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China Evergrande Group's credit risk soared to an all-time high amid weak investor confidence and stringent regulation

by Wang Anyi

- **Evergrande's NUS-CRI Agg PD soared to an all-time high as investors' confidence slumped**
- **Evergrande faces worsened credit outlook due to deteriorating financial health and stricter regulations**

In Oct 2020, NUS-CRI released a brief covering the China Evergrande Group (Evergrande) after Chinese regulators put forward the Three Red Lines (TRL) policy to curb excessive borrowing in the debt-laden real estate sector. Based on 2020 finances, Evergrande, the largest junk bond issuer in Asia, was one of the four players that remained in breach of the TRL and thus faces several limitations in further borrowing. Since the announcement of the TRL policy, the company has managed to raise funds through alternative methods including listing the spinoff, accelerating the sales, etc. Despite these efforts, its credit quality continued to worsen as concerns surrounding its solvency intensified. This is showcased by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD), which has increased since the TRL policy announcement in Aug-2020 and soared to an all-time high of 196bps in Jun-2021 (Figure 1a). In contrast, most of its peers have gone through a faster deleveraging process, thus demonstrating a more stable credit quality as shown by their Agg PD (Figure 1a).

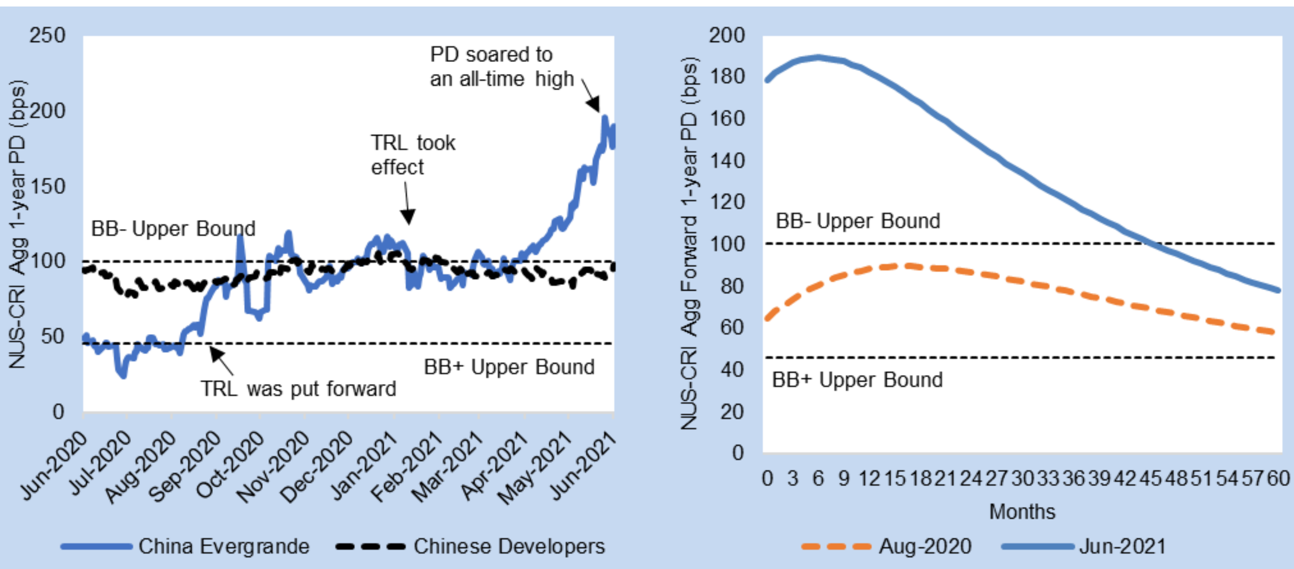

Figure 1a (LHS): NUS-CRI Agg 1-year PD for China Evergrande Group and other Chinese Developers from Jun-2020 to Jun-2021 with reference to PDiR2.0[1] bound. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Evergrande in Aug-2020 and Jun-2021 with reference to PDiR2.0 bound. *Source: NUS-CRI*

