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A Guide to the Evergrande Debacle: Four Questions for Making Sense of What Lies Ahead

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By now, you have probably heard about China's Evergrande Group, the world's most indebted company, which is teetering on the brink of financial collapse. If you do not think that this is a really big deal for the Chinese economy and the rest of the world, stop reading here. So what happens now? Even though the Chinese government controls its entire economy, it is difficult to imagine that this will resemble anything other than a train wreck in slow motion. This article addresses four questions to help make sense of it all.

Will the Chinese Government Allow Evergrande to Fail?

This might be the most important factor in determining the fate of Evergrande and its many creditors. In today's China, government's influence over business outcomes is forceful and deliberate. The impending failure of Evergrande will test how far the Chinese government is willing to go to manage the coming political and economic pain.

Beijing is walking a tightrope, as it must balance its current, more restrictive economic policies against the need to maintain social stability. It has recently enacted its "three red line" policy for new lending to curb excessive, debt-fueled real estate speculation. This policy seeks to mitigate the systemic risk of cascading real estate defaults, to maintain price stability in the overbuilt property sector and, ultimately, to make home ownership more affordable to ordinary Chinese citizens in a manner that promotes "common prosperity." As Chinese President Xi Jinping recently put it, "Homes are for living in, not for speculation."[2] Evergrande was way over all three lines. As such, it is precluded from incurring additional debt, thus precipitating its current existential liquidity crisis.

This suggests that the central government might simply let Evergrande fail in order to provide a teachable moment for those many other highly leveraged real estate companies that continue to binge on debt. Indeed, as the Communist Party is deep into a campaign to rein in high-flying private enterprises (and their billionaire owners), bailing out Evergrande with explicit government support would likely send the wrong message. Taking a hard-line approach to Evergrande would be entirely consistent with Beijing's recent clampdown on private companies in the fintech, data, gaming and education sectors — all of which have inflicted billions of dollars of losses upon their market capitalizations.

Balanced against the hard-line approach is the risk of a wider economic and political contagion (a Chinese "Lehman moment"). In the wake of an uncontrolled Evergrande failure, the resulting social instability might be significant. Cascading real estate defaults would roil those sectors of the Chinese economy that rely heavily on continuing debt-fueled real estate development, as well as on continued funding from global capital markets.

Considering that Evergrande alone owes more than $300 billion, such economic pain would almost certainly cause collateral business failures, higher unemployment, plummeting real estate prices, massive losses to institutional lenders and bondholders, commercial creditors and suppliers, and the evaporation of personal investments and retirement savings. All of this might be exacerbated by the continuing COVID-related disruptions to the Chinese economy. Any resulting spike in social unrest might threaten the legitimacy of a government whose policies allowed this to happen, but could not otherwise fix the problems it created. This hits too close to home for the Communist Party.

The social and political fault lines have already appeared. Because Evergrande has run out of cash to complete its about 1.6 million pre-sold-but-unfinished homes and apartments (valued at more than $200 billion), noisy protest demonstrations have erupted around the country. There is also growing unrest among those 80,000 Chinese individuals who hold more than $6 billion in Evergrande's (unsecured) wealth-management products, not to mention the individual investors, including many Evergrande employees, that hold its now likely worthless securities.

1 The opinions expressed are solely those of the authors and do not represent those of the Commonwealth of Pennsylvania Department of Banking and Securities, any law firm or any of its clients. This article has been adapted from Richard Vague, "Will China's Debt Bomb Explode?," *Democracy Journal* (Sept. 28, 2021), *available at* democracyjournal.org/arguments/will-chinas-debt-bomb-explode (unless otherwise specified, all links in this article were last visited on Oct. 25, 2021).

2 "Xi Renews Call Homes Are for Living in, Not for Speculation," Bloomberg (Oct. 18, 2017), *available at* bloombergquint.com/politics/xi-renews-call-housing-should-be-for-living-in-not-speculation.

As a large portion of the wealth recently accumulated by the Chinese middle class is tied up in real estate ownership, the government needs to ensure that any remedial actions do not either jeopardize real estate price stability or further exacerbate wealth inequality. Chinese citizens will likely demand government action to protect personal savings that might be quickly lost if Evergrande slips into a freefall bankruptcy. While the government has so far been able to mute protests by having police break up the demonstrations and censor outrage on social media, there might be a limit to its ability to quell social unrest if the fallout from a dramatic Evergrande collapse becomes really ugly. This is exactly what the Communist Party works tirelessly to avoid.

