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Investors May Be Further "Left Smarting" After Evergrande As China Retools Economic Policy

Global financial markets have stabilized after China's debt-laden developer China Evergrande said it would be able to make an interest payment due on bonds this week. Market volatility underscores risks with Beijing's debt-heavy development model, and has surfaced at a time when foreign investors in overseas-traded technology shares such as Alibaba and education companies such as New Oriental have been hit with losses as authorities switch domestic policy priorities.

"From housing to education to financial services, China is in the process of forcefully retooling aspects of the economy that the (Communist) Party believes have led to an unacceptable divide in incomes and a dangerous decline in birth rates," says Drew Bernstein, a China accounting expert and co-chair of MBP in New York. "Investors who are caught on the wrong side of these rapid gyrations are left smarting."

What's next with Evergrande and bailouts of similar China businesses? I exchanged by email with Bernstein today to learn more. MBP audits and advises Asian companies. Excerpts follow.

Flannery: Why is China Evergrande important?

Bernstein: A year ago, China Evergrande was famous for being the second largest property developer in China, with projects in more than 170 different cities. Today, it is famous for being the most indebted real estate company in the world, with more than $300 billion in debt, equivalent to 2% of China's annual GDP. Evergrande's tentacles reach deep into China's real estate and banking systems, owing money to Chinese banks, domestic bondholders, foreign bondholders, suppliers and contractors, and local governments. And as Evergrande's cash crunch grew more dire, it got creative selling high yield "wealth management" products to investors including

Evergrande property owners and many of its 200,000 employees. Evergrande, in short, owes money to almost everyone. And despite engaging in a fire sale of a range of its assets, Evergrande appears to have dim prospects of paying it back in a timely manner.

Aside from its sheer size, Evergrande is important because it highlights China's dependence on real estate development to power growth in its economy and how this has led to unsustainable rise in housing prices and debt levels.

Flannery: What does Evergrande tell us about China's broader real estate market?

Bernstein: In China, many people invest in apartments as a speculative store of value, even if they have no intention of living in them or renting them out. The land sales associated with new developments are also a major source of revenue for local governments and the whole cycle has been lubricated by ample lending by state-owned banks that often have close ties with government officials. Real estate and associated industries accounts for as much of 25% of China's GDP, giving it an outsized impact on both economic growth and the health of the financial system.

China's government is acutely aware of the risks associated with runaway development and taken active steps to slow the growth in debt and make housing more affordable. It implemented "red lines" last year as to the amount of leverage that developers could take on and Xi Jinping has repeatedly emphasized that housing should be "built to be inhabited, not for speculation." In fact, the reforms that the government took to reign in housing speculation are what likely surfaced the underlying weakness of the Evergrande empire.

Flannery: Is this China's "Lehman moment" that sets off a broader crisis?

Bernstein: Investors who are expecting a rapid series of implosions like the global financial crisis are likely to be disappointed. For one thing, China's regulators are diligent students of how that crisis unfolded and have maintained robust capital controls and a captive state-owned-banking system to reduce the risk of institutional panic. China Evergrande will probably engage in a process of orderly default negotiated among its domestic creditors under the watchful eye of the government.

Analysts are now trying to sort out to what extent the company may be a bellwether of more widespread disease among China's other large property development companies and banks. If additional reorganizations and write-downs become

necessary, we can expect policy makers to seek to grind it out over time rather than engage in shock therapy.

Flannery: Who wins and who loses as Evergrande gets unwound?

Bernstein: If this drama were unfolding in America there would be a rush to bankruptcy court where high-priced lawyers would help creditors jockey for position as the assets of Evergrande were sold off. The chances of various creditors collecting what they are owed would be determined by the seniority of their debt and what collateralizes it. The winners and losers in this case are likely to ultimately reflect the bedrock priorities of the Chinese government. Social stability is paramount, meaning that anything that might spark unrest or appear to privilege wealthy private investors or foreigners while wiping out the savings of average Chinese citizens is off the table. Equally important is avoiding any step that destabilizes the banking system by setting off a chain reaction of insolvencies. If this means bailing out large, state-owned banks, then the government will likely find a way to make that happen.

Evergrande indicated that it will somehow make a bond payment due to domestic investors on September 23rd, while making no mention of the coupon due on foreign bonds, which may be an indicator of the differential treatment to be meted out to different classes of creditors.

Flannery: What lessons should investors take away from the Evergrande affair?

Bernstein: First, China is actively and forcefully attempting to shift its economic model away from a reliance on debt and speculative construction towards more sustainable and high-quality growth. These policy moves, while necessary, can have sudden, unpredictable consequences for the companies that grew rich under the old model of borrowing, selling flats, and pouring concrete.

Second, when there is a conflict between the (Communist) Party's social goals and the interests of the corporate sector, corporations will be sacrificed every time. From housing to education to financial services, China is in the process of forcefully retooling aspects of the economy that the Party believes have led to an unacceptable divide in incomes and a dangerous decline in birth rates. Investors who are caught on the wrong side of these rapid gyrations are left smarting.

Third, in China no one is too big to fail. However, if the company strongly affects the key pillars of the Made in China 2025 plan and/or needs to be involved in the solution,

there will likely be a way to survive. As we see more unicorns at the super scale level, we can expect more ripple effects in the local and global markets.