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Asset Management

Evergrande: Developed Market Banks and Insurers Are OK

The Issues Are Longer Term and Domestic Focused

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China Evergrande Group, a large conglomerate focusing on property development, technology, healthcare, wealth management and other sectors, is experiencing severe cash flow difficulties, and has skipped recent loan and bond payments. Much of Evergrande's distress stems from its key property development segment, related high leverage, and recent efforts by the Chinese government to rein in property prices. Efforts are underway by the central and provincial governments, and state-owned enterprises (SOEs) to address Evergrande's difficulties, potentially including financial support and guidance with restructuring.

Banks and insurers in developed market economies have little, if any, direct exposure to Evergrande, though some of the investment funds they manage have small exposures. Spectrum expects any failure or restructuring of Evergrande to have minimal direct effects on developed market financial institutions. Evergrande's $300B in liabilities are overwhelmingly from domestic sources.

The issues Evergrande's difficulties pose are more medium and long term, and indirect. More than half of Evergrande's liabilities are accounts payable and the like, including deposits by would-be homeowners and so-called shadow banking investments. Thus, any failure or restructuring of Evergrande would directly affect local suppliers, investors and consumers. This makes Evergrande's difficulties a clear domestic Chinese political matter – and one the central and provincial governments, and their SOEs (which includes banks), very much want to solve, especially given the new political effort targeting 'Common Prosperity'. How this will work in practice is unclear, and open issues include how contract law will be interpreted, and the order of seniority of various claimants, given complex liability and legal entity structures.

In addition, around 20+% of Chinese GDP is construction-related. To the extent construction gets dialed back, it would affect not only Evergrande, but other property firms and their many suppliers, too, potentially requiring further transitional help from the government. Plus, it implies a slower rate of economic growth as the transition occurs, which would affect developed and developing market economies that export to China. As well, China has a high home ownership rate, and most household net worth is home equity. So, governmental efforts to rein in high property prices and address Evergrande's problems would have widespread ripple effects that would need to be managed.

All this said, the Chinese government has many more tools at its disposal to manage its economy than is true in more capitalist, democratic economies. Therefore, Spectrum is optimistic that China has both the means and the desire to see that Evergrande's – and the property sector's – challenges are managed in an orderly way.

Spectrum does not believe its investments will be materially affected by Evergrande's difficulties.

John J. Kriz, Senior Vice President
Joe Urciuoli, Head of Research