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AI-AUGMENTED FIXED INCOME INVESTING

China Evergrande Group (SEHK: 3333)

Case Study

25th October 2021

RATINGS

China Evergrande Group

Domicile	Cayman Islands
Long Term Rating	Ca
Type	LT Corporate Family Ratings – Com Curr
Outlook	Negative

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Summary

Evergrande Group is an investment holding company that primarily engages in property development business in China. They are China's second largest property company and the world's most indebted property developer. They have liabilities of approximately over $310 billion that are set to maturity over the next 6-12 months. This implies weak recovery prospects for creditors of Evergrande if they were to default.

How did it happen?

In the past, Evergrande has never reported a loss in profits and presents strong financials with consistent positive working capital in every accounting period in the company's history.

Investors became worried about Evergrande around Q4 of 2020 when a leaked letter from the company showed that they had requested the Chinese government for support to approve a now-dropped backdoor listing plan. The company claims that the letter was a forgery.

The leaked letter consists of information regarding the company's liabilities involving more than 128 banks and over 121 non-banking institutions. They also recently admitted that they are under "tremendous pressure" and may not be able to meet their debt obligations.

Since then, they have been downgraded by two credit rating agencies and their Hong Kong listed shares have collapsed by more than 80% this year.

In addition, Evergrande was the subject of a short seller report back in 2012. Andrew Left's Citron Research at the centre of which lay the claim that accounting misstatements allowed Evergrande to "mask its insolvent balance sheet". They identified 7 "red flags" that, at the time, included slowing cash collection, exploding debt and interest costs, declining presales, poor asset allocation, heavy discounting, and protests at the company's Danyang project and press reporting of corporate restructurings and vendor payments.

At the time Hong Kong's Securities and Futures Commission alleged that Left's report contained "false and misleading" information on Evergrande. Hong Kong's Market Misconduct Tribunal concluded that Left was Guilty.

Fast forward to 2021 and many of the concerns raised in Citron's report – excessive indebtedness, access to capital markets, off balance sheet debt, poor corporate governance, poor capital allocation and liquidity issues are all at the heart of the Evergrande crisis.

How does this affect the market?

China Evergrande Group have exposure to many financial institutions through direct loans and indirect holdings. Some of these large institutions could rely on receiving debt payments from Evergrande to fund their own debt obligations. This could result in a potential domino effect, causing property developers to fail, affecting the financial economy in China.

Evergrande announced in September that it would dispose of a 20% stake in Shengjing Bank to a state-owned group for c. $1.5bn. Shengjing Bank is one of the main lender's to Evergrande and has demanded that the net proceeds of the of the stake sale be used to repay all the financial liabilities Evergrande has with the bank. With the stake sale Evergrande's interest in Shengjing Bank is reduced to 14.75% from 34.5%. Prior to stake disposal, Evergrande was the largest shareholder in one of Shengjing Bank's lending account, highlighting the complexity of Evergrande's distressed situation. Furthermore, it accentuates how asset proceeds may be used to prioritise a particular creditor's claims.[1]

Off-balance sheet liabilities are also a major concern for lenders in China's real estate market. Fantasia Holdings Group, a now defaulted Chinese property developer, disclosed to Fitch Ratings "for the first time" that it had $150 million of private bonds held that was previously not reported in its financial statements.

Citron research, in its 2012 report, highlighted Evergrande's use of joint ventures to keep debt off its balance sheet. Reuter's reported that JPMorgan analysts estimated that Evergrande's true net gearing (a measure of financial leverage) was 177% at the end of June compared to the 100% reported on its accounts.[2]

As Evergrande's debt has grown to pay for acquired land and projects the company the company has used "Wealth Management Products" – essentially consumer facing loans offering high interest rates and gifts to encourage investment. These products face less financial regulation and are enable Evergrande to keep the associated debt off their balance sheet.

Evergrande has about 200,000 employees and hires 3.8 million people every year for project development. Also, it is reported that over 80,000 people – employees, their friends and families lent over $15.4bn to Evergrande in the last 5 years.[3] The company has sought to offer repayment in the form of property which led to large scale protests. The company made a 10% repayment of its wealth management products that were due at the end of September.[4]

The company relies heavily on cash deposits from customers for apartments upfront prior to projects being completed to finance the construction. Part of the liquidity crisis it has faced is due to halts in construction that have meant it has been unable to collect cash to pay its debts and interest coming due. There are reportedly hundreds of thousands of Chinese people having deposited payment for their homes that might never be built. Suppliers of the company could also end up going bankrupt if they are not paid too.

