Research on Measures for China's Real Estate Enterprises under the Background of 'Three Red Lines' Policy

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ABSTRACT
Since 1980, houses have been defined as commodities, and Chinese real estate has officially become an industry. On August 23, 2020, "a key real estate enterprise fund monitoring and financing management rules "which is also called "three red lines" have been formed. This article explains the constraints these rules exerted on the real estate firms by presenting the specific content of the "three red lines", illustrates the two main effects of the "three red lines" which are reducing the scale of financing and increasing the cost of financing for real estate firms, demonstrates and compares two firms' operational strategies and their current situation, and finally gives recommendations about financing strategies to firms belonging to different groups classified by the "three red lines" separately. The suggestions mainly focus on ways to improve liquidity and turnover rate. It is hoped to promote the stable and healthy development of the real estate industry under the background of the "three red lines" policy by delivering this article.

Keywords: *Real estate industry, Three red lines, Financing, Cash flow.*

1. INTRODUCTION

The real estate industry has already become the booster of China's economy. During the past 40 years, the real estate industry has played a huge role in the development of China's economy and contributed a lot to China's GDP growth.

According to the data, China's GDP in 2020 is 101598.6 billion yuan, and annual real estate development investment is 14144.3 billion yuan which accounted for 13.9% of the national GDP. Moreover, shown by the following graph, this trend existed not only in 2020 but also throughout the past 13 years.

In order to minimize the negative impacts of the 2008 global financial crisis, on 9th November 2008, China adopted the economic stimulus program, and moderately eased the monetary policy. As one of the three pillars of fixed asset investment, the real estate industry benefited a lot from the program and boomed. The production chain of the real estate industry is long and includes building materials, chemicals, steel and others. Therefore, the development of the real estate industry can successfully stimulate domestic demand and drive economic growth.

In addition to the known-to-all functions of real estate firms such as buying land, building houses, and selling houses to the public, real estate firms are also responsible for the construction of schools, parks, shopping malls, government personnel resettlement houses, and road repairs. What's more, real estate firms help the government to carry out the old city reconstruction projects through the primary and secondary linkage methods. During this process, real estate firms not only help to demolish the old, dilapidated houses to make the city look new, but also assist the government to resettle and relocate households and maintain social stability.

Table 1. China's annual GDP and annual real estate development investment by time

Item	2014	2015	2016	2017	2018	2019	2020
China's annual GDP/Trillion CNY	64.36	68.90	74.64	83.20	91.93	98.65	101.60
Annual real estate development investment/Trillion CNY	95.04	95.98	10.26	10.98	12.03	13.22	14.14

The social responsibility of real estate firms can mostly be represented by their contribution to environment protection and expenditure on charity. China has a star-level standard for green building certification which is divided into three levels. The level of star rating is the direct reflection of green buildings. Therefore, real estate projects certified as Samsung are the most authoritative green projects. Furthermore, every firm emphasizes and invests in one specific area of public welfare such as childcare, school donations, cure of special diseases, protection of endangered animals, disaster assistance, and so on. This kind of charity activity will be published in the media and directly or indirectly have effects on aimed minority groups. The impact of the activities on society is both spiritual and material. Expenditure on these activities earns most public recognition for firms and the amount of expenditure is the supporting data for proving the fulfillment of the social responsibility of real estate firms [1].

However, real estate companies have also encountered many problems during their development. In order to implement the real estate long-term mechanism and enhance the marketization, transparency and standardization of real estate firms' financing, the government has issued the "three red lines" policy to reduce the risks and social problems caused by the rapid development of real estate enterprises.

At present, the real estate industry is under heavy pressure due to the national macroeconomic rules aimed at reducing leverage. From 2016 to 2020, China has conducted comprehensive regulation on the real estate industry from both the supply side and the demand side. The regulation on the supply side is mainly embodied in three aspects: land resource regulation, commercial housing regulation, and capital regulation [2]. In terms of land, local governments in various regions have increased the supply of land and restricted the highest bidding price of land. In terms of commercial housing, local governments in various regions have issued restrictions on sales and price and required real estate firms to limit the number and price of houses sold. In terms of funds, real estate companies are asked to deleverage and reduce liabilities. Regulations on the demand side of real estate mainly include a series of policies such as purchase restrictions, price restrictions. Due to the compression of the market space brought by regulation, the competition among real estate companies has become more and more intense. Finding ways to survive in the cracks and seek development while living is a major task for all real estate firms. However, the suggestions and advice to real estate firms are still meagre.

