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The Cause and Enlightenment of Evergrande's Debt Crisis

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ABSTRACT
As a representative of China's real estate industry, Evergrande Group has been living under a highly leveraged operating condition for many years, and has expanded its assets at a speed of several times based on this. But recently, China's leading real estate company Evergrande has attracted widespread market attention because of the rising risk of debt default. This article analyzes the emergence of the debt crisis of Evergrande Group from two aspects: 'internal operating structure' and 'external market factors'. It can be concluded that the debt crisis is caused by a combination of overly aggressive business models and ignorance of market trends. At the end of the article, part of the thinking and inspiration will be presented in the discussion part in order to inspire Chinese companies.

Keywords: *Evergrande, real estate, default risk, high-leverage risk, Chinese policy*

1. INTRODUCTION

In the past decade, China's real estate industry has always been excessively dependent on high leverage and has continuously increased the leverage ratio via various channels to seek business and asset expansion [1]. Evergrande Group, as a leading real estate company in China, also takes this as its business philosophy. Over the last decade, the asset-liability ratio of Evergrande Group has remained above 80%. The high risk it carries has existed for many years, but it has not been fully exposed until the introduction of new policies in recent years. Judging from the annual report disclosed by Evergrande Group, as of June 2021, Evergrande's debt has been close to 2 trillion yuan, while the GDP of Shanghai, the economic centre of China, was less than 4 trillion yuan in the same year [2,3]. The recent event of the overdue payment of Evergrande wealth has pushed Evergrande to the forefront. At the same time, Moody has been continuously downgrading the rating of Evergrande Group in the past few months [4]. Under this scenario, the problem of how the debt crisis of Evergrande Group arises will be of great value for thinking and vigilance. Committed to reveal the reasons behind the Evergrande crisis and to enlighten Chinese companies from this, this article will analyze this problem through two aspects of 'internal operating structure' and 'external market factors'. Later, the inspirations will be discussed and summarized.

2. ANALYSIS

2.1. Internal Business Operation

Evergrande adopts highly leveraged financing methods for market occupation and expansion. Evergrande's highly leveraged business operation is problematic, while what makes Evergrande difficult is the pressure from short-term liabilities. According to Evergrande [2], as of June 30, 2021, nearly 1.6 trillion (about 80%) of Evergrande's liabilities of RMB 1,966.534 billion are short-term liabilities (Figure 1). However, the cash and cash equivalents, including Evergrande's restricted funds, are only 86.772 billion yuan. In that, Evergrande suffers tremendous liquidity solvency pressure, which is also the core problem that triggers Evergrande's debt crisis. Highly leveraged financing brings the potential risks of future uncertainty to Evergrande, and the high proportion of short-term liabilities keeps the company on the verge of breaking the capital chain simultaneously.

Figure 1 Evergrande's Liability Structure

Nevertheless, thanks to the outstanding performance of Evergrande's liquidity, these risks not only did not explode in the past few years but instead achieved multiple expansions of assets for Evergrande. Compared with ten years ago (December 31, 2011), Evergrande's book assets have increased tenfold [2] (Figure 2). This point conceals and downplays Evergrande's liability structure risk until China's Real Estate Policy reform.

