China Briefing

China's new model: Evergrande and energy show how China might change

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Executive summary

- *China's old rules of politics and economics are being rewritten. Real estate is not to drive growth any longer: another way must be found.*
- *The old "sell land, boost manufacturing" model relied on land prices rising and local governments competing to who could most improve growth. It's changing to who can provide the best services.*
- *In the short-term, the risks are devaluations in real estate prices and liquidity squeezes.*
- *China forcing its local governments to embrace markets will bring long-term gain. The balancing act is how to minimise short-term pain so that sentiment doesn't spiral downwards and out of control.*
- *The bottom line for investors: buckle up. The road to better economic growth will be bumpy. While there are challenges, there will be opportunities. The opportunities remain for investors who China views as helping the quality of growth.*

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What happened with Evergrande?

Evergrande was once the pride of Guangdong. Founded by a former steel mill manager turned builder, it created China's largest private housing community: 90,000 units made from what was once a pesticide factory.

Today, Evergrande is described breathlessly by foreign media as a possible reason for China's economy collapsing.

Why? Because Evergrande is deeply in hock. The company reports that it is balanced on a tightrope. As of the end of June, they reported total assets of RMB 2.38tn and total liabilities of nearly RMB 2tn — but its interest-bearing debt was only said to be RMB 572bn, and that is unlikely to cover its huge off-balance sheet debts from its unusual and complicated capital structure. As it only has RMB 158bn in cash that can repay short-term debts and interest, its liabilities look more and more formidable.

Even in good years, when Evergrande was turning a profit, its interest payments were greater than its profits. Those chits are now being cashed. How did Evergrande's debt become ever grander? Because its business model relies on land prices constantly rising over long periods of time.

Real estate projects take an age to come to fruition. It takes regular and huge capital injections to turn an empty piece of land into a sellable housing complex. So developers must build it and hope they come. They borrow to buy land, ask for large deposits upfront, and then borrow yet more money to invest in new projects while they are still building the old ones. Whoever is able to complete this cycle the fastest wins. This leads to what is called the "three locomotives" of Chinese real estate sales: high turnover, high profit, and high leverage. It also requires land prices to keep rising faster than the interest payments on the debt for the new projects. So if land prices fall, the model falls over.

Evergrande reports
as of end of June

RMB 2.38 trillion	RMB 2 trillion	RMB 572 billion	RMB 158 billion
in total assets	in total liabilities	in interest bearing debt	in cash in-hand

How did we get here?

While Evergrande is the most prominent example, nearly all Chinese real estate uses the same "three locomotives" business model. That has led to China's economy developing in a distinctive way.

Real estate is around 27% of China's GDP, roughly 10% more than the equivalent share of the US' GDP. Chinese citizens put most of their worth in housing — roughly three-quarters of Chinese household assets are in real estate; compare that to the US, where it is closer to 30%.

Understanding why requires understanding China's political economy. To solve its real estate problem, Beijing must transform the Chinese credit markets and the ways in which they allocate risk. It must decouple the three locomotives by stopping land prices from rising. That requires addressing China's debt problem, which is another way of saying we need to look at how China grows in the first place.

At heart, real estate is a moral hazard problem. Chinese lenders extend credit on the basis that large borrowers would be bailed out, because the largest borrowers had connections to or were a part of the Chinese state, and therefore were not seen as a credit risk. Local governments

and regulators were expected to restructure any liabilities and roll credit over if necessary. As a result, loan (and to a lesser extent, bond) portfolios are often built on political perceptions and pressures rather than around credit risk and the portfolio needs of creditors. There is not enough discrimination in credit pricing. So as long as you are seen as connected with the state, you are likely to get credit.

Land in that sense is politics. The major lenders are mainly state-owned companies that prioritise local government policy over profits and what they are told by central regulators.

Why do we argue this? Because the control that the centre has over local regulators and businesses diminishes fast once one is out of Beijing. The skein of checks and balances starts to dissolve and instead there is a direct link between industry, bank, and leader. That means that locals respond to their own incentives, no matter what outsiders may wish.

Moreover, contrary to what one might think, China is in some ways the most decentralised nation in the OECD. It has the highest rate of local government spending of any OECD country. China's massive size means that it needs services delivered locally; and indeed, 85% of all spending occurs outside of the central government. Change in China may start central but it is delivered locally.