Evergrande's increasing reliance on short term funding – customer deposits and its Wealth Management Products to meet its long-term obligations is one of the key reasons the company is looking to asset disposals to avoid default. Both, the exposure of local consumers and suppliers not only increases Evergrande's social and political exposure but also complicates the recovery prospects for the owners of its non-local USD denominated debt.

How has Evergrande's financial metrics changed?

Evergrande's profitability has declined significantly from the recent highs of June 18th. This was exacerbated by the Chinese Government introducing its 3 red lines policy for the property sector in August '20. The policy is designed to improve the financial health of the real estate sector.

The three red lines are:

1. Liability-to-asset ratio (excluding advance receipts) of less than 70%
2. Net gearing ratio of less than 100%
3. Cash-to-short-term debt ratio of more than 1x

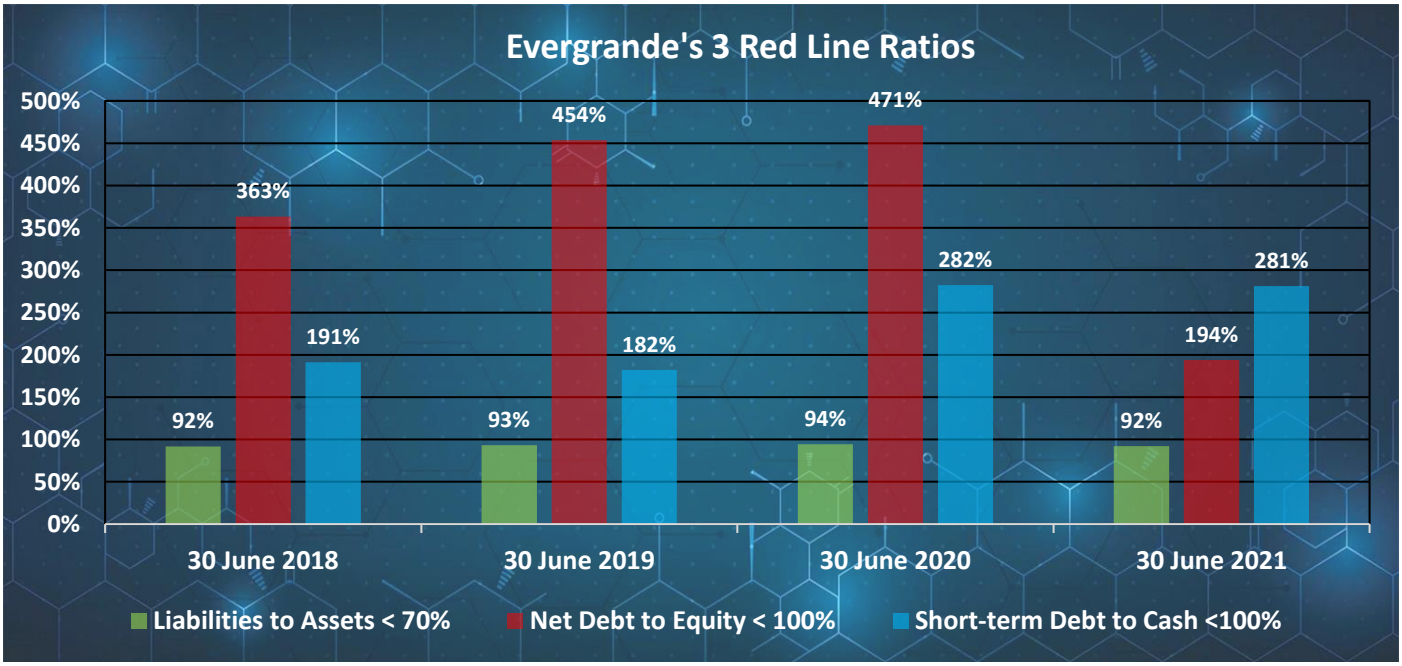
If the developers fail to fulfil one, two or all the 'three red lines', regulators will then place limits on the extent to which

[1] https://www.reuters.com/world/china/china-evergrande-transfer-15-bln-stake-shengjing-bank-state-firm-2021-09-29/
[2] https://www.reuters.com/world/china/what-lies-beneath-hidden-debt-fears-feed-chinas-property-woes-2021-10-20/
[3] https://www.aljazeera.com/economy/2021/9/22/evergrande-turned-to-employees-clients-suppliers-for-cash
[4] https://www.reuters.com/world/china/china-evergrande-says-made-10-repayment-wealth-management-products-due-sept-30-2021-09-30/

they can grow debt.

