Lazard Emerging Markets Debt
Letter from the Manager

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Assessing Evergrande and Potential Contagion Risks

China Evergrande Group, China's second-largest property developer, appears to be on the verge of becoming one of China's biggest debt restructurings. We do not hold any exposure to Evergrande in our emerging markets debt portfolios, however, given the size of Evergrande's balance sheet and recent headlines on the company, we have summarized our views on the potential for contagion.

What Is the Potential Fallout for the Chinese Real Estate Sector and Emerging Markets Corporates More Broadly?

We expect contagion from Evergrande's debt restructuring to be well-contained, with defaults and underperformance mostly limited to only the weakest among China's high yield property developers. Importantly, we do not expect the restructuring to trigger a broad-based sell-off in emerging markets corporate credit.

Markets are already pricing in an extremely pessimistic scenario for China's high yield property developers, with average spreads at distressed levels above 1000 basis points (bps) since July. The weakest, most liquidity-challenged high yield developers in China have borne the brunt of Evergrande contagion risk to date, with some 20% of Chinese property bonds now yielding 15% or more. Importantly, we do not view Evergrande's restructuring as a concern for the broader emerging markets credit universe, or even the Chinese property sector as a whole. Indeed, since Evergrande's bonds initially sold-off, high yield emerging markets corporate spreads have absorbed these risks and have tightened. Spreads on investment grade China property bonds have also tightened over this period—evidence that credit markets are appropriately distinguishing between financially challenged developers and the better capitalized, more cash-rich developers who meet China's "Three Red Lines" policy for curtailing excessive debt-to-capital ratios and ensuring liquidity sufficient to cover short-term debt.

China banks' exposure to Evergrande is small, and we do not see a systemic risk from a sudden collapse of the banking sector. The property sector traditionally has not relied on the banking sector for financing due to regulatory constraints. Of Evergrande's more than $300 billion in liabilities, less than $50 billion is in the form of bank loans, which are senior in any case to other capital structures. Even if the company did default on its bank loans, the impact should be manageable as the largest lenders, China Minsheng Bank and ICBC, are well-run banks with trillions of dollars in assets, and one local bank is owned by Evergrande itself. Banks have a greater exposure to real estate through mortgages with relatively safe loan-to-value ratios of less than 60%. Current owners who bought the title of their units from Evergrande should continue to service these obligations, which have little to do with Evergrande. Additionally, the People's Bank of China (PBoC) has signaled its ability and willingness to avoid a funding squeeze by injecting $14 billion of liquidity into the financial system on 17 September.

From the banks' perspective, the potential solution already exists, as Chinese authorities have shown a willingness to intervene in large workouts. We spoke privately with members of the management teams at the two of the largest state-owned banks in China in mid-September about the Evergrande situation and asked for their "personal thoughts" on how it will get resolved. Both management teams felt that the government will intervene to avoid a "hard and sudden default," which would create confusion among home buyers and suppliers. (Indeed, reports of such confusion are already being reported in some cities.)

The workout process will likely be similar to that of other recent high-profile bankruptcies: Anbang Insurance and HNA Airlines. In those, instances, the government appointed large state-owned enterprises (SOEs) as liquidators to mop up the liability stream by selling assets over the course of two or three years. And just last quarter, the government quickly bailed out Huarong Asset

Management, China's largest holder of distressed debt, because of its "too big to fail" status. Had Huarong faced a default, the commercial implication of unwinding too many contracts in the financial system would have caused people to lose faith in the system itself, which would have been a true "Lehman moment." By comparison, we believe Evergrande poses a relatively minor threat to the financial system. It involves a smaller group of real customers, the buyers who had put up deposits without getting their homes and the suppliers who haven't been paid for building them. The two groups can somehow be made whole, perhaps by transitioning unfinished properties to different developers.

What about the Social Impact?

Investors in Wealth Management Products (WMPs) may suffer losses. WMPs account for a significant share of Evergrande's liabilities. When WMP investors buy these instruments, which typically yield between 5%–8% and mature in less than a year, they are required to sign documents attesting to the fact that they understand the risks suggested by these juicy yields. Previous instances of WMP defaults had widely different outcomes. If WMPs were sold by high quality SOE banks in search of fee income, individual investors could claim ignorance of the WMPs' default and look to bank regulators to partially bail them out at typical recovery rates of 30%–70%. This was done by pushing up their seniority claims or making state-owned banks pay out of their own pocket if the total of such defaults was small. If the defaulted WMPs were sold by smaller banks or brokerage channels, investors typically received very little recovery.

Given the massive size of the Evergrande-linked WMPs, investor groups comprise a mix of retail individuals, who may expect some relief, and institutions and treasury desks that won't likely get such protection. The difficulty lies in how to distinguish these holdings, which means recovery rates on hundreds of different WMPs will not be known for some time, making it difficult to determine the social impact of a potential Evergrande default. In any event, the Evergrande outcome will likely support the deleveraging campaign by regulators, who have tried to eliminate WMPs over the last few years. Had they not clamped down on these products (by limiting maturities to less than a year, imposing signature collections, etc.), large-scale defaults of WMPs might have had significant social consequences.

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