Box A

Stress in the Chinese Property Development Sector

Financial conditions for the Chinese property sector have been stressed in recent months as the financial health of a number of highly leveraged property developers has deteriorated. Chinese authorities have prioritised deleveraging the property sector in recent years. In late 2020, they introduced the 'three red lines' policy, which requires developers to remain within limits on leverage, gearing and liquidity or be subject to tighter limits on their ability to take on new debt. Following this, concerns were initially centred around China Evergrande Group, a large and highly leveraged developer; however, these concerns have now spread to several other sizeable property developers. Spillovers to other sectors have been limited to date.

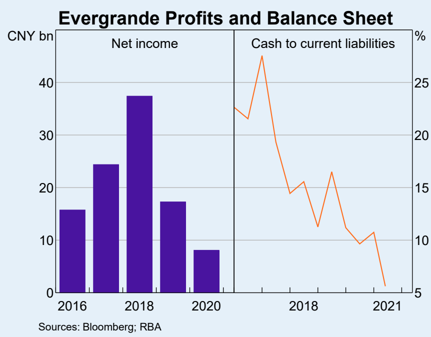
The financial position of Evergrande, a highly leveraged property developer, has deteriorated significantly

Evergrande, one of China's largest and most leveraged property developers, has been facing significant stress as investors have become increasingly concerned about the company's ability to meet its debt obligations. Evergrande's liabilities are large in absolute terms, although they are small relative to lending in the Chinese financial system. While Evergrande's total liabilities of around CNY2 trillion (around A$420 billion) are equivalent to around 2 per cent of China's GDP, its financial market liabilities (bank and trust loans, and onshore and offshore bonds) represent much less than 2 per cent of total liabilities in each of those markets.

In recent years, Evergrande's profitability has deteriorated at the same time as its core business has expanded rapidly (Graph A.1). This expansion has been underpinned by high and rising leverage, with much of their liabilities due to be repaid at short terms. It has also made sizeable investments in a wide range of businesses outside real estate development. Ongoing efforts by the Chinese authorities to reduce leverage in the real estate sector have contributed to Evergrande's inability to secure debt funding and maintain adequate liquidity. Pre-sales of apartments by Evergrande, which represent a key source of funds, have also declined sharply.

In recent months, given its low levels of liquidity and inability to raise new debt, Evergrande has found it difficult to meet a range of its obligations as they have fallen due. These obligations have included coupon payments, particularly on its offshore bonds.

Graph A.1



Evergrande has delayed payments to its suppliers, which are the largest component of its reported liabilities (Graph A.2). Evergrande has also attempted to sell some of its assets – some at a steep discount – to raise additional cash and improve its liquidity position, but has so far been unable to complete these deals.

Since late September, Evergrande has missed several coupon payments on US dollar bonds, although it has repaid the earliest two of those payments within a 30-day grace period. Beyond coupon payments due in 2021, Evergrande has a significant amount of onshore and offshore bonds maturing in 2022, as well as onshore bonds for which investors have the right to demand early repayment in 2022. Evergrande has missed repayments of funds maturing in September owed to some customers of its wealth management products (these are often marketed as savings vehicles to retail investors); it has begun returning some of these funds in instalments. Evergrande has also failed to discharge guarantee obligations on some wealth management products issued by third parties. In addition, it has a number of off-balance sheet liabilities.

Bond markets are now pricing a high probability that Evergrande will default on both its US dollar- and renminbi-denominated bonds (Graph A.3). US dollar bond prices suggest that creditors expect to be able to recover only 25 cents on the dollar. The company requested a trading suspension for its onshore bonds in mid September, after which these bonds have only traded via negotiated transactions.

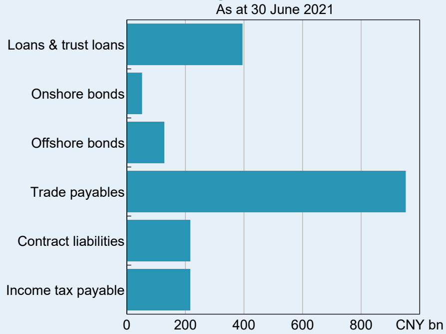
Concerns have spilled over to other developers facing similar pressures and banks with direct exposure to Evergrande

