

# Assessing Evergrande's impact on Asian high yields

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## Background

Concerns over property developing giant China Evergrande Group defaulting on its debt have rippled across the global financial markets. In the Asian high yield (HY) space, spreads have widened recently on the Chinese government's tightening of its property sector and increasing default risks associated with the sector in the wake of developments related to Evergrande. From a fixed income market perspective, we present potential scenarios for Evergrande, discuss the impact of the company's restructuring on the US dollar (USD) -denominated Asian HY market and assess the implications for the property developer's stakeholders.

## Scenarios for Evergrande

We see three potential scenarios for Evergrande going forward: 1) a disorderly default (bear case, unlikely), 2) a bailout by the Chinese government (bull case, unlikely) and 3) a debt restructuring with some government facilitation (base case).

We see a disorderly default as unlikely, as this would lead to systemic implications with wide-spread impact felt even outside the property sector. The Chinese government has reportedly stressed that Evergrande's debt should be resolved via a market oriented approach, while preventing systemic risks in the process and ensuring stable operations at Evergrande's projects. Evergrande was previously identified by the government as a company that could pose systemic risks to the financial system; a disorderly default would likely cause both social discontent (among buyers of Evergrande's unfinished projects) and a significant macroeconomic impact (including liquidity stress in the system and worries over some financial institutions' health), both of which the government would likely aim to avoid.

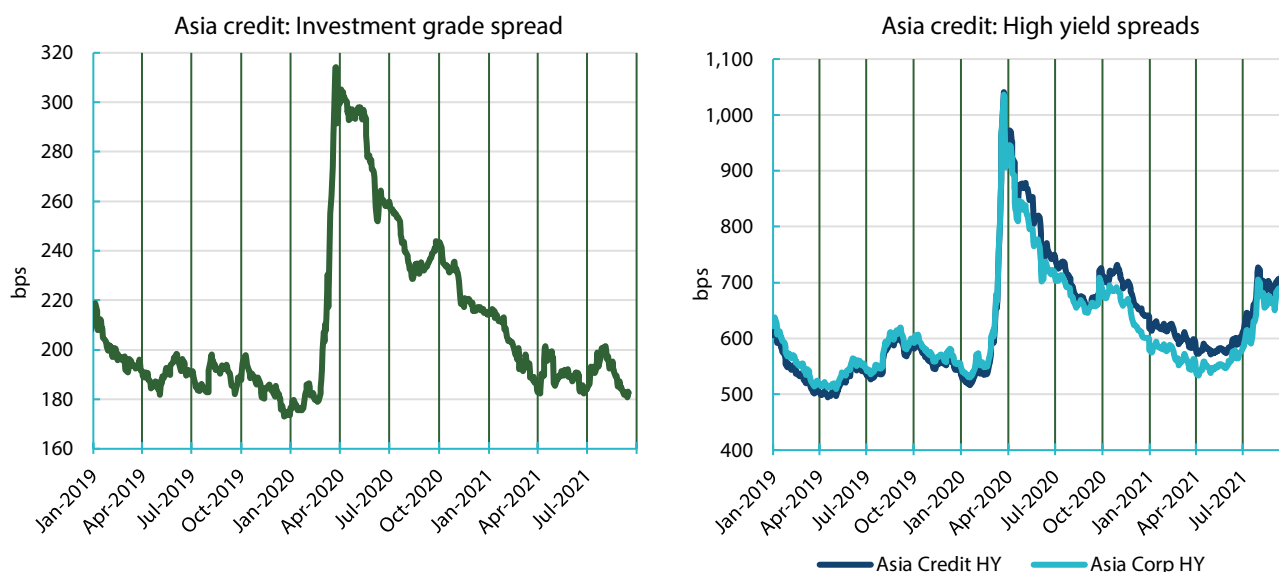
Meanwhile, a bailout by the government is also unlikely. As mentioned above, the government has reportedly stressed a market oriented approach to resolving Evergrande's debt. The government has also been trying to rein in developers' leverage, and bailing out Evergrande could deepen moral hazard issues and would likely undermine some of its efforts to reduce leverage. Just last week (as of this writing), the government warned major lenders that Evergrande would not be able to make interest payments due this week.

