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Evergrande: A Disaster in Making for Chinese Economy! - An Essay

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Abstract
China's second largest Agglomerate in the field of real estate Evergrande, over the years increased its debt to 300 bn. Dollar in the garb of extending its operations, venturing into the field of electric vehicle manufacturing thereby transgressing all the three redlines imposed by Xi Ping government on debt to be held by companies. Although majority of the borrowing is from one to one within the country, but international bonds are also held by some foreign entities. With this giant not in a position to meet the payment liabilities due since September, 2021, having been caught in a severe cash crunch, has barely managed to repay some dues within the country by disposing the assets at discounted rates and deferring payments to suppliers and by issuing paper bonds. The company has also failed to meet the international obligations in case of international bonds and may seek more time from them, the contagion will spread to some Central banks of countries across the globe but it is not expected to be so serious as in the Lehman Brothers case of 2008. However, due to non-payment of the dues within the country to the creditors and suppliers as well as to the customers who had deposited amount of advance with the company for booking the flats and bungalows in various provinces will cause considerable financial distress within the country, adversely affecting the demand as a whole in the economy. As the Central Government is not willing to bail out the company some of the provincial governments will try to protect the rights of some suppliers and customers to a small extent by disposing off the assets at highly discounted rates; but the proposed modalities of the process are still not clear. The aim is to reduce the impending damage to the targeted rate of growth of the economy, which is very considerably has hither to been achieved by resorting to such actions by big companies which constitute 'moral hazard', as now all creditors and suppliers are expected to act rationally. In this direction, therefore, all the court cases relating to the crisis are transferred to the provinces. However, another problem is the half-finished apartments which constitute a major part of the company's inventory; even for the completed apartments, the demand has dwindled. In China, real estate investment is a major part of average Chinese family expenditure from life-time earnings. With so much of money clogged, the average purchasing power of the citizens will come down drastically, affecting the rate of GDP growth. As the moral hazard growth rate of China has also dried up considerably, the Chinese economy will suffer a steep downward trend, unless they develop other forms of subsidiary growth rate involving moral hazard of some other kind. Looking to these conditions, the latest World Economic Outlook has revised the growth rate projection for China to 8.1% for 2021 and 4.8% for 2022, whereas for India it is 9.0% and 9.0% respectively (Source: IMF, The latest World Economic Outlook, January, 2022).

Keywords: Evergrande, Debt Crisis, Chinese Economy in 2021 and 2022, Moral Hazard Growth Rate of China

Introduction
In just a few years Evergrande Real Estate Group, a regional construction Company, catapulted into one of China's biggest Real Estate Group having more than 1300 projects spread over 380 cities in China. The world is still waiting to find out about what happens to the troubled conglomerate and its mountain of debt. The property developer's debt crisis is a major test for Beijing and some experts fear that it could turn into Chinese Lehman Brothers moment, sending shockwaves across the world economies. It is important to mention here that the real estate sector accounts for 30% of Chinese GDP. On a few occasions the company has failed to meet the crucial debt repayment deadline. What will happen next to the company—will Beijing bail it out or it will be restructured or it will be allowed to fail.

The expansion and how did it run into troubled waters
In recent years, Evergrande's debts ballooned as it borrowed heavily to finance its various pursuits. Now it has accumulated

over $300 billion worth of debt and liabilities and developed into an infamy to have become China's most indebted developer. The giant has also expanded into many other ventures and many experts like Goldman Sachs believe that the company's structure has made it "difficult to ascertain a more precise picture of its recovery". The complexity of Evergrande group and the lack of sufficient information on its assets and liabilities add to the uncertainty. Bekink observes that "The story of Evergrande is the story of the deep structural challenges to China's economy related to debt".