Beijing has the tools to mitigate the damage from an Evergrande collapse. It controls the monetary and banking system, and has more than sufficient cash to lubricate the process. There are likely many other fixes, both overt and subtle, at the national and local levels that might ease some of the pain — and separate the ordinary losers from the really big ones. While still keeping its cards close to its vest, Beijing may have tipped its hand by its warning to local governments in the more than 200 cities with unfinished Evergrande projects: Prepare for a possible storm.

What to look for: A controlled crash-and-burn orchestrated by the central government through which the economic pain will be specifically — and politically — allocated. Letting Evergrande simply fail is too economically risky, while bailing it out is too politically risky. A middle way is the least bad alternative.

Will Evergrande's Domestic and Foreign Creditors Receive Equal Treatment?

Most certainly not. Unlike insolvency schemes that are premised on the principle of equality of distribution among similarly situated creditors, the allocation of pain from an Evergrande fallout will be driven more by politics than by law or economics.

To begin with, Evergrande's debt is not equally distributed among its Chinese and foreign creditors. Most of the more than $300 billion that Evergrande owes is due to Chinese creditors. Only about $20 billion is held by international creditors, mostly in the form of dollar-denominated bond debt. (As of early November 2021, in order to stave off defaults and cross-defaults, Evergrande made payments on the very last days of the grace periods for certain tranches of its offshore bond debt whose coupon payments were previously missed.) As such, foreign creditors are a distinctly minority constituency.

More important, however, is the political dimension that is motivated by economic nationalism. Domestic Chinese creditors include state-owned lenders, the ecosystem of commercial contractors and suppliers that is tied to the real estate development sector, homebuyers who have pre-paid for units in unfinished buildings, individual holders of wealth-management products, employees who lent money to the company, and other investors. Prioritizing these claims addresses the risk of cascading business failures of highly exposed creditors dependent on payments due from Evergrande.

Considering that China has a rather flimsy social safety net, there is substantial political risk if social stability is threatened by widespread unemployment, business failures and declines in property prices. Any potential unrest from citizens whose family savings are tied up in undelivered apartments or wealth-management products might be destabilizing and could inflict unacceptably high political costs. Favoring domestic economic interests addresses the Communist Party's need to preserve the social compact that underlies its political legitimacy.

Another political dimension is China's increasingly chilly attitude toward foreign interests, especially those from the U.S. Against the backdrop of these geopolitical tensions, there seems to be little appetite — or political benefit — for the Chinese government to cushion the pain for foreign creditors. They have limited recourse, as Evergrande has few overseas assets against which to satisfy foreign creditors' claims, and they may be stuck pressing their claims in a Chinese bankruptcy proceeding, which might be distorted by government intervention. Allowing losses on foreign investors' debt will not threaten social stability like unpaid employees and out-of-pocket homeowners would. Favoring Chinese domestic interests over those of foreigners would be consistent with Xi Jinping's political agenda.

This runs the risk of foreclosing future access of Chinese businesses to global capital markets as foreign bondholders feel burned. However, the prospect of alienating foreign investors did not stop the government from recently effecting regulatory crackdowns on domestic private companies that cost billions of dollars in decreased global market capitalization. Indeed, counting on short institutional memories and the lure of participating in future growth of the Chinese markets may be a good bet.

What to look for: Disparate treatment, as the interests of domestic creditors will be consistently favored at the expense of foreign creditors, who will be squeezed out of information and denied access to scarce cash that will be allocated elsewhere.

What Impact Will an Evergrande Failure Have on Domestic and Global Markets?

Domestically, there will be blood. Evergrande simply owes too much to too many. Even if a restructuring is well-managed, it will not be quick. Delays in payments from the disposition of assets will likely be painful. Losses to domestic lenders might not be immediately apparent as they are absorbed by the state-owned banking system and the resolution of Evergrande's distressed bank debt gets kicked down the road. Losses suffered by unpaid contractors and suppliers, resulting in collateral business failures and higher unemployment, will be more immediately painful.

