

A Study of Debt Problems in the Chinese Real Estate Industry

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Abstract: This paper will focus on real estate industry in China, uses Evergrande group as a case to compare with another Chinese real estate company Vanke and a real estate company of United State which is AvalonBay Communities, Inc. This paper will introduce the background of real estate industry in China, and base on the case which is bankruptcy of Evergrande Group to throughout the “causes” find out the issues of real estate in China, in “causes” is discuss of three factors: Industry characteristics, financing channels, loan evaluation, analysing what make Evergrande can owe a massive \$2.4 trillion in debt, and analysing the United States real estate industry not usually having such high leverage. Essay will tell the strategy of real estate companies in China usually do. The strategy led to Evergrande group bankruptcy and compare with Vanke uses what strategy avoid debt crisis. Finally, conclude the chaos of real estate industry in China reflected by Evergrande group, recognise the issues of Evergrande group and prevent the significant consequence occur again.

Keywords: Debt Problems, Real Estate Industry, Chinese Property Sector Crisis

1. Introduction

In recent years, real estate market in China has experienced rapid development, the real estate market is hot, lot of real estate companies were born in this time, which also pushed up the housing price and greatly promoted China's economic development. However, there is a phenomenon is worth to research in the development of real estate market in China, which is the capital structure, especially for the high leverage operation. Evergrande Group is a representative example, which is lead to serious consequence in China, in this essay uses another Chinese real estate company Vanke and a real estate company from United States AvalonBay Communities, Inc to compare with Evergrande Group, aim to research the debt problem in Chinese real estate industry, and find the reason that why Evergrande Group is fail down. The high leverage of real estate is researchable, it can benefit to real estate company. Leverage can increase potential return of the investment; leverage is an imperative tool for real estate industry, and leverage increased the return expectation and risk because both of profit and losses is amplifies [1]. Real estate company need leverage to generate more profit [1]. The thesis of this paper is that: Is the high leverage of real estate industry in China is benefit or harm? This essay will through Evergrande group's case of the development story of Evergrande group first, then analysis the causes of industry characteristics in China, to introduce common characteristics in China, and use Evergrande group compare with AvalonBay Communities, Inc., analysis the different financing channel of two companies, reflect to the different of development level between China and United States, and analysis the loan evaluation in China, shows supply and demand relationship

between real estate industry and bank. After those part will move on to discuss the strategies, use Evergrande group compare with Vanke through equity financial factor to express equity financial is an imperative strategy, analysis liquidity risk from Evergrande group shows company cannot expand blindly, and shows risk from debt.

2. Case Description: Evergrande Group

The radical investment thinking of Evergrande Group and its chairman Xu led to Evergrande Group rapid expansion and rapid bankruptcy, finally remain the huge debt certainly impact on China.

The chairman of Evergrande Group Xu before establish Evergrande Group, he bought a piece of land and take a 20 million RMB loan from the bank and then goes to mortgage this land, uses this land continued obtained another 20 million RMB from the bank, then he decided to invest the capital in advertising and infrastructure first, then sell apartment in advance with a relatively low price compare with other real estate companies, after that started to build the apartment, this process led to large amount of capital coming into the company account before start build, this leveraging act almost no risk and legal, Xu uses the leveraging act established Evergrande Group [2].

After several years, Evergrande group is a leading enterprise in China's real estate industry, and it is developing rapidly with maintains high leverage ratio to operating [3]. In 2020, Evergrande group having 120 billion dollars debt totally, and it was average growing at 37.66% each year, during 2010 to 2020, Evergrande group expanded 18 times of the enterprise value, which is grew 34.13% each year in average, in 2021, in global 500 of 2021, Evergrande group owe 150 billion US dollars at 122nd of the rank [2].

Due to COVID-19 epidemic is bring negative impact to real estate industry in China [4]. Real estate companies tend to find it is harder to borrow money because of financing channels has been tightened by the new policy. But in the situation, Evergrande decide continued buy more land for expansion [3].

The "Three red lines" policy is issued in August 2020, which is aimed to standardize financing of real estate enterprises. This policy led to Evergrande group no longer can financing the capital as usual, that is locked part of the financial channels, due to Evergrande group has a quite lot of debt [3]. At that time, the liability to asset ratio of Evergrande is reached 76.57% which advanced recipient is excluded, astonishingly, the net gearing ratio is also reached 177.82% [2]. According to the "Three red lines" policy, Evergrande can't issue some of the perpetual bonds or debt [2]. In 2021, Evergrande group don't have the ability to repay for own debt anymore [5]. After that, the commercial ticket problem of Evergrande, unpaid wages, senior executive take cash then disappear and sort of the issues are publishing to the public, the occurrence of these events has led to unprecedented difficulties for Evergrande Group [6].

