Global Strategy

Is Evergrande a risk for global financial markets?

Global Macro Strategy

Global

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What has changed?

In our most recent note, we had highlighted that the notion "too big to fail" did still hold for higher quality SOE names, although we did not see Evergrande falling into this remit given the Chinese authorities' ongoing policy stance towards the property sector. That said, we did not see any imminent risk of a credit event occurring for Evergrande. Since then, there have been a number of setbacks which have led us to believe that a credit event seems unavoidable. These setbacks include: 1) Evergrande hiring financial advisors to explore feasible options to ease its liquidity woes, 2) expectations for contracted sales to decline over the next 1-2m (Figure 1) and 3) a further lack of progress in terms of property and non-property asset disposals (Figure 2). While the Chinese authorities have tried to intervene and ask banks to allow for payment extensions, the bottom line remains that the ability of Evergrande to generate sufficient liquidity in the near term through contracted sales and asset disposals has deteriorated considerably and in turn increased the likelihood of credit event occurring sooner rather than later.

How big is the size of the problem?

For the Chinese property sector, the offshore financing channel consists of the offshore bond market (USD denominated), offshore syndicated loan and private deal financing. The offshore bond market is the biggest in size (and where data is most readily available), with total debt outstanding currently at ~$209bn, ~70% of which is HY rated. Based on our estimates that the total liability of the Chinese property sector is close to $4.7trn, the offshore bond market therefore only accounts for only 4.5% of total financing for the sector. Evergrande Group's total liability size is ~$313bn, which is ~6.5% of the total liability of the Chinese property sector. In terms of total offshore bonds outstanding, Evergrande Group has ~$19bn, which is equivalent to roughly 9% of the total offshore bond market and 12% of the total HY offshore bond market. Other high beta B-rated property developer names make up a further ~12.5% of the total HY offshore bond market (Figure 3), which is important given the the high correlation between these names and the Evergrande price action.

What could cause spill over into global markets?

While our base case is now that a credit event for Evergrande seems unavoidable, the extent to which we get spill over into other markets will be contingent on whether Evergrande restructures or fully liquidates. As of today, we remain confident that the former is a much more probable outcome. On that basis, current pricing (Figure 4) of the 2025 bonds at $27 (implying a recovery rate of 25-30%) seems reasonable to us, with the current discount reflecting a haircut for Evergrande's weaker balance sheet, thin trading liquidity and some risk premium associated with a full liquidation. In the event of a restructuring, we expect the bonds to bounce off their lows and contagion to be broadly limited, but in the event of a full liquidation, we do expect to see a high degree of contagion via three key channels:

1. Investors getting extremely low recovery values, something which would lead to a material loss of investor confidence in the broader property sector/Asia HY offshore market and create spill over into the broader Chinese financial assets. We saw this play out the Baoshang bank bankruptcy last year, where a liquidity squeeze in the interbank market was caused by banks cut off their lending to non-bank institutions and small banks. This consequently led a sell-off in local rates in China. We think this could cause also lead to a repricing of risk premium across global credit markets, with EM underperforming DM and HY-IG decompression in both USD/EUR markets.

