China Credit

An Evergrande default is neither idiosyncratic nor systemic, but an industry-wide problem

Asia Corporate Research

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News flow seems to suggest that Evergrande could tip into default soon. We don't see this as an idiosyncratic event, but rather an industry-wide problem triggered by tighter government control. As the Evergrande saga unfolds amid a deceleration in both housing and land sales, we believe contagion risk would not be left unchecked and that the eventual spillover should be limited. Our base case assumes a standstill to allow an orderly restructuring of Evergrande. Even then, this could still drag down some of the weaker names. However, we don't believe this is likely to pose a systemic threat to the banking sector, as the government has levers to contain this risk. For the Asia credit market, the damage thus far has been limited to China HY property names, while the rest of the space has been holding up much better. We believe the damage has been cushioned by strong technicals as underscored by both inflows into Asia bond funds and the absorption of US$20 billion of new issuance last week. This should remain the case, in our view.

- **Not too big-to-fail after all**. Recent news on the suspension of interest payments and the appointment of financial advisors are ominous signs for the default of Evergrande, the largest and also most indebted property developer. The realization is still reverberating through the market. Despite some remarkable headlines calling this the 'Lehman moment' for China, damage remains well contained and limited mostly to the China HY property sector. We believe the market reaction remains rational, probably because the past few months offered plenty of time to digest this eventuality. This is also based on our assumptions that the government would and could contain the risk, given tight government policies have already succeeded in slowing down the property market.

- **An industry-wide problem for developers**. We believe the Evergrande problem is not an idiosyncratic event that could be brushed aside. Without a doubt, the company's overleveraged balance sheet made it vulnerable, but the fast deterioration has been accelerated by the government's policies, i.e. the three red-lines imposed on developers and the property lending limit imposed on banks. These have led to a liquidity squeeze for the whole sector and not just for Evergrande. Several weaker developers that have some near-term refinancing needs are already showing signs of distress with their bonds now trading at 50-60. Indeed, we could potentially see 11 defaults totaling US$30 billion bond (or 23% default rate for the sector) this year, based on our estimates.

- **Orderly or disorderly restructuring?** The breadth and depth of damage to the sector would much depend on how the Evergrande restructuring would be carried out. Our base case is a standstill for all lenders to give the company time to monetize non-core assets while ensuring timely completion of existing projects. We believe the government would eventually need to intervene to prevent a domino effect across the sector, e.g. facilitating Evergrande's asset sales, and for the sector, allowing easier credit access for homebuyers as well as project companies in areas undergoing a slowdown. As much as we recognize that the government would like to instill more financial discipline in developers and moderate price expectations, we don't believe that it would want to create a near-term systemic risk while trying to prevent one in future. All in all, we

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believe the expected default of Evergrande should have sent a very loud and clear warning to heavily indebted developers. In the meantime, the market could remain jittery until the government reiterates its stabilization stance, especially now that negative expectations could hurt demand further and a rising number of failed land auctions means there are less funds going to local governments. This also creates a second-order impact on the LGFV sector as land sales are the largest fiscal revenue source for the majority of the local governments in China (~40-50% according to WIND), and a material deterioration of their fiscal position due to lower land sale proceeds could weaken their ability to support and in turn pressure some of the LGFVs' ratings.

- **Some moderation in economic growth.** The property sector directly accounts for 14% of the China economy and 25% if the indirect contribution is included. As such, the economy would take a knock if the property sector were to slow drastically. This could in turn put some pressure on China credit fundamentals. We believe that the property sector would likely feel the brunt of the pressure. While non-property names would not be sheltered, we don't expect this to lead to any material rating pressure, especially for IG corporates. Nonetheless, some decompression in spreads through small widening in the BBB-rated China credits (especially real estate and LGFVs) is likely, in our view while we think other sectors such as utilities and tech should be relatively more resilient.

- **Systemic risk for banks is remote.** Evergrande's bank borrowing is only 0.22% of the system's loans. We therefore see little risk to the system from the event, although some banks with larger exposure may experience a material hit to earnings. China Minsheng Banking is most exposed in this regard, as the developer accounts for nearly 0.80% of loans. Nonetheless, the bank last week said the regulator blessed its plan to redeem the US$1.4bn of offshore additional Tier 1 (AT1) on the first call date, December 14, suggesting a comfortable outlook on capitalization. Wider stress across property appears manageable as well, in our view. The sector represents roughly 7% of system loans, while construction is another 3%. Our equity counterparts have stress tested this exposure with a 32% NPL ratio for developers and a 5% NPL ratio for construction lending. The stress test shows a 64bp average decline in the common equity Tier 1 ratio for banks in their coverage. To be clear, such a stress scenario is not a base case, and we note the system benefits from balance sheet reserves equal to 3.4% of loans and a 10.5% CET1 ratio. Further, we expect regulators to have their hands on the many levers at their disposal to manage volatility in the financial system.

