economic

WEEKLY REVIEW SERIES

The Evergrande Saga : Cause & Impact Analysis

Indonesia Macro Data Forecast

Macro Indicators	2020	2021F
Real GDP (%YoY)	-2.07	3.76
Average Inflation (%YoY)	2.04	1.87
BI-7 DRR (%)	3.75	3.5
Budget Deficit (%GDP)	6.09	5.73
USD/IDR	14,500	14,400
10 Year Indo GB (%)	5.89	6.46
JCI	5,979	6,320
EPS Growth (%)	-30	20

Source : BI, MoF, BPS, MNCS Estimate

Global & Domestic Key Rates

Rates (%)	Dec-20	Sep-21*
BI-7 DRR	3.75	3.50
Lending Facility	4.50	4.25
Deposit Facility	3.00	2.75
10 Year Indo GB	5.89	6.24
FFR	0.25	0.25
ECB Rate	0.00	0.00
BoE Rate	0.10	0.10
BoJ Rate	-0.10	-0.10

Source : Bloomberg, BI as of Sep 29, 2021

Tirta Widi Gilang Citradi
Economist & Fixed Income Analyst

Behind The Evergrande Debt Crisis

Last week, one of world most indebted property conglomerate China Evergrande Group (Evergrande) missed its USD83.5mn coupon payment causing jitters in the market. CBOE Volatility Index (VIX Index) rose to the highest level since May-21 and equity market sell off sparked across regions from Hong Kong to Wall Street.

The liquidity problem faced by Evergrande is serious and chronic. Despite its deleveraging effort , Evergrande has become heavily reliant on the use of commercial paper (CP). The nature of CP short term maturity leaves the company more susceptible to liquidity dry up.

Refinancing its debt would be increasingly difficult as its company and subsidiaries ratings were downgraded, besides surging on its bonds yield. Furthermore, access to Chinese banks credit would also be challenging with the major banks restricted credit disbursement to the distressed company.

Not a ‘Lehman Brothers’ Story

Evergrande debt crisis is different with ‘Lehman Brothers’ story in 2008 GFC based on assets characteristics & government control.

Lehman Brothers, hold financial assets that could drop to zero in value, meanwhile Evergrande has fixed assets such as landbanks which are safer than derivative assets like CDO. In addition for Lehman Brothers case, the U.S. investment bank also took an extremely risky leverage with 30x debt to equity.

Since the property sector contributed the second largest added value to China’s GDP and key source of the household wealth, we believe that government would not let Evergrande to fail.

Assessing Risks & Impacts

If we are only looking at Evergrande alone, particularly its < USD100mn missed interest payment, the systemic risk should be relatively small given China’s banking system has annual profit of USD220bn and provision of USD830bn.

However risks are coming from slowing China’s property market and rising corporate bond defaults. As the second largest economy in the world, any shock in China’s economy would also be felt by other economies, Indonesia is no exception.

China is the largest export destination and top 5 FDI contributor for Indonesia. Our regression analysis has shown that China’s GDP has unidirectional impact on Indonesia’s GDP. For every 1% change in China’s GDP would likely to be responded by 0.57-0.66% change in Indonesia’s economic output.

Contents

Behind The Evergrande Debt Crisis

The world most indebted property developer, Evergrande missed its interest payment last week due to liquidity crunch

Last week, one of world most indebted property conglomerate China Evergrande Group (Evergrande) missed its USD83.5mn coupon payment causing jitters in the market. CBOE Volatility Index (VIX Index) rose to 27.6%, the highest level since May-21 and equity market sell off sparked across regions from Hong Kong to Wall Street. In response to the spook in the market, PBoC pumped more than USD17bn to banking system to calm nerves.

Heightened Evergrande credit risks have been reflected on its soaring USD denominated bond yields for 5-year maturity that due in March 2022. As of September 24, Evergrande USD denominated bond was traded at more than 540% YTM and its stock price tumbled by more than 70% since year to date.

