Key Questions

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Is Evergrande a “Lehman Moment”?

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No, and while ripples may be felt, we think a “Mrs. O’Leary’s Cow Moment” is a more apt analogy.

Evergrande is China’s second largest property developer, and it has more debt on its balance sheet than any other property company in the world (in terms of debt outstanding). It owns over 2 billion square feet of land and real estate projects spread across nearly 200 Chinese cities. Evergrande is also a theme park operator, an insurance/financial services company, a manufacturer of electric vehicles, and even the owner of a national soccer team.

So, when speculation spread that the company would default on two debt payments due last week, stock prices fell worldwide. The possibility of such an event had been building for a while, and Evergrande had been in the crosshairs of investors for much of this year already: Hong Kong-listed shares of Evergrande had dropped 85% from their yearly high before this most recent news. But a recent shift in policy by the Chinese government regarding the property market roiled markets on fears that a potential contagion would spread globally.

Historically, September is a weak market month as the lower volatility of the summer months collides with position-taking into year end. This year is proving to be no exception. Uncertainty about the COVID-19 pandemic, geopolitical rhetoric, the prospect of higher taxes, and potential policy changes by the US Federal Reserve have reintroduced volatility into the market. Evergrande’s potential default was one more major source of uncertainty that markets had to process.

Evergrande’s debt is estimated at $300 billion, or about triple the amount of the Argentina default and half as much as the Lehman Brothers default in absolute terms. If Evergrande were to default on its debt, it could have far reaching consequences for both China’s economic future and worldwide stability.

Or so the potential story goes.

Potential systemic risk is a catalyst-driven story, a mythological Mrs. O’Leary’s cow that kicks over a lantern and allegedly starts the great Chicago fire in 1871. Weakness in China’s property market could engulf building suppliers and workers, which would hurt home prices, at which point China’s banks would begin calling their loans to other property managers, and so on.

The wildfire would spread worldwide in a re-rating of risk assets driven by Evergrande as the “kicking catalyst.”

This is a risk, but we believe that it is a very small risk. Unlike Lehman Brothers, Evergrande’s balance sheet contains real assets with embedded value. Too, Evergrande seemingly has no (or limited) counterparty risk. Yet some shockwaves seem likely and China’s economy will assuredly slow which is actually something policymakers there want.

China has the assets, the capacity, and the logistical acumen to bail out the company to the extent it wants.

The Chinese Communist Party has made it clear repeatedly over the past year that unchecked debt and property speculation would not be tolerated. The “Three Red Lines” policy, enacted in late 2020, provided stricter guidelines for property developers wanting to refinance. China is home to eight out of the world’s top ten most-indebted property development companies, and this policy tried to curb some of the exposure by putting a ceiling on liabilities to assets, capping net debt to equity, and establishing a floor on the cash to short-term borrowing ratio. It followed up these restrictions by asking state-owned lenders to trim exposure to the property sector and raise mortgage rates for buyers in particularly frothy property markets.

Evergrande and its chairman Hui Ka Yan, who owns more than 70% of the Hong-Kong listed shares, did not pivot quickly enough to limit the damage to its refinancing prospects. Interestingly, one could also read this “crisis” as a punishment for the chairman, along the lines of Jack Ma’s retreat from public comments last year. Super wealth does not put the individual above the Party. Beijing will allow the creditors and owners of Evergrande to shoulder some of the loss burden. However, we would stop short of saying that they would allow the losses to flow down to middle-income families, many of whom are on the hook for capital spent in the 1.6 million unfinished houses listed among Evergrande’s assets.

We have a hard time believing that China would allow the property system in the country to fail, as over 40% of household assets are in real estate. Housing and property markets have been part of the success story for Chinese capitalism, and Beijing is just refocusing policy to coincide with longer-term party goals, including bridging a wealth gap between the haves and the have-nots. Evergrande’s overextension appears to be a casualty of the policy shift.

While there may be near-term challenges as the market finds its footing and sees if Mrs. O’Leary’s cow is feeling ornery, the volatility is a part of a healthy market experience, testing its theses and rebutting overextensions where necessary. Recently, we lowered our recommended allocation to emerging market equities, but continue to emphasize stocks over bonds. Still, we will continue to monitor events closely as the Evergrande situation evolves and markets find their levels. Some signs of stress have formed, but the markets are behaving in an orderly way for now.

For more information, please contact your advisor.

About the Author

Don Saverno oversees third-party investment strategies within the International and Emerging markets asset classes with Key Private Bank. He also provides oversight regarding Socially Responsible and Environmental offerings, provides investment solutions, portfolio construction, and risk management services for Key Private Bank clients.

Before joining Key Private Bank, Don worked for RiverSource Investments as an Investment Risk Manager and Arbitrade Financial as an Options Market Maker and Proprietary Derivatives Trader. He has worked in the financial industry since 1999. Don earned his MBA from the University of Chicago Booth School of Business with concentrations in Finance, Corporate Strategy, and Managerial and Organizational Behavior.

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