Additionally, Evergrande Group has blind investment in the implementing diversification strategy, for example, Evergrande group is invested to bottle of water business that called Evergrande Bing Quan around 5.4 billion RMB, and invest almost 100 billion RMB to Evergrande EVs, much increase pressure of repayment to bank, and unfortunately, both of business generate lot of cost but not profitable [3].

The extremely radical investment thinking, and blind investment of Evergrande Group led to the consequence of the serious debt crisis.

3. Causes

3.1. Industry Characteristics

The most well-known and often discussed characteristics of real estate industry is high leverage operation, as discussed in the case study part of Evergrande Group is the one of the examples to this

characteristic, and another characteristic of real estate industry in China is policy influence by government, the developing of real estate industry is depends on the policy issued.

Government policy influence in China is an imperative factor that real estate industry must consider. China's real estate market is highly regulated, and its development is greatly influenced by government policies [7]. Government has the power to control the real estate market, real estate industry needs to follow the policies to developing. However, United States is totally opposite of China, United States is more driven by supply and demand [8]. Usually, the government does not intervene in the real estate market and the real estate industry.

As mentioned in introduction part, high leverage operation in real estate industry in China is common, Chinese real estate companies commonly adopt high-leverage operating models [9]. That is aimed to having more potential return of the by real estate business [1].

3.2. Financing Channel

The financing channel of China's real estate companies have much difference of United States, uses Evergrande group's financing channel as an example compare with the financing channel of AvalonBay Communities, Inc., to find the different.

Compared with the capital market of developed countries, the development of China's capital market is relatively backward. The financing channels of China's real estate companies are more from bank loans, and they are very dependent on bank loans [9].

Evergrande group: The financing channels of Evergrande Group in the maturity are mainly focus on current liabilities and non-current liabilities, non-current liabilities mainly include bank loans, Chinese corporate bonds, senior notes, and other loans and for current liabilities is included short-term loans from banks, and the another one is private trust fund, the initial issuance of trust funds in 2010 was 1.284 billion RMB, which increased to 168.1 billion RMB in 2016, growth really fast, in 2016, the amount of bank loan is 166.4 billion RMB, private trust fund is 168.1 billion RMB, and senior note is 22.1 billion RMB, Chinese corporate bonds is 53.8 billion RMB [10]. Bank loans and private trust fund are taking the most part of the financing channel of Evergrande group.

AvalonBay Communities, Inc: AvalonBay has four financing tools, which has corporate bonds, credit facility, bank loan and public capital market, however the bank loans involve the total financing only take a minimal part, and imperative financing tool is corporate bond of AvalonBay, which is take the most of part in total [9].

This is clear shows that the significant different of financing channel between Chinese real estate companies and real estate companies of United States, especially for the bank loan, Evergrande group take big part of total, but bank loan of AvalonBay Communities, Inc only minimal part, that expressed that Evergrande group is rely on bank loan, but AvalonBay Communities, Inc almost ignore bank loan. Which is reflect of the different of real estate industry in China and United States.

3.3. Loan Evaluation

Loan is one of the reasons to promote real estate industry rapid development in China in the past, that can help the real estate companies in China to have higher liquidity running business. In China the loan evaluation for real estate industry is worth to research.

In China, bank more likely to believe real estate credit is a high profit and safety business [11]. Because the low risk and high profit, banks are more prefer lending to real estate industry, even central authority is not advising them to do that [11]. Hence real estate companies can easily have more capital from bank. And most bank in China is suffered by excessive liquidity, that lead to bank would want to be lending as much as possible to reduce pressure from excessive liquidity [11]. Therefore, bank reduce supervision, expand amount of lending, and extend term of loans to real estate industry

[11]. This action make bank reduce pressure; also, real estate industry has plenty of capital, the cooperation of bank and real estate industry seem “double win”, but that more likely to lead to debt crisis as Evergrande group.

Also, Chinese real estate companies use a similar way as Japan during bubble economy, aim to more financing, because real estate companies know the process of loan approval well, they use affiliated companies to finance more capital from bank, and this behavior is often indiscernible [11].

It is precisely because the standards of loan evaluation are controllable and legal loopholes that the real estate industry can get a lot of loan from banks, then real estate companies take the chance to creates high leverage, which is inseparable from the overheating in real estate in China.

4. Strategy

4.1. Equity Financial

Vanke is be called “perfect model in Chinese real estate companies”, compare with Evergrande Group, which is under the debt crisis. One of the reasons is because they use different strategy in equity financial.

Evergrande group: As mentioned in financial channel part, Evergrande group has private trust fund is 168.1 billion RMB as equity financing. And in 2009, Evergrande group in Hong Kong Stock Exchange IPO listing financing, which is raised 4.9 billion RMB in the IPO of 1.615 billion shares [10].

