Strategic deleveraging strengthens credit profile of China Evergrande

by LU Chang

As one of the largest property developers in China, recent developments in China Evergrande Group drew widespread attention among investors. Evergrande's stock price tripled since the start of 2017, making it one of the top performers in the Hong Kong stock market. Better than expected sales performance and a move to deleverage its balance sheet boosted confidence within investors, sending Evergrande's share price soaring to new heights. Although there are still concerns surrounding the debt-laden company, recent strategic deleveraging efforts have effectively improved the credit profile of Evergrande.

For the first half of 2017, Evergrande achieved a 72% year-on-year growth in sales amounting to USD 36bn. Performances of other large Chinese developers have been outstanding as well, with Country Garden achieving sales growth of 131% in the same period. The Chinese property market remains bullish despite the Chinese government's efforts to cool the market. Although there have been fears over a property market bust, China's real estate investment growth remained resilient as area of property sold rose 16.1% year-on-year between January and June 2017. With 96% of Evergrande's revenue coming from property development, the company could reach sales of USD 74bn this year, exceeding its previous forecast of USD 66bn in 2017.

	2H 2014	1H 2015	2H 2015	1H 2016	2H 2016
Revenue (USD mn)	7806.55	12500.01	8726.67	13387.28	18367.95
Cash & marketable securities (USD mn)	6572.26	6141.53	15937.88	18454.18	29111.20
Debt/ Common Equity Ratio (%)	305.29	319.21	582.10	808.65	1209.47
Debt/ Total Assets Ratio (%)	32.89	34.32	39.22	38.13	39.61

Table 1: Selected financial metrics of China Evergrande Group. *Source: Bloomberg*

Evergrande's strong growth in revenue resulted in a build-up of cash and marketable securities on its balance sheet. It also entered into strategic cooperation agreements with various banks to secure additional facilities. The high leverage ratio of Evergrande is widely considered to be unsustainable and excess cash on hand gave Evergrande the option of re-organizing its capital structure. As such, Evergrande embarked on a period of strategic deleveraging through bond redemptions. It first announced a plan to redeem all its perpetual bonds by the end of June 2017. Although perpetual bonds are treated as equity on Evergrande's balance sheet, it has debt-like characteristics and incurs a high financing cost for the company. Not reflected as part of the interest expenses, total interest payments on these perpetual bonds amounted to USD 1.6bn for Evergrande in 2016. Cash redemption of perpetual bonds lowers financing costs significantly, placing Evergrande in a better financial position.

Other than perpetual bonds, Evergrande also has plans to redeem USD 658.8mn worth of its senior notes that are due in the next three years in an attempt to extend the maturity profile of its debts. These senior notes will be redeemed using proceeds from the issuance of 2021, 2023 and 2025 senior notes. The extended maturity profile aims at reducing financing costs and optimizing Evergrande's current debt structure. Originally, this redemption was to be funded by internal cash and proceeds from strategic investors. However, the proceeds of USD 10.3bn raised from strategic investors were intended for a backdoor listing on the Shenzhen stock exchange.

Evergrande's liquidity position appears healthy with a high cash to total asset ratio. Its cash & marketable securities balance has been growing and is sufficient to cover its short-term obligations. Debt to total assets ratio stands at 39.6% at the end of 2016, but this number is expected to decrease in 2017 with debt redemptions and a proposed acquisition pipeline. In the long term, Evergrande's strong financial profile and its good relations with financial institutions could make it easier for the company to receive financing at a relatively low cost. According to ABCI Research, financing cost of Evergrande is projected to decrease from USD 940mn in 2016 to USD 800mn in 2019.

The abovementioned factors result in China Evergrande's strengthening credit profile. The RMI-CRI 1-year Probability of Default (PD) for the company fell from 104.6 bps at the start of the year to 22.7 bps on 13 July 2017. The main reason for the decline in RMI-CRI 1-year PD is due to the increase in RMI-CRI distance-to-default (DTD), which is a function of the firm's market capitalization and liabilities. China Evergrande's market capitalization spiked during this period, due to aggressive share buybacks by the company. These buybacks marked a sign of confidence from the company against short-sellers, boosting market confidence and pushing share price upwards. The company's cash to total asset ratio also doubled over the same period, indicating stronger liquidity and caused the RMI-CRI 1-year PD to fall.