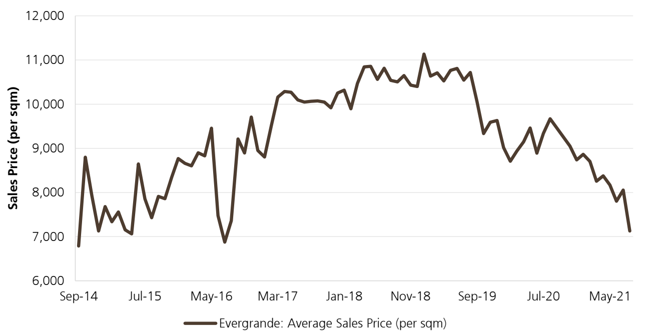
2. A domino effect of credit events, given that both banks and non-banks with large exposures to Evergrande could potentially go under or be forced into restructuring. This would again create spill over into other Chinese financial assets and drive underperformance of financials in particular across both DM and EM credit/equity markets, led by those names with direct exposure either to Evergrande itself, its subsidiaries or its creditors. Evergrande's liabilities are said to involve more than ~130 banks and over ~120 non-banking institutions, while the developer also hires ~4mn people every year for project developments, something which could also lead to increased investor concerns around financial stability risks in China.
3. A full liquidation would involve Keepwell Agreements not being adhered to – something which we think will force rating agencies to recalibrate their methodologies and remove multiple rating uplifts and assumptions of state support across non-property sectors both within the offshore USD market as well as the onshore market. This could lead to added selling pressure and drive large liquidity distortions across both Chinese offshore and onshore bond markets, with potential for spillover into EM credit, given that several EM credit accounts do tend to hold Chinese offshore bonds as a part of their Asia HY exposure.

What should investors be watching out for?

The primary thing we think investors should be watching out for in the coming weeks/months will be upcoming coupon payments on offshore bonds, as this could be the trigger for a credit event. Upcoming coupon payments on offshore bonds are due on the 23/09, 29/09 and 11/10 (see Figure 5). The second thing to watch will be the price action in other high beta B-rated developer credits, something we think will provide a useful gauge of systemic risk in the property sector as well as consensus expectations with respect to what an Evergrande credit event might look like. Spill over into other high beta B-rated developer credits has been fairly muted thus far, with investors still hopeful of a creditor friendly resolution for Evergrande and fundamentals generally having sequentially improved through H1 21' despite increased regulation/tighter Chinese credit. The third and final thing to watch will be Chinese credit/property policy. Our expectation is that the government is set to stay tight generally on property policies but not to escalate tightening further, although we do think that local governments may ease the implementation if housing construction decline sharply for a few months, something which should help provide some sentiment relief for issuers across the sector.

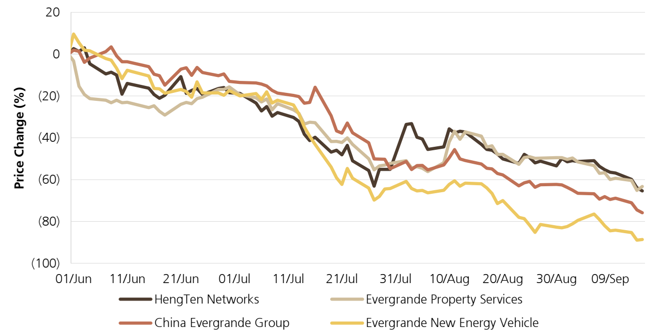
Figures 1 to 6 on next page...

Figure 1: We had previously stated that contracted sales would be a key near term source of liquidity to help ease default fears. With sales volumes and prices set to be challenged over the next few months, default risks have increased fairly materially…



Source : Bloomberg, UBS

Figure 2: Secondly, we had assumed that Evergrande would make further progress in terms of generating liquidity through property and non-property assets sales. We have seen very little evidence of this so far, while asset values have continued to fall…



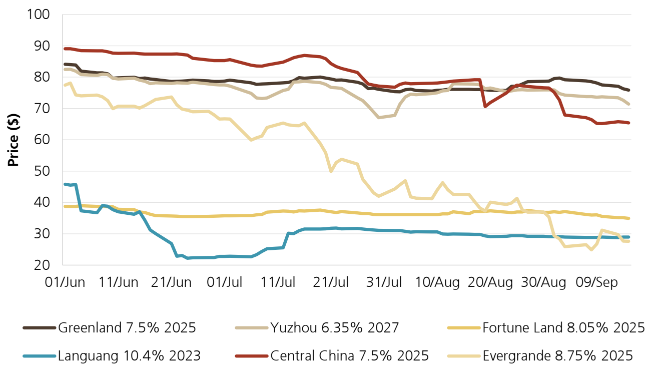
Source : Bloomberg, UBS

Figure 3: In terms of size, Evergrande makes up ~10% of Chinese HY Offshore market, while other high beta B-rated credits make up a further 8%. Weakness in these credits we think could drive broader contagion, with positioning in Evergrande remains light…

