Evergrande: How Large is the Anticipated Fallout?

September 2021

- New limitations on borrowing, coupled with aggressive pre-sale practices that created a growing pile of unfinished projects, left Evergrande with more obligations than it could realistically afford to accommodate.
- Evergrande's troubles do not appear to pose significant risk outside of China since it isn't globally interconnected on anything remotely close to a Lehman Brothers scale.
- We have no direct exposure to Evergrande in any of our investment strategies.

Investors have recently grown unsettled by the misfortunes mounting against Evergrande, one of China's largest real estate developers. Evergrande has accumulated roughly $300 billion in debt primarily by borrowing to fund new domestic construction projects[1].

How did Evergrande's situation grow so dire?

The People's Republic of China introduced limits last year on the pace at which developers would be allowed to accumulate debt. These new regulations were intended to moderate a sharp debt-fueled rebound in the Chinese real estate market following the country's early first wave of COVID-19.

New limitations on borrowing, coupled with aggressive pre-sale practices that created a growing pile of unfinished projects, left Evergrande with more obligations than it could realistically afford to accommodate. Several banks began denying mortgages on these unfinished projects in July as Evergrande's problems became more apparent.

Why has this become such a critical issue now?

Evergrande owes its creditors more than $100 million in interest payments over the next few weeks, and its credit rating was recently downgraded as the possibility of default has increased. As with any debt-centric crisis, default severely limits a debtor's ability to borrow or refinance, and raises its future borrowing costs, increasing the challenges in an already-strained situation.

The overarching concern among investors centers on how Evergrande's problems are ultimately resolved. There's widespread agreement that the company's debt load is unmanageable, but whether it tumbles into a disorderly bankruptcy, undergoes an orderly restructuring, or gets bailed out by the Chinese government remains to be seen.

Furthermore, is Evergrande's looming default a symptom of a systemic problem? If so, is that problem limited to China, or could it have a significant international impact?

SEI's View

We'll address the most acute concern first: Evergrande does not appear to pose significant risk outside of China since it isn't globally interconnected on anything remotely close to a Lehman Brothers scale. Foreign investor exposure is mostly limited to Evergrande's $18 billion in foreign-currency bonds, which is certainly not enough to ignite a global systemic crisis.

The most likely outcome would be an orderly restructuring of Evergrande's debts and unfinished projects rather than an unmanaged collapse or a government-backed bailout. State-backed media has cautioned that creditors shouldn't expect to be made whole, however, and priority in restructuring is expected to be given to homebuyers, so there may well be steep enough creditor losses to push some of them into default.

Fortunately, a default on Evergrande's unsecured debts would only dent China's system-wide bank reserves, and a restructuring with a measure of Chinese government support would alleviate at least some of the pain to creditors.

We also believe President Xi Jinping is not going to sit idly by if a broader panic begins to pose a threat. The People's Republic of China's wide-ranging reforms this summer are already stressing the country, and Xi has the tools and power to put the necessary backstops in place if Evergrande appears poised to tip into a systemic threat. Evergrande certainly

[1] "Evergrande's Debt by Any Other Name." The Wall Street Journal. March 31, 2021.

has company in terms of developers with high leverage and pre-sale practices, so it's possible these developers and some of their creditors could encounter similar challenges.

There's already evidence that the People's Bank of China (PBOC) will lean into accommodation to help offset tighter financial conditions. China's central bank began to ease its Reserve Requirement Ratio in July when Evergrande's problems first reached a boil after remaining notably restrained compared to other major central banks throughout most of the pandemic. We expect a more active role for the PBOC if warranted by deteriorating domestic financial conditions.

We have historically not been great fans of Chinese markets due to their lack of transparency. If China's over-indebted developers actually resulted in a round of bankruptcies it would be taken as a sign of healthy progress in the Chinese market's development.

Beyond the immediate concerns associated with Evergrande, China's recent struggles with the delta variant, tech-centered crackdowns, and now the property sector will likely shave a bit off of global growth at the margin. The size of China's real estate sector is large enough that we can't overlook the risk of a reverse wealth effect on the Chinese and global economies.

Other countries, like India, and the broader emerging Asia region, have recently benefitted from improving vaccination figures and will need to pick up the slack. Despite these concerns and general worries over "peak growth" we believe the outlook for global corporate earnings remains solid.

Longer term, however, China's demographics are an important risk to its real estate sector and economic growth in general. While not identical, there are similarities between China's emerging predicament and the end of Japan's expansion in the late 1980s—specifically, a deteriorating demographic outlook against the backdrop of a highly levered property sector.