Yet, this intertwining of local government and business is at odds with Xi Jinping's "war on debt". The central government wants local governments to cut their debt levels. But it also ties the hands of local governments. The centre collects 65% of all taxes, and also restricts local governments from charging fees for programmes and services to reduce graft. Local governments must make up the shortfall from providing services promised by the centre.

But at the same time, China's regulators have repeatedly emphasised their wish to control financial risk (see China Briefing on China's three red lines). Xi Jinping's speeches outline his view very clearly: houses are for living in, investing in state-connected entities is for helping the nation and the real economy, and while those more willing to take risks are welcome to invest in stocks and property, he does not see this as helping the nation. This, however, will lead to major problems for his own local leaders.

That is because local governments' growth is fuelled by land. At local levels, land finance is nearly everything. A recent book by a high-profile Chinese economist estimates that land finance in general makes up 89% of local government budgets.

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High-profile Chinese economist, Lan Xiao Huan, estimates that land finance in general makes up 89% of local government budgets

The land/industry finance cycle must be understood to know how China works. To simplify, it is far more profitable to convert agricultural land to city land, and once it is made into city land, the local government gains the highest return by then using it to build residences rather than by using the land for industry. Around half of total converted land was used for industrial purposes, but the value of that land has not grown very fast. Between 2000-2018 industrial land prices only grew 85%, while commercial land increased 4.6x, and residential 7.4x.

This is why real estate firms like Evergrande are so intertwined with the local government. Local governments make far more money from residential land development than land usage taxes; but they also need land prices to keep rising. Because if they don't, they will need to turn to other methods such as borrowing. Local debt significantly exploded in the Global Financial Crisis (GFC) for example, because the centre made local governments responsible for not only local stimulus programmes but also requiring them to spend a lot on pro-social infrastructure. Many projects such as sewage don't make money (or even lose) money but are necessary, so "bad" projects have to be bundled with profitable ones, and in either case the local government has to pay. That has to be paid for by land sales or debt.

As a result, local governments have become an "entrepreneurial state". By law, local governments cannot get debt from banks, and before 2015, could not issue debt securities. So if they wanted to invest, they needed to form a special company. Most of these companies are wholly government owned, and called "local government fundraising platforms." Their official names often have "construction investment" or "investment development" in them.

The other way local governments do more with less is that they maximise the things they can control. For example, since more tax flows to them from manufacturing rather than consumption, they stimulate supply rather than demand. Making something is more important than making what people want, leading to tremendous oversupply. (Especially in the post-GFC period, when Chinese economists estimate about half of China's tax revenue came from industries with oversupply.)

There is a double squeeze on industry to produce more. Not only, as described above, do they make the local government more money, but they also need to be growing nearly exponentially in order to produce the same return as flipping land.

But local governments have little recourse. If you need the money as a local government, what else are you to do?

How is the government trying to fix this?

The solutions that Beijing will propose have already been well outlined by China's leaders. The Minister of Housing and Urban-Rural Development wrote in December 2020 that China had shifted "from large-scale incremental construction to equal emphasis in quality transformation of the stock and incremental structural adjustment". In a simpler translation, this isn't like last time when the central government outlined a "slum redevelopment" program that allowed land reclassification and allowed more lending. No more.

Beijing's goals are to prevent property prices from rising, to limit "land finance," and cut down on further debt by reducing local governments' ability to raise money and SOEs' over-indebtedness.

For local governments, though, all of this is happening as land sales go down (43% already for September on last year) and energy prices go up rapidly, forcing local industry to close down. At present, 96% of spending on local services for education, healthcare, and social security comes from local government.

> **So their question is simple: where will our money come from?**

A property tax is one possibility, but it will hurt consumption and lead to possibly awkward questions about who owns what and why. Indeed, this tax has been on the legislative agenda since the mid-1980s; there is a reason it is unlikely. Xi Jinping has succeeded in having 10 pilot cities introduce a tax. The Wall Street Journal reports that this was meant to be 30 cities. That leaves nearly 800 cities left to go, and such a change will not be quick.

So what we see as more likely is that Beijing will reform fundraising. It may be necessary to allow local governments to collect more of the revenues, and to issue more bonds that are explicitly pro-social, such as green bonds. (Beijing sees bonds as better than loans because they can be transferred, allowing some level of equalisation, and they are also more public).

China has less government debt than developed countries but more corporate debt (154% of GDP in China vs 75% in US and 58% in Germany). Much of the problem is that, as shown above, this government debt is intertwined and hidden in corporate debt through things like local infrastructure projects. A better bond market may help.

