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HNA, Evergrande Woes Underscore How China Paradigm For Business Success Is Being Swept Away

A gathering wave of regulatory action and debt restructurings in China underscores how old business paradigms are disappearing and a new era for corporate governance is taking shape.

That's according to Drew Bernstein, co-chairman of MBP, a New York-based audit and advisory firm that specializes in Asian companies "The old paradigm for building a corporate juggernaut in China has been swept away," Bernstein said in an email exchange. "Previously, the interests of the private and public sector were strongly intertwined," he said. "Now, there is a level of distinction between private and public interests."

China's crackdown on technology companies such as DiDi Global and Alibaba Group over data-sharing and other practices in recent months has triggered big declines in their share prices this year. That "regulatory blitz" has further hit new fundraising on international stock exchanges, while at the same time occurred alongside moves that aim to attract more capital at home in line with tech industry development goals spelled out in the country's "Made in China 2025" plan, Bernstein said.

Though many international investors in China have been focused in recent weeks on the fallout from Evergrande's woes and changing tech industry rules, the debt-fueled expansion and follow-on restructuring at HNA Group is also "an amazing case study of the challenges inherent to the meteoric 'go global' expansion model" and an economic growth model that relies greatly on state-supported loans, Bernstein said.

Hainan Airlines, which evolved to become HNA Group, acquired other airlines to build a national and international network, then moved into airport services, financial services, real estate, technology and other fields. "Starting in 2015, HNA Group went on a $40 billion global shopping spree, snapping up stakes in Hilton, Virgin Australia, Ingram Micro, and Deutsche Bank, along with a Park Avenue skyscraper and several golf courses" – part of a total of 123 transactions in three years funded by debt supplied by state banks and overseas investors that created a total of 321 subsidiaries and a complex, interlocking ownership structure, he said. "A complex organization, it became challenging to determine who owned and controlled what. The stakes get higher as a company pursues global endeavors."

By 2018, "it was clear that (HNA's) purchases were at a premium and the debt was unmanageable," and HNA began to sell off assets and refocus on the core business, Bernstein said. Then, the Covid-19 pandemic hit. The Hainan government seized control of the company in early 2020 and then put it into bankruptcy proceedings at the beginning of this year. HNA Group had over 60,000 creditors, 410,000 employees, and debts of $171 billion – "so it is a massive undertaking," he said. "The bankruptcy may provide insights into how future reorganizations are handled. Protecting employment and the interests of small creditors will be paramount."

Expect business leaders to try to keep a low profile. "China is working to manage through the consequences of overleveraging across different sectors of the economy. The HNA case reinforces the message that no company is too big to fail. And no entrepreneur is too famous or well-connected to be protected. In fact, having a high profile is more of a liability right now," Bernstein said. HNA Group's chairman Chen Feng was detained in late September for suspected, though unspecified, crime (see post here); Hainan Airlines last week announced a plan to double the number of shares and raise new money.

Though excessive borrowing was a big reason of HNA and Evergrande's problems, another important lesson for foreign businesses and investors is the need to view current developments through the prism of China's current promotion of "common prosperity," Bernstein said. "We are learning that this phrase 'common prosperity' is resetting the bounds for corporate governance. Recent restructurings may create opportunities for investors to drive the business segments that are still healthy," he believes.

And yet, he added, "success depends not only on dissecting cash flows and balance sheets, but on understanding how a transaction aligns with the goals of 'common prosperity.' Can a transaction be positioned as preserving employment and preventing financial contagion? Does it correct any prior transgressions? Will it promote stable, quality growth?"

Big changes, indeed.