Evergrande is not China's Lehman moment. It's China's Evergrande moment

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Back in 2009, it was easy to lose money investing in Chinese property developers. Coming from Australia, where residential property is an obsession, I recognised the signs. Chinese household wealth is built on bricks, mortar and speculative fervour, as in Australia. But it wasn't just the psychology. Operationally, even the developers looked like carbon copies.

Boy, did I get that one wrong. On the outside, the similarities seemed real enough. Underneath, things couldn't have been more different. We learned the hard way and vowed not to repeat the mistake.

In 2017, when Chinese property giant Evergrande's share price skyrocketed from $5 to over $30 in under ten months, we got our chance. In 17 years as a portfolio manager and chief investment officer, this was the only full year when we underperformed the benchmark. Not owning stocks like Evergrande explained why.

Losing money is what happens when you focus on a rising share price rather than the fundamentals of the business behind it. Evergrande investors are belatedly finding that out.

Four years ago, all the signs were there: rising debt; opaque structures; and the absence of a land bank that might have offered support to such rich valuations. Needless to say, by leveraging the company to excess whilst reaping USD$11bn in dividends over the past decade, the Evergrande chairman had become extremely rich. Now, the bill falls due.

Despite Evergrande's 'market darling' status, its structure and governance were deeply flawed. That is now self-evident. The company presently features a market capitalisation of USD$3.5bn, carrying over USD$300bn in liabilities, two-thirds owed to once hopeful homeowners. Some are now protesting in the streets, waving their worthless title deeds. Others have taken employees hostage.

Today, our exposure to banks and property stocks in China and the rest of the Asian region is a big, fat zero. This may change if valuations become attractive, but we will be avoiding stocks like Evergrande no matter what. There is no price at which companies like this are worth buying.

Meanwhile, there are many high-quality Chinese businesses that have been sold off and look far more appealing. Amid the carnage, our cash levels are falling. There are many attractive companies in China worth investing in for structural growth; China remains a huge source of alpha for us and our clients.

Many western commentators are saying this is China's Lehman moment**.** They are wrong. This is China's Evergrande moment.

This is not a story of fanciful derivative products with three letter acronyms, full of trash but sold to the unsuspecting as AAA bonds. The Evergrande crash is more mundane - an over-leveraged property developer run by a greedy chairman. The final act - a hunger game to see who gets to feed on the bony carcass - awaits.

The potential social unrest from up to a million unfinished Evergrande homes is a bigger issue than the debt. The largest political party in the world is also the largest owner of property in China. It has a vested interest to step in and use its full powers to avoid further unrest.

I expect verbal support will be used to stabilise sentiment, followed by a debt restructuring and forced asset sales. Bond and equity holders should prepare for a massive haircut while state-owned enterprises can expect a telephone call informing them of their purchase of some distressed assets.

The call to Chairman Xu (Hui) Jiayin will be less well received. He is likely to be made an example of as China makes its position clear on the dangers of over-leverage.

The nine points below explain why contagion is less of a risk than many Westerners believe.

1. **Fragmented market** - Evergrande might be one of China's three largest property developers, but its market share is less than 4%. China's property sector is extremely fragmented, with the top 20 developers accounting for a third of total market share. Half of the top 10 of this cohort would need to fail before systemic risk became a real threat.
2. **Preparation time** - The world's most-indebted developer had a liquidity scare in 2020. It reportedly sent a letter to the provincial government of Guangdong in August warning that payments due in January 2021 might not be met. The authorities have had plenty of time to prepare.
3. **Quantifiable** - Evergrande's bank borrowing is only 0.22% of total system loans. It is a small and known quantity that is highly unlikely to cause systemic problems.
4. **Low non-performing loans (NPL) ratios** - The NPL ratio of Chinese developers is just 1.75%. About 40% of bank loans are collateralised with properties. With the inclusion of mortgage loans (21% of

total) and SME loans, this collateralised figure jumps to 85%. Most of China's other large developers have a gearing of <50%.

5. **Vested interest** – As noted earlier, the Chinese government is the largest owner of property in the country. In addition, fiscal revenues raised by local governments via land sales have seen a 165-fold increase according to data from the Ministry of Finance (MOF). All levels of government have an interest in fixing the problem.
6. **Too big to fail** - Directly and indirectly, this sector accounts for about a quarter of China's GDP. It is simply too big to fail.
7. **The tools to control** - The Chinese government controls the yuan, the debt, the company and the property cycle. China's monetary toolbox should also not be underestimated (See: 'QE China Style I' and 'QE China Style II' whitepapers I authored in Sept 2015 and May 2016, *available online*). This is not a liquidity crisis. All the tools to ensure an orderly wind-down are available to be deployed.
8. **Prior experience** - Developer deleveraging has been a Beijing policy objective for a few years now. The 'Three red lines policy' has already seen average developer gearing falling from a peak of 92% of equity in 1H19 to 64% in 1H21 (JPM estimates). This was not enough to save Evergrande, but it may well save others.
9. **Don't underestimate Chinese government capabilities** - "It is necessary to focus on preventing risks on the basis of steady growth, while strengthening the countercyclical adjustment of fiscal policy and monetary policy and ensuring that the economy operates in a reasonable range," said Xi in 2019. With every word scrutinised and acted upon, officials will have prepared for events such as this.

About Stonehorn Global Partners

Stonehorn Global Partners (Stonehorn) based in Hong Kong is boutique asset manager majority owned by its staff and believes an alignment of interest with their clients is what builds sustainable partnerships. Stonehorn's founding members have partnered together in Asia for over 13 years and have a long and strong record investing in Asian equities. Since then, they have built an extensive network of relationships with Asian companies, government bodies and industry contacts.

This level of access together with their experience allows them to select investments carefully by cross-checking investment assumptions with management discussions, financial analysis, and industry checks.

Stonehorn conducts research via a deep dive bottom-up approach focusing on Environmental, Social and Governance (ESG) factors. Stonehorn's proprietary due diligence and research methods are based on a seamless collaboration with each member correctly trusting each other.

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