The Financials

Some of the latest Financial Ratios of the company are:

Valuation			
Price/Book	Price/Cash Flow	Price/Sales	Price/Earnings
0.17	0.35	0.07	2.04

Financial Health			
Quick Ratio (Current Assets-Inventories)/ (Current liabilities)	Current Ratio (Current Assets)/ (Current Liabilities)	Interest Coverage	Debt/Equity
0.17	1.24	5.66	3.00

From the above ratios the main observations at macro-level can be summarized as: -

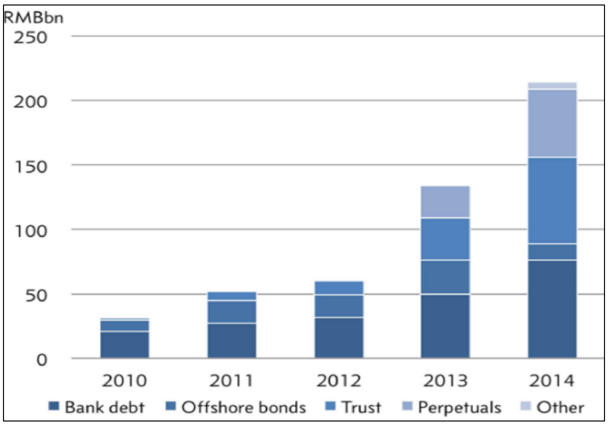
1. Highly leveraged: total debt over 3x shareholders' equity.
2. Reliant on short-term funding.
3. Spiralling interest payments.
4. Negative cash profits.
5. Liabilities probably exceed value of assets: strong possibility insolvent.

The extraordinary growth has been mainly debt-financed. Moreover, it is highly leveraged with large borrowings and other liabilities balanced on a small silver of equity (Debt/Equity). This ratio, as shown above is now over three times shareholders' equity. It is reliant on its lenders' continuing support by offering short-term borrowings.

The ballooning debt

It has been observed that since 2010, more than half of the company's growth started to be financed by debt, rising to two-thirds in the year 2013 and in the year 2014, it tripled. Share of Equity in total funding had fallen to just 13%, despite an increased contribution from minority investors and significant revaluation gains on its investment properties. Similarly, the proportion of financing provided by customer deposits on pre-sold properties had more than halved during this period. The below Figure-1 indicates the breakup of the total borrowings including perpetual capital instruments which had more than tripled by 2014.

Fig-1[1]



Since 2013, the company has borrowed large amounts of perpetual capital instruments. These are regarded as equity for accounting purposes, as they have no fixed repayment date and distributions can be deferred. However, for shareholders it is a debt, as they will be paid ahead of them in case of bankruptcy. Although perpetuals are issued by onshore subsidiaries, they will rank ahead of the company's offshore bonds. However, one peculiar feature of the perpetuals is that after second year, the company is imposed with punitive interest rate.

Thus, Evergrande is reliant on the continuing support of creditors and has a severe refinancing risk. Hence it may not be wise to assume by shareholders and offshore bond holders that Evergrande is "too big to fail".

Weakening cashflow

In order to see if the travails of Evergrande's could have been anticipated, we have to look at the annual reports of the last five years. The crucial revenue figures are given below: -

	2016	2017	2018	2019	2020[2]
Revenue in Millions RMB	211,444	311022	466,196	477,561	507,248
Revenue Growth	59%	47%	49%	2%	6%

Thus, Evergrande's revenue growth fell consistently from 59% to 2% in 2019 before recovering to 6% in 2020, the largest drop being between 2018 and 2019. This is troubling since rapidly falling growth is more than just a warning sign as it may incentivise bad accounting practices and also risky business practices in order to make the figures look pretty.

Although the revenue of the company rose and profits stayed flat, the cash-flow statement tells a different story. The main relevant data are given below:

	2016	2017	2018	2019	2020
Cash Flow from Operations (CFO)	-58,610	-150,973	54,749	-67,357	110,063
Free Cash Flow to the Firm (FCFF)	-44,063	-111,696	99,487	-15,729	169,791
CFO/Net Income	-3.33	-4.07	0.82	-2.1	3.5

Negative CFO shows that the company is unable to make money from its operations. An erratic CFO means that the firm may be at the mercy of lenders to fund its operations.

