



News

The Evergrande Crisis is Shaking Up the Global Economy

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Chinese real estate giant China Evergrande Group may default on their \$300+ billion debt. What impact will this have on the economy?

In recent developments, Evergrande is building up to be one of the greatest corporate collapses as the company struggles to claw its way out of financial debt.

As one of China's largest property developers, Evergrande has borrowed massive sums of money in order to build properties and sell them.

Faced with regulations from the government that precipitated this disaster, Evergrande has been pulled thin along with the hordes of angry consumers and contractors that they owe money to.



Source: Barcroft Media/Getty

How This All Started: Evergrande's Successful Beginnings

Evergrande Group, also known as Evergrande Real Estate Group, is the second-largest property developer in China and has expanded in various business ventures since its founding in 1996 by Xu Jiayan.

Since the early 2000s, the company has grown rapidly as the Chinese real estate market developed and expanded. Evergrande builds large real estate development projects and sells them to end consumers. However, in order to grow these projects while satisfying the required upfront investment, they were forced to take on debt.

The property development company was able to fund this through their own cash, down payments from consumers, and large amounts of debt.

Evergrande built itself up as one of the largest property developers in the country and their success allowed them to expand into other business ventures.

Some of these businesses included their very own football team, an automobile manufacturing company, life insurance, and much more. As the company grew, its assets and liabilities rapidly grew to trillions of Chinese Yuan (¥).

However, by betting on the inflating real estate market, Evergrande's highly profitable development projects were enough to keep them afloat.



Photo by Jason Dent on Unsplash

Evergrande's Power in the Real Estate Sector

The real estate sector accounts for approximately 20% of China's GDP and with currency controls making it difficult to invest in the stock, many invest in real estate as an alternative.

To reiterate, Evergrande specializes and funds residential property development and allows real estate investors to buy properties as both personal residences and as investments.

In order to fund new real estate developments, Evergrande borrowed hundreds of billions and was able to turn an impressive profit by selling these properties for high prices.

By 2017, their stock price rallied up 5x the amount and resulted in a market cap and excess of 300 billion HK\$ (approximately 38.5 million USD).



Photo by Nuno Alberto on Unsplash

Regulations by the Chinese Government Cripple Evergrande. Who's At Fault?

While Evergrande was able to become extremely successful and profitable in their business for over more than two decades, concerns began to arise in the Chinese government about the potential real estate bubble.

With the intention of reducing leverage in the real estate sector, regulations were established in an attempt to tame the growing bubble. These new regulations control how much debt property developers were allowed to take on and as a result, Evergrande was forced to sell their existing properties at heavily discounted prices.

Another regulation put a limit on banks and restrained the amount of money they can lend to property developers, making it harder for the company to roll over debt to later maturities.

Considering the massive amounts of debt Evergrande has accumulated over the years, even small losses on sales could potentially cause a liquidity crisis. These crippling and limiting regulations put the company in a precarious situation that caused them to struggle to pay construction contractors.

Essentially, Evergrande promises their contractors that they will be paid at a later date, and this is heavily affected if their property sales decline. Low sales mean that they will struggle to pay off the labor that went into their property developments.

To add even more to their dilemma, Evergrande also owes consumers who initially paid a down payment before the property is fully built. If they fail to meet their ends and go bankrupt, many of these consumers will inevitably feel the brunt force of it.

As Evergrande sinks under the growing financial pressure, their stock price has declined more than 80% since the beginning of the year — a shuddering difference compared to their initial success and stock price boost a few years back. Their bonds have also declined and trade for pennies.



Photo by Hanny Naibaho on Unsplash

Chinese Economy and the Domino Effect on Banks in China, Creditors, and More...

Considering the hundreds of investors and hundreds of thousands of employees under Evergrande, a default would be incredibly disastrous – sending a crashing domino effect of defaults and bankruptcies across the Chinese economy and financial system.

This has been compared to the Lehman Brothers bankruptcy in 2008 with \$639 billion in assets and \$619 billion in debt. As mentioned, 20% of China's GDP is controlled by the real estate sector. A default will put millions of construction jobs and businesses tied to Evergrande at risk and has the potential to plunge China into a deep recession.

To get a sense of its current scope:

- Evergrande made \$110 billion in sales last year and owns \$355 billion worth of assets across 1,300 developments.
- The company currently has 200,00 employees.
- They indirectly hire about 3.8 million employees every year for their project developments.