This leads to another of Beijing's more likely measures. In the longer term, they want to reform capital markets (and even introduce new stock markets, such as that recently announced in Beijing), and to have far deeper capital markets. China's total equity markets are only around USD 7tn. But this will not instantly fix the local government's problems.

Indeed, it is almost impossible to find a way forward that does not directly deal with housing. Why? Because nearly all of China's assets are tied up in real estate. Figure 1 below compares the US and Japan's distribution of household assets with China's. In China, your home is not only your castle, but also where you have all your money.

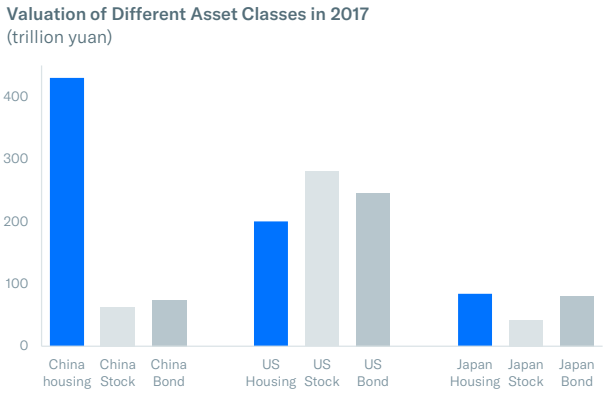

Figure 1: China, US, and Japan's asset class valuations
Source: China Charts

In the medium-term, the government must fix this. So, a better land market is likely. At present there is no national land swap market, but rather each province is allotted how much land can be developed; the provinces then pass this down to the municipalities and they in turn down to the counties. There are already mooted reforms for this, but the Evergrande events will exacerbate them.

> **"This is the government saying enough is enough. It's a big moment for change."**
> — Mike Imam, CEO, Silverhorn

Where does Evergrande fit in?

At some point the carousel stops spinning and one must figure out the cost of the ride. In China, this comes when everything is sold. Evergrande themselves maintain that should the planned construction go ahead, all of its debts could be repaid.

That sale would be long off. But Evergrande's debts are due today. So who does Evergrande owe?
First, local banks. Secondly, Evergrande also borrowed from its own staff. When developers seek funds from banks, lenders often require personal investments from the developers' executives as a risk-control measure. These funds are considerable. Thirdly, developers take payment for the house before it is built — so in the Evergrande case there are around 200,000 buyers waiting for their home to be delivered. (Caixin estimates that it will require around RMB 100bn to complete and deliver the units.) And finally, Evergrande created wealth management products that promised safe and stable returns of around 20% per annum.

Figuring out the order of who will get paid what and when is undoubtedly complicated. There are many banks and bondholders to repay. State banks are likely to reclaim assets first. Home buyers will certainly receive support, and in the longer-term, the houses they have already paid for. What we are so far unsure about is Evergrande staff, investors in Evergrande wealth management products, and Evergrande's foreign currency denominated bond holders, all of whom can only claim access to enormously illiquid residual value as other lenders have seniority.

Some are calling this China's Minsky moment, referring to the point at which creditors all pull their money out at once, depressing the price of the very assets they are trying to sell and making them less willing to wait for their repayments. Or, as more literary types put it, the moment when you go broke suddenly after going broke gradually.

Real estate-driven growth has obvious weaknesses. First, it leads to housing bubbles; as Tom Orlik's book puts it, China is the "bubble that never pops". Until it does. This remains a perennial fear in China.

Secondly, real estate driven development is unequal development. China suffers from an undersupply of housing in the most popular areas — Beijing, Shanghai, Guangzhou for example — and yet an oversupply nationally. Rhodium Group estimates that there is enough empty property in China to house over 90mn people. But most land is released by central fiat and is in the less-sought-after western areas of China. There is no national land market or equalising device. This then flows into local goods and services. Wealthy areas with high demand for land spend more on public services, which makes their real estate more attractive but national inequality worse.

And it leads to a lot of debt. Chinese bank estimates put it that there is around RMB 18tn of debt related to property developers (bank loans, trusts, onshore/offshore bonds) or roughly 10% of total corporate credit and 26% of total debt held by banks.

It is the debt that has people most worried. China's official debt-to-GDP ratio has soared by nearly 45 percentage points in the past five years, leaving it with among the highest debt ratios for any developing country in history.