Net income is a mix of accruals and cash, while CFO is pure cash. Therefore, CFO to Net Income ratio tells how much of

[1] Evergrande: Death Spiral (OTCMKTS: EGRNF) |Seeking Alpha, 2015

[2] Balance Sheet and Annual Reports of Evergrande.

the booked profits for a year were received in cash. In healthy firms, this ratio will be flat to rising. A falling or volatile ratio of CFO/Net Income indicates an unusually high number of accruals and thus both are alarming. An unusually high number of accruals in the income statement is caused by the volatility of the ratio and falling CFO.s

Boosting cash by delaying payments

Delaying payment to the suppliers' bolsters CFO in response to poor cash inflows. The ratio indicating this tendency is the number of days payable outstanding (DPO), or the number of days the cost of sales is lying unpaid. If everything else remains constant, an increasing DPO becomes troublesome. In case of Evergrande, the DPO jumped from 379 days in 2016 to 553 days in 2020. The company's cashflow statement shows that CFO soared from a deficit of 67 BN RMB in 2019 to 110 bn RMB in 2020. This was due to receipt of trade payables, which rose by RMB 77 bn despite decline in property construction activity. This is not sustainable. From this increase in the cashflow, the company repurchased RMB 4 bn of shares and paid dividend worth 59 bn RMB in 2020. This draws the inference that Evergrande likely delayed payments to the suppliers boosting CFO to pay dividends and repurchase shares. At the same time in 2020, it took new loans of RMB 303 bn.

Increasing write-downs

Another manipulation in accounting that was resorted to by Evergrande was showing properties under development (PUD) and properties held for sale (PHS) as assets on its balance sheet. In aggregate, these accounted for nearly 60% of the firm's assets during 2019 and 2020. Although the amounts involved are small, they tend to indicate a deteriorating market for the firm's properties. This trend started in 2017 and ultimately showed slowing growth of sales.

The increasing borrowing costs

The following are the year-wise borrowing cost of the debt for Evergrande: -

2016	2017	2018	2019	2020
8.27%	8.09%	8.11%	8.63%	9.46%

The increase in the borrowing rates may be due to two reasons: - (i) Rise in the general lending rate in China or (ii) increased credit risk. However, China's prime lending rate has remained the same since 2017. Therefore, the only reason can be that the banking sector feels risk in the lendings to Evergrande.

Chinese regulators' crusade against Excessive Debt

For the past several years Chinese regulators have worked hard to reduce overreliance of the economy on debt. As a part of this regulatory push, they have implemented, what is called "the three red lines" for property developers last year. These include hard limits on a company's debt/asset ratio, debt-to-equity ratio and its cash-to-short-term-debt ratio. These three red lines affected all the highly indebted developers, as also Evergrande. The companies were forced to pay down debts, sell assets and many had to cut back their operations.

The reasons were obvious why the policymakers have been so much concerned about real estate debt in China and debt in general—China's official debt-to-GDP ratio soared by 45% points in the last five years, living with amongst the highest debt ratios for any developing country in the history. Moreover, the real estate sector is notorious for its addiction to debt. This they did not only from the banks and bonds but also by preselling apartments to homebuyers many months and years in advance by taking full or partial value in advance. They paid to suppliers and contractors by means of commercial papers and receivables rather than cash. They even sold credit products known as wealth management products to retail investors. As a result, the Real Estate sector became one of the major drivers of Chinese economy accounting for almost 30% of the country's GDP. This generated a real estate bubble where the housing prices became several times higher than the relative household income, much higher than that in the US in 2008 downturn. This resulted in a lot of empty homes and apartments, even as high as 20-25%, especially in more desirable cities, owned by speculative buyers who had no interest in either moving in or renting out. Empty housing creates no economic value, rather it incurs a significant economic cost. Such problem had never stuck China in the past and debt did not become such a big problem as they expected that at the last moment local government and regulators will step in to recapitalize the borrower if needed. As a result, there was very little credit differentiation in lending markets and the Banks, insurance companies and bond funds fell over each other to lend to large, systemically important borrowers. In other words, moral hazard underpinned the entire credit market. Therefore, it is not an easy problem to resolve. If they intervene to support creditors, they will reinforce moral hazard and lose credibility. If they do not and force the borrower and its creditors to work out their disputes using only the internal resources of Evergrande, the regulators will face roiled credit markets, widespread financial distress and the role of debt in propping up China's GDP growth.