In this article, the content of "three red lines", analysis the influence of the rules on real estate companies' fund management, SWOT analysis results and strategies utilized by good-performing companies and bad-performing companies, suggestive measures to real estate companies to respond to the rules and finally the summary and inspiration are given.

2. EFFECTS OF "THREE RED LINES" ON REAL ESTATE FIRMS

2.1. Content of "three red lines"

The specific content of "three red lines" is that large real estate firms will be categorized into the green group, orange group, yellow group, and red group according to three criteria which are a liability to asset ratio of less than 70%, net gearing ratio of less than 100%, cash to short-term debt ratio of at least 1. Specifically, if a firm passes all three criteria, it will be marked green; if a firm misses one criterion, it will be marked yellow; if a firm misses two criteria, it will be marked orange; if all three criteria are violated by the firm, it will be marked red. In terms of the different groups to which each firm belongs, the extent of its debt growth allowed in the next year is decided. Firms belonging to the green group can increase their debt up to 15% next year, while firms belonging to the yellow group, orange group, and red group are entitled to increase debt up to 10%, 5%, and 0% respectively.

As a typical representative of the capital-intensive industry, the real estate industry usually has large investment and need a lot of funds, as a large amount of money is required in the stage of the land auction, project construction, and sale promotion. However, the entire sales collection cycles of the real estate industry are long and often takes a few years. Therefore, financial support is indispensable in the development of the real estate industry. Moreover, the real estate industry is a highly indebted industry. From the acquisition of land to the completion of the sale of real estate companies, there are many chances to increase leverage. Since the beginning of the land auction and deposit payment process, borrowing from financial institutions was the first opportunity to increase leverage. When paying for the land, borrowing again from financial institutions is the second opportunity to increase leverage. Applying for a development loan from a bank is the third opportunity to increase leverage. When the settlement of construction is paid to the contractor, paying settlement by bills is the fourth opportunity to increase leverage. The last opportunity is the buyer's mortgage loan [3]. In short, real estate companies have repeatedly increased leverage to make their own debt ratios very high. The above procedures are closely linked, and an error in one link may cause damage to the entire chain.

With the implementation of the "three red lines", China's real estate firms' financing has been changed to a great extent.

2.2. Real estate firms’ financing scale will decrease

The “three red lines” set 15% as the maximum percentage debt growth per year. As a result, the ceiling of real estate firms’ annual financing amount is set. No matter what kind of financing method real estate firms use, they will ultimately be restricted by the limiting amount of financing [4]. In this way, the financing scale which can be defined as the total amount raised by the firm in a fixed operating cycle will decrease. Shown by the incomplete statistics from CRIC, the total financing amount of 100 typical real estate firms in the first half of 2021 was 609 billion yuan. The total amount decreased by 34% on a year-on-year basis and 29% on a month-on-month basis and reached the lowest level since 2018. At the same time, the situation of corporate financing is not optimistic. Only 36% of real estate firms increased their financing scale. Among all the real estate firms that decreased in financing scale, about 30% of them experienced a decrease of more than 50% [5]. Therefore, it would be of great importance for real estate firms to constantly introspect their long-term and short-term solvency and profitability and keep rebalancing between development and liquidity.

2.3. Real estate firms' financing costs will increase

The continuous negative events in real estate firms such as the default of a 1.3-billion-yuan dollar bond from Fantasis Holding Group triggered the loss of confidence, doubts to the fund chain of China's real estate firms and the spread of panic sentiment. Consequently, there have been plummets in prices of dollar bonds of China’s real estate firms. On 9th October 2021, prices of dollar bonds of China SCE Group Holdings Ltd (01966.HK) which will be due in April 2024 fell to 85.0775, accomplished the record of the largest single-day drop since the issuance, with a yield of 14.753%. The decline of the dollar bond of China SCE Group Holdings Ltd which will be due in March 2022 continued to expand, and the yield continued to rise to 16.8324%. On the same day, dollar bonds of Modern Land (01107.HK) plummeted as well. The price of Sunshine City's dollar bond which will be due in March 2022 fell 27.189%, and the yield reached 239.609%. On October 11, the price of Sunshine City's dollar bond which will be due in January 2022 fell by more than 10.099%, and the yield reached 358.8437% [6]. Generally, the issuance of dollar debt by real estate companies and the maturity of the debt have followed one after another. There is an obvious trend for real estate firms to exchange dollar bonds with high costs.