As the most indebted and reliant on debt in the sector, Evergrande has had trouble paying suppliers and had to halt construction which led to a negative feedback loop as its revenues fell, reducing cash from pre-sales, reducing its ability to paydown debt with lenders actively looking to reduce their exposure to the company.

Source: Moody's, Intellibonds



Source: Moody's, Intellibonds

The company has announced several asset disposals. Whilst it has been successful in some small disposals and in reducing its stake in Shengjing Bank, it has failed to sell key assets which include its stakes in listed entities Evergrande New Energy and Evergrande Property Services which were valued at c.$3.22 bn and c.$2.57 bn. At the end of September, Fitch Ratings assigned a Recovery Rating of "RR6" to Evergrande's bonds. This is the lowest recovery rating

possible and implies a recovery of 0-10% for bondholders.[5]

Market expectations are for a "controlled" bankruptcy, absent successful asset disposals, with the company likely to use its c. RMB 1.23 trillion inventory of land and projects in development as sources of liquidity via sales or as payment in kind with lenders taking security over projects in lieu of payment.

Will Evergrande's default cause a "Lehman" moment?

Whilst Evergrande's debt is approximately 2% of China's GDP, a default by the developer will not lead to a systemic or financial crisis – the impact will be felt most within the property sector.

Banks have been managing down their exposure to Evergrande for some time. S&P Global Ratings reported that the Chinese Central bank carried out a stress test that looked at banks' exposure to the property sector. Under the most severe scenario, bank's Capital Adequacy Ratios would be impacted by 2.1%. This is not insignificant and represents the average, with some weaker banks being more severely impacted. Overall, it is likely that the situation would be manageable.

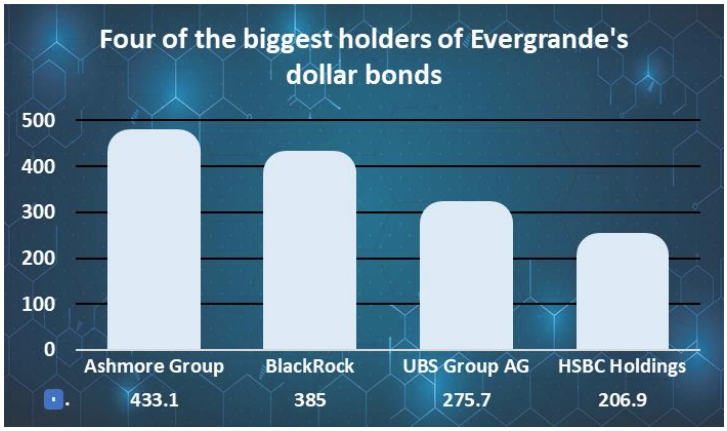
S&P Global Ratings also point to Evergrande's total debt of c.571billion as representing 0.35% of total loans outstanding and 0.2% of total assets.[6]

Evergrande has "real" assets as opposed to financial assets. It has land and development projects and there is significant government control that manages building supply and the resale of property. Disposals of land by Evergrande are unlikely to be allowed to put severe pressure on land and property prices.

Who has exposure to these debt obligations?

Ashmore Group, a London-based investment manager which specialises in emerging market debt has approximately more than $400 million worth of Evergrande bonds based on Q2 of 2021 filings. BlackRock, UBS Group AG and HSBC Holdings were also huge stakeholders as a majority of them held by vehicles which focuses on riskier emerging market or Asian credits.

Both law firm Kirkland & Ellis and investment bank Moelis & Co were hired as advisers by some of the bondholders.



