

A new turn in China's Evergrande crisis

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The crisis of the massively indebted Chinese property developer, Evergrande, has entered a new stage with the direct involvement of Chinese regulatory authorities in what appears to be an effort to ensure an orderly re-organisation of its international obligations and eventually a wind up of the company.

The move was precipitated by a company announcement to the Hong Kong stock exchange on Friday evening that it may not be able to meet a demand for repayment of a \$260 million debt.

“In the event that the group is unable to meet its guaranteed obligations or certain other obligations it may lead creditors to demand acceleration of repayment,” it said. “In the light of the current liquidity status of the group, there is no guarantee that the group will have sufficient funds to perform its financial obligations.”

This was a warning that failure to meet the payment would lead to a rush by creditors to secure what they could from the cash-strapped company leading to full-scale liquidation. If that took place, it could have contagious effects on the rest of the highly-indebted Chinese property development sector.

Accordingly, following the announcement, Evergrande's founder and major shareholder, the multi-billionaire Hui Ka Yan, was called to a meeting by the Guangdong provincial government to discuss the company's situation.

Evergrande's position worsened when investors reported that they had not received payments on bonds after the expiration of a 30-day grace period on Monday, effectively meaning it was in formal default.

The crisis emerged last September, when Evergrande began missing debt obligations and only came up with the money during a 30-day grace period, thereby avoiding a declaration of default. It has since been living a hand-to-mouth existence as far as its cash flow is concerned.

It has raked up money by sales of assets and through the sale of shares at vastly deflated prices by Hui, under pressure from the central government, who has then put the money into the company.

Following the meeting with provincial government authorities, Evergrande announced on Monday that “in view of the operations and financial challenges” the board had set up a risk management committee.

Its members include representatives from state-owned companies, including Guangdong Holdings. This is an investment company controlled by the provincial government and China Cinda Asset Management Company, which is one of China's largest managers of distressed assets.

Hui and Evergrande's chief financial officer Pan Darong are also on the new management committee and will “play an important role in mitigating and eliminating the future risks of the group,” the company statement said.

Any pretence by Evergrande that its executives remain in control is exposed by the fact that state authorities have the majority of seats in the new management authority. The operation has been described by the *Financial Times* as a “slow motion collapse” of Evergrande as authorities seek to find third parties to take over its projects.

In response to the latest developments, China's central bank repeated an earlier statement criticising the company for “poor management” and pursuing “blind expansion.”

This is something of a cover-up because Evergrande's modus operandi was very much in line with the promotion of highly indebted property development sanctioned by the central government which is the characteristic of many other developers.

In August last year, however, the central government became increasingly concerned that the model it had promoted was leading to the creation of a financial crisis throughout the property sector. The sector has been estimated to account for up to 30 percent of the Chinese economy when flow-on effects are taken into account.

In an effort to bring the debt bubble under control, authorities instituted what became known as a “three red lines” policy, restricting credit, leading to a crisis for Evergrande as well as others.

Besides heavy borrowing, Evergrande financed itself

with prepayments from purchasers of apartments that were then used to finance further expansion—in effect receiving interest-free cash from buyers in what amounted to a kind of Ponzi scheme.

The move to set up a debt management team has been broadly welcomed in financial circles. Citigroup issued a note to clients saying the “managed restructuring” of Evergrande had officially started.

“We see this is as a positive development, and the uncertainty associated with the debt resolution of the second largest developer in China has been finally removed,” it said.

This claim may be somewhat premature. As an article in the *Wall Street Journal* noted: “The process of thrashing out a restructuring is still in its very early stages.”

Evergrande has had conversations with offshore creditors but has not begun formal talks with them about what a restructuring process would look like, it said.

Debt restructuring processes are never simple because they generally require the agreement of all parties involved over what losses they will take. It can fall apart if some creditors decide they are better off if they pursue their claims independently.

The Chinese government is treading a fine line. It is opposed to organising a bailout because this would cut across its efforts to reduce debt accumulation in the property sector, setting a precedent for other companies that may well go the same way as Evergrande.

As Andrew Lawrence of TS Lombard, a long-time property sector analyst told *the Wall Street Journal*: “Evergrande has definitely pushed it further than most, but there are a lot of developers out there that share the same model. It’s been a massive boom and they’ve overtraded in order to get bigger.”

While opposing bailouts, the central government does not want to precipitate a sudden collapse because of the possible flow-effects to the rest of the financial system, notwithstanding claims by financial authorities that they have the Evergrande situation under control.

There are thousands of Chinese property development companies with at least 100 listed on the Hong Kong stock exchange with a combined market value of \$242 billion. Among the biggest names in trouble is Sinic Holdings Group, which failed to repay \$250 million in bonds last October.

Other defaulters include Modern Land (China), Fantasia Holdings and China Fortune Land Development.

The offshore borrowing of the property development

companies is only the tip of a very much bigger debt iceberg. As the *Journal* reported, according to the Japanese financial firm Nomura, as of last June overall borrowings were in excess of \$5 trillion.

The crisis in the property development market is now starting to make its effects felt throughout the economy. According to a report in the *Australian Financial Review*, China’s top 100 property developers made a combined \$118 billion from sales in September, down 36.2 percent year-on-year, following a 20.7 decline in August.

Construction starts fell 33.14 percent year-on-year in October, following a 13.54 percent fall in September.

The *Financial Times* has reported that sales of urban plots of land have fallen sharply in recent months causing problems for local government authorities which use the revenue from such sales to finance infrastructure projects.

According to Nomura, last year sales of land generated the equivalent of \$1.31 trillion for local governments, more than 30 percent of their total revenue.

The decline in property could make it increasingly difficult for the central government to achieve its growth targets and the growth rate could drop below 5 percent.

As Larry Hu, chief China economist at Macquarie told the FT: “The biggest growth headwind will be the property downturn. The tumbling property sector poses significant contagion risk for the Chinese economy.”



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