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Weekly Credit Brief **Oct 13 - Oct 19 2020**

China Evergrande Group's credit outlook worsens as China increases regulation on highly leveraged developers

by Sean Lau Koon Leong

- **China's new "three red lines" policy, which comes into effect in 2021, could greatly hamper Evergrande's financing capabilities**
- **NUS-CRI Forward PD indicates that Evergrande's short-term credit risk will increase**

China Evergrande Group (Evergrande), the most indebted property developer in the world, could face a cash crunch as China looks to tighten access to funding across its highly indebted property sector. As of June, the company had a whopping CNY 835.5bn of total debt, of which 44.5% is due this year. The increase in regulation has left Evergrande no choice but to quickly raise cash to pay off its maturing debt, increasing the firm's credit risk. This is supported by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[1]) shown in Figure 1 below with Evergrande's PD due to increase around 20bps in the coming months. The solvency of the company will depend on its ability to ramp up sales this quarter, control its spending and ensure the swift listing of its spinoff companies to raise funds.

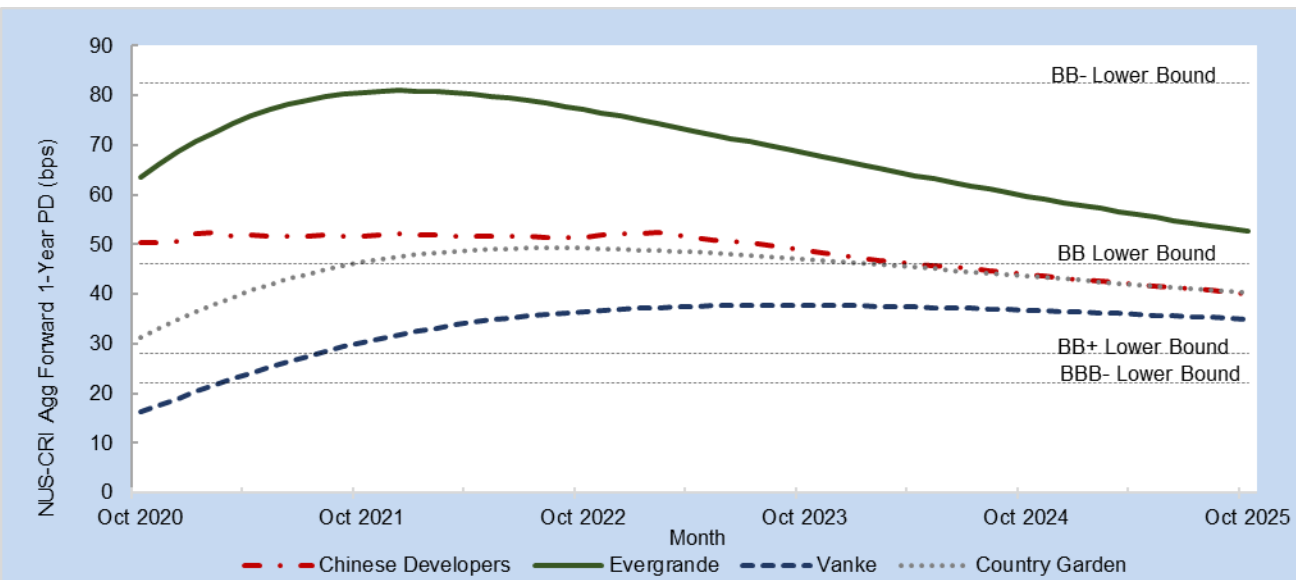

Figure 1: NUS-CRI Agg Forward 1-year PD of China's developers, China Evergrande Group, China Vanke and Country Garden Holdings with reference to PDIR2.0[2] bounds. *Source: NUS-CRI*

As China's property market has been on a tear in recent years, many companies have leveraged up to take advantage of the breakneck speed of China's urbanisation. In 2019, Chinese developers issued USD 46.2bn of debt, double the amount issued in 2018, to fuel this continued expansion. With the sector being so integral to

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 1 year plus 6 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.

the Chinese economy, accounting for 17% of the nation's GDP in 2018, the government decided to instil measures to crackdown on excessive debt and risky lending from shadow banks to reduce the sector's default risk. In August, the People's Bank of China (PBOC) put in place a new policy dubbed 'the three red lines' that would come into effect in 2021. This policy will restrict the issuance of interest-bearing debt by property developers if they cross the following 'three red lines': 70% debt-to-asset ratio; 100% net debt-to-equity ratio; and 100% debt-to-cash ratio. Evergrande has already crossed all three of these restrictions, disqualifying it from issuing new debt once the policy comes into effect next year.