Source: Data compiled by Bloomberg

[5] https://www.fitchratings.com/research/corporate-finance/fitch-downgrades-evergrande-subsidiaries-hengda-tianji-to-c-28-09-2021

[6] https://www.spglobal.com/ratings/en/research/articles/210920-credit-faq-evergrande-default-contagion-risk-ripple-or-wave-12114813

Who might be next – Peer Group

China Aoyuan Group Limited	China SCE Group Holdings Limited	Country Garden Holdings Co. Ltd
Sunac China Holdings Limited	Tahoe Group Co. Ltd	China Vanke Co. Ltd
Times China Holdings Limited	Central China Real Estate	Greenland Holdings Co. Ltd

Due to how intertwined the Chinese economy is, a default in Evergrande could lead to several repercussions, mainly due to the domino effect relationship each company have with each other. This could be seen by one of the most recent developer, Kaisa, being downgraded to CCC rating by S&P and Fitch Ratings. They both cited concerns over Kaisa's debt load and capital structure being unsustainable given the company's sizable near-term debt maturities, and inadequacy of free cash flow through 2022. This highlights a minor contagion risk which might gradually ripple into the larger economy.

What could happen next?

The financial contagion that is sweeping through the sector represents a serious risk for China. It is reported that one third of China's property developers will find it difficult to repay their outstanding debts in the next 12 months due to increasingly strong headwinds from declining sales, restricted access to credit and a wider downturn in the market.

China Evergrande Group has made attempts to offload its most profitable assets and were unsuccessful. Their $2.6 billion asset sales collapsed and most of their assets are classified as inventory that are either in Work-In-Progress or left to idle. The company is still expected to continue to try to offload its assets while going about business as usual. However, a default in the company will result in a closed-door opportunity from overseas financing.

The Chinese government would usually lead an assessment of the company's assets and liabilities after it defaults. Bankruptcy proceedings typically do not start until a rough rehabilitation plan is in place. Therefore, it will take a period of time before the company actually goes under. Even though Evergrande is one of the largest developers in the world, its market share still remains relatively low. It is likely that Evergrande's direct negative effects on other major competitors or partners would be containable even in a scenario where Evergrande defaults.

The People's Bank of China has injected cash amounting to approximately $15.5 billion on 26th Oct vowing to maintain healthy development of the real estate market and safeguarding the legitimate rights and interests of housing consumers. They also highlighted the need to not use "real estate as a short-term economic stimulus" as a tool.

When is the next deadline?

Evergrande recently averted a default last week when it paid $45.2 million interest on a 2024 bond that should have been paid for on Sept. 29. Overall, Evergrande has missed coupon payment totalling up to $148.2 on three bonds on Oct. 11.

As for Evergrande's foreign currency-denominated bonds, they often come with cross-default provisions, meaning that when the borrower defaults on one, others will automatically follow suit too. This could potentially put Evergrande in default on all of its outstanding dollar bonds.

As for its yuan-denominated bonds, it does not have cross-default provisions, therefore, a default on a dollar bond will not affect those holders. So far, Evergrande primary mainland unit has made payments equivalent to $19 million in coupons payments to the yuan bondholders. These yuan bondholders could still receive interest and their principal back.

Evergrande's liquidity is weak with its unrestricted cash on hand of RMB 86.8 billion as of Q2 of 2021 which is not adequate to cover its short-term debt and maturing long-term debt over the next 12 months.

Evergrande's offshore bonds maturing by end of 2022

Issuer/Guarantor	Issuing Currency	Coupon (%)	Issue Date	Maturity Date	Amount outstanding (USD millions)
Evergrande	USD	8.25	23/3/2017	23/3/2022	2,025
Evergrande	USD	9.5	11/4/2019	11/4/2022	1,450
Tianji	USD	11.5	24/1/2020	24/10/2022	2,000
Tianji	USD	13	6/11/2018	6/11/2022	645
Total					**6,120**

