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EVERGRANDE CRISIS AND CONTAGION RISKS

Our Emerging Markets Equity team shares its views on Chinese property developer Evergrande and the real estate sector in general.

Franklin Templeton Emerging Markets Equity

As this situation is fluid and subject to quickly change, these are the team's comments based on the latest news as of September 22, 2021. For a broader view of regulations in China, see "China's Regulatory Tightening: Our View on Goals and Scope."

Evergrande and its financial instruments are under pressure as the company's ability to service its debt becomes increasingly unviable given its sector-high leverage and continued stringent government policy on the real estate sector. Markets are concerned about contagion risk given the scale of Evergrande's property development, as well as the importance of the real estate sector to the Chinese economy. The situation remains fluid and we continue to monitor the contagion risks in the real estate sector and the broader market closely.

OVERVIEW

What if Evergrande Defaults?

- In China, property developer deleveraging has been a focus area for 2-3 years. Therefore, overall gearing in the property development sector has continued to come down as most listed developers work toward achieving compliance to the "Three Red Lines"—debt metrics which must be met to borrow more.
- From a banking-sector perspective, an Evergrande default alone would not pose significant stress on the banking sector given its very small share of the total China banking system loan book.
- While market sentiment has been very negative toward both China's real estate and financials sectors and investor concerns have been high, we do not think the risk of systemic contagion is significant.

Potential Resolution

- Given the importance of the real estate sector to the Chinese economy and the importance of housing as an asset class, the government is strongly incentivized to ensure orderly default and resolution of Evergrande's debts.
- While the very near term is likely to remain volatile, a potential Beijing-driven resolution, when outlined, could remove uncertainty. We think that an orderly unwinding of Evergrande would be received positively by investors.

PROPERTY SECTOR UNDER PRESSURE

Evergrande's financial instruments are under pressure as the company's ability to service its debt becomes increasingly unviable given its sector-high leverage and continued stringent government policy on the real estate sector which has slowed down property sales (via high mortgage rates and caps on banks' lending exposure to the property sector) and reduced sources of liquidity and bank funding (via the "Three Red Lines" policy and bank lending caps).

Beyond Evergrande, financial markets are concerned about contagion risk given the scale of Evergrande's property development business (one of China's three largest property developers and among the largest borrowers in the Chinese offshore high yield market), as well as the importance of the real estate sector to the Chinese economy.

China's property developer deleveraging has been a focus area for several years; we highlight that the pressures on Evergrande are not sudden and the government stance on regulating the property industry has been clear since the 19th party congress in which President Xi Jinping commented that "houses are for living not for speculation" in 2017. Since then, the government has become increasingly stringent on deleveraging the sector to reduce systemic risk and implementing measures to cool down property price growth in the last 2-3 years.

The focus on housing affordability has become more important under the current regulatory mandate of "common prosperity," as housing (along with education and health care) have been highlighted as the "three mountains" pressuring Chinese families today. We emphasize that the Three Red Lines guidance was created to increase financial discipline among real estate developers, not to cut off all funding to the sector. This is reflected in the continued stability of issuances by developers such as China Resources Land, for example.

Given the clear government stance in the past 2-3 years toward reducing risk in the property sector, overall gearing in the property development sector has continued to come down as most listed developers work toward achieving compliance to the "Three Red Lines."

From a banking sector perspective, an Evergrande default alone would not pose significant stress on the banking sector given its very small share of the total China banking system loan book (including its entire supply chain). Even in a spillover scenario, we note that real estate developer loans account for a high single-digit percentage of total banking system loans.

Moreover, pre-sales (properties sold before being completed) represent the bulk of China Evergrande's liabilities, with the government eager to ensure that projects are completed and delivered to buyers. The rest of its liabilities are actually fairly diversified and spread across multiple (typically second tier) banks.

Despite Evergrande's size in absolute terms, the company only represents a low single-digit share of China's huge property market, which in itself is also very fragmented. However, given the importance of the real estate sector to the Chinese economy and the importance of housing as an asset class, the government is strongly incentivized to ensure orderly default and resolution of Evergrande's debts.

It should be noted that the Chinese property market accounts for about a quarter of the country's gross domestic product (directly and indirectly, including upstream and downstream sectors) according to various estimates, so its contribution to the economy is significant. While the government wants to contain the pace of property price increases to avoid issues around affordability (aligned with the common prosperity goal), it would not want to see property prices fall, as this could have a negative wealth effect (conflicting with the common prosperity goal, and with the national stability goal due to potential political ramifications). Should other large developers show signs of weakness, we would expect to see some loosening of monetary policy to provide relief.

While the very near term is likely to remain volatile, a potential Beijing-driven resolution, when outlined, could remove uncertainty. We think that an orderly unwinding of Evergrande would be received positively by investors.

For the reasons outlined above, while market sentiment has been very negative toward both China's real estate and financials sectors and investor concerns have been high, we do not think the risk of systemic contagion is significant.

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