Warnings of domino effect if Chinese property giant Evergrande is liquidated

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In little more than two weeks a court case is set to begin in Hong Kong seeking the liquidation of the Chinese property giant Evergrande. This could have major flow on effects for the rest of the property market, the Chinese financial system and even globally.

The case, which is set to begin on October 30, looks almost certain to go ahead unless a last-minute agreement can be reached to restructure Evergrande's debts to offshore bondholders.

Evergrande ran into major problems two years ago when it failed to meet payments on its bonds. A series of negotiations got underway, lasting more than a year, aimed at trying to prevent the liquidation of the company because of fears of what it could trigger.

It appeared that a restructure operation would be undertaken until late last month when Evergrande announced that one of its subsidiaries had failed to make a debt repayment and Chinese authorities said they were undertaking an investigation into the company's chairman Hui Ka Yan.

Few details have been released but it is said that he is subject to "mandatory measures" due to "suspicion of illegal crimes," thought to be related to the transfer of money abroad. As a result of the investigation, his movements have been restricted.

The central component of the restructuring agreement, which has involved protracted and complex negotiations with creditors, was the issuing of new securities by Evergrande to investors that they could convert into equity or debt.

But it now appears that as a result of the investigation that the China Securities Regulatory Commission (CSRC) has refused Evergrande's application to issue the securities.

This has far-reaching implications because, as investors in the company have warned, if the proposed restructuring does not go ahead "it would render any offshore restructuring of Chinese real estate companies a mission impossible."

Writing in the *Sydney Morning Herald* on Wednesday, economic columnist Stepehen Bartholomeusz noted that with the restructuring deal in jeopardy, the "threat to topple the world's most indebted property developer… could trigger a domino-like wave of crashes across the highly-geared property sector."

According to Bartholomeusz, the core group of bond holders involved in the negotiations "warned on Monday that if Evergrande couldn't convince the regulator to allow it to issue new bonds, the abandonment of the restructuring would likely lead to the 'uncontrolled collapse' of the group and have a catastrophic effect on other distressed companies in the sector."

Creditors say they have been left in the dark and there is "zero clarity" as to why the CSRC will not allow the issuing of new securities.

The article provided some important facts and figures on the magnitude of the Evergrande crisis and the worsening situation in the Chinese property sector more broadly.

"Evergrande," Bartholomeusz wrote, "is the big tip of a very large iceberg. It has total liabilities at its last balance sheet date—monies owed, not just to its bondholders and banks but to suppliers and those who have paid deposits for its apartments—of about $335 billion, but total assets of $252 billion, leaving a deficiency in its shareholders funds of $83 billion."

If Evergrande were a stand-alone case, its problems could be dealt with. But dozens of Chinese property developers have defaulted with an estimated $30 billion of missed interest payments last year. Companies that

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have defaulted, either on their principal or interest payments, account for 40 percent of China's home sales.

The problems of the developers are reaching into the financial sector. An analysis by the Hong Kong-based *South China Morning Post* of China's 18 systemically important banks concluded they had $40 billion in non-performing loans to developers as of the end of June, a 37 percent increase over the previous year.

However, as Evergrande heads for liquidation, with all that entails, there is a another, potentially bigger, disaster looming.

This week Country Garden, China's largest property developer and until recent times regarded as secure, issued a statement to the Hong Kong stock exchange that it expects it "will not be able to meet all of its offshore payment obligations" when they become due.

"Such non-payment may lead to relevant creditors of the Group demanding acceleration of payment of the relevant indebtedness owed to them or pursuing enforcement action," it said.

In other words, court action could be launched including possible liquidation.

Country Garden has around $200 billion in liabilities and $10 billion in dollar-denominated debt. Its problems first surfaced in August when it missed an international bond payment. It was able to meet its obligations during a 30-day grace period and avoided a default.

However, in its latest statement, it said it expects it will not be able to make payments "within relevant grace periods," one of which expires next week.

Reporting on the Country Garden crisis, the *Financial Times* (FT) said it had confirmed what investors had been dreading, that it was heading for a default and had hired lawyers to deal with the consequences.

"Shock waves from the Chinese real estate crisis will ripple through Asian markets," the FT warned, adding that any restructuring of the company "would be of a historic size."

Even if there was a restructure operation it would make little difference for investors because the company's bonds trade at around 5 cents on the dollar and its shares have become a "penny stock."

Country Garden is even bigger than Evergrande with about four times the number of housing projects. Last month it disclosed a loss of $7 billion for the first half of the year and its sales volumes for September fell by 81 percent.

The overall situation appears to be worsening. It had been hoped that the first week of October, a holiday time known as "golden week" because of higher property sales, would provide a lift. But sales were down 22 percent on last year.

The problems of the highly indebted developers were triggered by the government's decision in August 2020 to tighten the availability of credit, fearing that the escalation of debt would eventually create systemic financial problems if it continued.

So far it has showed no signs of providing a boost to the property sector. Some minor relaxations on credit have been introduced as well as lower mortgage rates and deposit levels to make home buying more attractive. However, they have had little or no effect.

The Xi Jinping regime no doubt calculates that with the massive state involvement in the banking system it will be able ride out the consequences of the deepening property crisis even as major firms go to the wall. That assumption may prove to be correct, but it will be sorely tested in the coming period and there are certain to be shock waves which will hit both Asia and the rest of the world.

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