Source: Bloomberg

Evergrande's onshore bonds maturing by end of 2022

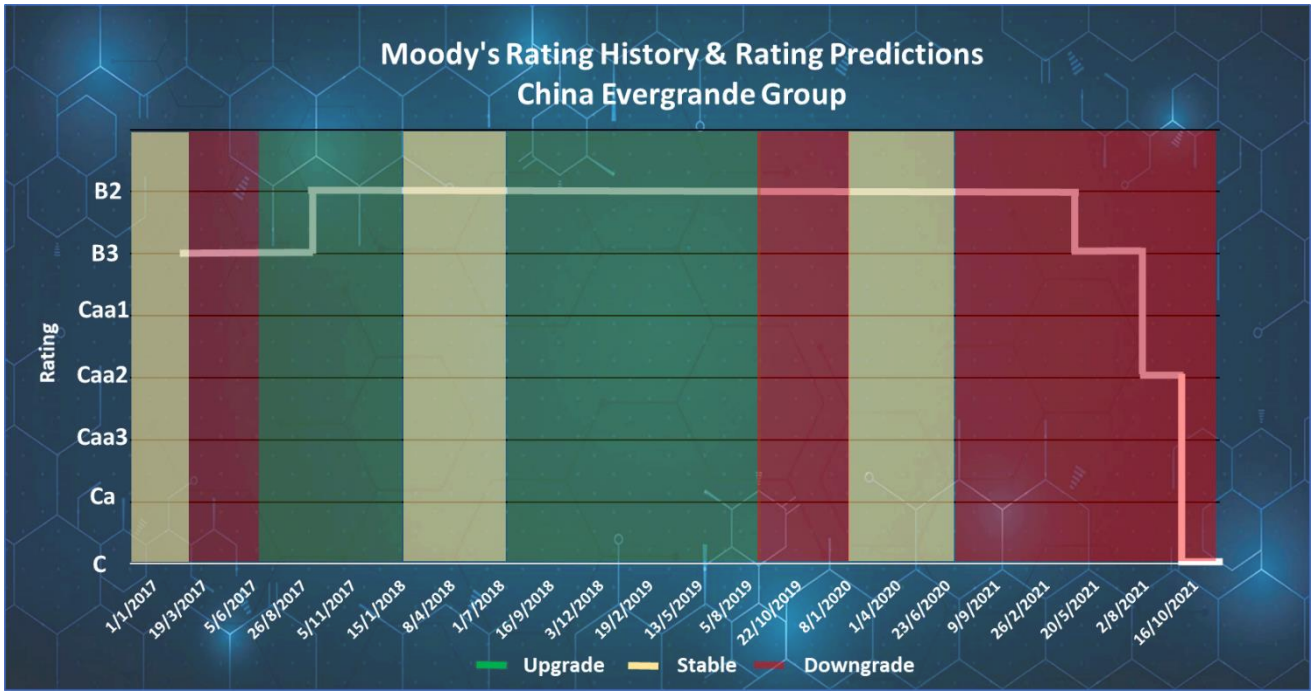
Issuer/Guarantor	Issuing Currency	Coupon (%)	Issue Date	Maturity Date	Amount outstanding (USD millions)
Hengda	RMB	6.98	6/1/2020	8/1/2023	692
Hengda	RMB	6.8	29/4/2019	6/5/2024	769
Hengda	RMB	5.9	22/5/2020	26/5/2023	615
Hengda	RMB	5.6	3/6/2020	5/6/2023	385
Hengda	RMB	6.98	8/7/2015	8/7/2022	1,262
Total					**3,723**

Source: Wind

How clients benefited from using Intellibonds software?

Intellibonds AI-augmented platform forecasted deterioration in financial metrics and creditworthiness of Evergrande. As a results of credit risk predictions and other associated predictive algorithms, we assigned underweight score to Evergrande bonds throughout most of 2021, saving clients millions.

Intellibonds' proprietary rating models predicted China Evergrande Group rating downgrades successfully more than a year ago before Evergrande downfall. As seen from the chart, on 22nd October 2019, our software predicted a downgrade from B2 rating and has been consistently accurate in terms of predicting a fall in the rating itself.