The credit outlook of Evergrande also worsened since Aug-2020, as demonstrated by the upward shift of the NUS-CRI Agg Forward 1-year PD (Forward PD[2]) in Figure 1b. This can be partially attributed to the Chinese watchdog's policies. Specifically, the Chinese government has been tightening shadow funding of development projects, in addition to curbs on traditional funding via TRL policy. For years, China's property developers have tapped shadowy pools of capital to fund real estate projects. Evergrande has also drawn on shadow lenders. It issued debt privately with over a 15% annual interest rate to at least one onshore and two offshore trust

[1] 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.
[2] 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.

companies in 2020. Furthermore, Evergrande also has other liabilities in disguise which are not captured by TRL metrics. For example, its contract liabilities, mainly the presale of not-yet-built housing, increased 43% last year. As the tightening scrutiny of shadow debts will further limit developers' access to funding, the debt-ridden company would face bigger challenges ahead.

The recent anxiety over Evergrande's credit health stems from an investigation into the CNY 100bn of potentially illegal funding transactions between Evergrande and Shengjing Bank. Shengjing Bank holds a substantial amount of Evergrande's bonds, while Evergrande, the largest shareholder of Shengjing, owns a 36.4% stake in the lender. Caixin media's WeNews alleged Shengjing Bank for both, directly and indirectly, lending up to USD 20bn to Evergrande, although the investigation did not reach a conclusion. This negative news triggered a selloff of Evergrande's offshore bonds. The price of the company's dollar bond due in Jun 2025 fell dramatically in May-2021 and it's currently traded at a YTM of around 20%, much higher than the 14% before the news (Figure 3). Meanwhile, the YTM of Evergrande's bond due in Apr-2022 surged to almost 30%. The slump in investor confidence may greatly hinder the company from favorable borrowing terms and constrain its ability to roll over its debt.

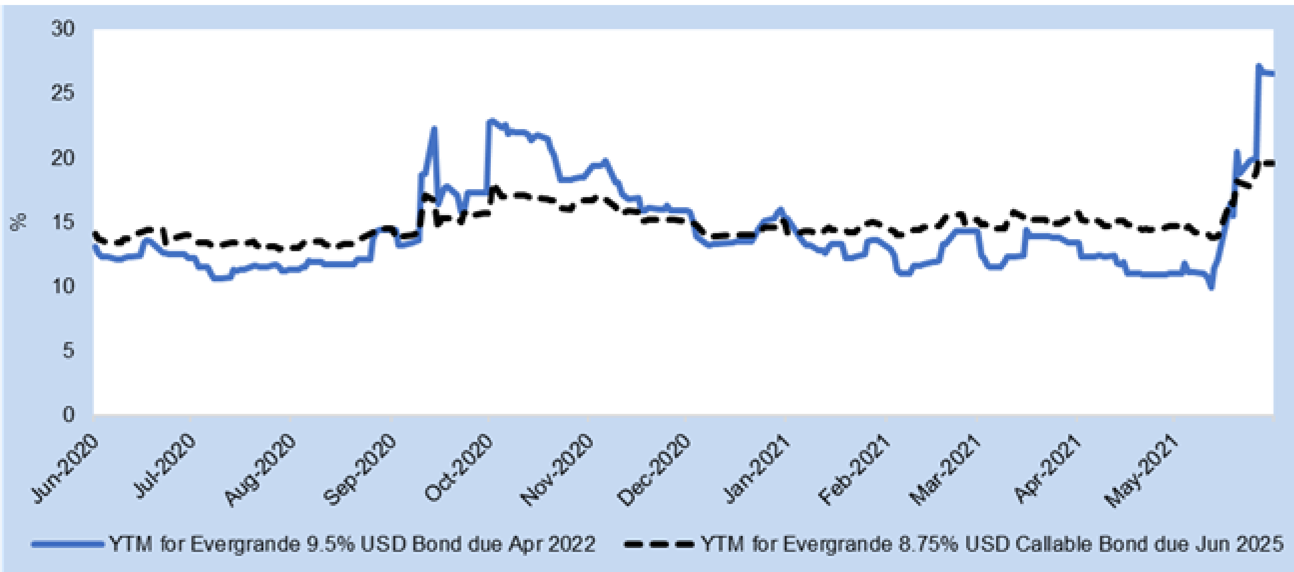

Figure 2: YTM for Evergande's USD-denominated short-term and long-term corporate bonds. *Source: Bloomberg*

Furthermore, Evergrande's finances and credit health are also unfavorable. Its Total Debt to EBITDA was 10.16 at the end of 2020, in stark contrast to its competitors (See Table 1). The Cash to Short-term Debt ratio was 0.5, falling short of the TRL requirement of 1.0. The current YTM of bonds due in 2021 and 2022 (Figure 2) indicates the high borrowing costs it would face should it need to raise funds now. Given that 77% of its debt will come due in the next 12 months, there is a considerable risk on short-term liquidity.