	% of CH HY Market							
	2014	2015	2016	2017	2018	2019	2020	YTD-2021
Evergrande Group	**18%**	**13%**	**10%**	**4%**	**9%**	**11%**	**10%**	**10%**
Kaisa	2%	3%	4%	0%	4%	4%	4%	5%
Guangzhou R&F	1%	2%	4%	2%	2%	2%	2%	2%
China South City	1%	1%	1%	1%	0%	1%	1%	1%
Xinyuan real Estate	1%	1%	1%	1%	1%	1%	1%	0%
High beta B-	**22%**	**19%**	**19%**	**8%**	**16%**	**19%**	**18%**	**18%**
CH HY props	72%	73%	75%	54%	51%	60%	66%	70%

Source : Bloomberg, UBS

Figure 4: Current pricing of the 2025 bonds at $27 seems reasonable to us, with the current discount reflecting a haircut for Evergrande's weaker balance sheet, thin trading liquidity and some risk premium associated with a potential full liquidation…



Source : Bloomberg, UBS

Figure 5: The primary thing we think investors should be watching out for in the coming weeks/months will be upcoming coupon payments on offshore bonds, a this could be the trigger for a default event…

Bond	Maturity	Next Call Date	Next Coupon Date	Amount Oustanding ($, bn)
EVERRE 8 1/4 03/23/22	**23/03/2022**	**15/10/2021**	**23/09/2021**	**2.025**
EVERRE 9 1/2 03/29/24	**29/03/2024**	**15/10/2021**	**29/09/2021**	**0.951**
EVERRE 10 1/2 04/11/24	**11/04/2024**	**11/04/2022**	**11/10/2021**	**0.700**
EVERRE 10 04/11/23	**11/04/2023**	**15/10/2021**	**11/10/2021**	**0.850**
EVERRE 9 1/2 04/11/22	**11/04/2022**	**-**	**11/10/2021**	**1.450**
EVERRE 8 3/4 06/28/25	28/06/2025	15/10/2021	28/12/2021	4.680
EVERRE 7 1/2 06/28/23	28/06/2023	15/10/2021	28/12/2021	1.345
EVERRE 12 01/22/24	22/01/2024	22/01/2022	22/01/2022	1.000
EVERRE 11 1/2 01/22/23	22/01/2023	-	22/01/2022	1.000
EVERRE 4 1/4 02/14/23	14/02/2023	-	14/02/2022	0.101

Source : Bloomberg, UBS

Figure 6: With carry having been the primary driver of Asia HY returns over the past 10 years, we do think that the current yields on offer in more fundamentally sound credits will be hard to ignore for investors. This should drive spreads tighter into year end…

	Total Return	Carry Return	Non-Carry Return	Excess Return	Carry Return	Non-Carry Return
2011	3.3%	8.2%	-4.9%	-8.1%	6.1%	-14.2%
2012	20.5%	8.0%	12.5%	18.1%	6.0%	12.1%
2013	1.5%	7.9%	-6.4%	3.4%	6.1%	-2.7%
2014	6.1%	7.6%	-1.5%	3.6%	6.0%	-2.4%
2015	4.7%	7.1%	-2.4%	3.4%	5.5%	-2.1%
2016	11.5%	6.9%	4.5%	10.3%	5.3%	5.0%
2017	6.9%	6.4%	0.5%	6.0%	4.7%	1.3%
2018	-3.4%	6.1%	-9.5%	-4.8%	4.3%	-9.1%
2019	12.6%	6.4%	6.2%	8.2%	4.3%	3.8%
2020	5.2%	6.7%	-1.5%	0.9%	4.6%	-3.8%
2021	**0.8%**	**3.7%**	**-2.9%**	**0.9%**	**2.8%**	**-1.9%**
Median Return	5.6%	7.0%	-1.5%	3.5%	5.4%	-2.2%
Return % Total		**124.6%**	**-26.7%**		**154.1%**	**-63.3%**
Return Volatility	6.6%	0.7%	6.5%	7.4%	0.8%	7.4%
Volatility % Total	**-**	**11.2%**	**98.1%**	**-**	**10.2%**	**99.4%**