Vanke: Vanke established in 1984, in 1988, Vanke success went public. The main business of Vanke is residential development, is one of the largest real estate companies, and it is widely regarded as one of the most successful real estate companies in China, data show that from 2007 to 2015, Vanke is the highest annual sales revenue company in China, furthermore, Vanke not only has a good performance among China's real estate enterprises, but also has the lowest bank loans in total liabilities among China's real estate company, Vanke has 6 major financial tools that Bank loan, over loan, stock, mergers and acquisitions, real estate fund and trust [9]. That shows Vanke has lot of resource of capital, not only rely on bank loan, which means Vanke's financing tool are quite diversified.

Vanke during 1989 to 2008, using equity financing 18 times obtained around 19.2 billion RMB, which is include the ways of IPO, convertible bonds, private placement, allotment and secondary public offering, and Vanke in 2014 raised 13.9 billion RMB (17.62 billion HK \$17.62) because went IPO on Hong Kong Stock Exchange, Vanke issued a total of 20.56 billion RMB of corporate bonds in the overseas capital market [9].

Compare with Evergrande Group and Vanke, shows that the equity financial is imperative factor, Vanke has more equity financial as they strategy, this is one of the reasons make Vanke being “perfect model in Chinese real estate companies”, as discuss before, the debt financial strategy is made Evergrande group under the debt crisis, the different strategy lead to different result.

4.2. Liquidity

The liquidity risk of Evergrande group need to be discuss necessary, which is an important reason for demise of Evergrande group. Throughout the data, it is clearly showing the liquidity problems caused by Evergrande group and can also understand why the liquidity risk is caused by Evergrande group’s strategy.

Evergrande group’s current ratio in 2016 to 2019 is about 1.4, the lowest year is 2018, which is only 1.36 [12]. Which means the solvency ability is moderate, at least the current asset is more than current liability. 2016 to 2023, Evergrande group’s current ratio is never reach 2, that means Evergrande group cannot make repayment of debt on time, and the repayment ability is continuing to

weaken [12]. This is a bad sign for Evergrande group, Evergrande group is needed to make the liquidity ability stronger in this time, however the fact shows Evergrande group is not has a suitable policy to promote it.

The liquidity risk is caused by the strategy by Evergrande group. Evergrande Group's profit quality is reduced due to implement diversification strategy, increased financial pressure on the company, and expanded too fast but ignoring that the financial resources were insufficient to support such expansion [12]. Evergrande group is meant to having higher returns faster, but ignored potential risk, which is explained the liquidity risk occur of Evergrande group.

4.3. Debt

As discuss in case study part, Evergrande group has huge amount debt, this amount of debt is also because of the debt strategy of Evergrande group, Evergrande group is keep getting more debt, which is lead to the debt of Evergrande group is reached more than 300 billion US dollar [13]. Which is 2.4 trillion in RMB.

Evergrande's use of debt financing as a strategy has foreshadowed Evergrande's future [2]. In addition to the normal debt financing methods of the debt sector, the surprising is the sustainable capital instruments of the equity sector. Evergrande includes "perpetual capital instruments", or perpetual bonds, into shareholders' equity, that means actual debt of Evergrande must be higher than total debt from the official report [2]. Qi has point out that, "the perpetual capital instruments should be treated as perpetual debt" [14]. The perpetual bonds at least take about 15% of total debt of Evergrande Group, this tell that the true total debt of Evergrande should at least plus the 15% [2]. But remember, in case of the plus of 15%, Evergrande group is have the net gearing ratio reached 177.82% in 2021 [2].

Perpetual bonds are compounded at a much higher interest rate than the borrowing rate [14]. That means Evergrande group is needed to pay more by the perpetual bonds, this led to much more expense of Evergrande group to continue grow.

These sort of strategies of Evergrande group is add more pressure to its finance, in the process of financing, Evergrande group never considered about the cost performance to obtain more capital, that is reduces the investment fault tolerance rate of Evergrande Group.

5. Conclusion

Evergrande group's debt crisis is due to its own major decision-making mistakes. The debt crisis event is reflecting the current situation of China's real estate industry, most of real estate companies are still own high leverage, however real estate companies in China is under the high risk, under the risk, Evergrande group is the first companies which is went down, other companies should learn the lesson from Evergrande group as a warn, to avoid the same crisis occur on them. The real estate in China should learn more about the real estate companies in United States, reduce the debt financing but increase of the equity financing, although the debt financing is cheaper and easily to get. as a companies, should pay more attention to take the social responsibility, rather than find ways to get more revenue, a development of a company or industry is not only involved profit, environment responsibility, social responsibility, economic responsibility and governance responsibility are all imperative, otherwise companies and industries will become unsustainable.

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