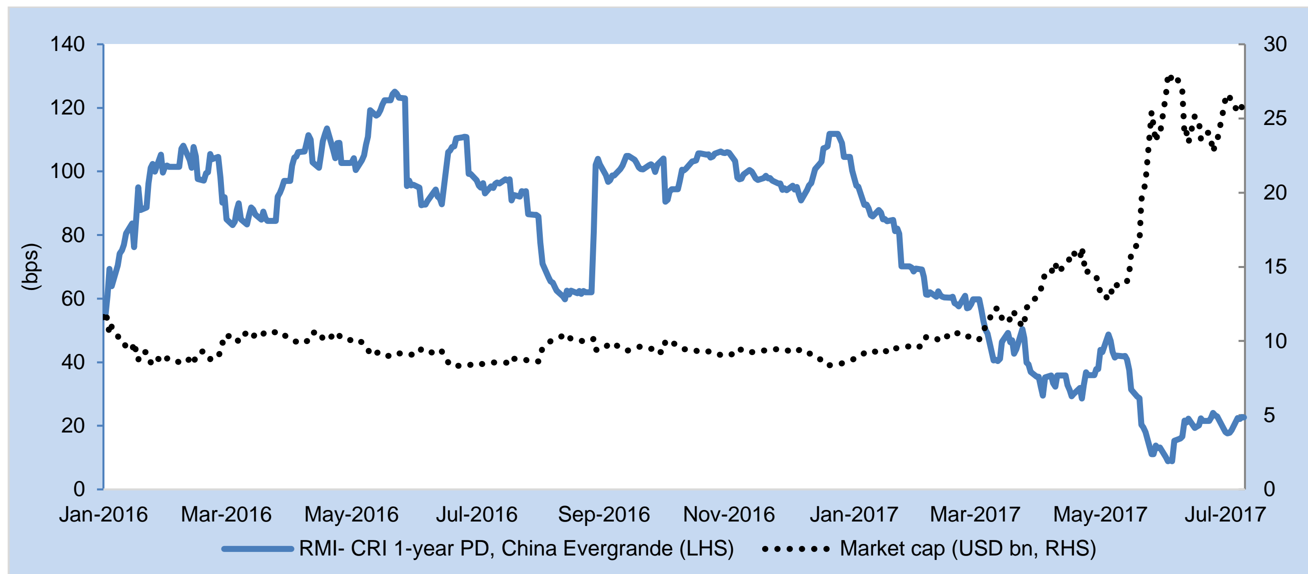

Figure 1: RMI-CRI 1-year PD and market capitalization for China Evergrande Group. *Source: RMI-CRI, Bloomberg*

Besides the improving figures, Evergrande shifted its focus from growing revenue to improving cost efficiency and profitability. In 1H 2017, Evergrande dropped from first place to third in terms of contracted sales. The new emphasis on profitability saw Evergrande slowing down its pace of expansion and placing more consideration on financing costs than before. With this in mind, ABCI Research estimates Evergrande's net profits to increase by 173% to USD 2.04bn at the end of 2017 following its revised strategy.

Although Evergrande's credit profile is strengthening, it has a track record for operating on high leverage and engaging in aggressive tactics for expansion. Its debt to common equity ratio was at a staggering 1209% in 2016 and was heavily dependent on debt for financing. The industry average debt to common equity ratio for real estate companies was 178% in 2016 and Evergrande's leverage is evidently higher than its peers. Investors still need to be cautious about Evergrande reverting to its old strategy of engaging in acquisition sprees through heavy borrowing. The company was relatively unscathed during the recent crackdown by the Chinese authorities on large overseas asset acquirers in China as most of its acquisitions are domestic. Despite this, Evergrande needs to be wary of the toughened stance of the Chinese government against highly leveraged Chinese companies.

