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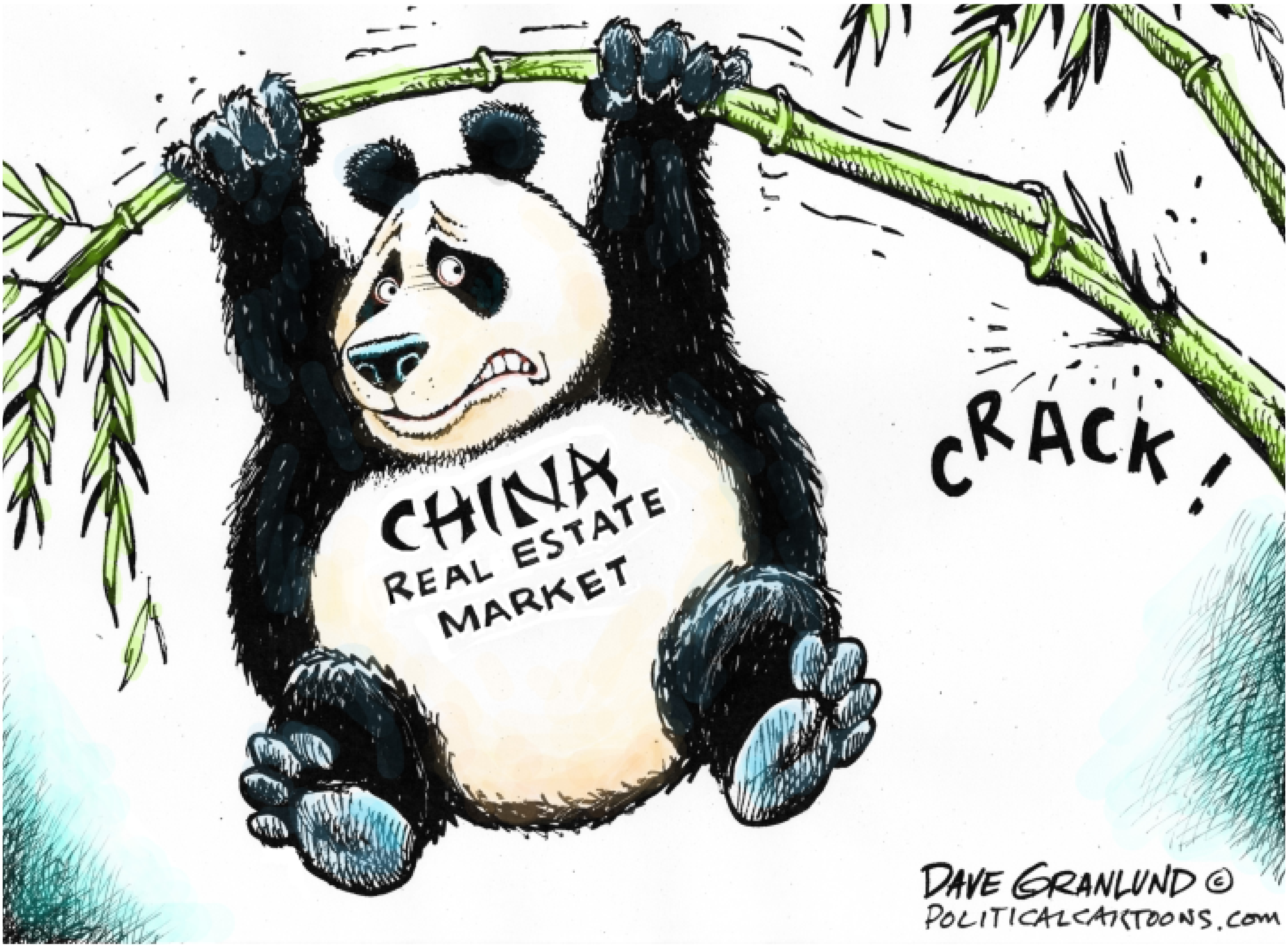
WILL AUSTRALIA CATCH A COLD?



IF EVERGRANDE SNEEZES... WILL AUSTRALIA CATCH A COLD

BY PAUL MIRON

Evergrande, one of the world's largest property developers/builders operating in the 2nd largest economy in the world (China), is the most indebted company globally, with approximately $416billion (AUD) in debt. It is presently defaulting on its loan repayments and is on the verge of collapse. It operates within China's most critical and most significant sector being property and construction, an industry which contributes between 25% to 29% of their national GDP. The significance of these events is not just related to one company; they have the potential to have far-reaching consequences globally.

As we attempt to peel off layers of this incredibly significant event, we believe it certainly has the potential to be a catalyst of a deep and enduring crisis that might take years to resolve and will impact Australians' wealth portfolios.

To understand how this will impact Australian investors, we will explore the Chinese property market, history, drivers and compare them to the Australian property market fundamentals.

Who is Evergrande?

From humble beginnings, Evergrande was founded in 1996 by Hui Ka Yan, who originally worked in a steel factory.

Evergrande made its debut on the Hong Kong Stock Exchange in 2009, raising $722 million in its IPO and peaked in 2017 to be the world's highest-valued property company whilst Hui Ka Yan became the wealthiest man in China. Its stellar growth was fuelled by two key ingredients, China's astounding urbanisation story and exorbitant debt.

Chinese Property Market fundamentals

China's accomplishments are equally as astonishing as Hui Ka Yan’s, as it urbanised a nation of 1.4 billion people into high-tech megacities with impressive state-of-the-art infrastructure. It was not too long ago that China's per capita income was the poorest globally to the middle-class income levels of Chile, Hungary, and Romania. China is now the second-largest economy globally and is close to eradicating absolute poverty.

