China’s Evergrande set to default on debt payment

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Tomorrow is looming as crunch day for the beleaguered debt-burdened Chinese property developer Evergrande when interest payments on two bonds fall due.

Evergrande is up for a payment of $83.5 million in interest on an 8.25 percent five-year bond and a $36 million payment on another debt on the same day.

Financial markets have priced in the prospect of payment as unlikely with one of its bonds trading at less than 30 percent of its face value. Whatever the outcome of events tomorrow, the prospect of default will continue to hang over the company as, according to the *Financial Times*, it has $850 million in interest payments falling due before the end of the year.

On Monday the Evergrande crisis triggered significant falls on global share markets with Wall Street experiencing its largest one-day fall since May. At one stage the Dow was down by 972 points before paring back some of the losses to finish down by 614 points, a 1.8 percent decline.

The S&P 500 index dropped by 1.7 percent with the tech-heavy NASDAQ down by 2.2 percent after falling by more than 3 percent at one stage during trading.

The sell-off was halted on Tuesday, with the S&P 500 and the Dow only marginally lower for the day. This was largely on the back of assurances from major finance houses that the Chinese government had the situation under control. As Bloomberg commented: “Wall Street analysts are putting their faith in the Chinese Communist Party.”

It cited a list of statements to the effect that China was not facing a “Lehman moment,” a reference to the collapse of the New York investment bank which led to the financial crisis of 2008.

A comment by Judy Zhang of Citigroup was typical of many. “We do not see the Evergrande crisis as China’s Lehman moment given policymakers will likely uphold the bottom line of preventing systemic risk to buy time for resolving the debt risk and push forward marginal easing for the overall credit environment.”

But despite these reassurances the Evergrande crisis does have implications for the Chinese financial system and the economy as a whole.

As the *Wall Street Journal* columnist James Mackintosh commented, “Evergrande is the Chinese economy in miniature.”

“Both have operated for decades on the principle that it was worth borrowing to build, in Evergrande’s case mostly housing, in China’s case not just apartments, but roads, rail, airports and other infrastructure.”

The Evergrande debacle was sparked by a decision last month to tighten credit regulations for highly leveraged companies, particularly in the real estate sector. It was motivated by the fear that the escalation of debt, which it had previously encouraged, was getting out of control and had to be scaled back lest it provoke a financial crisis.

The government had for some time been seeking to halt debt accumulation, largely to little effect. But the new regulations, characterised as “three red lines,” introduced more stringent measures. Financial authorities declared that borrowers had to meet three criteria: the ratio of liabilities to assets had to be less than 70 percent; net debt to equity ratios had to be below 100 percent and cash levels had to be at least equal to short-term debt.

Evergrande failed on all three. Its business model has depended on the continuous inflow of money and the expectation of a continued rise in the price of apartments.

It sold dwellings off the plan, either through a significant deposit or a full payment, and then used the money obtained to finance further projects. The company is reported to have a total of $300 billion in debts with 778 projects under way in 223 cities. It supplemented its cash flow with short-term borrowings, often from firms in the so-called shadow banking system, and even raised money from its own employees to finance day-to-day

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operations.

For a time, it appeared to be riding an endless property boom and moved into other areas including bottled water, professional sport and electric vehicles. It is now trying desperately to sell of some these assets in order to alleviate its cash-flow crisis.

But with a credit crunch imposed by financial authorities and a falling housing market it is now running out of cash to complete the construction of many apartment block projects.

According to an estimate from Barclays, there are as many as 1.6 million people who have put money into the purchase of apartments they may now never receive.

The crisis is not confined to Evergrande, which has been described as the "tip of the iceberg." The credit rating of the property development Fantasia Group was downgraded by the rating agency Fitch earlier this month and Guangzhou R&F has also had its credit rating downgraded. Earlier this year, China Fortune Land Development, a company that specialises in the development of industrial parks in the northern province of Hubei, defaulted. This cost Ping An, China's biggest insurer, $3.2 billion.

Morgan Stanley has estimated that property development firms defaulted on $6.2 billion of risky debt in the year to mid-August, more than the previous 12 years combined.

Evidence of the broader crisis in the property market was visible this week when television programs around the world showed videos of 15 uncompleted apartment blocks being demolished because the developers had run out of money to complete them.

Despite assurances that Evergrande will not provoke a financial crisis, at least in the very short term, numerous commentators and analysts have pointed to the flow on effects of the Evergrande crisis both for the Chinese economy and the world economy as a whole. It is estimated that property development and related industries account for more than 25 percent of the Chinese economy.

"This is a threat to global growth," Ilya Feygin, a managing director at WallachBeth Capital told the *Wall Street Journal*. "What if things worsen? That means a hit to the financial system in China [and] overall economic activity around the world because of China's importance."

The dangers contained in the rise and rise of Evergrande have been known for some time, but the belief has been that the Chinese government would ensure that they were contained. Now that assessment is at least being questioned.

Goldman Sachs analysts have called on financial authorities to send a "clearer message" on how they intended to stop Evergrande from causing "significant spillovers" to the rest of the economy. Citigroup said officials may commit a "policy error of overtightening" and economists at Société Générale have said there is a 30 percent possibility of a "hard landing."

Ding Shuang, an economist at Standard Chartered in Hong Kong said: "Even though most people don't expect Evergrande to collapse all of a sudden, the silence and lack of major actions from policy makers is making everyone panic."

In a note published on Sunday, Goldman Sachs economists pointed to the longer-term issues for Chinese property development because of its key role in the economy.

"With policy makers showing no signs of wavering on property market deleveraging, the latest headlines regarding Evergrande suggest that housing activity may deteriorate further in the absence of the government providing a clear path towards an eventual resolution," they said.

Some of the companies hardest hit in the stock market selloff triggered by Evergrande have been those involved in the mining and refining of basic metals. And for good reason. Rapid calculations published in the FT noted that the Chinese real estate sector accounts for the consumption of around one-fifth of the world supply of copper and steel.

At the start of the week, iron ore futures in Singapore fell by as much as 11.5 percent to below $100 per tonne. Back in May the ore price was around double this level. Last week iron ore prices fell by 20 percent, in their worst week since the financial crisis of 2008.

This is not entirely due to the Evergrande crisis. But the growing problems in the Chinese property market are feeding into a general assessment that, far from experiencing a bounce-back as governments scrap public health measures to deal with the pandemic, the world economy is entering a downswing.

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