

September 2021

## Capital Markets Insight

# China's Debt Dilemma

Since the middle of the last decade, the Chinese government has taken steps to reduce moral hazard, the presumption that the state will bailout companies if a default would be sufficiently disruptive to the financial system. Recently, Chinese authorities have allowed several firms to default on their debts without providing any assistance, even state-owned enterprises, but the authorities have engineered selective bailouts to forestall all-out bankruptcies of firms it deems to be systemically important by arranging rescues by state-owned lenders.

The case of Evergrande, the large, highly indebted Chinese property developer, is a particularly difficult one. As much as authorities may want to allow the firm to go under in order to rid the system of corporate excesses, such an action could leave hundreds of thousands of Chinese citizens in the lurch as many have placed down payments on apartments that Evergrande has yet to complete. Banks and suppliers would also be heavily impacted, creating the prospect of contagion and systemic risks to the Chinese economy. Given the heavy exposure to real estate among Chinese citizens (the Economist estimates that 75% of Chinese household wealth is committed to real estate) and the role that sector plays in China's GDP (about 15%), a disorderly Evergrande collapsed could reverberate through the Chinese, and global, economies.

China's leaders will need to weigh the potential for social unrest stemming from a disorderly winddown of Evergrande against the potential for exacerbating moral hazard by sponsoring a government-supported resolution. So far, the Chinese state media has warned that "Evergrande should use market means to save itself," and to date, some lenders have agreed to extend the payment terms on Evergrande's debt several times, but with over \$140 billion in debt and payables coming due over the next year, the company has its work cut out for it. It has embarked on a series of asset sales, but those efforts have proven insufficient to stave off the growing debt crisis.

The Evergrande problem is symptomatic of years of corporate excess that have only begun to be corrected. Without a doubt, the company's overleveraged balance sheet has made it vulnerable, but its speedy deterioration has been accelerated by government policies such as the three "red-lines" imposed on developers — a 70% ceiling on the ratio of liabilities to assets, a cap of 100% on debt-to-equity ratios and a cash-to-short-term borrowing ratio of at least 1 — and property lending limits imposed on banks. These policies have led to a liquidity squeeze for the broader Chinese real estate sector. Several weaker developers that have near-term refinancing needs are showing signs of distress. So far in 2021, three publicly listed Chinese real estate developers have defaulted on their debts, and we estimate as many as 11 defaults this year, totaling \$30 billion of bonds (a 23% default rate for the sector) if the policy environment remains tight and the sector loses market access to credit.



China's policymakers, who cannot afford to make a policy error at this critical juncture, seem to be trying to thread the needle by inflicting sufficient discomfort on property developers through a painful debt restructuring to limit their future risk-taking without setting off a cascading credit crisis that significantly disrupts economic growth. In our view, Chinese officials are likely to stop well short of a direct bailout of Evergrande while helping to facilitate a restructuring. The MFS investment team continues to closely monitor the situation. ▲

The views expressed in this commentary are those of MFS and are subject to change at any time. These views should not be relied upon as investment advice, as securities recommendations, or as an indication of trading intent on behalf of any other MFS investment product.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S.** – MFS Institutional Advisors, Inc. (“MFSI”), MFS Investment Management and MFS Fund Distributors, Inc.; **Latin America** – MFS International Ltd.; **Canada** – MFS Investment Management Canada Limited. No securities commission or similar regulatory authority in Canada has reviewed this communication; **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited (“MIL UK”), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** – MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** - MFS International Australia Pty Ltd (“MFS Australia”) (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** - MFS International (Hong Kong) Limited (“MIL HK”), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the “SFC”). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to “professional investors” as defined in the Securities and Futures Ordinance (“SFO”); **For Professional Investors in China** – MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan** - MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments.