Weekly Credit Brief Jul 27 - Aug 02 2021

Evergrande's credit crisis peaks as repayment pressures pile on and refinancing woes deepen

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- **Consistent with the NUS-CRI Forward 1-year PD data presented in our June Weekly Credit Brief, Evergrande's credit risk profile has indeed continued to deteriorate after Jun-2021**
- **Drivers of increasing credit risk include weakened access to capital markets and credit lines as well as low lender confidence amid the slate of recent tumultuous events**

In Jun-2021, NUS-CRI released a brief discussing how the world's most indebted property conglomerate, China Evergrande Group (Evergrande), had been facing heightened credit risks, partially due to the impact of regulatory overhauls that took the property sector by storm and concerns surrounding the company's financial health. In line with last month's NUS-CRI Forward 1-year Probability of Default (Forward PD[1]) data, Evergrande's PD since then has indeed risen, surpassing the B+ upper bound according to PDiR2.0[2] in late Jul-2021 and reaching an all-time high of 500bps (See Figure 1a). Evergrande's rising credit risk comes amid weakening refinancing capabilities, primarily driven by its weakening access to capital markets and bank credit lines for funding. Concerns over its liquidity have also soared amid the company's reversal on its promise to pay a special dividend to its investors and halts in sales of its ongoing projects.

As indicated by the worsening Forward PD between Jun-2021 and Jul-2021, Evergrande's short-term default risk has skyrocketed, suggesting that the company is increasingly likely to default soon without intervention from the Chinese authorities or other private entities (See Figure 1b). Conditional on the survival of the ongoing credit crisis in the short run, however, the Forward PD also highlights a probable improvement in Evergrande's subsequent credit health. This may be driven by state or others' support, or liquidation of assets owned by the company[3]. That being said, with a possible default on the horizon, it remains to be seen whether the conglomerate will be able to tide through the rough waters without assistance from others.

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.
[3] This includes Evergrande's tourism property, electric vehicle subsidiary, among others.

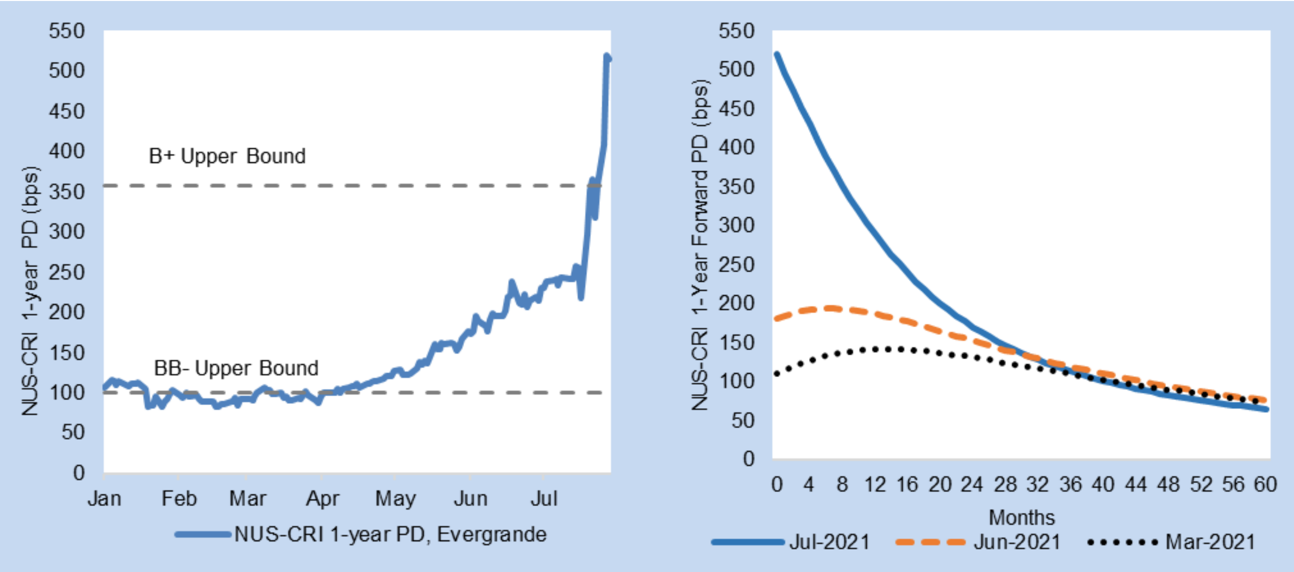

Figure 1a (LHS): NUS-CRI 1-year PD for China Evergrande Group from Jan-2021 to Jul-2021 with reference to PDiR2.0 bound. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Evergrande in Mar-2021, Jun-2021 and Jul-2021. *Source: NUS-CRI*