- **China bank credit is a shelter in the current storm.** The US$ credit market is largely represented by the system's strongest banks; the two banks with the largest exposure to Evergrande, Minsheng and Everbright, represent only 1.7% of China financials in the JACI. Indeed, China AT1 have tightened 25bp in the time EVERRE '25s have dropped 50pts. We thus think China banks, including AT1 from SOE issuers, will remain defensive and can be a relatively good place to hide from market volatility.

- **Fund inflows have helped to compartmentalize risks**. We have not seen the Evergrande problem spill over to the wider credit market. Even in the property sector that is feeling the brunt of the pressure, double-B property names have held their ground relatively well. We attribute this to continued inflow into Asia bond funds, and thus far we have only seen three weeks of outflows (e.g. the first week of April and the first two weeks of August) so far this year. This probably explained how the market could easily absorb US$20 billion of new

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supply (including some China HY property bonds) last week. As such, fund flows would remain one gauge of risk from this industry-wide problem boiling over to the wider market.

- **A bifurcated market for now**. We believe performance could diverge further in the near term, as investors reduce exposure to weaker credits. We expect names such Wanda Commercial and Logan to outperform either due to recurring income from non-residential businesses or a favorable demand outlook driven by an influx of new residents. Downward pressure on China single-B property names is likely to continue until we see the government showing some leniency to the property sector. That said, we also believe that valuations for the sector have factored in an extreme case scenario. Stripping off those potential default names, the sector is now trading at z+1464 and implied default rate of 19%, based on 300bp excess return and 40a % recovery rate. Including our estimated 23% default rate this year, this means close to 40% of China HY property bonds would default, which looks excessive, in our view. We also do not expect much spillover to other sectors for now under our base case assumption that the government would relax somewhat to provide developers some breathing space.
- **China-growth sensitive sectors could be nonetheless affected if contagion risks increase:** While our base case remains that contagion risks from the Evergrande episode can be contained through policy measures and broad sector support if required, we think any delays in such support forthcoming could reprice some China-growth sensitive sectors especially in the commodities space – base metals and steel but less so for oil.

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	Date	Action	Rating/Designation	Ticker/ISIN
Issuer	15 Feb 19	Upgrade	Overweight	LOGPH
7% perp '22 *	01 Aug 19	Upgrade	Neutral	XS1619838292
7% perp '22 *	14 Feb 20	Upgrade	Overweight	XS1619838292
11.25% '19	13 Jul 17	Terminate	Not Covered	XS1063367509
4.7% '26	29 Jun 21	Initiate	Overweight	XS2342970402
5.125% '18	15 Nov 18	Terminate	Not Covered	XS1711177045
5.25% '23	15 Feb 19	Upgrade	Overweight	XS1618597535
5.25% '23	24 Feb 21	Downgrade	Neutral	XS1618597535
5.25% '23	29 Jun 21	Upgrade	Overweight	XS1618597535
5.75% '22	23 Mar 18	Upgrade	Neutral	XS1541978851
6.375% '21	15 Nov 18	Upgrade	Overweight	XS1772325210
6.375% '21	01 Aug 19	Downgrade	Neutral	XS1772325210
6.375% '21	29 Jun 21	Terminate	Not Covered	XS1772325210
6.875% '21	29 Jun 21	Terminate	Not Covered	XS1808311424
7.5% '21	13 Sep 18	Initiate	Neutral	XS1870205819
7.7% '20	13 Sep 18	Terminate	Not Covered	XS1342837264
8.75% '20	07 Dec 18	Initiate	Overweight	XS1920256564
8.75% '20	16 Sep 20	Downgrade	Neutral	XS1920256564
8.75% '20	29 Jun 21	Terminate	Not Covered	XS1920256564
9.75% '17	11 Jan 18	Terminate	Not Covered	XS1143878517

Dalian Wanda - J.P. Morgan Credit Opinion History

	Date	Action	Rating/Designation	Ticker/ISIN
Issuer	23 Jun 17	Upgrade	Overweight	DALWAN
7.25% '24 *	20 Jul 17	Upgrade	Overweight	XS1023280271
4.875% '18	15 Nov 18	Downgrade	Neutral	XS0989286850
4.875% '18	15 Feb 19	Terminate	Not Covered	XS0989286850
6.875% '23	21 Jan 20	Initiate	Overweight	XS2100658066
6.95% '22	28 Nov 19	Initiate	Overweight	XS2078814147
7.5% '22	15 Nov 19	Initiate	Neutral	XS2029997942

***Indicates representative/primary bond/instrument.**

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