Source : Bloomberg indices, UBS

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Neutral	FSR is between -6% and 6% of the MRA.	36%	30%
Sell	FSR is > 6% below the MRA.	11%	21%
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Company Name	Reuters	12-month rating	Price	Price date
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Source: UBS. All prices as of local market close.
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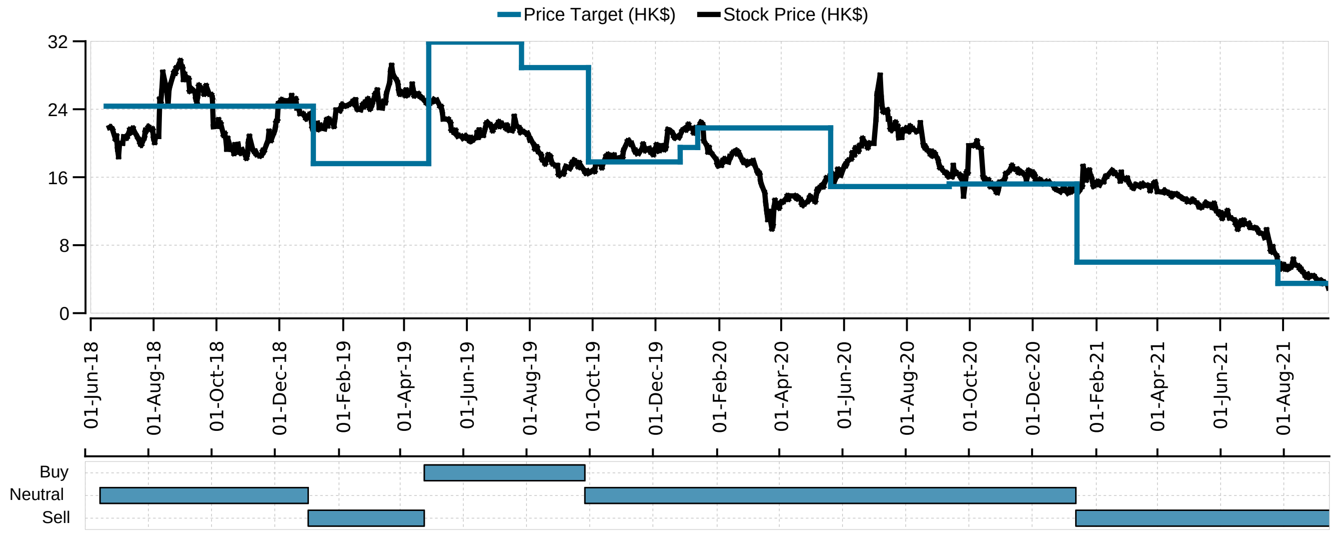
China Evergrande Group (HK$)



Date	Stock Price (HK$)	Price Target (HK$)	Rating
2018-06-15	22.70	24.36	Neutral
2019-01-02	21.80	17.60	Sell
2019-04-24	25.00	31.90	Buy
2019-07-23	21.30	28.90	Buy
2019-09-26	16.72	17.80	Neutral
2019-12-24	20.70	19.50	Neutral
2020-01-10	21.50	21.80	Neutral
2020-05-18	15.96	14.90	Neutral
2020-09-10	16.10	15.20	Neutral
2021-01-12	14.50	6.00	Sell
2021-07-26	6.71	3.50	Sell

Source: UBS; as of 15-Sep-2021

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