In a bid to deleverage, Evergrande has become heavily reliant on the use of commercial paper, a popular financing tool in China's real estate industry. The short-term nature of these bills leaves the company particularly susceptible to liquidity dry-up, and Evergrande's growing reliance on them could reflect the increasing reluctance of lenders to provide the company with long-term financing. Thus, despite the widely publicized deleveraging that occurred this year, the company's ramping up of short-term IOUs raises questions about whether its deleveraging strategy has truly made its finances more sustainable. Although the debt on its balance sheet has fallen, its total trade and bills payables grew 14% to CNY 622bn, alongside an increase in its total liabilities which reached a record CNY 1.95tn in late 2020.

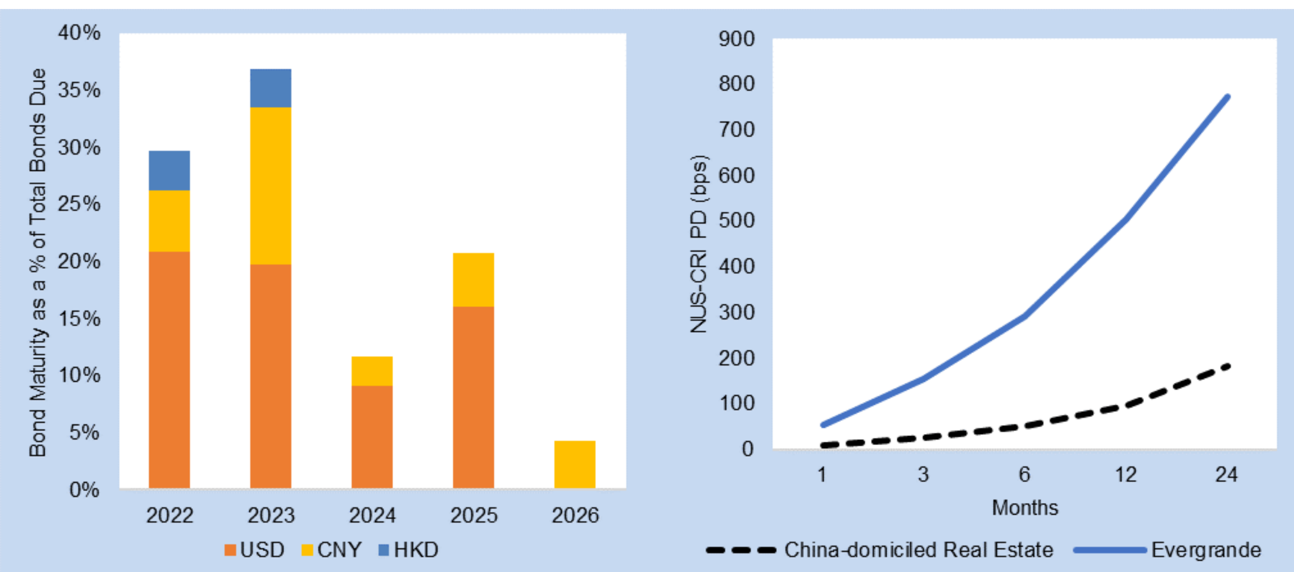

Figure 2a (LHS): Bond Maturity as a percentage of total bonds due by year. Figure 2b (RHS): NUS-CRI PD 24-month term structure for Evergrande and other Chinese real estate developers, as extracted on 29th July 2021. *Source: Bloomberg, NUS-CRI*

Despite deleveraging, Evergrande still faces a heavy debt burden. With more than 60% of its debts due in the next two years (See Figure 2a), refinancing its debts could become an increasingly difficult task. Its USD denominated bonds due 2022[4] are trading at around 131% YTM, underlining the mounting pressures on the company's access to the debt capital markets for short-term refinancing. Equity financing could also prove increasingly challenging as recent events, including the company's decision to forgo a planned special dividend and China Guangfa Bank's request to freeze CNY 132mn of Hengda's deposits in a court order, have further spooked investors. Consequently, Evergrande's shares have fallen by over 70% since the start of Aug-2020. Beyond capital markets, Evergrande faces increasingly limited financing options from banks, with major Chinese

[4] China Evergrande Group 9.5% bond maturing in Apr 2022. Yield referenced as of 3rd August 2021.

banks recently restricting credit to the debt-laden distressed company. Banks are also limiting the company's use of untapped credit lines in an effort to mitigate further exposure. Furthermore, trust funds, which are the second biggest lenders to Evergrande, have also been reassessing their exposure to Evergrande. The growing reluctance of banks and trust funds to extend loans could further restrict Evergrande's refinancing capabilities, especially amid sustained curbs on liquidity flowing to the Chinese property industry. Resultantly, the NUS-CRI PD term structure at the end of Jul-2021 (See Figure 2b) demonstrates the increasing divergence between Evergrande and its peers as the debt burden coming due over the next 24 months puts excessive liquidity pressure on an already cash-strapped Evergrande.