Company	Total Debt to EBITDA	Cash and Cash Equivalents to Short-term Debt
China Evergrande	10.16	0.47
Vanke	2.31	2.18
Country Garden	4.42	1.73
China Overseas	3.52	2.44

Table 1: Total Debt to EBITDA and Cash and Cash Equivalents to Short-term Debt in 2020 for China Evergrande and its competitors. *Source: Bloomberg*

Last week, Chinese regulators asked banks to stress test their exposure to Evergrande, highlighting the seriousness of the government's concern. The company is considered systemically important due to its extensive borrowings from 128 banks and 121 trusts, its dependence on local governments, as well as its ties with substantial households' wealth. 81% of its debt due in 2021 is from banks, including ICBC and China Minsheng Bank.

With the tighter scrutiny and potentially little-to-no support from the government, Evergrande faces an uncertain future. On the positive side, Evergrande has undertaken multiple steps to raise funds and restore investor confidence. Last year, it obtained a USD 4.6bn investment from state-linked companies and lined up 23 investors for the spinoff of its property services arm, Evergrande Property Services Group Ltd. In terms of sales, Evergrande's sales from January to May this year increased by 4.5% YoY, exceeding the 3.7% target. The Group also sold a small portion of its shares in its subsidiary Evergrande New Energy Vehicle, through which it raised HKD 10.6bn. Meanwhile, it is taking some of the most aggressive steps, pledging to list its 8 subsidiaries in different sectors to acquire more funds through equity financing. It recently announced that its debt level will drop close to the year-end target and meet at least one of the red lines by the end of June. However, considering the Evergrande's unfavorable credit profile, coupled with the mounting refinancing risks and regulatory pressures, the possibility of a continued worsening credit outlook and even a default cannot be ignored. As the asset manager Huarong and travel conglomerate Hainan Airlines Group (HNA) have already shaken investors' confidence in China's capital market, Evergrande finds itself in a delicate position.

Credit News

Bond Funds cheer Emerging Markets moving fast to choke inflation

June 14. Bond investors are seeking investments in emerging markets that have reacted proactively to manage inflation. Central bankers in emerging market economies have to maintain a fine balance between reducing inflationary pressures (driven by climbing commodity prices) and stimulating recovery in struggling economies. Brazil and Russia have succeeded in attracting bond investors as central bankers in both countries have reiterated their commitment to maintaining inflation within target and have undertaken multiple rate hikes. On the other hand, investors have been wary of investing in economies like Poland and Hungary, where policymakers have not addressed mounting price pressures. However, irrespective of local central bank stance, the looming threat faced by all emerging economies is the possibility of rate hikes by the US Federal Reserve, possibly resulting in investment outflow from emerging markets. (Bloomberg)

Riskier Mortgage Bonds Thrive Off U.K. Pandemic Property Boom

June 11. As a result of the Treasury's tax holiday on property purchases and a housing boom that favors lower-end borrowers, mortgage securitization has been experiencing increased demand. Lenders have been increasing their lending facilities to cater to lower-end homeowners who typically fail mortgage requirements. Non-bank lenders have sold more than GBP 17bn of debt pooling non-confirming and buy-to-let loans, the highest in 4 years. Extensive monetary stimulus provides a source of cheap funds for lenders. Coupled with The Bank of England's emergency bond-buying program, which contributed to diminished corporate bond yields, bond investors are venturing into riskier loans like mortgage securitization. Non-bank lenders are one of the main drivers fuelling the demand in residential mortgage-backed securities, with traditional banks increasing their rate of borrowing only by a small margin as many have leapfrogged debt markets in favor of cheaper central bank funding. (Bloomberg)

