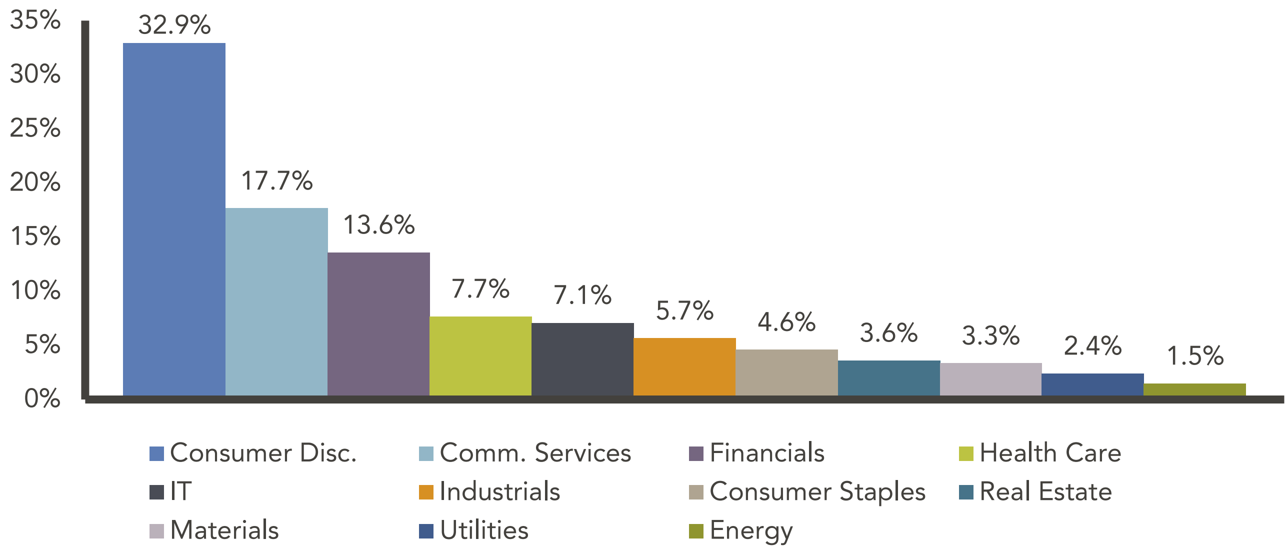
Exhibit 3: Year-to-date Cumulative Performance of Evergrande, China Real Estate, and MSCI China Index



Source: Bloomberg

As a result, Evergrande's stock is down 82% year-to-date through September 27th. The Chinese real estate sector has also come under pressure, losing 32% over that same time period. While this sector is only 3.6% of the broader China equity index, this issue is an additional link to a chain of regulatory events and government actions that have concerned investors over the last twelve months. Additionally, in September, markets became increasingly concerned over any spillover impacts of an Evergrande default. This put pressure on global equities the week leading up to the company's September 23rd $83.5M interest payment.

Exhibit 4: MSCI China Sector Weights



Source: MSCI as of August 2021

THE INTEREST PAYMENTS

Evergrande had an interest payment of $83.5M due on September 23rd. As of the writing of this article, there is no indication that the company has met that obligation. The company has a separate interest payment of $47.5M due on September 29th. Both interest payments have a 30-day grace period before a default occurs.

THE RISKS

Is this a Lehman Brothers event? That is the big question that the market has been contemplating. The real estate sector is a small part of the equity market index based on capitalization. However, it is a large part of China's economy, with real estate, construction, and property services accounting for 15% of the country's gross domestic product. Ultimately, investors are concerned that a default would have a domino effect where other financial institutions are drastically and negatively impacted. There is also concern that other property developers may go the way of Evergrande.

To be clear, most market experts do not see this as a Lehman Crisis. Both the Fed Chairman and ECB President have noted that the United States and Eurozone have very limited exposure. The People's Bank of China has pledged to ensure a healthy property market and injected $71B of short-term cash into the banking system over the last several days in an attempt to restore some calm to its credit markets. Additionally, while China has been reluctant to directly intervene via a bailout, several news organizations have noted the government has encouraged other companies to purchase Evergrande assets in order to raise funds.

CONCLUSION

Over the last year, China has stepped up its regulatory actions as it has shifted its priority from growth at all costs to quality growth with a focus on common prosperity and sustainability. After years of taking on debt to support sales growth, Evergrande now faces a new environment with tighter credit conditions. It is currently attempting to sell assets to raise the cash needed to meet its debt obligations. The key concern for investors is whether a default would have a ripple effect on the Chinese financial system and possibly the rest of the world. Most market experts do not see this as a high probability given the debt containment. Additionally, China has infused the banking system with $71B in cash and has encouraged other companies to buy up Evergrande assets. This issue will likely lead to higher volatility over the coming weeks as updates on the debt payments and asset raising come out. Over the longer term, we see this transition to quality growth as a positive, though it will likely lead to further challenges over the next six to twelve months.

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