Evergrande's predicament is also testing its 'too-big-to-fail' position. A possible solution to its troubles could take a form similar to Suning.com's state-bailout, which saw the Chinese retailer raising USD 1.36bn in investments from a consortium linked to governments in Jiangsu in exchange for control of the company. The systemic risk Evergrande poses to China indicates that state support could be possible. With USD 300bn in liabilities to over 128 banks and 121 non-banking institutions, Evergrande's default would generate shockwaves throughout China's financial system. Late payments could result in cross-defaults rippling through the financial sector as many financial institutions have exposure to Evergrande through direct loans and indirect holdings of the company's financial instruments. Furthermore, as bonds issued by Evergrande account for a heavy 4% of the high-yield Chinese real-estate market, a sell-off in the developer's bonds may cause ripple effects in the wider HY credit markets. The residual impact of missed commercial paper payments would also weigh on the liquidity of Evergrande's suppliers who hold large stakes in the developer's IOUs, and are less able to absorb losses. The creditworthiness of the Chinese banking network has already been plagued by potential systemic risk brought upon by their large exposure to the heavily indebted property sector, an industry where creditor confidence has already soured due to recent defaults by China Fortune Land Development Co. and Sichuan Languang Development Co.

These pressures are worsened by challenges to its cash flow generating abilities, exemplified by a recent suspension of the pre-sales for two of its housing projects. During pre-sales, Chinese developers are required to deposit funds into supervised bank accounts. Although Evergrande's sales were subsequently allowed to resume, the possibility that insufficient deposits triggered the sales halt highlights their strained cash flows. Evergrande's sales model has also been under scrutiny due to its reliance on pre-sales, a notoriously unstable source of revenue. When pre-sales tumble, the developer will be forced to borrow more from banks by pledging assets and higher guarantees; suppliers could also demand earlier payment and consumers' confidence in the completion of the development falls. This may result in lower margins for Evergrande as the developer reduces prices to boost sales.

To make matters worse, Evergrande's onshore subsidiary, Hengda, recently delayed payment on some commercial papers, underscoring the pressure on Evergrande's liquidity. In an effort to shore up finances, Evergrande has recently sold stakes in its Internet unit, HengTen Networks Group Ltd. Although Evergrande is an asset-rich company and the sale of assets to increase their cash position may provide sufficient liquidity in the short term, it will have a negative impact on their margins. The developer has also had its assets frozen on account of civil lawsuits brought forward by a state-backed builder, further limiting its ability to improve liquidity through asset sales.

However, Evergrande could be at a turning point. On one hand, its default risk has reached an all-time high as refinancing pressures weigh on the company while its access to credit lines is weakening. Major Hong Kong banks have stopped extending mortgages for two of Evergrande's real estate developments due to concerns over the developer's lack of liquidity to complete its projects. On the other hand, regulators in China and Hong Kong may still want to prevent a steep loss of faith in Evergrande due to the company's interconnectedness in China's domestic real estate and financial sector. Hence, the credit outlook and financial health of the company may improve in the near term, as the likelihood of a state bailout increases amidst its recent cash troubles. Although the systemic risk posed by the company could pressure the Chinese authorities into supporting the world's most indebted developer, the decision to intervene may be weighed against the state's ongoing campaign to curb the moral hazard problem.

Credit News

Credit market pain seen potentially spreading from China to U.S

July 28. Amid the Chinese government's crackdown on industries, such as technology, education, and property, rising credit stress in China could spread to US investors' credit portfolios. The resultant selloff of more liquid and high-performing US high-yield bonds of global fund managers to meet redemptions could weigh in on their valuations. Credit distress in China is the most significant risk to credit markets worldwide. As the government may allow more defaults, much of the outcome in China depends on what the government does next. On Wednesday, yields on Chinese junk dollar bonds hit a 15-month high. One of the biggest concerns now is China Evergrande Group, whose dollar bonds due 2025 fell to about 44.5%. While the fallout from Evergrande and the China regulatory risks has so far been solely in Asia, one source of vulnerability for US junk bonds is their relatively high valuations as the Bloomberg Barclays US Corporate High Yield total return index hover close to the record-high level. (Bloomberg)