3. COMPARISON BETWEEN VANKE CO., LTD. AND EVERGRANDE GROUPE

3.1. Introduction of Vanke Co., Ltd. and Evergrande Groupe

Vanke Co., Ltd. was established in May 1984. In 1992, the firm decided to regard real estate as its core business and mainly focus on residential housing. Through years of development, Vanke Co., Ltd. established a good reputation in the industry through its accurate positioning, advanced planning, and high-quality property management. Every step of Vanke's development is closely related to environmental factors such as the country's macroeconomic situation, the cycle of the real estate industry, and its own operations.

Evergrande Groupe was established in 1997. Evergrande Group is one of the world’s top 500 enterprises which is based on civic real estate and supplemented by cultural tourism, health and wellness. At present, Evergrande has total assets of 2.1 trillion yuan, annual sales of more than 600 billion yuan, cumulative tax payments of more than 240 billion yuan, charitable donations of more than 14.8 billion yuan, and 140,000 employees.

3.2. SWOT analysis of two firms

The strengths of Vanke Co., Ltd. are its wise strategy, professional management team, rational governance structure, sterling products, attractive corporate culture, high level of brand awareness and close relationship with customers [7]. The weakness of Vanke Co., Ltd. is the lack of the preferential policies given by the government in terms of obtaining land resources and purchasing land compared with real estate companies that are restructured from state-owned enterprises. The strengths of Evergrande Group are its large scale, brand effect and team culture of high efficiency. The weaknesses of Evergrande Group are its overly rich product line and high level of centralization. The opportunities for both firms are the promotion of urbanization and the trend of speeding up the development of the infrastructure industry. In terms of the threats, both Vanke Co., Ltd. and Evergrande Group face the difficulties of higher cost, more competition and lower profitability due to more strict government rules.

3.3. Comparison between two firms' different strategies

In order to maintain a certain amount of free cash flow, Vanke Co., Ltd. implemented the strategy of "cash is king", launched the slogan "keep-alive", was cautious on land buying, did not blindly expand the scale, and persisted on the business strategy of rapid development and sales. At the end of 2007 when other real estate firms were still excited and sanguine towards the real estate market, Shi Wang proposed the "real estate market turning point theory" and pointed out the cost-performance ratio of houses was low [8]. Shi Wang claimed that the middle class would no longer afford houses if the situation that increases of housing price exceeded that of income continued. This was the sign of the soaring real estate bubble and abnormality of the real estate market, hence, in-depth adjustments to the real estate industry were foreseen and required. His calling of rational and meticulous development coincided with the government's macro-control rules. At the beginning of 2008, Vanke Co., Ltd. lowered prices in a timely manner, increased number of small units and the proportion of fine decoration, as a result, the housing payment was better recovered. The above statement does not mean Vanke Co., Ltd. is pessimistic about future, instead, Vanke Co., Ltd. is always ready for future development but in a prudent way. From the perspective of land bank, Vanke Co., Ltd. began to reserve a large amount of land in 2006, and its inventory even reached 63.5% of its total assets. Besides, Vanke Co., Ltd. secured projects in cities such as Hefei, Chongqing and Xi'an through cooperation and other safer methods and succeeded in further expanding the market.

Table 2. Financial situation of Evergrande real estate in 2015~2020

Year	Total Asset	Total Liability	Equity	Account Receivable
2015	757,035	614,893	142,142	10,730
2016	1,350,868	1,158,336	192,532	9,342
2017	1,761,752	1,519,544	242,208	4,352
2018	1,880,028	1,571,402	308,626	6,029
2019	2,206,577	1,848,040	358,537	6,332
2020	2,301,200	1,950,000	351,200	7110

*unit:million yuan

According to the data in table2, the growth rate of Evergrande Group's total assets was very unstable with the lowest rate of 6.7% and the highest rate of 78% and was positively correlated with the growth rate of total liabilities. Meanwhile, the growth rate of equity decreased constantly, and the debt-to-asset ratio continued to be higher than 80% which means Evergrande Group is highly dependent on debt. However, under the current government's rules, an excessively high debt ratio will prevent the firm from starting a new round of financing and may lead to a rupture in cash flow. As of 30th June 2020, Evergrande borrowed 835.5 billion yuan with an average annual interest rate of 9.14%, while its net interest rate last year was only 7%. What makes the situation even worse and exerts huge pressure on Evergrande Group is that among all the debt, those need to be paid within two years account for as high as 70%, about 600 billion yuan [9]. Last but not the least, Evergrande Group has had insufficient advance payments and a relatively low average asset turnover rate of 0.2 for the past five years.