Despite these achievements, the Chinese property market has deviated from traditional fundamentals. As high as 22% of all properties (90 million properties) in China are unoccupied, fuelled by speculative purchasers invigorated by debt. 68% of Chinese wealth is stored in the property, not shares or businesses.

The Chinese communist government is responsible for the property market reaching this point by exerting undue power and influence over the market forces and their limitations. The property market kept expanding because investors and developers generally thought it was far too important for the government's economic aspirations to allow the property market to flatten and they turned a blind eye to the risks. Not just because it adds 29% to GDP but also because, unlike anywhere else in the world, Chinese construction industry encompasses the entire supply chain from the provision of nails to the building of kitchens and bathrooms, except for the raw materials traditionally imported from Australia.

China's property market is fundamentally imbalanced: too much housing, too little demand among owner-occupiers, and not enough people moving to the places where housing is oversupplied (creating ghost cities).

China's urbanisation rates and household formation rates arguably peaked when the working-age population declined between 2013 and 2015. The rate of new residential building projects just kept rising, and construction kept powering the economy. Such projects hit a new high only in 2019, with developers initiating construction of around 18 to 19 million units.

Why contagion is not an option when it comes to Evergrande demise

Despite the reassurance of Jerone Powell of the US Federal Reserve and Christine Lagarde, President of the EU bank, that Evergrande's exposure will be limited and contained internally in China (this now seems less likely), we believe that Evergrande's troubles are only the tip of the iceberg. How many other Chinese developers are teetering on the verge of collapse? How do you contain them and not trigger a domino effect in the sector?

Our predictions are as follows:
1) Undoubtedly, the Chinese property market will need to go into a period of deleveraging, and property prices will need to orderly deflate. Bloomberg's research has demonstrated property prices in certain Chinese cities are the most unaffordable in the world.

2) It is a common belief that the government will rescue Evergrande. Ultimately it is now in the hands of the government. Irrespective of the methods used (i.e. complete government buyout, business restructures, fire sales of assets, mergers with others, and debt restructuring), something must happen and quickly. There is a lot at stake:

- There are over 1300 unfinished projects spanning over 280 cities in China;
- There are approximately 1.6m purchasers who have paid deposits of 30% which have been directly released to Evergrande;
- Close to 125 Chinese banks and 121 Chinese non-banks that lent to Evergrande;
- Suppliers impacting thousands of small to large businesses across the country;

- 3.6m direct employees;
- 80,000 investors owed approx more than $8b;
- Shareholders and international bondholders who will most likely lose out.

Late in 2020, the Chinese government acknowledged it needed to rely on the property market for growth and curb debt to avoid the unavoidable.

New developers' financing regulations were imposed on three key financial ratios, labelled the "three red lines": future access to finance to developers will need to adhere to strict criteria, including liability to asset ratio of less than 70%, net gearing ratio of less than 100%, and cash to short term debt ratios of more than 1x.

UBS researched the most prominent 50 Chinese developers in January 2021. The key finding was that only 6.3% complied with all three key requirements.

Evergrande is getting all the attention right now, but it is only part of a broader weakness emerging in China's property sector. Sales are falling nationally in volume, by 8% in July, 16%in August, and around 33% (in 30 large cities) through Sept. 25.

The government's latest form of intervention is to restrict discounting and pricing of new property by developers, not to exceed more than 15%, and to limit any increases to prices.

China is clearly on the path to reduce the Chinese economy's reliance on the property sector, as evidenced by the frequent official repetition of Chinese President Xi Jinping's words that "houses are for the living, not for speculation.

How does the Australian property market compare to China?

There are significant differences worth noting as below:

- The construction sector in Australia contributes 8.8% to GDP;
- There is a chronic undersupply of property within the broader market;
- The growth in demand for debt is 2.2% for investors rather than 8.4% for owner-occupiers, which is very conservative;
- Australia's banking system is highly regulated and capitalised and the Reserve Bank (RBA) is governed independently of the government;
- Demographic constraints do not limit our property market, and Australia has the second-highest net migration of skilled labour globally pre Covid and which we believe will resume in December this year.

In my previous article, "Are low-interest rates a risk to the property market and economy?", written April 2021, I predicted that the property prices would increase by 30% and at this point, macroprudential action would be taken to dampen demand.

In summary, the main issue is that Evergrande will impact investors both globally and in Australia.

At best, China's economy will slow as it attempts to ween off its extraordinarily high reliance on property. China historically contributes up to 30% of the world's GDP growth this alone is a material impact on the global economy.

We anticipate that international bondholders will become victims of this saga, losing their capital, impacting the returns of many international bond funds. Australia's trade with China is already on a downward trajectory and will continue to decrease over the coming years.

At worst, other Chinese developers' international bonds will begin to default, and this will spook the global bond market and trigger a run-on capital, resulting in a credit crunch.

Investors sentiment can turn very quickly, increasing the cost of funds internationally and initiating a credit crunch.

We have witnessed these cycles in previous crises, increasing cost of funds and reversing some of the gains within the share market and property market.

Investors should be aware of the risks, balance, and diversify their portfolios appropriately to withstand expected and unexpected shocks. It also demonstrates the power of investing in a defensive asset class such as direct mortgages ensuring your investment is secured by the physical and readily saleable assets to give you the asset preservation characteristics.

The structure of Msquared's Fund accommodates this operates such a fund and we would be happy to discuss these attributes and future opportunities with you.

If you would like to know more about how Msquared Capital can be a part of your investment portfolio and the added benefit of our unique structure, platform, and offers. Please feel free to contact Paul Miron on +61 2 9157 8608 or sending an email to investor@msqcapital.com.au.

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