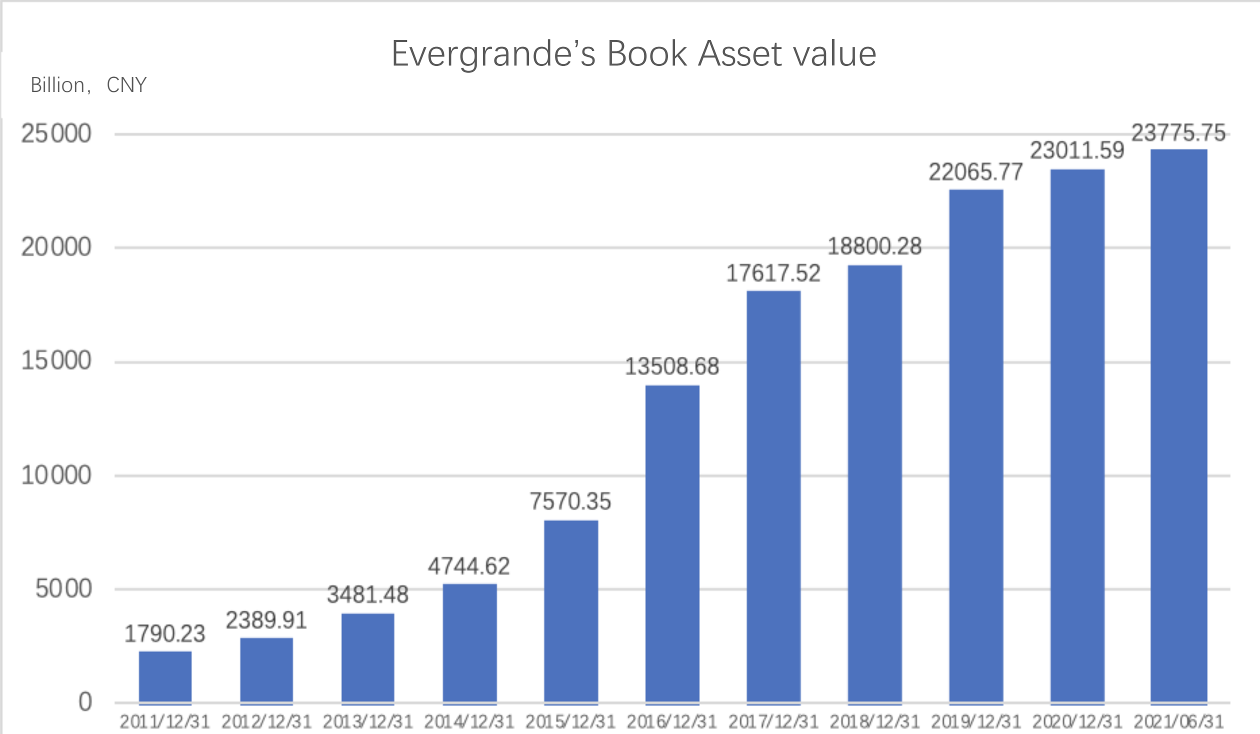

Figure 2 Evergrande's Book Asset value

2.2. External Market Factors

Unfortunately, Evergrande's financing capacity and high-level liquidity capabilities for survival and turnover have been drastically reduced in recent years due to external market factors. The most influential external market factors mainly come from the series of policies issued by the Chinese government on the real estate industry.

In China, the rapid development and expansion of the real estate market have been aggressive in the past few decades. Since 1998, Chinese housing has gradually not only carried the housing demand but also assumed certain financial attributes and functions [5]. However, with the wanton expansion and growth of China's real estate market, the real estate economic bubble has become a significant problem in the Chinese economy [6]. The easing policy during this period has achieved extremely high liquidity and profitability for Evergrande. Nonetheless, as the Chinese government recognized the risks of stimulating the economy by excessively relying on real estate, the mindset of China's real estate policy has changed [7].

2.2.1. Financing Obstruction

The obstruction of Evergrande's financing is a concrete manifestation of the policy. At the end of 2016, the central government officially proposed the policy positioning that 'houses should play a role in housing, not in finance' for the first time [8]. Subsequently, a series of increasingly stringent policy controls have been introduced. In September 2020, the new 'three red lines' rules for real estate enterprise financing control were released. 'The "three red lines" policy restricts the upper limit of the asset-liability, net debt ratio, and short-term debt ratio of real estate companies. Once the upper limit is reached, there will be varying degrees of control. According to the data, as of the end of 2020, all the debt indicators of Evergrande's book data have exceeded the three upper limits. In other words, Evergrande will not be able to borrow new interest-bearing debt to repay the original debt before it meets the "three red line" standards, which greatly increases Evergrande's debt pressure. Besides, Evergrande Group's plan to go public under the name of " Shenzhen Special Economic Zone Real Estate & Properties (Group) Co., Ltd." in 2020 was also forced to shelve. This is undoubtedly another blockage of Evergrande's financing channels.