In a move to comply with this regulation, Evergrande reduced its debt by CNY 53.4bn in Q2 and Q3 of 2020, and even prepaid loans worth CNY 43.5bn. Despite the company's attempts to deleverage, the investor sentiment surrounding Evergrande's bonds has still deteriorated. As of 19th October, Evergrande's 2025 USD denominated bond trades at a Yield to Maturity of 16.9%, doubling since inception. This is a stark contrast to its competitors such as Country Garden whose equivalent bond trades at a Yield to Maturity of 3.8%, lower than its yield at inception. Banks and trust firms have also turned more cautious on Evergrande, with some even preventing the company from drawing on its unused credit lines. This high perceived risk has complicated the company's efforts to issue debt under favourable terms. For instance, the most recent issue of USD 6bn earlier this year was priced at a high 12% interest rate, increasing the company's average borrowing cost across all its loans to 9%. This issuance of debt increased the company's total debt to equity ratio to 2.65, double of its local peers such as Vanke China. The company also has a very high Total Debt to EBITDA ratio of 6.89 compared to its competitors Country Garden (1.22) and Vanke China (1.07). Despite this, Evergrande has not relented in its active acquisition, spending USD 606mn to acquire a Hong Kong residential plot above market rates in July, and CNY 2.3bn on a mixed-use site in Shanghai in September.

In order to raise funds, Evergrande is offering USD 555mn in a private share placement and is looking to list its property management business on the Hong Kong exchange to raise an additional USD 2bn. The company has also been making additional efforts to slash its debt by selling land and accelerating its sales. The company announced earlier this year that it planned to 'grow sales, control scale and reduce leverage' as it targeted a 33% increase in sales this year. The timing for this shift could not have been worse as it came amidst the backdrop of the COVID-19 pandemic that has slowed China's growth. Even though China's property sales fell 21% in Q1, Evergrande still reported sales growth of 25%. This however came at a cost to the company's profitability as it had offered massive discounts of up to 22% on its residential properties, leading to a 46% decline in Evergrande's core profit in 1H 2020.

Evergrande is also attempting a secondary listing of its New Energy Vehicle group on the Shanghai exchange. The business unit represents Evergrande's attempt to diversify its business by entering the red-hot Electric Vehicle market. This endeavour is especially concerning seeing that Evergrande poured CNY 15bn into the business last year despite the group's soaring debt levels. Evergrande is working towards launching its first model next year as the firm is determined to catch up to other emerging companies like Nio and Xpeng motors, which already have cars on the market. The group has announced that it will continue to invest another CNY 20bn in the business in the next 2 years.

The company has also been trying to get its Hengda real estate unit listed on the Shenzhen stock exchange since 2017. Until the listing is approved by the government, the CNY 130bn raised from investors will be treated as quasi-debt, thus further burdening the company. Evergrande has managed to convince the bulk of its investors to roll over their debt, avoiding a looming January payment. However, some investors are still adamant on pulling CNY 28.2bn of their investment from the Hengda unit due to a lack of confidence in the listing's approval.

The new regulation enacted by the PBOC increased Evergrande's credit risk as the company scrambles for funding to repay its maturing debt. The next 3 quarters will be crucial as USD 7.9bn worth of debt comes due. Aided by the increase in housing prices in recent months, Evergrande is looking to take advantage of China's peak property season known as "golden September, silver October". The company is looking to offer discounts on new homes of up to 30% during this period to achieve its sales aim of CNY 200bn. China's aging population could lead to the property market cooling off in the coming years. Evergrande's move to diversify its business with Electric Vehicles could therefore lower the downside risk for the company in the long-term if the growth of its core business stalls. However, the company must first be prudent with its cash-outflows to get across its debt hurdles.

