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Evergrande Group and China’s Debt Challenges

Concerns about China’s high debt levels intensified in September 2021, when its second-largest property developer, Evergrande Group, failed to repay its debt obligations. The government of the People’s Republic of China (PRC or China) seeks to reduce debt and curtail market risks among firms like Evergrande, but defaults and a decline in property values could have broader effects. China’s property market accounts for almost 30% of GDP, a higher percentage than in most countries, and thus has complicated China’s efforts to reduce debt. Property is a main source of local government revenue and a key factor in corporate valuations and household net worth. This constrains policy options, despite China’s leader Xi Jinping’s statements that support reducing debt and inequality. Declining land revenue could affect local governments’ ability to repay loans and special bonds, which Nomura Holdings estimates reached almost \$7 trillion (44% of China’s GDP) in 2020. China relies on debt-financed fixed asset investment (including property) and exports for growth. Supply disruptions, energy and commodity shortages, and industrial and property overcapacity are most likely exacerbating economic risks. The situation highlights potential broader and longer-term risks in China’s economy that Congress may consider as U.S. financial firms seek to expand their exposure to China.

Evergrande Group

Evergrande Group is a state-tied property conglomerate based in Shenzhen that also operates energy, entertainment, health, insurance, and technology businesses. The firm was founded in 1996 when the government was liberalizing investment in the property sector. Tax reforms in 1994 had shifted a significant amount of local revenue flows to the central government, prompting local governments to turn to property sales and bond issuances for new revenue streams. This shift increased the importance of land sales, real estate transactions, and property values to local governments.

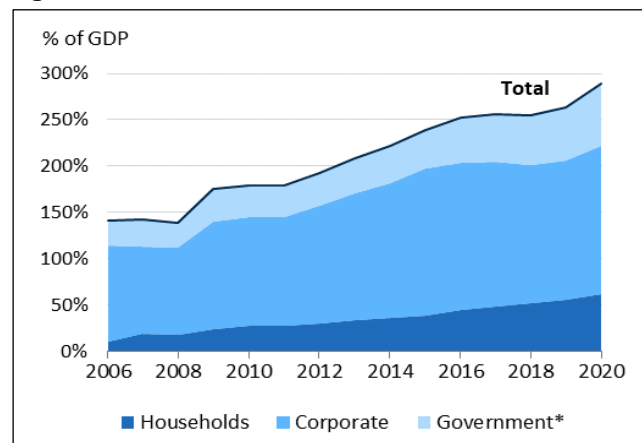
The Shenzhen government is a large shareholder in Evergrande. In 2017, Evergrande moved its real estate assets into the Hengda Real Estate firm, with plans (later deferred) to list Hengda on the Shenzhen Stock Exchange through a reverse takeover of Shenzhen Real Estate, a Shenzhen government firm. Hengda sold 25% of its shares to the Shenzhen government and other state investors. Evergrande is also tied to the central government. The Ministry of Finance’s CITIC Group is a shareholder. Moreover, in 2018, Evergrande signed a \$16 billion agreement with the central government’s China Academy of Science to invest in priority emerging technologies on its behalf. Evergrande has acquired firms that produce electric vehicles in the United States, the UK, and Sweden, and has invested in biotechnology research at Harvard University.

Evergrande’s overseas presence allows it to raise and transfer funds in and out of China. Evergrande Group and three subsidiaries—China New Energy Vehicle, HengTen Networks, and Evergrande Property—are listed in Hong Kong. Its corporate bonds trade in Singapore, and it operates a wealth management business through its life insurance subsidiary. Evergrande’s CEO controls two firms registered in the British Virgin Islands (BVI)—Xin Xin (BVI) Ltd. and CEG Holdings (BVI) Ltd.—to facilitate offshore investments. Xin Xin has over 960 subsidiaries.

Evergrande and China’s Debt

Evergrande owes about \$305 billion in debt (2% of China’s GDP). The firm is obligated to repay \$124 billion this year—including \$19.3 billion in bonds—but may only have 10% of this amount in cash on hand. The firm is said to owe money to 171 domestic banks and 121 financial firms. Off-book liabilities have not been disclosed. As China’s largest issuer of high-yield dollar denominated debt, Evergrande was an attractive investment, despite known risks, because it paid annual interest rates of 7.5% to 14%. China’s total debt—household, corporate, and government—reached 290% of GDP in 2020 (**Figure 1**), with the majority of debt held by companies. China has an estimated \$100 billion in U.S. dollar-denominated debt due in 2021. Within China, PRC firms owe an estimated \$706 billion in 2021.

Figure 1. China’s Debt as Share of China’s GDP



Source: CRS with data from the Bank for International Settlements.
Notes: *Government debt in nominal value. Does not include financial sector debt. Comparable U.S. debt as a share of U.S. GDP was 295.5% in 2020.

