By John Auerbach

China Evergrande: Managing the Risk of a Black Box Economy

With the high-profile struggles of real estate giant China Evergrande Group in the news, long-time China market watchers can be forgiven for feeling a touch of *déjà vu*. This week the company reportedly defaulted on over USD 300 billion of debt, and earlier in December the government stepped in to assist the company in its restructuring, with a risk committee comprised of officials from various state entities. The problem threatens to spread further into the Chinese real estate sector, with Sinic Holdings and Fantasia Holdings each recently announcing default on over USD 200 million in bonds. In part due to this contraction in the real estate market, China has revised its 2021 Q3 GDP growth projection downwards, from 5.2% to 4.9%.

The crisis is partly government-initiated. In August 2020, China's central government directed the largest real estate companies to clean up their balance sheets, specifically, to address their unsustainable debt loads. The Ministry of Housing and Urban-Rural Development and the People's Bank of China announced the so-called "Three Red Lines" standard pertaining to cash flow, assets, and capital levels that developers must meet if they want to take on more debt.

Government intervention aside, the fact remains that these default crises involve public companies audited by the world's largest, most sophisticated public accounting firms. Questions have long circled around the quality of Evergrande's financial reporting. For years, independent financial researchers have pointed out clear red flags, including misclassification of assets such as parking spaces and garages and the retention on its balance sheet of failed, vacant properties. Hong Kong regulators have since opened an inquiry into the Evergrande audit, but investors can justifiably wonder whether the right questions are being asked by those responsible for verifying the true financial health of these public companies.

We have been here before. One only has to go back the Luckin Coffee scandal last year, where one of China's most supposedly successful listers on the NASDAQ was found to have fabricated over USD 300 million in earnings in 2019, but not before raising over USD 800 million from investors. Or one can look back a decade, when an estimated USD 50 billion of market capitalization was lost after hundreds of Chinese firms listed on North American exchanges through the reverse-IPO process were removed or withdrew their listings after having been found to have inflated or flat-out falsified results. In all these cases, the fact pattern has been remarkably similar, even if the scale has grown — surprise liabilities and inflated earnings created by false documentation and collusion with undisclosed related companies.

This prompted the passage of the Holding Foreign Companies Accountable Act in late 2020, which promises to delist any firm that does not submit to Public Company Accounting Oversight Board (PCAOB) audit inspections for three years in a row. This is reportedly causing many of the approximately 250 Chinese companies currently listed on US exchanges to consider a 'delist, relist' strategy — exiting US exchanges for more 'friendly' markets such as Hong Kong or Shenzhen — rather than face PCAOB scrutiny.

In short, these cases are starting to look less like a bug in the system and more like a feature. Driven by the linkage of key industries and multinational corporations to China's national reputation and strategic economic goals, weaknesses in these companies are often treated like state secrets. To this point, the struggles of Evergrande and of the sector in general have received muted coverage in official Chinese media. Also, the sheer size of these companies makes them hard to analyze and intimidating for auditors to challenge with appropriate professional skepticism and, in so doing, endanger lucrative client accounts. The net effect is, in many ways, a 'black box economy' where investor risks are kept obscured until it is too late to remediate or divest.

While the large companies draw media attention, this is not just a big company problem. Comparable black box scenarios are playing out in smaller to mid-sized companies, often the favored targets of private equity firms. Evergrande may turn out to be too big to fail, but under the media radar, across multiple sectors, lie many potential mini-Evergrandes — similarly overleveraged, overextended, and under-scrutinized. Every class of investor — retail, institutional, and private equity — is exposed to this risk. At the same time, however, investor sentiment surveys consistently point against withdrawal from the Chinese market despite these challenges. Therefore, this risk will have to be managed on an ongoing basis.

So how to respond? One clear lesson from these cases is that reliance on conventionally audited financials may not be enough when performing diligence on these companies. There are too many ways to hide questionable performance and too many incentives to do so. In cases with substantial financial or reputational exposure, a targeted, qualitative approach can cut through quantitative smokescreens. Our work for clients has shown that problem companies frequently share tell-tale characteristics, including: (i) a murky ownership structure that features nominated agents or cutout companies; (ii) undisclosed related party companies controlled by management, particularly within the supply or sales channel; (iii) logical gaps between the scale and type of physical operations and sales and production figures; and (iv) political exposure at local, provincial, or central government levels.

Our investigations have surfaced issues with target companies such as phantom factories, falsified bank statements, and undisclosed corruption investigations, and these warning signs tend not to show up in audited books and records. They are more often discovered through multifaceted open-source research and source inquiries (taking care to work within the guidelines of China's new data privacy requirements). In many cases, only this qualitative diligence can pierce the veil of reported financials and detect looming problems. Evergrande's stumble, while unprecedented in scale, is an indicator of broader challenges ahead.

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