

OPINION

Evergrande's liquidation will not pay off for foreign investors

Bondholders who took Chinese developer to court may get only emotional satisfaction



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An unfinished China Evergrande residential project in the city of Shijiazhuang: Developers' operations and assets remain mostly based in mainland China. © Reuters

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In the eyes of some observers, the liquidation of property developer China Evergrande Group will be a key test of whether Beijing respects the rights of foreign investors.

But from my experience over the last two decades, I believe China will uphold foreign investors' rights in the Evergrande case. Yet that is likely to be of little benefit to them.

The fact is, there is not much residual value for Evergrande's liquidators, appointed last week by Hong Kong High Court Judge Linda Chen, to liquidate. Chinese banks have a direct claim on most of Evergrande's assets, pledged as collateral for domestic loans.

When it comes to divvying up the remainder of the group's assets among unsecured creditors -- including domestic bondholders, unpaid suppliers and staff owed back wages -- overseas bondholders will be at the back of the line.

Foreign investors have historically invested in the Chinese property sector by lending to developers' offshore holding companies, many of which are listed on the Hong Kong Stock Exchange.

Meanwhile, the developers' operations and assets remained mostly based in mainland China. The offshore entities held equity in the mainland operating companies but did not own any mainland property assets themselves or generate their own operating revenue.

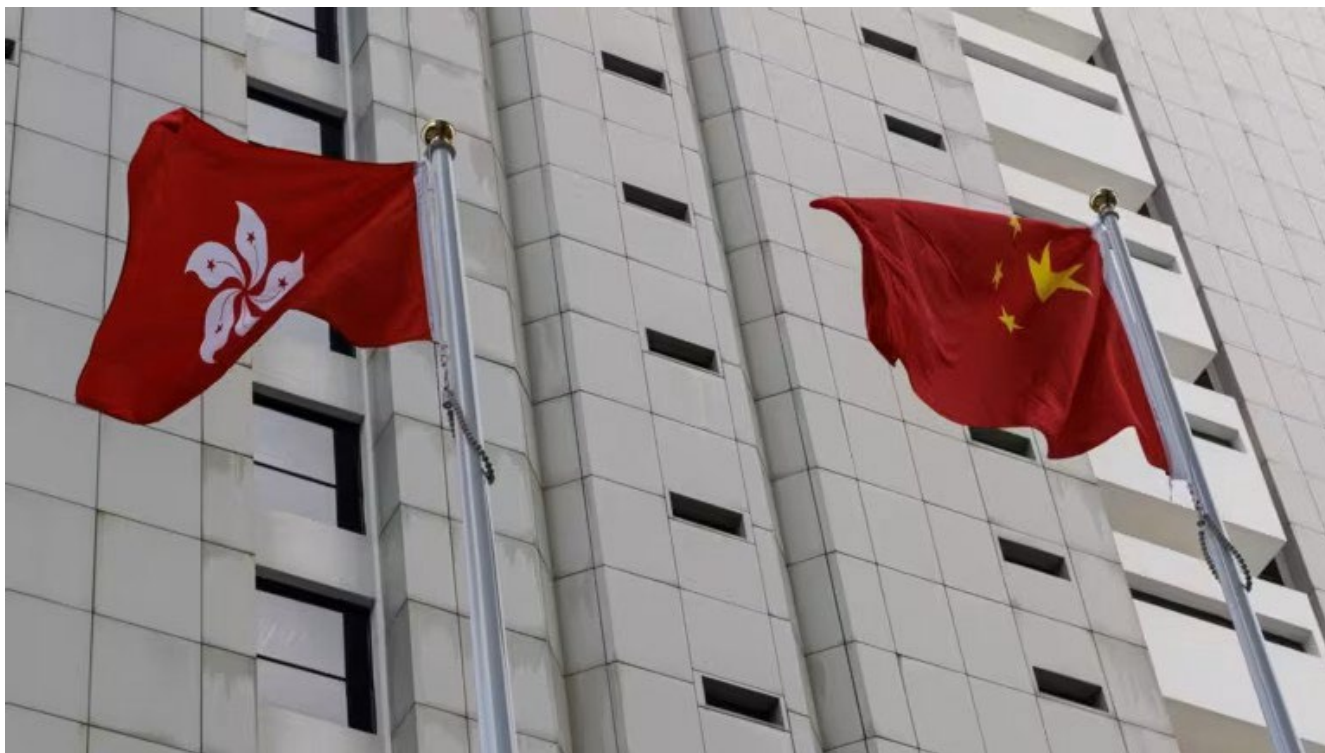
In short, then, investors who bought bonds issued by the Hong Kong-listed entities were lending to companies that lacked their own physical, revenue-generating assets. By contrast, most of the Chinese developers' onshore creditors have valid claims directly on the mainland operating units and assets.

This means that the offshore debt investors are subordinate to virtually all the developers' other creditors. As a legal matter, they come last in a liquidation -- not because China is unfair to foreign investors, but because as a structural matter, such investors chose to buy credit instruments that come last in repayment priority.

It would be no different in a Western liquidation. For example, if a property developer in California set up a similar holding company entity in Hong Kong, lenders to the Hong Kong group would find themselves in the same legal position: In the event of liquidation, they would come last while all California taxes, employees, bank loans and contractors' liens would be paid before them.

For decades, being at the bottom of the creditor stack apparently did not matter to investors in Chinese developers' offshore debt because liquidation -- particularly of such a large player as Evergrande -- seemed unthinkable.

These investors made two faulty assumptions. First, that China's economic conditions could not deteriorate to a point at which a default by such a large developer was possible. And second, that even if conditions did deteriorate, Beijing would bail out the company and make unsecured investors whole.



Chinese and Hong Kong flags outside the Hong Kong High Court: Beijing has never explicitly signed on to a sovereign guarantee for the offshore bonds of a private developer. © Reuters

Both assumptions were unsupported by history and law. First, by allowing Guangdong International Trust and Investment Corp. to collapse in 1998, China has made clear that it does not always consider massive companies too big to fail. Second, Beijing never explicitly signed on to a sovereign guarantee for the offshore bonds of any large private developer.

Perhaps counterintuitively, foreigners could have made a safer bet on the creditworthiness of Chinese developers by buying onshore loans on which they had fallen behind.

For over two decades, China has allowed foreign investors to buy soured domestic bank loans. If the nonperforming loan has a first lien on the borrower's assets, it puts the investor first in line in a liquidation in terms of onshore collateral.

Since China streamlined its court enforcement process in 2017, nonperforming loans have often taken less time to work out than the years Evergrande's offshore bondholders have spent in a back-and-forth with the company in court in Hong Kong. In my experience investing in such loans over the last 20 years, Chinese courts have never shown signs of treating foreign investors differently than domestic creditors.

China has been quite explicit about its support of foreign investors in bad loans, even in recent days. Last month, the National Administration for Financial Regulation in Beijing publicly set an objective of "supporting foreign-funded institutions with obvious characteristics and expertise in areas such as wealth management, elderly care and health care, and management of nonperforming assets to establish business in China."

Global markets have been confused by China's regulatory moves in recent years but underlying most of the developments is a common message: Beijing is no longer pursuing a strategy of growth at all costs but instead sees long-term economic health and stability as equally important, if not more so, even when it involves defaults and letting insolvent companies disappear.

If Beijing keeps its focus on sustainable long-term economic stability, the last thing it will do is go outside standard legal procedures to rescue Evergrande's foreign bondholders, who have little recourse under a proper reading of the law.