Green Junk Bonds may not deliver green results

June 9. A record number of junk-rated green bonds is on track to be issued this year. However, these green bonds, which are meant to finance environmental projects, often include fine-print warnings that the companies might not fulfill their environmental pledges. As such, there is no legal recourse for investors, and the only loss to a borrower for failing to fulfill its environmental pledge is reputational. This is fueling concerns of 'greenwashing' in green bond sales. Nevertheless, even without legal proscriptions, companies may not be willing to risk damage to their environmental credentials due to the risk of a public-relations fallout, and there have so far been no public cases of an issuer intentionally reneging on its environmental commitment. (WSJ)

Bond Market Bargains Stoke M&A Frenzy in Nordic Property Sector

June 9. The Nordic property sector has experienced increased consolidation led by low borrowing costs in the European bond markets. Companies are increasingly refinancing their expensive debts with European bonds in hopes of taking over smaller rival firms. These long-term bonds with interest rates materially below 1% are only accessible to a small number of large listed entities. As such, the refinancing of expensive debt with cheaper European bonds will allow these larger companies to consolidate the property sector. Stock market trends are a key factor behind increasing M&A transactions in the following years. The presence of small companies trading at lower premiums to net asset values as compared to the larger companies results in large differences in valuations among real estate firms. Since shares can finance acquisitions, these differences translate into more takeovers. (Bloomberg)

Huarong, Evergrande Bond Slump Tests Too-Big-to-Fail Belief

June 9. Amid the barrage of negative news in recent weeks, China Evergrande Group's bonds and shares have slumped further, adding to the sense of unease created by Huarong Asset Management Co. and raising concerns over contagion risks in the country's USD862bn bond market. The dollar bonds for both companies have been causing losses for investors, with Evergrande's dollar note due 2025 falling 0.3 cents to 73.1 cents, on pace for its lowest close since Oct-2020, and Huarong's longer-dated dollar bonds still trading well below par. Evergrande's shares also sank as much as 7.6% on Wednesday as HKD 336mn buyback earlier in the week failed to arrest the slump in its stock, which has tumbled about 60% from its peak last July. The selloff further worsened after reports that its transactions with Shengjing Bank were under investigation by banking regulators. (Bloomberg)

EU prepares for take-off with EUR 800bn bond issuance scheme (FT)

U.S. 10-Year Treasury Yield Slips Below 1.5% (WSJ)

Demand Surges for Bonds With Rating-Cut Protection (Bloomberg)

Regulatory Updates

RBI explores buying highly rated foreign corporation bonds

June 14. Shifting from its current strategy of investing solely in gold and sovereign debt, the Reserve Bank of India (RBI) is exploring the possibility of investing in investment-grade foreign corporate bonds to capture the higher yields. The investment in overseas corporate debt will be a minuscule fraction of the forex reserves RBI holds. RBI also seeks to engage external investment managers to manage part of its USD 600bn forex reserves, thus reinstating a process that had been discontinued for the past few years. In the past, investment managers were required by regulation to restrict their investments to deposits with central banks, foreign commercial banks, and sovereign or sovereign guaranteed debt instruments with maturities of less than 10 years. (Mint)

ECB's Knot says European debt rules need to become more flexible

June 11. Copious budget spending and suspension of the EU's debt limits during the pandemic has bode well for the region's recovery so far. However, in a recent speech, ECB policymaker Klaas Knot said that such flexibility should be an intrinsic feature of the system and not one that arises only in emergencies. The EU's normal fiscal rules limit member states' budget deficits to 3% of economic output and are part of a pact that aims to rein in excessive borrowing by its member states. However, with long-standing taboos, such as joint debt issuance being broken and low-interest rates likely to persist, Knot argues that more importance should be placed on the structural role of fiscal policy in the region's macroeconomic stabilization. In particular, he highlights the crucial role that fiscal policy plays in generating potential economic growth, which could, in turn, increases states' debt repayment capacities. (Bloomberg)

China's top banking regulator warns of bad debt, local real estate bubbles (Reuters)

China Tells Banks to Stress Test Their Evergrande Exposure (Bloomberg)

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