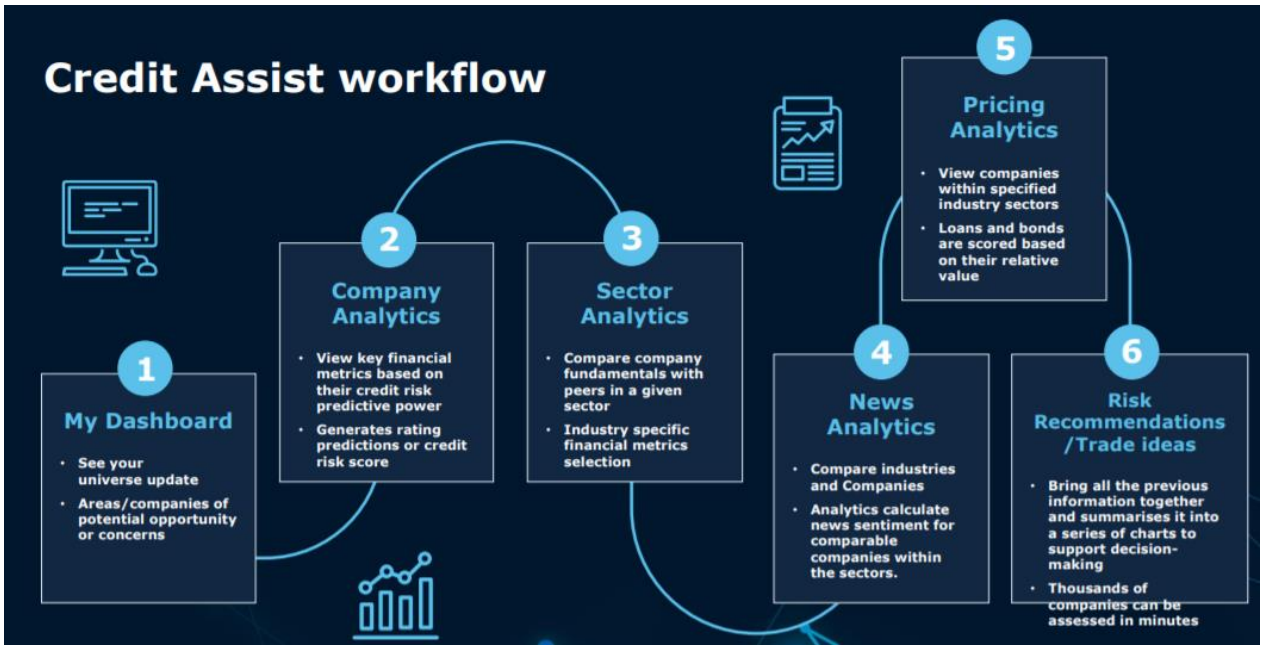
Source: Intellibonds

	Financials Driven Prediction Last Financial Data : 2021-Sep-07		Market Driven Prediction Last Market Data : 2021-Oct-22		Combined Prediction	
Predicted Time	Rating	Conviction	Rating	Conviction	Rating	Conviction
3M Forward	Possible Downgrade	Medium	Stable	Medium	Possible Downgrade	Medium
6M Forward	Possible Downgrade	Medium	Stable	Medium	Possible Downgrade	Medium
9M Forward	Possible Downgrade	Medium	Stable	Medium	Possible Downgrade	Medium
12M Forward	Possible Downgrade	Medium	Stable	Medium	Possible Downgrade	Medium

Source: Intellibonds

These insights were derived through one of the products we currently offer: Credit Assist. The product supports analyst's daily workflow inclusive of fundamental predicitions, news sentiment scoring and relative value analysis. Credit Assist also provide rich/cheap recommendations to users daily, combining insights from multiple algorithms into a proprietary IB score.

Our algorithms are able to predict a downgrade up to 12 months ahead. As seen in the table above, our combined prediction of 3M, 6M, 9M and 12M forward is a downgrade with a medium conviction despite stabilization in market driven prediction (default probabilities).



Source: Intellibonds

How can Intellibonds platform prevent losses and predict risks for users?

By integrating both artifical and human intelligence, Intelllibonds is the first collaborative platform which supports real-time interaction between algorithms and fixed income professionals. The user can collaborate with AI and colleagues in real time irrespective of their location in our cloud-based platform. The 'collaboration' with the user and access to multiple datasets means that our AI is able to react even in situations of highly unusual data paterns such as those that occurred during the latest Covid pandemic. By doing so, we're able to proactively manage risks and prevent losses for our clients.

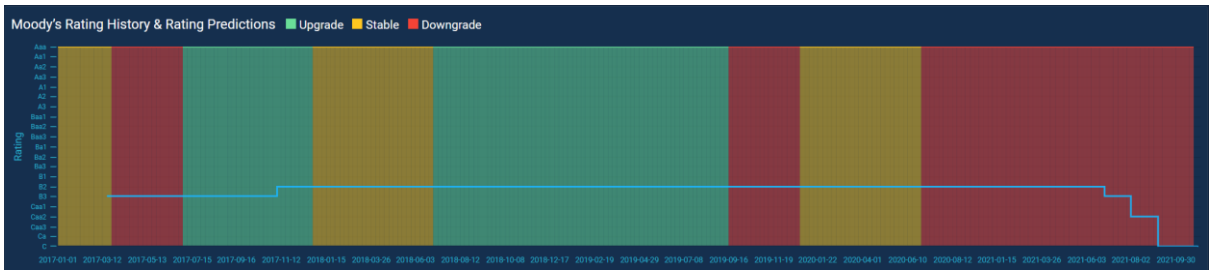
Source: Intellibonds

Intellibonds helps institutional investors lower costs through intelligent automation whilst transforming data into alpha. Our virtual AI assistants 'collaborate' with your investment professionals, allowing them to save time and improve decision-making.