Developments around Evergrande have precipitated a sharp fall in bond and equity prices for other developers with low levels of liquid assets relative to their short-term liabilities. Bond markets are pricing in a significant probability of default for several medium-sized property developers that are not state owned, such as Kaisa Group and Yuzhou Group (Graph A.4). Adverse news about the financial health of several much smaller developers – including Modern Land, Fantasia Holdings and Sinic – have also weighed on market sentiment. Bond market prices recovered somewhat after Chinese central bank officials suggested that risks

Graph A.2

Evergrande Liabilities

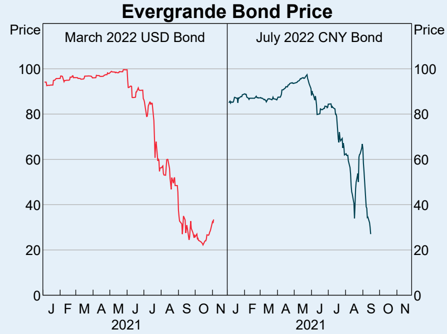
As at 30 June 2021



Source: Company report

Graph A.3

Evergrande Bond Price



Sources: Bloomberg; RBA

from Evergrande are controllable, and that banks may roll over maturing funding even for highly indebted developers. Other large developers have been relatively unaffected, with the exception of the highly leveraged Sunac and Greenland Holdings.

Equity prices have fallen for some Chinese banks, particularly for joint-stock banks with considerable direct exposure to Evergrande and other property developers (Graph A.5). By contrast, bank bond prices have not declined materially, suggesting that markets are not concerned that the stresses facing developers will affect the risk of default by any of the larger banking institutions that issue bonds. Likewise, yields have remained relatively stable for investment-grade corporate bonds, even though yields on high-yield offshore bonds – around two-thirds of which are developer bonds – have risen significantly (Graph A.6). Yields on bonds issued by local government financing vehicles, for which land holdings are an important asset, have also remained stable. Equity prices for listed companies that are known suppliers to Evergrande have declined. But broader equity prices, particularly for those listed on the mainland, have remained fairly stable as other sectors have remained broadly unaffected by Evergrande's issues.

Financial market developments more broadly suggest that spillovers from stress among Evergrande and other property developers to other parts of the Chinese financial system have so far been limited. That said, it is difficult to observe stress in less-transparent parts of the Chinese financial system, including among smaller banks. Moreover, the situation remains fluid, and further stress in the property sector could lead to a significant slowdown in the Chinese

Graph A.5

Chinese Equity Prices

4 Jan 2021 = 100

* Excluding Skshu Paint

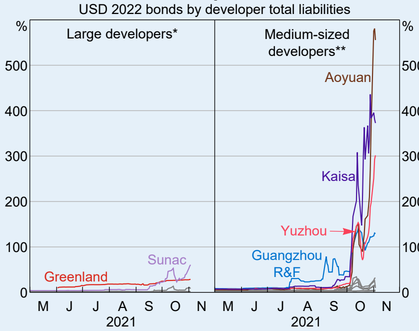
** Excluding China Merchants Bank

Sources: Bloomberg; Macquarie Research; RBA

Graph A.4

Chinese Developer Bond Yields

USD 2022 bonds by developer total liabilities



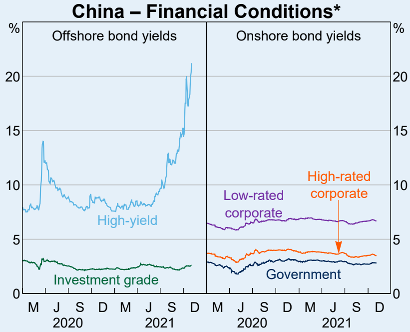
* Developers with liabilities more than CNY 500 billion

** Developers with liabilities of CNY 100–500 billion

Sources: Bloomberg; RBA

Graph A.6

China – Financial Conditions*



* Onshore bond yields shown for five-year maturities, offshore bond yields are a weighted index with average maturity of six to seven years

Sources: Bloomberg; CEIC; RBA

economy and broader stresses in the financial system. Policymakers in China face the challenge of avoiding further spillovers while also focusing on their longer-term objective to reduce leverage in the property sector.[1]

Endnotes

[1] For discussion on potential channels of contagion from Evergrande, see RBA (2021), Financial Stability Review, October. Available at <https://www.rba.gov.au/publications/fsr/2021/oct/>