Most of the difficulties associated with that episode were largely confined to Japan, but they took a long time to work through.

It is also worth noting that Evergrande is not the only concern on the horizon. Equity markets have not sold off in a notable way for quite some time. The anticipated tapering of asset purchases by the U.S. Federal Reserve and the possibility of lingering heightened inflation are just as likely to serve as catalysts for a pullback as debt problems in China's real estate sector.

Our Strategies

We have no direct exposure to Evergrande in any of our investment strategies.

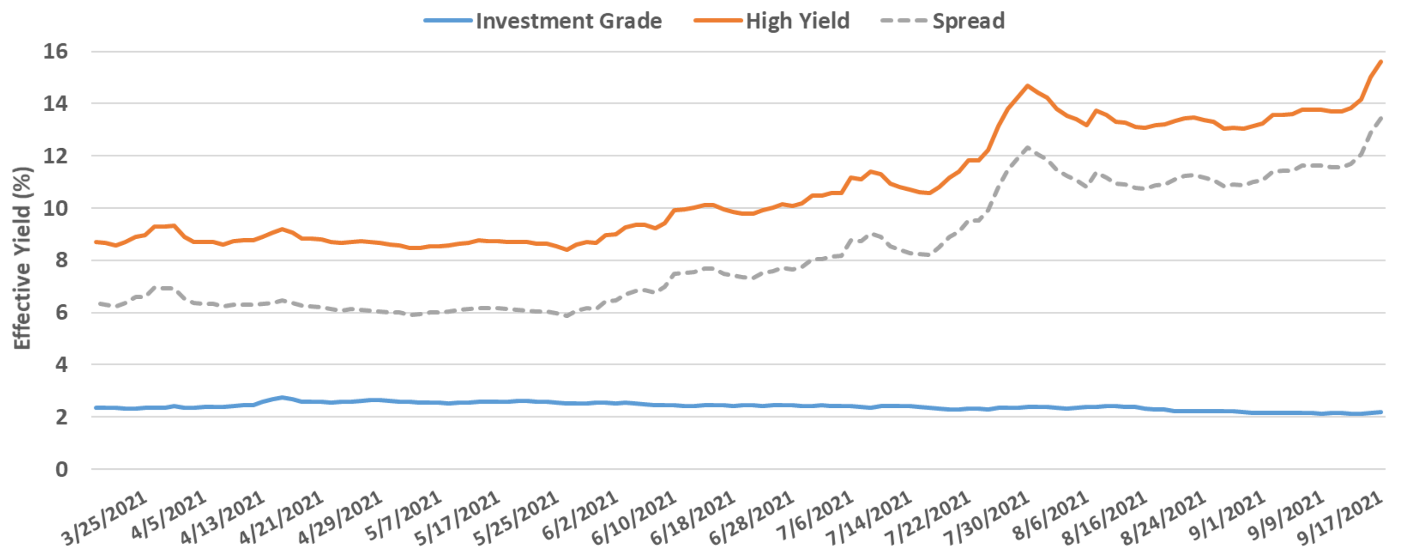
With regard to indirect exposures, our emerging-market equity strategy is underweight China (including Hong Kong) by more than 4% compared to the benchmark's 33.8% allocation. The Chinese financials sector is underweight, representing an allocation of slightly more than 4% of portfolio value, while Chinese real estate is a bit more than 1% of the portfolio (in-line with the benchmark).

China represents an even smaller exposure within our emerging-market debt strategy (4.19% of portfolio value versus the benchmark's 5.84%). Moreover, 98.5% of the portfolio's China-issued holdings are rated investment grade by Moody's. Exhibit 1 on the next page makes clear that the fears of bond defaults have been limited to high yield, where yields have climbed sharply since the spring, while investment-grade yields have actually declined in recent months.

Only 0.25% of the portfolio's value is held in Chinese bonds that are not government issued, and less than 0.04% represent Chinese real-estate bonds. We are also underweight Hong Kong, and our entire exposure there totals about 0.16% of the portfolio's value.

Elsewhere, we have underweight exposure to Chinese bonds in our international fixed income strategy. 100% of the portfolio's China-issued holdings are rated investment grade by Moody's.

Exhibit 1: Pressure on Chinese Corporates Has Been Limited to High Yield



3/18/21 to 9/17/21. Investment Grade = ICE BofA Investment Grade Emerging Markets Corporate Plus China Issuers Index; High Yield = ICE BofA High Yield Emerging Markets Corporate Plus China Issuers Index. Source: Bloomberg, SEI.

Important Information

Investment strategy positioning information is current as of September 20, 2021.

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