The appendix below shows a list of China Evergrande Group peers with the history of credit rating predictions. If you would like to learn more, please get in touch with our team.

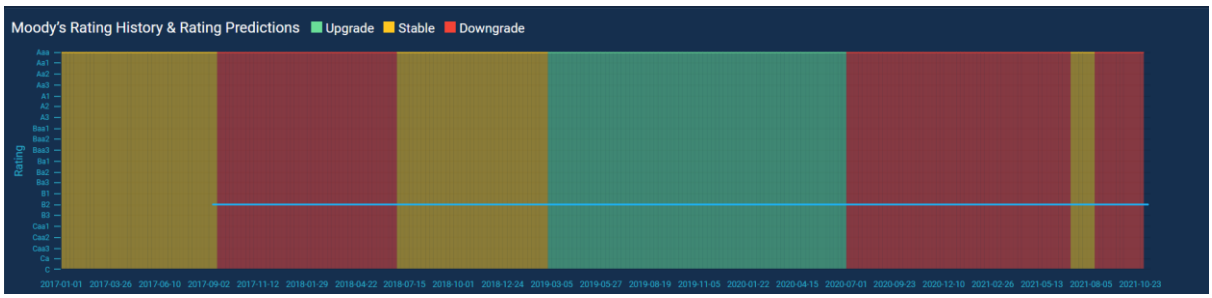
Appendix

China Evergrande Group



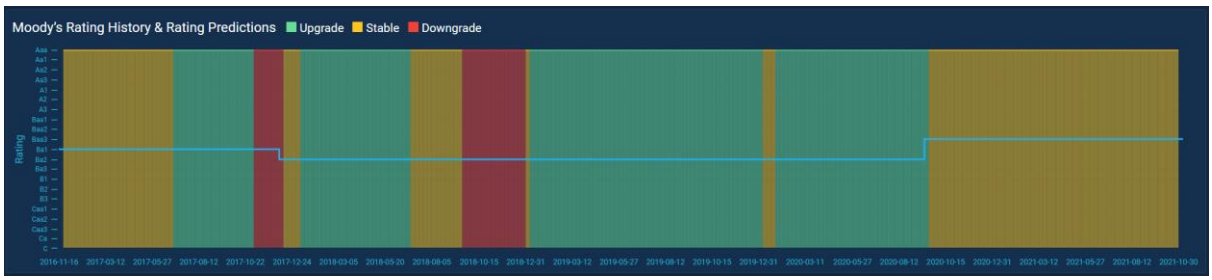
Source: Intellibonds

China Aoyuan Group Limited



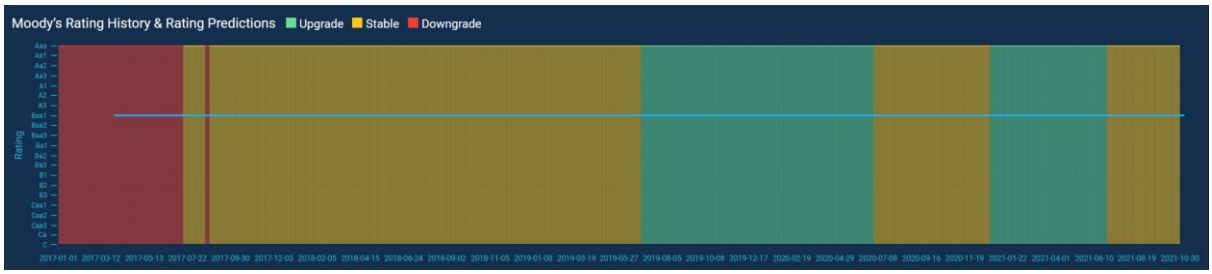
Source: Intellibonds