This is most probably why Beijing acted. The longer loans are allowed to be rolled over, the more likely liquidity can suddenly dry up and the more the government needs to choose whether to bail them out or not, even letting some go out of business to show that no one may be "too big to fail".

Evergrande is a risky firm to choose to make one's point — its liabilities are roughly equal to 3% of China's GDP. And Evergrande is just one of many. According to Rhodium Group estimates, there's USD 221bn in offshore USD bond offerings, and a lot of this is currently priced as if it is going to default.

Beijing, however, appears determined to do something about this. We have already seen how China's fears of financial risk led to it cancelling the Ant IPO. Real estate appears to be the next market, as we predicted in the China Briefing on online education, and as with previous priorities, leaders are serious. Indeed, a recent bond default was of Fantasia, a high-end real estate firm owned in part by family members of China's very highest leaders. Connections will not save anyone this time.

Moreover, forecasts of Chinese economic demise are overblown. This is not the US during the GFC.

In China,

- Property requires 30% down payment upfront. It takes a lot for anyone to want to foreclose. (A recent book in China estimated foreclosures in 2018 to be just 0.3% for example.)

- There is virtually no real estate debt derivatives market, unlike the US.
- Capital controls mean that foreign capital cannot leave easily. Beijing controls banks and thus also capital flight. At times like this, it gives China's leaders access to the nation's vast deposits, providing a thick financial cushion.

Rather, the problem is one of confidence. China's household debt is around 20% lower than that of the US (54% to 76% in 2018), but it grew three times in the decade 2008 to 2018. It is hard to spend more as a household when you are worried about repayments.

So we see the biggest risk to investors from Evergrande as being consumption. China's leaders will need to wean the population off the idea that empty apartments are a good vehicle to save money, without destroying everyone's savings. That will hurt consumer sentiment. Most Chinese citizens have their household wealth in real estate, and their debt incurred to buy houses — China's central bank puts property as a little more than half of all household debt.

Evergrande and its highly levered peers thus threaten China's future growth. Their demise could lead to a balance sheet recession as local governments have to deal with yet more restructuring, and that could slow Chinese growth considerably. Fixed asset investment, which last year totalled RMB 51.9tn (USD 8tn), is 43% of GDP. That will shrink.

Why Evergrande points to an ever-present problem

Beijing will have to make some very difficult trade-offs. The local government and industry dynamic described above can be seen throughout China, and is fundamental to how we think about business and investing in China writ large.

Why? First, because politics happen behind closed doors but investing requires open information.

> **Politics happen behind closed doors but investing requires open information.**

Moreover, the link between land and politics may also hurt consumption; as discussed above, if decisions on credit and debt may be affected by politics and that is out of your control as an ordinary citizen, you want to play safe and save as much as possible rather than expand or spend.

Second, because it shows a more general problem. China is between models, and still somewhat between market and plan. The previous sections showed how real estate developers such as Evergrande were logical extensions of local governments playing the tough hand given to them from above. China's need for a new model cannot only be seen in real estate, however.

Let us look at the current issue of energy shortages. China is currently suffering from crippling power cuts with reports of shortages and even outages in most provinces in the past few weeks. The ripple effects disrupted global supply chains as textile, steel, and other factories shut down and production plunged.

There are a couple of reasons for this.

First, coal producers stopped producing as much, and China blocked some foreign imports from Australia for political reasons, imposed by the central government. That could be as much as 5% of China's electricity.

Second, China's local industry is producing more. From January to August, China's total export value hit a record RMB 13.56tn (USD 2.1tn), up 23.2% YoY. But that has involved power-hungry exports: In the first eight months, China's power usage rose 13.8%, 2.5% faster than power could be generated. Caixin notes that this is the largest gap since 2003.

But, when coal prices skyrocketed amid the widening gap between supply and demand — between January 4 and September 28, the most-traded thermal coal futures contract on the Zhengzhou Commodity Exchange rose 90% — the price producers could charge for electricity was low. Every kilowatt lost you money, so China stopped producing energy.

The reason, as with real estate, is due to Beijing's interactions with markets. China's energy market is still based on inefficient set pricing. While China's coal prices are set by the market, power prices are under state control. When fuel prices including coal and natural gas surge, electricity prices don't reflect the changes. A central state-led electricity pricing regime doesn't allow power companies to pass on price rises to the consumer, discouraging generation.

