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TRANSCRIPT

Resignations and a Looming Crisis in China

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Mike Disabato:

What's up everyone and welcome to the weekly addition of ESG now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato and this week we have one big story for you. It's about China. It's about the real estate market, and it's about the late night resignation of auditors that is rocking the vital industry. Thanks as always for joining us. Stay tuned.

Mike Disabato:

Independent financial auditors are dull. Not as people. I'm sure they're great as people, but just the act of auditing financial documents. It's austere, it's regimented, it's a systemic annual examination of a company's accounting and financial records to assure their accuracy. They are a cornerstone of good governance though, and all publicly traded companies get them done. And let me tell you, independent auditing firms, don't really like to be in the news. They will do anything they can to ensure they aren't of news, which is why the constant stream of news about auditor resignations at Chinese real estate development companies is so damn troubling. In March PricewaterhouseCoopers, which, if you're just joining us, is one of the big auditing firms. There used to be five big auditing firms, but then the Enron scandal happened, PWC as they're called, quit as auditors at three developers, Ronshine, China Holdings, Powerlong Real Estate Holdings and Shamal Group Holdings.

Mike Disabato:

They also quit at two linked property management companies, Ronshine Service Holdings, and Powerlong Commercial Management. When auditors publicly resign, it sometimes means that they've seen or heard revelations about what are actually on the balance sheets of companies that they are auditing that cannot be fixed, even though they've likely tried over and over and over and over and over again to fix them. And they are deciding to distance themselves from those companies in case the situation gets so bad, in the hypothetical, that the big four auditing firms turn into the big three auditing firms. Now this is an ESG story that has two parts to it. And the first is how important the real estate market is for China, because it is extremely important for China, more so than any other country in the world. But don't take my word for that. Listen to my colleague in Singapore, Miranda Carr, who has been talking about the Chinese real estate market for over a decade, and she's going to tell you why.

Miranda Carr:

Well, the real estate market in China has historically been one of the most important economic drivers. The general estimate is it accounts for about 25% of GDP. And it's in times of market stress, it's been crucially supported by both the monetary authorities and of course the central government in order to maintain both property prices and confidence within the market-

Mike Disabato:

25%, let me cut in here real quick. 25% is a lot when your industry is that much of a share of GDP. Especially GDP, as big as China's. Let's compare that to two other economies. The U.K....the U.K., the real estate market is only 20% of their GDP. In the U.S. it's only 17%. You remember what happened when a certain market sector failed in the U.S. in 2008. That was a big problem. So the fact that China has more than 25% of its GDP tied up into its real estate activities is a big deal. And that's not just property develop that's builders, that's homeowners, that's people that put their life savings into banks that then lend out for people to buy homes with. It is tied in everything that China does, and it is an extremely important part of that economy and society.

Miranda Carr:

But, during all this time, over the past 10 years where you've seen government support for the market, you've also had rising levels of leverage, particularly in there, for the private companies. And also rising concerns about house prices and also about things like ghost cities, where the developers would just build... Over build. You would get over capacity and there wouldn't be the demand. So over the past 10 years, we've had constant calls that there's going to be a bubble that the property market is going to burst. And then this is going drag China's whole economy down with it. And this has been one of the major bear calls on China over the past... over the past 10 years. But what we're seeing now with the auditor resignations and the question marks over raising financing, and also the resignation of some of the directors, is that this is the first major event where you're seeing confidence in the market being dented really on a domestic level. And this is what's causing the main concern.

Mike Disabato:

So what Miranda means there, when she says that confidence is being dented on a domestic level, it's that international interlopers and interlocutors were saying things like China's real estate market is going to fail. And it never really did for about 10 years but those were external pressures. Those were international pressures. Now there is this domestic level problem happening that is signaling the possible last toll for the Chinese real estate market. And now you take that problem and you add the importance of the historical migration of Chinese citizens from rural to urban areas. The fact that the Chinese market is one where companies could sell properties before they're finished and the eye watering leverage the companies have taken on, and you have a crisis on par with any that we have seen in the world economy. A possible crisis. It seems to be happening. That's why we're talking about this today.