Deleveraging Efforts

In 2016, the Chinese government initiated a campaign to reign in debt accrued by banks, local governments, and unauthorized lending. The effort included scrutiny of overseas real estate, entertainment, and sports investments. In July 2017, *People’s Daily*, the Communist Party of

China's paper of record, published an article about financial risks caused by *gray rhino* firms, a term U.S. author Michele Wucker coined to describe market risks that are so big and obvious that they are often ignored. This signaled a government push to curtail certain firms, including Anbang Insurance, Dalian Wanda Group, Fosun International, and HNA Group. The government restructured these firms' debt and aligned investments with state goals, established state trusteeship, and transferred assets to state investors.

In 2018, China's leader Xi pledged to tackle financial risk as one of "three tough battles." The campaign led to several bank bailouts in 2019, but defaults fell in 2020 due to pandemic stimulus and laxer rules. The government issued \$142.9 billion of special treasury bonds, the first issue since 2007; increased the quota for local government special bonds (a source of infrastructure funding); and fast-tracked the issuance of corporate bonds. In August 2020, the government launched a "three red lines" policy for property developers that sets: (1) a 70% ceiling on liability to asset ratios; (2) a 100% cap on net debt to equity ratio; and (3) a cash requirement to cover short-term liabilities. Since April 2021, the government has restricted and restructured Ant Financial's lending business, and asserted control, with state firms taking stakes in the company.

Traditional Approaches to Corporate Risk

The PRC government so far is using a traditional toolkit to rein in risky activity while trying to avoid market contagion and moral hazard, a tendency toward riskier behavior when someone else bears the risks. The government benefits from a closed capital account, but the size of Evergrande's exposure (including secondary exposure) could complicate this approach, weaken confidence, and raise debt levels.

- **Commercial bankruptcy is a policy choice prompted by government actions.** Evergrande's debt crisis arguably was triggered by government restrictions on its ability to raise new funds to pay its debt obligations, exposing its highly leveraged position. Tightening of domestic housing policies also weakened the market and the position of Evergrande and other property firms.
- **Restructuring assets and shareholding aims to stabilize operations and avoid a direct bailout.** The PRC government is a shareholder in Evergrande and many other firms it investigates or restructures. The government typically directs state investors to acquire assets and shareholding positions to cover liabilities and reposition troubled firms, at times realigning winners and losers within China's system. In 1999 and 2003, the government created large asset management companies to offload pervasive non-performing loans in the state banking sector. In 2012, the government directed firms to prop up the Shanghai Stock Exchange. The Shenzhen government has intervened to support Evergrande in the past. State investors are now investing in the firm and its subsidiaries, and are assuming some of its liabilities.
- **Creditors may not be repaid equally.** It is uncertain to what extent China will allow losses on Evergrande's creditors and preferential repayment terms for certain domestic creditors. Some analysts expect the Chinese government to prioritize domestic retail investors, suppliers, contractors, and banks. With the collapse of the Guangdong Investment Trust Corporation in 1999,

the government prioritized domestic creditors. Internal transactions among business units and executives, as well as unregistered investments may not be repaid. In its restructuring, HNA Group plans to only repay \$25 billion of \$60 billion in obligations.

Investment and Accounting Methods

Evergrande's U.S. auditors and underwriters signed off on the firm's investment and accounting practices for years. These practices that affect the firm's financial position and which other firms may use include

- **Counting unbuilt and unsold properties and interest payments as assets.** About 60% of the firm's assets are unbuilt and unsold properties, and the firm counts loan interest payments as assets. This inflates the firm's position and increases risks if property values fall.
- **Using previously-financed deals as collateral for new loans.** This practice allowed the firm to accumulate debt and become leveraged. The People's High Court of Hainan Province determined that HNA affiliates provided mutual guarantees for repayments, a practice that the Swiss government determined in 2019 that HNA used in its global acquisitions and operations.
- **Investing in unrelated sectors beyond the core business.** Some PRC firms use insurance, trust, and wealth management businesses to earn higher returns and invest offshore. The Shenzhen government is investigating Evergrande's insurance business.
- **Use of complex offshore structures tied to the CEO.** Evergrande uses overlapping contracts and shareholding to facilitate financial flows that make it difficult to assess liabilities. The CEO and his family reportedly hold a large share of the firm's offshore debt. In March 2021, a Hainan court ruled that HNA's 320 affiliates should be merged because: (1) relationships and shareholding were too confusing to disaggregate; (2) internal controls were fictitious; (3) internal credit and debit dealings were impossible to align; and (4) shell companies were used extensively.

Issues for Congress

Evergrande's situation raises questions about the full scope of its liabilities and the potential direct and indirect exposure for U.S. and other firms. The role of U.S. and other underwriters and auditors of Chinese firms also raises questions about whether risks are sufficiently assessed and disclosed to investors. Other questions include

- How common are Evergrande's accounting and investment practices among other PRC firms?
- What do government restructuring efforts show about the role of the state in China's companies?
- Are there risks of Chinese government overreach or miscalculation?
- How open, transparent, and accountable are China's financial markets to U.S. investors? Do U.S. investors have the same rights in China that PRC investors have in the United States?

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