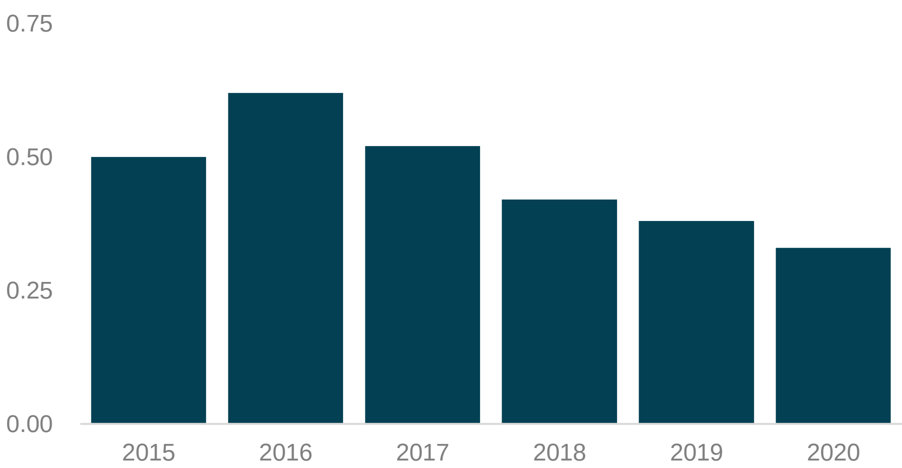
Evergrande is also facing another USD47.5mn interest payment this week. The company has stated to pay its obligation and recently saying that it will sell its 1.75 bn stake in Shengjing Bank worth of USD1.5bn as it faced a tight deadline on its interest payment.

However, liquidity crunch faced by the company is still posing a risk to investors holding its bonds. In fact, company's liquidity health has been deteriorated in the last 5 years indicating a more chronic problem for the debt laden property giant (Exhibit 3 & 4).

Despite its deleveraging effort , Evergrande has become heavily reliant on the use of commercial paper (CP). The nature of CP short term maturity leaves the company more susceptible to liquidity dry up. In addition, Evergrande also faces a heavy debt burden with nearly USD8.41bn debt and interest payment due in next year (Exhibit 5).

Refinancing its debt would be increasingly difficult as its company and subsidiaries ratings were downgraded, besides surging on its bonds yield. Furthermore, access to Chinese banks credit would also be challenging with the major banks restricted credit disbursement to the distressed company.

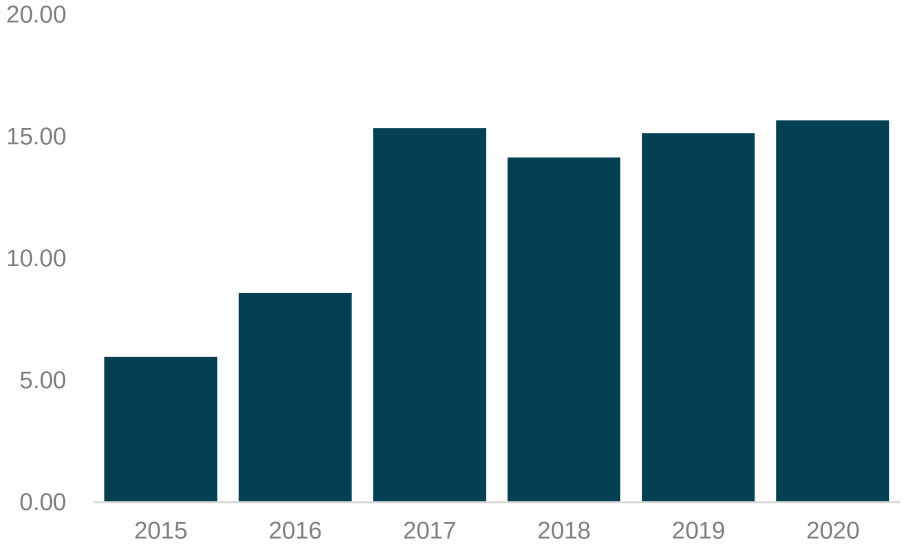
Exhibit 3. Evergrande Group Quick Ratio



Source : Bloomberg, MNCS

Indonesia Macro Data Forecast

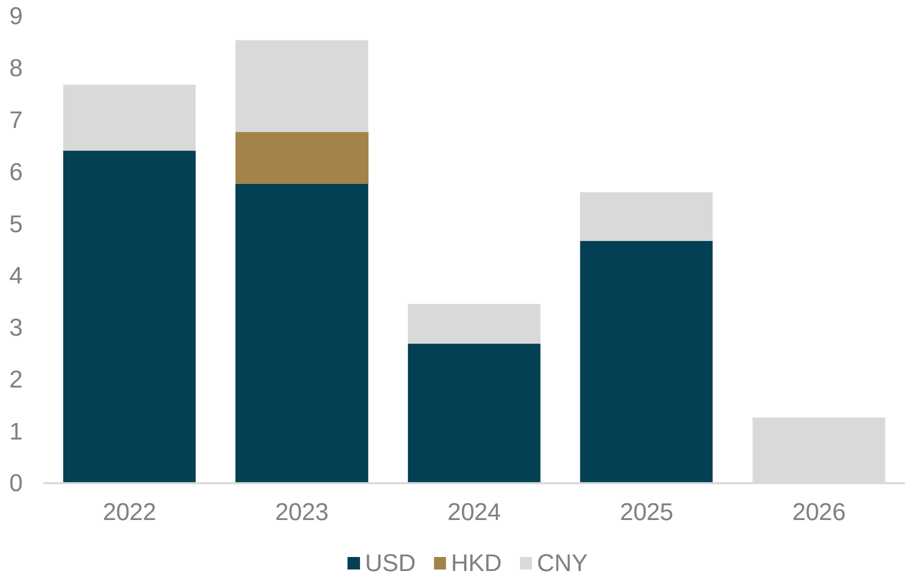
Exhibit 4. Evergrande Group Asset/Equity (x)