Country Garden Holdings Company Limited



Source: Intellibonds

China Vanke Co. Ltd

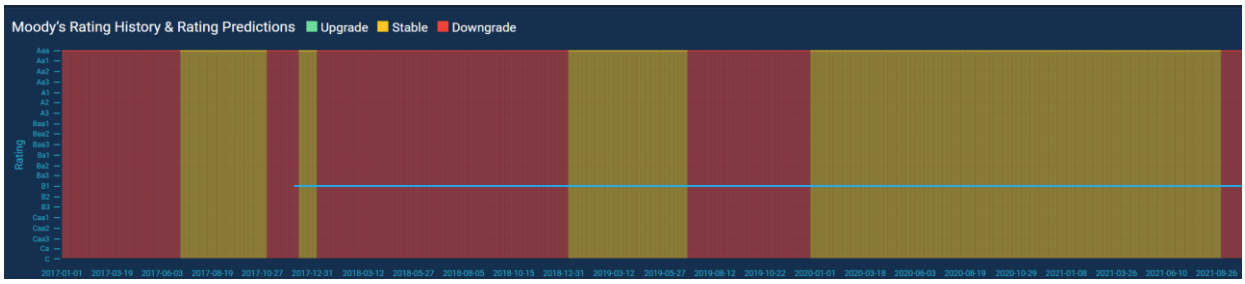


Source: Intellibonds

Times China Holdings Limited

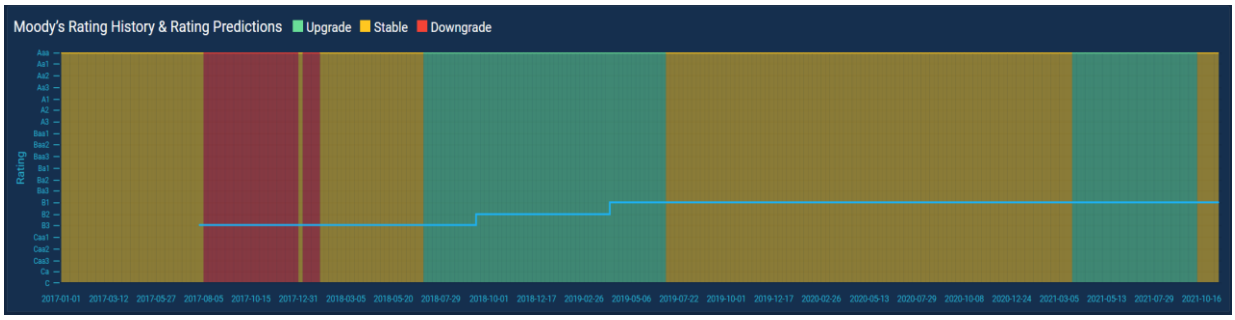
Source: Intellibonds

Central China Real Estate Limited



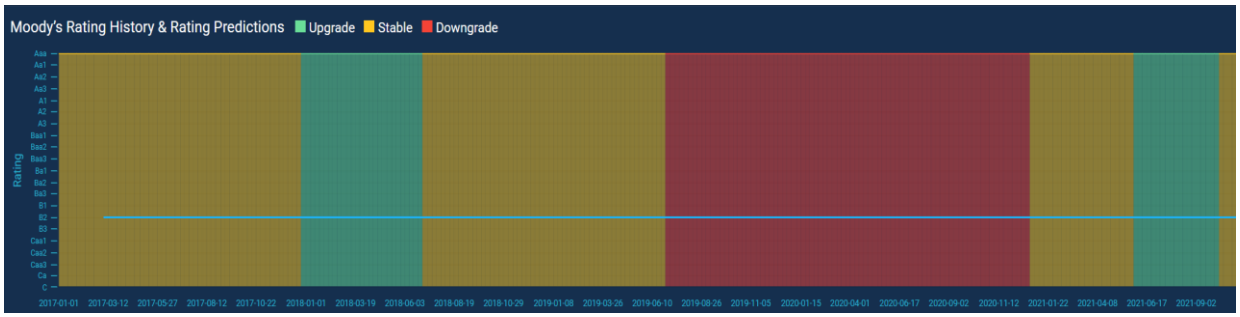
Source: Intellibonds

Sunac China Holding Limited



Source: Intellibonds

China SCE Group Holding Limited



Source: Intellibonds