Credit News

Blackstone warns of internet impact on US shopping malls

Jul 17. The world's largest real estate investor has warned that the outlook for America's enclosed shopping malls is darkening quicker than experts expected as the growing online retail threat hammers their valuations. Retail woes are intensifying pressures on shopping malls, especially of the lower-end enclosed type in smaller American cities and towns, where tenants are moving out or demanding lower rents. The market for second-tier enclosed malls has virtually frozen given how pessimistic investors are. Despite the mounting concerns, however, some real estate experts argued that overbuilding is the central challenge rather than internet shopping. (FT)

Insurers look for cover from stormy conditions

Jul 17. The specialist insurance and reinsurance sectors have been experiencing falling prices for five years, which start to erode their profit margins. One of the reasons that contributed to the falling prices is the lack of large claims that tend to drive prices up. Added to that has been an influx of capital competing directly with traditional reinsurers. Although return on equity shows the insurers are still profitable, some insiders argued, the way insurers report results does not reflect the underlying performance. They are underestimating risks such as catastrophe risks. Actions are taken in the industry, e.g. cost-cutting, changing business plans and offering generous coverage for customers. So far, the upturn in the market hasn't arrived yet and many investors believe the prices will be kept low for years. (FT)

Sistema suffers technical bond default after court order

Jul 17. Russian conglomerate Sistema has announced it has suffered a technical default on RUB 3.9bn worth of debt, after a court froze more than USD 3bn worth of its assets as part of a legal battle with state-controlled oil giant Rosneft. The company, a powerful associate of Russian president Vladimir Putin, has accused the conglomerate of stripping assets from Bashneft, an oil producer now owned by Rosneft but previously held by Sistema. Sistema has appealed against the asset freeze and denies the asset-stripping charges, saying its actions were legal and public. The next hearing in the case will take place on Wednesday. (FT)

Debt collecting a brisk business in tough times

Jul 17. Singapore's slow economic growth in recent years has hit many industries; however, the debt collection sector stands out as one that enjoying brisk business. For example, KX-Unit Debt Collection Agency saw a 30% increase in its clientele since its operations in 2015. One of the reasons for the growing customer base appears to be a rise in defaults among small businesses that are still facing a tougher time amid rising operation costs and therefore rising debt burdens. Although it seems a good time for debt collection business, the competition becomes stiff. The number of debt collection firms in Singapore has escalated rapidly to more than 200 nowadays compared to around 40 in 2003. (Business Times)

Venezuela cut deeper into junk by S&P

Jul 12. Bad days continue to haunt Venezuela as S&P Global Ratings continues to reduce the nation's long-term foreign and local currency ratings to CCC-, or three notches from investment grade, from CCC on Tuesday while keeping a negative outlook. Analysts in S&P attributed the downgrade to the recent developments in the country that raised the risk of default within the next six months, including through a debt exchange, absent unanticipated significant improvement in Venezuela's economic and political conditions. According to CDS data compiled by Bloomberg, the implied probability of the country missing a payment over the next 12 months rose to 56% in June, reflecting the nation's falling international reserves. The rating agency expects the country's economy to contract by at least 6% and its inflation rate to be at 950% this year. (Bloomberg)

China economy grows 6.9% in Q2, beating expectations on strong investment, consumption (Straits Times)
Singapore home sales fall 21% in June as fewer projects launched (Bloomberg)

Wells Fargo prepares to shed more businesses (FT)

Regulatory Updates

China's Xi orders debt crackdown for state-owned groups

Jul 16. At last weekend's National Financial Work Conference, Xi Jinping instructed China's state-owned enterprises to lower their debt levels. He also reminded the country's financial officials to bring "zombie" enterprises under control through extra supervision on credit extension. Mr. Xi's warning to the state sector came as four of China's largest private-sector companies were closely monitored following their involvements in a slew of Chinese overseas debt-fueled M&A activities, which have been increasing to date. However, he did not announce the creation of a central bank-led super regulator to consolidate powers held by separate regulatory commissions that oversee the banking, securities and insurance industries. This gave rise to the possibility that PBOC would be further empowered to take increasing responsibilities, such as the supervision of China's four largest state banks. (FT)

EU adopts plan to tackle bad loans, could push up capital buffers

Jul 11. After a decade-long financial crisis which left European banks holding nearly EUR 1tn of non-performing loans (NPLs), European Union finance ministers recommended quicker unloading of bad debt by banks and more capital buffers. The strategy being proposed is to increase bank supervisors' powers in order to force banks to raise capital buffers against increasing NPLs risk. However, banks warned that these measures could be excessive and in turn increase costs for the banking industry. Other measures being proposed include a better functioning secondary market for NPLs, which will help push up the price of NPLs and setting up national 'asset management companies' to help develop the market for bad loans. (Straits Times)

China to punish Wanda for breaching investment rules (Bloomberg)

Sweden's banks now adding risk weights to government bonds (Gulf Times)

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