

Is Evergrande China's Lehman Moment?



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There's a lot of muttering in the distressed investing space these days bemoaning that there's nothing to do right now. But could this be the calm before the storm? Our economy has just absorbed the largest fiscal and monetary stimulus in history in response to the COVID pandemic. As that winds down and QE tapers off, the big question is, "What comes next?" There's uncertainty over exactly how future distress will play out, but if the past is prologue, it will present itself soon enough. Major structural change, combined with high levels of leverage, is usually a precursor to distress. Heading into the next distress cycle, we already have excessive debt. Perhaps the structural change that pushes us into a new default cycle will simply be the roll back of all that prior stimulus.

We have already seen signs of distress in China as its massive real estate bubble bursts. It seems that the world's second-largest economy is experiencing its own Lehman moment, shockingly reminiscent of what the U.S. experienced leading up to the Great Financial Crisis. The real estate bubble was fueled by excessive leverage and speculation propped up by governmental support of local housing markets. In many ways, the situation in China is even more precarious than was the case in the U.S., because so much of its economy is tied to housing and construction.

The big question for U.S. investors is how spillover from China's struggles may systemically impact the U.S. economy. As the back up of container ships waiting to unload at U.S. ports painfully demonstrates, the supply chain is global and events in one country can dramatically affect another. The busting of China's real estate bubble could likely be the impetus for the onset of the next default cycle in the U.S. as well.

For the last decade, China's rapid development was the main engine for economic growth around the world. Its real estate market, considered by some to be the most important sector in the world economy, was the driving force. Valued at ~\$55 trillion, China's real estate market is nearly four times larger than its GDP. Almost 30% of the country's annual GDP comes from the housing sector. If the Chinese real estate market continues to grow and new home building proceeds at the same pace, the rest of the world would be very pleased. But clearly, it can't.

There are an estimated 65 million vacant housing units in China, about 20% of the total. Recent research notes that over 90% of Chinese households are already homeowners, while 20% own more

than one home. Just as we saw when the U.S. real estate bubble surfaced, the widespread belief that real estate is always a safe investment led many Chinese families to buy additional homes with the hope of flipping them for profit. However, speculation has pushed prices beyond the reach of many people in a country where average annual wages are under USD 15,000 per person. There are also fewer potential buyers, with the 2020 Chinese census showing the slowest population growth in half a century. On top of that, China's households have borrowed over \$6.4 trillion in the last six years, an increase similar to what the U.S. experienced leading up to the 2008 real estate market collapse.

Last year, China's government tightened borrowing standards for builders and President Xi has continually voiced the mantra that "housing is for living, not for speculation." Nevertheless, these measures may not be enough. Evergrande had sold 1.6 million units of undelivered apartments on a pre-order basis to Chinese consumers after traditional lending vanished. Should Evergrande fail, which seems highly likely, it will be the largest real estate company default in history with \$300 billion in debt.

When Evergrande defaults, the bankruptcy is sure to be even messier than Lehman Brothers', and the implications for the world economy could be massive. The Chinese government may ultimately decide that Evergrande and the rest of the sector are "too big to fail," mirroring our own post-Lehman experience. Most politicians around the world are similarly motivated regardless of their ideological label. Chinese leaders will doubtless feel immense pressure to support this industry. Potentially, they will also feel pressure to bolster the debt market, where construction company securities trade at pennies on the dollar.

While we keep an eye on this possible Lehman moment in China and its potential systemic impact on the global economy, there are also indications of future distress closer to home. The first is a tightening of U.S. credit markets, as interest rates begin to rise and quantitative easing shrinks in the face of ever-mounting inflation. Another future concern that could lead to distress is higher tax rates. The Biden administration is currently focused on getting its massive social spending and infrastructure bills through Congress. To pass these, U.S. politicians need a means in which to pay for all that spending. Higher corporate taxes, fewer subsidies, higher individual rates, and the elimination or reduction of capital gains tax breaks are just a few of the revenue avenues being considered. Many of these structural tax changes could wreak havoc among over-leveraged corporate borrowers. Finally, there's also been a record level of new debt issuance by the lowest-quality junk-rated borrowers—which also increases the likelihood of future distress in the U.S.

While it's true that default rates have dropped to historic lows, that doesn't mean there are no opportunities for distressed securities investors. That may be the case for those who must invest long only or only focus on credit investing. However, those with a flexible approach to distressed securities investing can extend the cycle by investing long or short, before, during or even after distress. The post-distress investing segment is particularly attractive right now. Many companies that emerged from distress, especially those impacted by COVID, present excellent investment opportunities right now. Their newly "orphaned" equities, both public and private, are often ignored, or not fully understood by traditional investors, due to the overhang of their prior distress.

Private companies that were previously distressed have the opportunity to re-emerge in the public domain, possibly through merging with a SPAC. Their ability to become reaccepted by the public market once they've fixed their balance sheet problems is a natural progression back to an overall

winning strategy. The attractiveness of investing in both public and private post-distress equities in this part of the cycle will likely remain very interesting for the medium-term.

In the meantime, it would be wise to also keep an eye on China due to the risk of systemic fallout from its bursting real estate bubble.