Credit News

Slowdown in corporate bond issuance could boost investment-grade debt

Oct 16. In so far, 2020 has seen over USD 525bn in debt issuances from Europe and a whopping USD 1.2tn from the US. Baigneres, from JPMorgan, suggested that refinancing activities might continue should there be an orderly election. With volatility down and spreads tight, there remains ample liquidity for smaller firms and high yield issuers to refinance as funds inflows remain healthy. One could expect smaller deals and less newly issued investment grade debts for the rest of the year. Today, spreads have fallen to new lows since the Covid-19 pandemic which has brought about a huge spike in credit risk. (WSJ)

Ligado tests limits of bond markets with highest rate in 9 years

Oct 16. The wireless communication firm is currently raising capital to finance developments in 5G across the United States. This venture came at a high cost as they are preparing to pay 17.5% in their upcoming debt deal. The rate is the highest rate on any corporate bond since 2011. The premium paid stems from the financial distress faced by the firm. While the Fed lowered interest rate, the pandemic hit firms, such as Viking Cruises, Carnival Corporation, and American Airlines, are offering double-digit interest rates. (FT)

Big US banks offer muddled outlook on how bad coronavirus losses might get

Oct 15. Given delays and uncertainty with the anticipated stimulus program, the outlook moving forward remains muddled for the US economy. While loan loss provisions have yet to increase drastically for Q4, US bank executives warned that the impending loan losses might only take shape next year. Citigroup found pressure from its credit card business. Bank of America anticipates commercial losses to be chunky next year. Optimistically, JPMorgan's base case looked rosy compared to last quarter. Moving forward, there remains a risk as the US continues to fight Covid-19. (Reuters)

Rolls-Royce and Jaguar Land Rover pay up for bond deals

Oct 14. Both of the UK engineering stalwarts are required to pay relatively high-interest rates to lenders. Rolls Royce offered 6-year coupon rates within 4.63% and 5.75% for an overall issuance of EUR 2bn. The rates are elevated relative to the European benchmark of 3.75% (marked by ICE BofA Index of high yield debt). JLR sought a deal worth EUR 700m at a 5-year coupon rate of 7.75%. Some likened investment with these firms to "catching a falling knife" as the industry continues to be challenged by dampened demand and increasing environment regulations. (FT)

Bankruptcies pile up in North America energy sector in third quarter: Haynes and Boone

Oct 14. Law firm Haynes and Boone reported that bankruptcies in the North America energy sector surged in the third quarter amid weak fuel demand, lower crude prices and a dearth of available credit. Oilfield service providers have been hit harder as producers halted or scaled back exploration and drilling to rein in expenses. While the midstream sector has been relatively shielded from the recent rout, a number of them might file for bankruptcy during the rest of the year as market turmoil continues to drag on and producers try to avoid onerous contracts. The energy sector might face further losses in their borrowing power as lenders are set to undertake the bi-annual redetermination of the amount of credit made available to producers. (Reuters)

Bankrupt car rental firm Hertz secures USD 1.65bn in financing, share soars (Reuters)

Garuda Indonesia, steelmaker Krakatau Steel to issue convertible bonds (Reuters)

China September new bank loans rise to CNY 1.9tn, top estimates (Reuters)

Regulatory Updates

EU sets sights on money market fund reform

Oct 18. The financial regulators and markets watchdogs are increasingly concerned with outflows from EU's money market funds and are calling for reforms. As outflows creep to levels similar to the 2008 financial crisis, many demanded changes in light of a possible large scale liquidity crisis. In France alone, outflows reached EUR 46bn in 3 weeks. This could lead to detrimental effects on the whole financial sector and the EU monetary system. The money market funds are important as they provide short term funding for many enterprises – A function that is even more critical today in light of the pandemic. (FT)

Global regulators eye 'actions' to ease capital burden on banks

Oct 14. The Financial Stability Board (FSB) stated that regulators will discuss next month how to ease pressure on global banks to hold unnecessarily large levels of capital in every country they operate. The currently large amounts of capital and liquidity that banks are forced to "ring-fence" at every foreign branch fragments capital markets and bumps up costs for banks and users. Furthermore, FSB is looking at how regulators from different countries could "defer" to each other should they have similar robust rules to reduce cost in compliance for financial firms. Despite the recent strong market recovery, FSB Chair Randal Quarles told G20 ministers that the path of recovery for the real economy remains uncertain and this could have potential implications for the financial system. (Reuters)

Bank of England says company disclosures on climate risks will be mandatory (Reuters)

China central bank injects CNY 500bn of medium-term loans, rates unchanged for 6th month (Reuters)

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