Founder and chairman Xu Jiayin offered a firm vow and wrote, "I am convinced that through the joint efforts and hard work of leaders and employees at all levels, Evergrande will surely walk out of the darkness as soon as possible," in a letter to his employees.



Photo by Rafael Kellermann Streit on Unsplash

Hong Kong, Europe, and the United States: Who's Affected By Evergrande's Fall?

Now how does this affect the economy on a global scale? While this is expected to be contained by the Chinese government, the fear of this domino effect spreading to the world economy has already negatively affected share prices.

How This Affects Asia

A slowdown in Chinese economic growth will affect companies that export there, and there is concern that this could flow into other economies.

Jimmy Chang, chief investment officer at Rockefeller Global Family Office, mentions that “If China were to have a serious economic issue because of China Evergrande, the rest of the global economy would have contagion from it.”

Marketing experts don't believe this can lead to the next financial crisis, but it can lead to more volatility. A question has been asked on whether this Evergrande situation will become another Lehman Brothers — a fallout that wreaked havoc on global markets.

While the property development company has serious implications for the Chinese economy, many speculate that Evergrande will most likely be restructured than end up like a Lehman-type failure.

How This Affects the West

As for the United States, experts say that Evergrande's crisis is unlikely to pose a serious broad threat to the U.S. economy. “Right now, I think this is a bigger concern for China, rather than the U.S. economy,” said Rubeela Farooqi, chief U.S. economist of High Frequency Economics.

The biggest risk to the \$20 trillion U.S. economy would be a decline in the \$120 billion worth of exports to China each year. However, this is a small percentage and most trading should not be affected.

How This Affects Europe

The pan-European Stoxx 600 index ended the session Tuesday down by 1.7% provisionally. European banking stocks tanked 4.1% on average, posting their worst session so far this year.

Among major bourses, the German Dax was down around 2.3%. The negative session for Europe comes as global stocks continue to struggle in September - traditionally a weak month for markets - in addition to the fallout from the Evergrande scheme, with the Dow Jones Industrial Average on track for its biggest one-day drop since July 19.

“The big question is whether Evergrande’s problems will cause a contagion to other companies/sectors in China and hit growth there,” said Marshall Gittler, head of investment research at BDSwiss Holding.



Guangzhou Evergrande: What to Expect

China’s most successful soccer club, Guangzhou FC, is also on the verge of collapse and is seeking a government bailout, as it is owned by debt-ridden China Evergrande Group.

Guangzhou FC has transfer-listed all of its players in a desperate attempt to raise cash to stave off administration. The Guangdong government is looking to take over a 10-15% stake in the club after the head of the soccer association in the province asked the provincial government for help.

According to the report, a state-owned enterprise would acquire the rest of the club. It is understood that many of the highly-paid stars at the club are plotting an exit, with many looking to leave China and the Chinese Super League (CSL) after wages went unpaid last month.

You can expect head coach Fabio Cannavaro to follow as well, as he's one of the highest-paid coaches in the world. Last year, the Guangzhou FC club began construction of a 100,000-plus-seat stadium that would be the biggest in the world, but it's unclear whether that project will finish by next year, as scheduled.

Evergrande: Outlook and Expectations

The Evergrande share price (OTC:EGRN.F), as well as American depositary receipts (ADRs) of the Evergrande Group (OTC:EGRN.Y) traded higher in Wednesday morning trading, rising 40.1% and 47.5% respectively, through 10:25 a.m. EDT, and pulling up the share prices of other Chinese stocks in their wake.

This Evergrande crisis is being closely watched as the world waits to see what happens this coming Thursday – the company's deadline for their debt payment. As observed this morning, "the real test" for Evergrande could arrive early, when the company is supposed to pay their \$83.5 million coupons on a dollar-denominated bond.

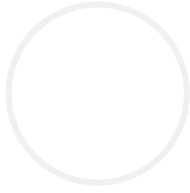
Failure to pay that interest on time would start the clock on a 30-day grace period, giving Evergrande time to pull a trick from their sleeves, but probably shaking investor confidence – and Evergrande's stock price – even further.

While the Chinese government will attempt to contain this, this fallout has the potential to send ripples across the global economy. Not to mention, Beijing's lack of official comment on how the crisis will be resolved has left a major source of uncertainty among investors.

For now, the world waits to see Evergrande's ultimate fate and how this will further affect the global market.

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