Hot housing market lets banks sell mortgage risk

July 28. A boom in the housing market has created a market for a new kind of security. A bond that shares mortgage risk and loan defaults with institutional investors. Texas Capital Bank recently sold USD 275mn of such bonds, backed by short-term loans made by the bank to mortgage lenders. If the lenders' borrowers default, the loss is borne by the investors of the bonds. Such products aim at safeguarding Fannie Mae and Freddie Mac from a reversal in the mortgage market. Large banks have increased the sale of such securities, especially those that are backing mortgages, auto loans, and corporate loans. However, the entry of regional banks into this space marks a new phase in the market's expansion. (WSJ)

Guaranteed loans are one sign of confidence in Chinese companies

July 29. The underwritten corporate loans in China indicate a growth outlook for Chinese companies, even though the regulatory crackdown triggers investors' concerns. The underwritten loans issued in mainland China and Hong Kong increased 35% YoY to USD 9bn in the first half of 2021, reaching the highest first half-year since 2019. The increase shows debt dealers' confidence in the borrowers as otherwise; they will get in trouble with a surplus of unsubscribed debts in the primary market. For now, the recovering Chinese economy and ample liquidity in the loan market have kept bankers optimistic about the outlook of underwritten loans. However, demand for the underwritten loans will decrease if the regulatory crackdown hinders Chinese corporate activities (Bloomberg)

UK banks scramble to meet demand for mortgages

July 25. UK's banks and building societies are now struggling to keep up with a booming mortgage market, which has become increasingly competitive and thus may adversely affect profit. Average mortgage spreads, which are used as a benchmark to measure the profitability of mortgage loans, reached a seven-year high by the end of 2020 and have since been on a gradual decline. The competition, which creates a challenging environment for banks, is good news for borrowers. The average interest rate for a two-year fixed mortgage with 75% loan-to-value was almost at an all-time low in June-2021. (FT)

End of student loan relief poses risk to Credit card, Auto ABS

July 30. When the COVID-related relief program expires on Sep 30, US consumers will need to resume making payments on federal student loans, and some may face difficulties. This phenomenon could spill over into bonds backed by student loans, along with auto loans and credit cards, which have fared well over the last year, thanks to COVID stimulus and debt relief programs that have helped borrowers pay their bills or skip payments. The Mar 2020 CARES ACT suspended payments and collections on defaulted federal student loans and reduced interest rates down to 0%. The program covered USD 1.5tn of federal student loans, amounting to 94% of total outstanding. When consumers restart payments, it may put pressure on their overall finances, extending to other areas of consumer asset-backed securities. As conditions normalize where a relatively high number of borrowers shift from non-repayment to repayment status, the student loan market is expected to see weaker credit performance. (Bloomberg)

Trillions of negative-yielding debt redeem Europe's bond bulls (Bloomberg)

Air Canada sells record "Loonie" junk bond in boosted debt deal (Bloomberg)

Monte Paschi is Europe's worst lender as UniCredit deal looms (Bloomberg)

Regulatory Updates

US benchmark reform panel endorses forward-looking rate to replace Libor

July 30. The US benchmark reform panel approves a new term rate based on the US-priority Libor alternative, Sofr, to replace the scandal-damaged benchmark Libor. Regulators have announced to withdraw significantly from Libor by the end of this year and adopt alternative reference rates for new contracts from next year. To meet all business needs, Sofr should cover both back- and forward-looking interest rates. Last week, the Alternative Reference Rates Committee, ARRC, boosted its confidence in term Sofr. Although it is still uncertain which alternative interest rate will be the new practice next, the ARRC hopes that it can be left for companies to decide based on the business needs. (FT)

Fed's Bullard wants taper to start in fall, end by Mar-2022

July 30. James Bullard, president of the Federal Reserve Bank of St. Louis, said that policymakers should begin tapering in September 2021 and complete it by the end of the first quarter of 2022. The timeline suggested by Bullard is more aggressive than the one envisaged by the Fed chief, who reiterated in the latest meeting that the purchases would continue until there is substantial progress towards their goals for employment and inflation. Bullard warns that if the Fed starts tapering in 2022, it might have to tackle a higher level of inflation which would require the committee to raise rates rapidly. He believes that an aggressive increase in rates could prove to be disruptive and increase the risk of a recession. (Bloomberg)

Cash flood drives use of Fed reverse repo to record USD 1tn (Bloomberg)

Colombia holds key rate but signals tightening to come (Bloomberg)

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