2.2.2. Liquidity Reduction

As for the liquidity ability, the real estate industry's liquidity ability is mainly reflected in the sales of core assets, which is the key to solving the liquidity problem. After the financing was limited, implementing the discount and dumping house plan for payment collection was not ideal. According to the announcement issued by China Evergrande Group on the Hong Kong Stock Exchange, Evergrande's contracted property sales in June, July and August were 71.63 billion yuan, 43.78 billion yuan and 38.08 billion yuan, showing a clear downward trend (Figure 3). Additionally, Evergrande also expects that the company's property contract sales will continue to fall sharply in September in China [9]. The reasons can be roughly divided into two respects:

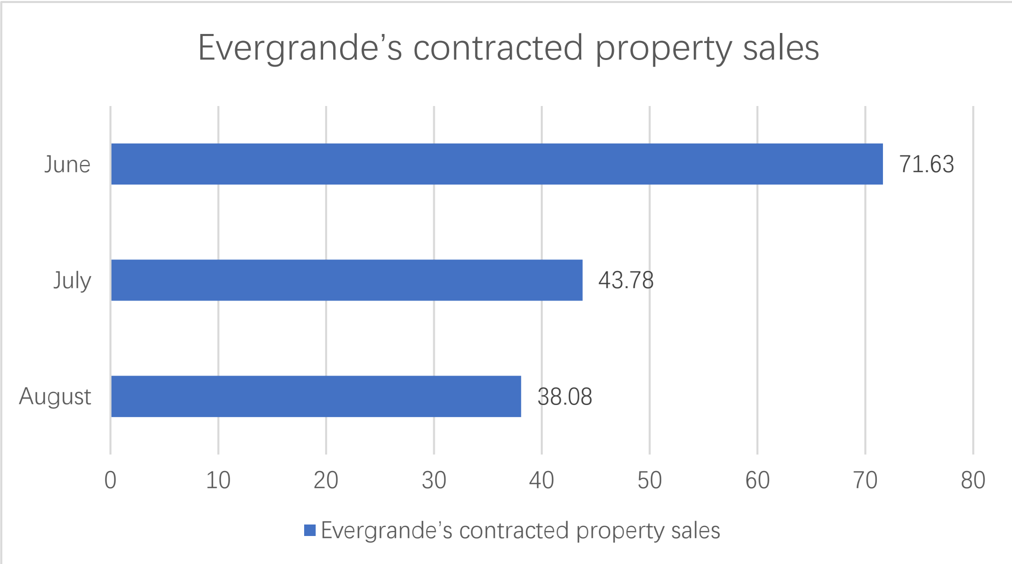

Figure 3 Evergrande's contracted property sales

a. Although China's real estate market has not weakened, mortgage lending by major banks has slowed down. According to the 'Notice on Establishing a Centralization Management System for Real Estate Loans of Banking Financial Institutions' promulgated in early 2021, banks should control the issuance of real estate and personal housing loan balances. The proportion of the two types of loans in the institution's RMB loan balance shall not exceed the upper limit set by the People's Bank of China and the China Banking and Insurance Regulatory Commission [10]. This led to difficulties and delays in debt release by many banks, which negatively affected housing sales and payment collection.

b. Housing prices are subject to double price restrictions, and a policy of restricting price declines has been added to the previous policy of limiting excessive price increases. "Security Daily" highlighted that to control the real estate industry and eliminate vicious competition, many cities in China have issued relevant policies to restrict the low-price dumping of commercial housing [11]. This suppressed the implementation effect of Evergrande's low-price dumping strategy, which aimed for collecting payment in speed, and led to a sharp increase in pressure on the sales side.

The promulgation of these policies has significantly reduced Evergrande Group's financing ability and liquidity for survival and turnover. Therefore, based on the inherent liquidity risk of the operation, the double deterioration of financing ability and asset liquidity exposed Evergrande's previously concealed liquidity risk problem, which directly led to this global turbulent debt crisis.

3. DISCUSSION

From this crisis, this article believes that there are two key points worthy of consideration and attention in the Evergrande incident.

In terms of internal operations, Evergrande has a very high debt ratio and current debt ratio. This has allowed Evergrande to demonstrate high asset expansion capabilities within a certain period, but it is also the key to Evergrande's collapse. It is worth noting that Evergrande did not perform well in the tradeoff between profit and risk and underestimated the importance of risk control.

Considering the external market factors, Evergrande did not follow the development trend of the times. In China, the direction of government policies is closely integrated with the development trend of the times. As early as 2016, the Chinese government proposed a policy to control the housing market, but Evergrande Group did not fundamentally change its business strategy. This has led to Evergrande's dilemma under the current tightening policy.

4. CONCLUSION

In conclusion, this article analyzes the reasons for Evergrande's current predicament from both internal and external aspects. From the facts, internal high-liquidity liabilities are the root cause of the crisis, and external market factors are the fuse that detonates liquidity risks. The root cause of this problem is Evergrande's underestimation of risks and ignorance of the trend of the times, which is worthy of reflection.

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