

FUNDAMENTAL FLASH

Unpacking Evergrande's Debt Woes

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Too Big to Fail?

There has been plenty of market chatter regarding the potential default of China's leading real estate developer Evergrande.

With over US\$300 billion in liabilities, the property giant is also the most indebted in the world. Is this a 'Lehman moment' for China and how could this impact the bond market?

Esther Teo, Senior Director, Fixed Income shares her thoughts in our latest Fundamental Flash.

Questions

1. Last week, China's Evergrande managed to resolve an interest payment due on its onshore bond, although its fair to say they are not out of the woods yet. What are our expectations and is a default on the cards?

In our view, a default appears imminent. Even if the group is able to resolve its overdue interest payments, Evergrande will be facing a maturity wall in 2022; where it has USD\$8.1bn worth of offshore USD bonds that are due for repayment.



Flashpoints

- A default by Evergrande appears imminent with an upcoming maturity wall in 2022 with over US\$8.1 billion worth of offshore USD bonds due for repayment.
- Though, a government-led restructuring of the group to protect interests of various stakeholders can help mitigate the full impact.
- Volatility is expected to remain in the near-term as the saga unfolds. Any potential sell-off could be a knee-jerk reaction with much of the weakness already priced-in.
- Confirmation of a default will remove a key overhang of the market.

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Evergrande has already missed a US\$83.5million coupon payment for one of its bonds on 23 September 2021. The cash-strapped developer has another approximately US\$48million coupon payment due on 29 September 2021.

No easy resolution, but we do expect an orderly restructuring of the firm, led by the government. The process is likely to be lengthy. We believe the government's main focus would be to protect homebuyers' interests; ensuring project construction continues until delivery as well as a handover of completed units.

2. Should investors be worried about a 'Lehman Brothers' moment in China?

In short, we do not believe so. Although the leverage metrics of Evergrande (and other property developers in China) are high, these ratios still do not come close to that as of US financial institutions including Lehman Brothers' prior to the 2008-GFC.

The investor base for Evergrande is also much smaller compared to Lehman's. Hence, we believe the spill over implications and effects would not be as significant. Nevertheless, we will not rule out the possibility of additional high yield bonds from the sector defaulting by year end.

3. What is the outlook for the Asian and Chinese bond market?

Volatility will be here to stay in the near-term given that sentiment is expected to remain fragile as the Evergrande saga unfolds. We could see another round of sell-off upon confirmation of Evergrande's default; even though much of this has already been priced-in by the market.

The sell-off would likely impact lower-rated developers with weaker liquidity profiles. However, this would be more of a knee-jerk reaction given the largest overhang for the market has been removed. In addition, we believe valuations for the Chinese property high-yield (HY) bond market will be undemanding post sell-off.

4. Could we see any spill over effects to other sectors beyond property?

So far, the spill over effects are mainly felt within the property sector itself. Evergrande's outstanding borrowings account for 0.14% of the total outstanding loans in China. Hence from this perspective, the risk should be manageable. There could be contagion impacts to the supply chain especially business counterparts that have been reliant on Evergrande.

However, the Chinese economy is still reliant on the property sector, where it collectively (*both directly & indirectly*) account for 25-30% of China's GDP.

The Chinese developers' financial difficulties may have an amplified tightening effect on the credit conditions and future economic outlook for China.

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5. How are we positioning our Fixed Income portfolios?

As bond markets are expected to stay volatile until the market has more clarity, we remain prudent in our credit selection process. We are constantly monitoring the credit profiles of the companies in our universe, and we are comfortable with the liquidity profile of the companies that we have positions in.

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