Contagion risks within China

The first and foremost contagion risk lies with the credit-market of China. Any credible of moral hazard must transform the Chinese Credit Markets and the ways in which they allocate risks. This process will though be good in the long-run but in short-run it will be financially disruptive process. This is because for three decades, Chinese lenders have made loans based on the assumption that the large borrowers would be bailed out. As a result, the credit and bond portfolios have built around political perceptions and pressures rather than around credit risk and the portfolio needs of creditors and there has been very little discrimination in credit pricing. Therefore, in the long run, the financial markets will have to go through a major repricing of credit and the corresponding reallocation of credit risk portfolios. Reforms of this level will not be easy and all the stake-holders would respond rationally, which will result in creditors to liquidate a substantial portion of their credit portfolios or at the very least, refuse to extend new loans. This very reluctance would create distortions in clearing process, which could lead to financial disruption and the contagion may spread even to healthy borrowers. Signs of such a distress are already becoming visible. For example, homebuyers are frightened by what they read in newspapers and are reluctant to close on homes, resulting in an already sharp declining home sale. They are also likely to refuse to prepurchase unfinished apartments or put down deposits, except at large discounts, thereby squeezing liquidity further and raising financial costs for the developers. Even suppliers and construction workers have stopped work and do not accept commercial papers anymore. As this rational behaviour on part of stakeholders is affecting the whole of the property sector of China, if it is not quickly halted, it will drive the developer companies to insolvency.

Moral hazard growth rate of China

The indications are that the Central Chinese Government would not bail out Evergrande. China's ability to achieve politically determined GDP growth rate targets requires moral hazard and the regulators cannot eliminate moral hazards until Beijing scraps the growth target and allows growth to fall to whatever underlying rate the economy can accommodate. In order to achieve this growth rate China has another source of economic activity, referred to as residual growth. This growth mostly consists of malinvestment by property sector and by local governments building excessive amounts of infrastructure. Whenever high-quality growth falls short of the target, this residual rate makes for it. For example, last year China's growth rate was negative Beijing stepped it by residual growth.

However, the problems faced by the Real Estate Sector in China are hard to resolve as it is a very complicated problem with politically conflicting objectives. However, this may involve what Zhou Xin, of the *South China Morning Post*, describes as another "cocktail of proven tricks: rolling over debt, haircuts on assets and emergency payments to the most vulnerable".

Because local Banks are expected to continue to fund growth, they will probably be next in line, followed by other Chinese creditors, with external currency creditors probably bringing up the rear. A surge in lawsuits by these foreign creditors claim unfair discrimination can be expected. However, a hunt for those who will be held responsible for especially egregious forms of financial losses could also be in the offing.

Is it China's lehman brothers moment?

As Evergrande's woes mounted some commentators are comparing it with the Lehman Brothers fall in 2008, which had filed for bankruptcy in the most dramatic collapse of the global financial crisis. But analysts have largely talked down the global financial crisis comparison which will be too pessimistic to think. While the US and Chinese financial systems are vastly different, with government intervention in China is far from an exception, the comparison is accurate in that both firms engaged in irresponsible activities when times were good and later faced the spectre of sudden illiquidity when financial conditions deteriorated. On the other hand, in China's case, the deterioration was to some extent self-imposed due to tightening of restrictions on real estate firm indebtedness.

Other startling difference is that Lehman was dealing with cash, whereas Evergrande's principal asset is land bank. The Chinese government, while being averse to bail out, has rightly been urging Evergrande to liquidate its unsold properties in order to stave off default on interest on its US bond falling, due shortly, but it will take liberties with the distant off-shore lenders by pleading for time and getting it. Furthermore, unlike in the US crisis, the flashpoint in L'affaire Evergrande is not default by home loan takers but by the property developer Evergrande itself. And the putative default is only with regard to interest with the earliest tranche of bonds maturing in 2024. That said, the market cannot be oblivious of the brewing trouble because real estate accounts for >25% of GDP and 80 percent of household wealth of China. It is also a big source of government revenue. Debt-fuelled real estate growth is one reason China's credit to GDP ratio is 300 percent-plus. What should worry Chinese Government is the unedifying appellation of junk bonds Evergrande's debt instrument has inevitably attracted. Evergrande's dollar bond due 2025 is indicated at 25.2 cents on the dollar as Bloomberg compilation shows.

The latest World Economic Outlook has revised the growth projection of China to 8.1% in 2021 and 4.8% in 2022, whereas for India it is 9.0% and 9.0% respectively[3].

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