We see a debt restructuring with some government facilitation as the most likely eventual outcome for Evergrande, and market prices of Evergrande's bonds have also priced in a high likelihood of this outcome. There have also been reports of the government taking actions which have typically been indicative of a potential future restructuring, including centralizing lawsuits against the company to a court in Guangzhou and soliciting feedback from banks about forming a credit committee. We describe our expected impact and outlook under this scenario below.

## Expected impact on the USD-denominated Asian HY space and sector outlook

Given the potential systemic risk implications from Evergrande, as well as a continued very tight policy environment, we believe that near-term downside risks in the China property space have increased and have adopted a more defensive positioning for the sector. Nevertheless, considering where Evergrande bond prices currently stand, the market impact from the eventual restructuring is unlikely to create large (and forced) selling from investors.

**Chart 1: Asia HY spreads have widened on China property sector tightening and increasing default risks**



Source: Nikko AM and Bloomberg as at 16 September 2021

Evergrande has total liabilities of nearly Chinese yuan (CNY) 2 trillion, and this impact is likely to be spread out and felt across different stakeholder groups. Overall, we expect the government and Evergrande to focus on protecting the property developer's customers and suppliers, while ensuring an orderly restructuring for creditors who are likely to take a larger impact. We see the systemic implications to the financial system as manageable, while the financing environment to developers is likely to tighten even further.

## Systemic implications across stakeholder groups

The largest group of stakeholders are suppliers (including construction companies), which Evergrande has CNY ~900+ billion in payables to, likely spread out across hundreds of suppliers. Evergrande has also taken CNY ~200+ billion in down payments from customers for pre-sold, uncompleted homes. We expect the government and Evergrande to focus on ensuring Evergrande completes its unfinished projects (Evergrande executives are already seen to be signing a "military order" to complete homes), suggesting suppliers will be paid, at least on better terms relative to creditors, to ensure work continues. Before resolution however, we will likely see drops in property sales for other high risk developers as customers become more wary, while suppliers could become more cautious in granting developers' credit.

In the credit market, Evergrande owes CNY ~570 billion to creditors, including trust firms (estimated CNY ~222 billion, ~1.1% of trust assets), banks (estimated CNY ~170 billion, ~0.1% of system loans), USD bondholders (USD ~19 billion, ~2% of JACI<sup>1</sup> HY Corporates by market value and ~6% by face value) and CNY bondholders (CNY ~53 billion, ~0.18% of China onshore corporate bonds).

<sup>1</sup> J.P. Morgan Asia Credit Index

- **Trust firms:** We are likely to see a further unwinding of trust financing towards property. This risk is partly mitigated as trust financing to the sector has already dropped significantly, and developers' reliance on trust financing has already come down significantly over the past two years and is currently ~5-30% for single B developers and ~0-15% for BB developers.
- **Banks:** The direct impact to China's banking sector is not large, given loans to Evergrande represent just ~0.1% of system loans. However, capital levels at key lenders (reported to include China Minsheng Bank and China Zheshang Bank) may come close to regulatory requirements.
- **USD bonds:** Evergrande bond prices already reflect a high probability of restructuring, and the eventual restructuring is unlikely to create large (and forced) selling from investors. However, contagion to other issuers will likely continue until Evergrande's issues are resolved. The default rate of Asian USD-denominated HY corporates will rise significantly with the inclusion of Evergrande (~6% of face values of JACI HY Corporates).
- **CNY bonds:** Evergrande is relatively small in the onshore bond market. In addition, Evergrande affiliates are likely to hold a proportion of onshore bonds.

### Summary

As a base case scenario, we see Evergrande going through debt restructuring with some government facilitation, with a focus on protecting customers and suppliers while ensuring an orderly restructuring for creditors. Given the potential systemic risk implications from Evergrande, as well as a continued very tight policy environment, we believe that near-term downside risks in the China property space have increased and have adopted a more defensive positioning for the sector.

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