Source : Bloomberg, MNCS

Evergrande is expected to repay its bond maturing next year with the total amount of more than USD8bn

Exhibit 5. Evergrande Group Bonds by Maturity & Denominated Currency



Source : Bloomberg, MNCS

Not a 'Lehman Brothers' Story

Evergrande debt crisis is different with 'Lehman Brothers' story in 2008 GFC based on assets characteristics & government control

Evergrande debt crisis has prompted comparisons to the collapse of U.S. largest investment bank (Lehman Brother) in 2008 GFC. Despite sharing similarity in terms property sector association and a high leveraged business, Evergrande story has some major differences with Lehman Brothers.

The key difference lies on the nature of the assets that they hold. Evergrande is a property developer holding a fixed assets such as land and property with a cash flow problems. Meanwhile Lehman Brother as investment bank traded securities mainly betting on derivates (i.e CDO) that had caused a collapse in the global financial system.

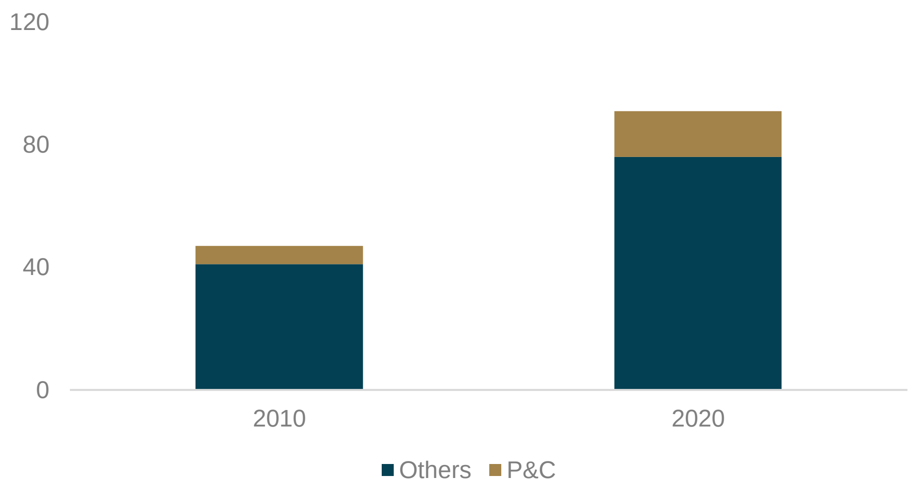
Since the underlying assets are different so the impact would be different too. The financial assets are having higher volatility and value could drop to zero. In contrast, land and property could never go down to zero.

The level of leverage ratio takes us to another different level. Even with the large holding in financial assets, Lehman Brother used higher leverage with more than 30x debt to equity investing in CDO vs Evergrande with only 5x of debt to equity on its balance sheet.

As China and U.S. economic and political system differ, hence we believe that with strong Chinese government control would not let Evergrande to fail and causing a systemic risk since property sector share to GDP is the second largest after industry & manufacturing sector.

To put in the context, share of real estate and construction to total China's GDP has increased by more than 200 bps from 12.2% to 14.5% in the last decade in real terms. However these sectors total added value to China's economic output has risen by 11.02% in CAGR (Exhibit 6).

Exhibit 6. China Property & Construction (P&C) Contribution to GDP (CNY trillion)



Notes : values are in a constant price after adjusting for deflator
Source : Bloomberg, Statista, World Bank, MNCS

Risks are coming from slowing China's property market and rising corporate bond defaults. As the second largest economy in the world, any shock in China's economy would also be felt by other economies, Indonesia is no exception

Assessing Risks & Impacts

If we are only looking at Evergrande alone, particularly its < USD100mn missed interest payment, the systemic risk should be relatively small given China's banking system has annual profit of USD220bn and provision of USD830bn according to Macquarie Research.