Mike Disabato:

And no company represented this gloomy miasma more than a company called China Evergrande. Evergrande sort of came out of nowhere a couple of decades ago and has had an annual revenue growth of 44% annualized. They went from being worth about 200 million U.S. dollars in 2004 to 79.8 billion U.S. dollars in 2020. And they did that, in part, by receiving the unenviable title of the world's most indebted company. And over the past couple of years, China Evergrande has fallen onto hard times due to, as Miranda noted, domestic pressures. That's the important part. Along with much of the Chinese real estate market. Now, to tell us more about those domestic pressures here is my colleague Sophia Chang.

Sophia Chang:

So the company has been struggling to repay debts and fails to meet interest payments to its international investors, to befriend... So sorry... To improve its liquidity positions, China Evergrande has been selling assets in recent months to raise money. The company also recently set up a risk management committee in December, 2021 for dept restructuring plans. It is a non board level committee chaired by the board chairman, Hui Ka Yan, and it complies of two senior executives of the company and some officials from the state entities. But however, the worries over its financial health is still mounting, especially after the company announced, they were not able to release its 2021, annual results on time. Which is supposed to ... The first financial reporting since the industry dept crisis spread.

Mike Disabato:

When you have rumors of a debt crisis spreading, and you create a risk management committee to show you have a good governance structure, and yet you don't release your austere auditors reports for the year, well people start to get worried. But as Miranda noted, the China Evergrande crisis has been going on for some time. Why have auditors just now decided to publicly resign? Well, the reason is those domestic pressures. Why Evergrande could become the most indebted company in the world is because it had access to bank lending and no investor, either domestic or international or lender, either domestic or international, used to worry about Evergrande's massive leverage because they assumed the Chinese government would not let the company fail. And the Chinese government was aware of this problem. The industry, the real estate industry was growing too quickly.

Mike Disabato:

Companies like Evergrande were becoming like the Lehman Brothers of the financial crisis in the U.S. in 2008. In 2020, the Chinese government did two things. It told companies to slow down their mortgage issuances and it created a policy called the Three Red Line Policy. Which are three debt ratios that Chinese real estate developers must meet in order to gain access to the all important bank loans. And so here's my colleague, Yan Zhuo explaining what those debt ratios are.

Yan Zhou:

The liability ratio, which would now be more than 70% of the assets. Also excluding some advance proceeds from the project, certain contract. And the second threshold would be the net dept, which should not be exceed the total equity. And then finally the cash must not be at least equal to... must be at least equal to the short term borrowings.

Mike Disabato:

Let's go through those. Liability to asset ratio, less than 70%. Does Evergrande meet that? No. A net gearing ratio, less than a hundred percent, net gearing compares equity to funds borrowed by the company. Does Evergrande meet that? No. A cash to short term debt ratio, more than one, meaning does a company have more cash than they have short term debt? Does evergreen meet that? No, they do not. They don't meet any of the three. In fact, according to reporting by the Financial Times, The Wall Street Journal, Bloomberg, et cetera, more than half of China's real estate development companies, couldn't meet those thresholds, which quickly cooled the loan market for real estate developers in China.

Yan Zhou:

So also, but we noticed that in fact, the loans are suddenly reduced very quick. So which is faster than everyone has expected.

Mike Disabato:

Everyone got a splash of water in their face. There was this slow down of the entire real estate market in China. There was no access to bank loans. Then there was the advice by the government to have companies slow down the issuance of mortgage loans. And then consumer demand also slowed down. And this meant that recently a lot of companies have issued profit warnings to investors. And then even more recently, we have these decisions by companies to delay the release of their annual audited financial statements. Here is Sophia Chang again.