4. SUGGESTIONS TO FIRMS

4.1. Firms belonging to red groups: reducing debt and speeding up sales, and increasing advance payments, cash and cash equivalents

Firms belonging to the red group are not allowed to further increase liability and therefore can only rely on internal financing which mainly comes from sales credits of projects, so it's urgent to accelerate the sale process. However, the current internal financing cannot meet the demands of operation, as the long-lasting purchase restriction such as housing ticket causes the sales growth to shrink, and the higher cost of land and labour reduce the profitability simultaneously. To address the imbalance between demands and supply, firms need to find new growth engines in internal financing. For example, the method that can be adopted is the comprehensive development of supporting real estate projects. For example, firms can launch the comprehensive projects supplementing to real estate such as the construction of industrial towns. This method enables firms to earn profit and rich cash flow from not only the sale of property but also the investment from enterprises.

4.2. Firms belonging to orange groups: Increasing the turnover rate, letting the growth rate of repayment surpass the growth rate of debt

Firms belonging to the orange group are allowed to increase liability up to 5%. Although interest-bearing debt still has room to grow, an increase in debt alone will directly cause the increase in the ratio of short-term cash debts. In order to control the growth rate and meet requirements of "three red lines", firms belonging to the orange group must increase the rate of collection while increasing their liabilities and make sure the rate of collection is greater than the growth rate of liabilities. By doing so, the debt-to-asset ratio and net debt ratio after excluding advance payments can be reduced. As of the second half of 2020, real estate development loan was about 1 trillion yuan, increased by 12.2% year-on-year, but the increase rate slowed significantly compared with 2019. Specifically, strategy of firms belonging to the orange group would be withdrawing funds by accelerating sales and increasing sales volume at the expense of price. This strategy will be helpful to maintain the stability of house prices as well.

4.3. Firms belonging to yellow groups: increasing shareholders' equity and importing strategic investment

Firms belonging to the yellow group are allowed to increase liability up to 10%. These firms need to improve the financing model. The implementation of "three red lines" makes a large number of trust financing of the real estate industry become illegal funds. In 2020, many firms cancelled the plans of trust financing reached in 2018 and 2019 which are inconsistent with the "three red lines" and switched to stock pledge repurchase and PPP-ABS's trust usufruct financing. Although innovation of financing model is the best way to offset the negative effects of "three red lines", it will increase financing costs. Therefore, an urgent problem for firms belonging to a yellow group is how to improve existing financing model. On the one hand, in accordance with the "three red lines", firms should replace illegal trust financing with the financing tools that best meet their own needs. On the other hand, the channels of internal financing can be expanded by introducing strategic investors.

4.4. Firms belonging to green groups: accelerating the collection of advance payments and improving product quality

Firms belonging to the green group are allowed to increase liability up to 15%. Most of the debt-to-asset ratios of firms belonging to the green group after excluding advance payments have little difference to the requirement. From the current point of view, the operating turnover speed does not vary significantly among the firms belonging to the green group. The real gap happens in the sales stage. By shortening the sales cycle and formulating excellent sales plans, firms belonging to the green group achieve a rapid recollection of the advance payments. In addition, some firms have also increased the advance payments by improving product quality. Due to the impacts of price restrictions in recent years, firms cannot directly put premiums on houses, so they use refined decoration and parking spaces to improve product quality and attract consumers to buy as well as to make themselves more competitive [10].

In sum, the overall strategies of all real estate firms are prudent operation, risk prevention, and adaptation to market changes. For different patterns of different cities' markets, firms should formulate more tailored sales strategies, deepen sales channels, improve turnover efficiency, and accelerate cash collection. Moreover, with the implementation of demand-side reforms, more attention should be paid to the characteristics and trends of the demand side. It will be difficult to adapt to market trends only from work done on supply side. This reform will force real estate firms to change their development ideas and accelerate their transformation to the buyer's market [11].

5. CONCLUSION

In conclusion, the main purpose of government policies such as the "three red lines" and "houses for living, not for speculation" is to curb the finalization and foaming trend of the real estate industry and promote steady and healthy development of the whole industry. Besides, to improve urban amenities and to make cities become places that citizens enjoy living and working in are also the main orientation of government policies. Under the three red lines, the growth of interest-bearing liabilities of real estate firms is restricted and the real estate industry's financing reliance will gradually decrease. This article indicates that, in the future, real estate companies should put more emphasis on increasing turnover rate, accelerating sales collection process, and standardizing and improving the projects' operation and management process. In this way, real estate firms can prevent and avoid risks brought by the new rules and ensure the continuous boom of the entire industry on the premise of improving the individual competitiveness of each firm [12].

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