However if take a look further to Chinese corporate bond market widely, risk is getting bigger. There were USD18bn of corporate bond default reported in 1H21. In 1Q21, property sector corporate bond default has accounted more than a quarter of all defaults.

Highly levered property and construction business combined with slowing housing prices have contributed to lower return for developers. We understand that soaring property valuations in China has become major government concerns (Exhibit 7).

Exhibit 7. Real Residential Property Prices for China

Notes : index 2010 = 100, not seasonally adjusted
Source : Federal Reserves Economic Data (FRED) St. Louis

Government regulation in China's property sector has been increasing so far. The government has been working to control surging home prices and excessive borrowing.

Last year Chinese government enacted the policy named the 'three red lines' on certain developers to help curb debt levels. Slower home price as key source of household wealth in China means slower economic growth.

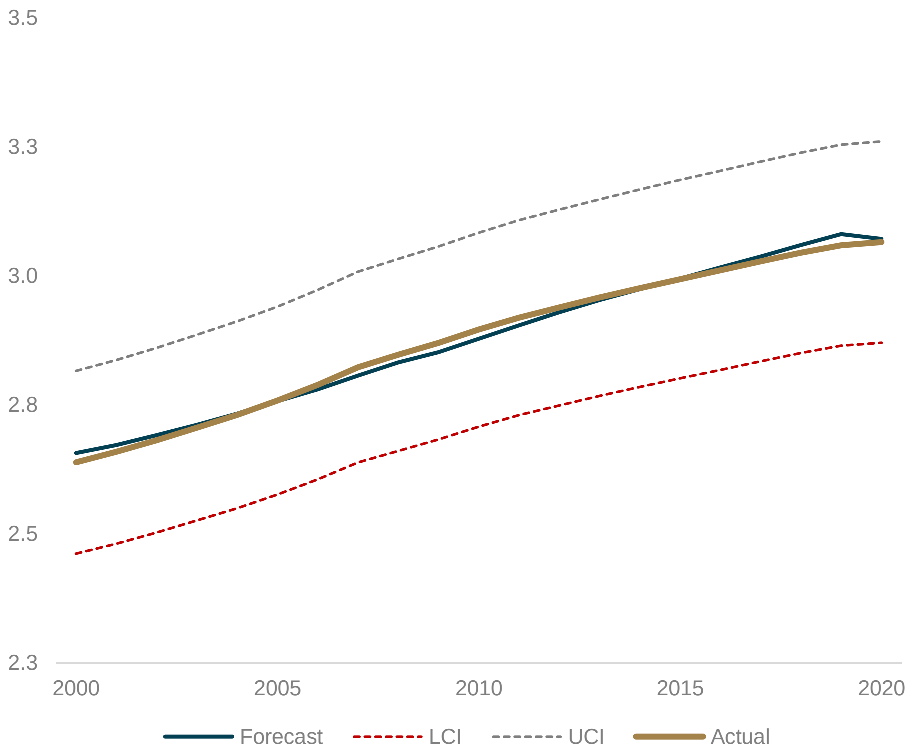
According to Bloomberg consensus, China's GDP is expected to expand by 8.5% this year before moderating next year. However due to decelerating home price, some economists have cut their forecasts for China's economic growth to 7.7-8.2% this year.

As the second largest economy in the world, lower China's GDP growth would likely to impact other economies as the world become more integrated and reliant to China. Indonesia is no exception.

China is the largest export destination and top 5 FDI contributor for Indonesia. Our regression analysis has shown that China's GDP has unidirectional impact on Indonesia's GDP. For every 1% change in China's GDP would likely to be responded by 0.57-0.66% change in Indonesia's economic output (Exhibit 8).

Based on our regression analysis for every 1% change in China's GDP would likely to be responded by 0.57-0.66% change in Indonesia's economic output

Exhibit 8. Impact of Log China Real GDP on Log Indonesia's Real GDP



Notes : The logarithmic numbers on Y-axis are based on USD billion of real GDP; LCI & UCI indicated lower and upper confidence level of 95%, R-squared = 0.99. Our Granger Causality Test showed that China's economy has unidirectional impact to Indonesia's GDP
Source : World Bank, Bloomberg, CEIC, MNCS

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

PT MNC SEKURITAS
MNC Financial Center Lt. 14 – 16
Jl. Kebon Sirih No. 21 - 27, Jakarta Pusat 10340
Telp : (021) 2980 3111
Fax : (021) 3983 6899
Call Center : 1500 899