This is a structural problem. When industry booms unexpectedly (2008-2010, 2016, or 2020-21) or when there is significant overcapacity (2013-2015), China faces boom or bust. At heart: the price of coal or other energy sources is much higher than the pre-arranged benchmark price (which is set annually and only allows 10% for fluctuations according to price, far below the recent rises in the coal price) and price increases are not able to be passed on to end users.

Some may see the energy crisis as due to China's environmental commitments. There is some merit in that: some provinces are cutting power to get back on track for their "dual-controls" targets for power intensity and consumption. But those targets do not count renewable energy in the quota, and so this seems more a justification of choice rather than an explanation of environmental prioritisation. Either way, as we wrote in "China goes red to be green", China is serious about meeting its goals, and its measures are real.

What comes next?

If we understand the drivers then it is easier to see what might come next. China's old model is built on a number of principles that we think are about to change, we think. For Beijing, the issue is how to best to get what they want. In practice, this is largely a question of how they use markets, and how they can coordinate policy better (these two things are often interlinked: markets help China's leaders coordinate).

> **For Beijing, this is largely a question of how they use markets, and how they can coordinate policy better.**

Local governments still face the biggest challenge. They need to go from being real estate- and production-led to being services-led. The old model, as we have shown above, is likely to change from big projects and big sales to rising incomes and better services. For this to occur, China will need to increase household income; cities will have to welcome rural migrants and make them a fully-fledged part of society; and people will have to want to move away from where jobs currently are to where houses are. None of that will be popular. All of it will need to be done by local leaders. Most likely, the central government will need to force it through by changing how local leaders are measured — while still ensuring that they promote market measures and simultaneously keep people loyal to the Party. That will be a tricky tightrope to balance upon.

China will be more than able to deal with the current energy crisis. It could increase its domestic production of coal, which is currently being throttled for political and environmental reasons. It could let in Australian coal, which is currently sitting on ships on China's coast due to political disputes. Another option is to have State Grid, an SOE and energy distributor that makes a lot of money, provide cheap energy for power plants in order to serve the nation.

At the local government level, enormous changes have already occurred. Two of China's largest provinces have both allowed electricity companies to pass on higher costs of generation to consumers instead of using prices set in Beijing. End users of energy are also signing 3-year contracts promising to stay with the market in return for (more expensive) energy now. Making people pay more for coal will help China's energy efficiency and make renewable energy more competitive.

Where does this leave investors?

First, China's demographics are pointing away from explosive new growth anyway.

> **Should China succeed in this new model, then it will have better quality growth, but less of it.**

In the last few decades, high growth was necessary in order to create between 5-8mn jobs every year for people moving from the country side into cities. But China has gotten old before it has gotten rich. So explosive growth is less important than high-quality growth. There will therefore be a less amenable or simple overall environment, but opportunities remain for investors who China views as helping the quality of growth.

At the macro-level, China is likely to have a short-term inflation hit. Winter is coming and power prices are unlikely to fall. Rising power prices are likely to mean water shortages in the coal producing areas, as mining is incredibly water intensive. China already has significant water supply challenges. Increased water prices may also need to be passed on to the consumer in order to ration its use.

But in the longer term, better Chinese growth is better for everyone. Some big commodity exporters (especially one Down Under) may be less happy, as there will be less long-term demand for raw materials for steel and commodities such as coal. But for the rest of the world, as Michael Pettis and Matthew Klein argued persuasively recently, a better balance of trade for the globe is a good thing.

Finally, wise investors are likely to watch what China's private companies do, and act similarly. We have shown in previous reports the to-and-fro between tech giant and regulator and shown how the government needs the tech companies.

For example, it is worth noting that all of the big US-listed Chinese tech firms have already pumped billions into "Common Prosperity" funds to boost investment in public services. According to a report by Bloomberg, by early September, 73 of China's listed firms informed respective shareholders they would be making contributions to the Common Prosperity initiative. This does not mean that foreigners also donate to China's "Common Prosperity". But neither should these programmes be treated as slogans or window dressing. China's new model is real, and investors will need to adapt.

"A large part of the China high yield real estate universe trades at stressed/distressed levels. Potential exists for outsized returns over the next 12-24 months for investors willing to take the risk, but working with a specialist who intimately understands the market is essential."

— **Marco Klaus**, Managing Director of Investments and Products, Silverhorn

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