Sophia Chang:

So what's happening in the market is, recently we have seen a massive group of distressed property developers in China that have missed the deadline of financial results reporting. At least 14 Chinese real estate companies in [MASIA coverage 00:11:06], including China Evergrande, and some other major ones like Kaiser Group, Shamal Group, Fantasia Holdings, et cetera. They were not able to release their audited 2021 financial results on March 31st as required by the listing rules. And half of them have been suspended from training due to the delay. So most of the companies that are mentioned, recited the large number of additional audit procedures and the impact of COVID-19 pandemic lockdown as the reasons why they couldn't complete the audit work on time.

Mike Disabato:

Which okay, sure. We've all had our lives upended by COVID-19. Why not major companies? A lot of people are stressed. There's a lack of resources. Places are getting shut down, they're getting reopened. That makes sense. Right? But then came the slew of auditor resignations in the real estate market.

Sophia Chang:

Just to name a few, Shamal Group recently being suspended from the trading due to delays, finding they had the auditors PWC resigns just a week before the reporting deadline, same to Ronshine China and Powerlong. PWC quit the companies just a few days before the reporting deadlines and they failed. The companies, they failed to publish results by the deadline

Mike Disabato:

With this high number of resignations of independent auditors does, is it creates an environment of uncertainty for investors. It erodes the confidence in the market that anyone can understand what is actually happening and where the liabilities are in this ever expanding, ever indebted Chinese real estate market. Without audited financial statements, you can't know if the company is, for example, selling itself assets, a practice called related party transactions. You can't know what guarantees are behind the loans they're taking out. What assets are underlining, the loans where the loans are propping up a domino, that if it falls, the entire sector might fall. As an investor you're basically in the dark most of the time. And the light you are given is from independent auditors, independent directors, people that give governance oversight. And so here's Miranda Carr again, on what this erosion of governance control might do to companies in China, in the real estate sector, in the long run. By the way, she says private companies, right in the beginning, she's making the difference between stateowned enterprises, which are SOEs and non state-owned enterprises that's what she means by private companies. Okay here she is.

Miranda Carr:

What we're likely to see, in the long term, is a lot of the private companies are going to really struggle to raise financing. And those companies that have weak boards, weak board control, overstretched financing are the ones that we think are the ones which will have the greatest risk. Unless there's some other factors or they have some other backers coming in to support them. These governance metrics can help you identify which of the companies are most at risk during this market turmoil. And so we'll see over the longer term, the stronger companies, the ones that have not had such stretched financing, not had such a weak board control and also probably the ones that have the state backing. So the SOEs, they will take up more of the market. They will be able to, still raise financing from banks and also from the bond markets, whereas there's a risk for a lot of the smaller developers, a lot of the weaker developers and those which haven't had such good, either governance or financial control, actually facing either bankruptcy or takeover.

Mike Disabato:

The point is, this is a story about governance issues because it just reinforces the importance of looking, not just at the fundamentals of a company, but it's governance controls. China Evergrande. You know how many independent directors they have? Three out of nine. You know how much the founder and chairman of Evergrande, Hui Ka Yan, owns of the company? 77%. This is a highly controlled, highly levered company that isn't alone in the Chinese real estate market. So via Chang, my colleague, you heard from earlier, she told me that of all the 14 companies in our coverage that are dealing with auditor problems since this been to training, they're all owned in similar ways as China. Evergrande is. Which for us, for ESG, is a signal of a possible and now looming long term risk.

Mike Disabato:

And that's it for the week. I want to thank Yan, Sophia and Miranda for talking to me about the news with an ESG twist. I want to thank you so much for listening. I really appreciate it. If you like, what you heard, please rate and review us that pushes us higher up and lists. People get to hear us more. We get to have more chats that people like. It's a lot of fun. And if you want to hear me each week, don't forget to subscribe and I can be automatically downloaded to your podcast medium. Thanks again. And talk to you next week.

Speaker 5:

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