In order to mitigate any possible domestic contagion, Beijing must juggle competing policies of limiting speculative real estate growth and maintaining price stability. Because of tightened real estate credit, other highly leveraged real estate developers are in imminent danger of failing. Prices of their dollar-denominated bonds have fallen, and their credit ratings have been downgraded. Interest-payment defaults have already occurred, with more on the horizon

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as more than $28 billion in dollar-denominated bond payments come due in 2022. China's central bank has injected increased liquidity into the banking system and urged lenders to cooperate with local governments to maintain the stability of property markets and protect homeowners' interests. Governments must manage the disposal of Evergrande's assets without causing a disorderly collapse of property prices that would spread the pain to existing property owners and likely slow growth in the broader economy.

Housing sales in China have already begun to slow as concerns mount about other highly leveraged developers' financial stability. This could precipitate a contagious downward spiral: As developers scramble for alternative sources of funding to continue building, they may resort to fire sales to create liquidity and avoid loan defaults, thus resulting in declines in property values. Slower growth in real estate development also means less for local governments who rely heavily on land sales for income. Because about 70 percent of Chinese households have their personal wealth tied up in real estate ownership, the implications of a collapse of the real estate sector in the wake of an Evergrande failure could be staggering.

The big quandary is whether social unrest can be contained. This will, in large measure, fall to local governments. They must somehow arrange to complete Evergrande's unfinished buildings to avoid a backlash from homebuyers who prepaid for Evergrande apartments. It is one thing to complete a building that has already been started; it is quite another to finance, construct and deliver one that been prepaid by purchasers but is still on the drawing board. Multiply this by 1.6 million pre-sold units spread over 200 cities, and the sheer scale of the problem is daunting.

As for the effect on global markets, predictions range from a systemic collapse to institutional losses that are readily digestible. As Evergrande bonds are trading at deep discounts, global bondholders anticipate a massive haircut from any restructuring. The deeper concern is that large losses from a contagion that spreads to other Chinese real estate companies (which have aggregate debt of about $5 trillion) might destabilize global institutions. Any significant dislocation in the Chinese domestic market could ripple through global markets in the form of further disruptions to supply chains, slower growth, less demand for goods and commodities exported from abroad, and generally more market volatility.

In the short term, there might be a loss of confidence among foreign investors confronted with the reality that the Chinese government may again intervene to distort market outcomes. This has been confirmed by recent Chinese regulatory crackdowns on its domestic companies without regard to the painful losses inflicted on global markets. Fallout from Evergrande's failure may further exacerbate geopolitical tensions and accelerate decoupling with western economies.

What to look for: Domestic markets will be roiled by unavoidable losses, regardless of how skillfully the crisis is managed by Chinese governments at the national and local levels. Whether there is systemic damage to global markets will depend on whether losses can be limited to specific foreign investors, and whether turmoil in domestic markets has a destabilizing effect on global financial institutions.

What Will Happen to Evergrande's Billionaire Founder and Largest Shareholder?

There is a human-interest aspect to this story. Hui Ka Yan, Evergrande's founder, chairman and largest shareholder, might become another high-flying entrepreneur whom the government brings down to earth. Known for his rags-to-riches rise, lavish lifestyle and well-connected friends, he built Evergrande into a real estate colossus. Along the way, he became one of China's richest men, personally receiving about $8 billion in dividends from Evergrande in the last several years. He is the face of Evergrande and might now be held to account for its impending collapse.

While he might not be detained (like executives of bankrupt HNA Group) or executed (like the former chairman of China Huarong Asset Management Co., who was convicted of financial crimes), it is uncertain how much of his wealth and freedom he will he be able to retain — and whether the Communist Party makes an example of him as it has with other chastened billionaire entrepreneurs (*e.g.*, Chinese business magnate Jack Ma). Allowing him to remain rich is not a good look when compared with more than 1 million ordinary Chinese citizens whose life savings are tied up in yet-unbuilt Evergrande real estate. It certainly sends the wrong message when social stability may be at stake.

What to look for: Hui Ka Yan will pay a price for Evergrande's failure. The question is whether he will be sacrificed at the altar of "common prosperity" and become a scapegoat for decades of Chinese government policies that allowed — and even encouraged — debt-fueled real estate development in order to promote growth.

Conclusion

Evergrande might be the biggest business failure of our lifetimes. For students of distressed debt, it should be instructive to see how the system of Chinese state capitalism manages the fallout from such a massive unraveling with global economic and geopolitical implications — a so-called bankruptcy with Chinese characteristics. It also invites an interesting comparative thought experiment on how the Evergrande debacle could be playing out under U.S. bankruptcy law. Never let a good crisis go to waste. abi