

China Evergrande Group Crisis

Reading Project: Financial Risk MVE022/MSA400



Work Distribution

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Introduction

In China, Evergrande Group is the second largest real estate company, measured by sales. Evergrande mostly caters to upper- and middle-class residents and in 2018, it became the world's most valuable corporation in the property sector. However, while real estate is the company's main area of business, Evergrande has expanded its enterprise to other industries such as sports, tourism, health and entertainment. For example, they own amusement parks, bottled water brands and they have high stakes in both electric vehicles and insurance companies. Furthermore, they bought what is now known as the *Guangzhou Evergrande Football Club* and made a substantial investment in acquiring some of the most elite players. The team even went on to win the most prestigious football tournament, the ACF Champions League, in 2013. (2021-10-03, Wikipedia, *Evergrande Group*) Today, Evergrande has over a thousand projects in more than two hundred cities across mainland China. (2021-12-09, Hoskins, P., *Evergrande: China property giant misses debt deadline*)

Background

The founder of Evergrande, Xu Jiayin (Hui Ka Yan), started his career as a worker in a steel factory after being born in rural poverty. He founded Evergrande with virtually zero initial wealth, which might seem odd at first. But a prominent factor behind his, and the company's, success in raising capital was his strong social connections to powerful politicians and billionaires such as Jack Ma. There's no secret that corruption plays a big role in communist countries and dictatorships, and we can safely assume that it's the case with Evergrande as well. (2021-09-22, Archyde, *Splendors and miseries of Xu Jiayin*). Xu Jiayin is also a member of China's People Political Consultative Conference which advises the central government.

Founded in 1996, Evergrande was in a favorable position for what was about to take place within the Chinese housing market. In 1998 the reigning Party introduced a housing reform that made public urban homes available for a very cheap price. This was the third step of the reform that began in the 1970's. (2011, Yanyun Man, J., *China's housing reform and outcomes*) Employers in the cities were also allowed to subsidize rental properties to its employees, all paid for by the government. Pricing pressure as a result of the reform was aided by a trend of urbanization as well.

The housing market in China has ever since been profitable for owners, investors and speculators alike. In fact, for the average citizen, owning and investing in real estate seemed like the only viable option to improve their economy. When looking at investments for 2020, 51.5 percent could be connected to real estate, with real estate development investments accounting for 27.3 percent" (2022-01-04, Huld, A., *What's happening in China's property market?*)

An astonishing 78% of Chinese household wealth is still found in real estate and property. (2021-08-10, Stevenson, A. & Li, C., *Evergrande Went From China's Biggest Developer to One of Its Worst Debtors*) This explains why the homebuyers of China were ready to pay a large amount of the price upfront, place bids at inflated prices, and use real estate as a speculative investment on a broad scale. Prices had been increasing at a steady pace for over 20 years and seemed to be doing so indefinitely. In many cases even, subletting the property was unnecessary as the actual return came from substantial price increases.

Price-to-Income Ratio for Selected Countries and China

Nation	Affordable (<3.0)	Moderately Unaffordable (3.1–4.0)	Seriously Unaffordable (4.1–5.0)	Severely Unaffordable (>5.1)	Total Cities	Median PIR
Australia	0	0	3	24	27	6.0
Canada	10	15	5	4	34	3.5
Ireland	0	0	2	3	5	5.4
New Zealand	0	0	1	7	8	5.7
United Kingdom	0	0	6	10	16	5.2
United States	77	59	23	16	175	3.2
China (2010)	3 (1.1%)	31 (11.7%)	47 (17.7%)	184 (69.4%)	265 (100%)	6.25

SOURCES: Demographia, 2009, for all countries except China; the data for China were calculated by the author based on National Bureau of Statistics of China data sets.

Fig. 1: By 2010, China already had one of the most inflated real estate markets in the world.

Not only did the real estate market in itself expand during the past 20 years, Evergrande did too. The company reported a CAGR of revenue above 40% and that its total assets grew over 31% annually. (source: annual reports).

Debt Problem

So how did Evergrande manage to rack up so much debt?

Since projects in real estate construction are both capital intensive and have a long payback time, a lot of funding is required. Typically, Evergrande would look to borrow this money from banks. As of 2022 Evergrande owes money to 171 domestic banks (2021-09-21, The Guardian, *Evergrande: will it collapse and what would happen if it did?*). The complete debt structure of the company is still hidden amongst its many subsidiaries and a real mess to sort out, but it's confirmed that Evergrande issued dollar denominated bonds overseas as well, which in turn is responsible for \$20B of its present debt.

The negotiation of property deals with the Chinese government was done behind closed doors, and we can safely assume that a lot of projects were acquired under market value. Furthermore, as prices in real estate continued to soar, Evergrande's debt ratio went down, which allowed the company to take on even more debt, essentially using the inflated value as collateral. Since the projects managed to generate profits already in the construction phase, Evergrande consequently chose not to complete them, and instead transferred the money into other aquirerings.

Evergrande's properties under construction (yuan, billions)

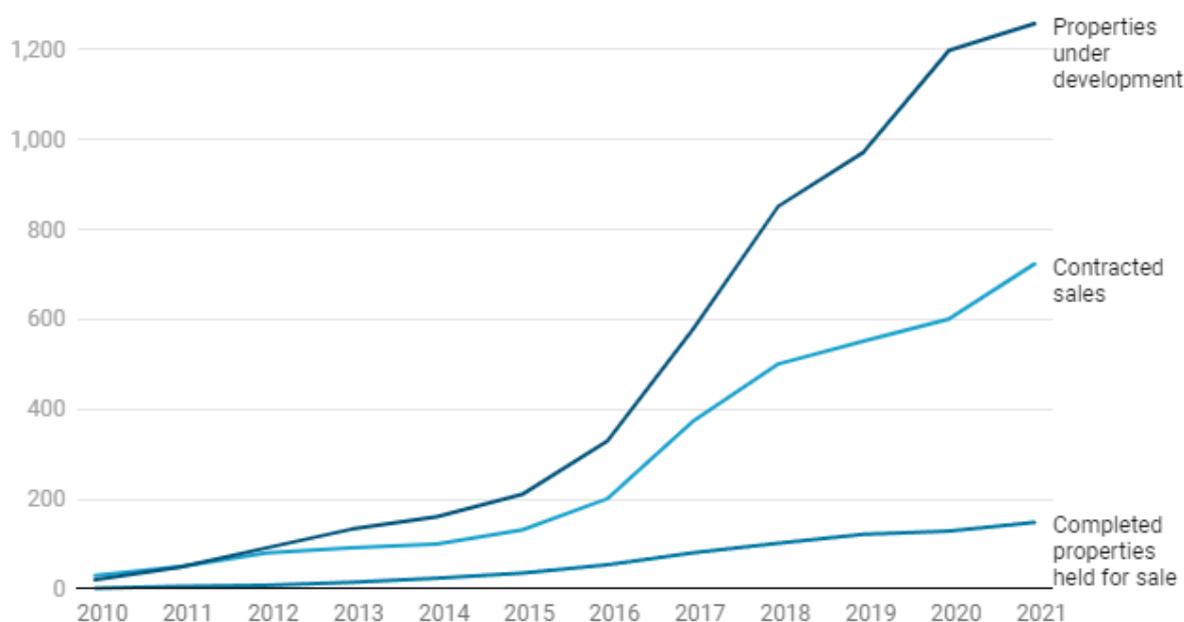


Fig. 2: Evergrande's properties under construction.

As this continued, the company's debt became unbearable and the liquidity issues that come with owning property instead of finishing it began to show. The solutions for this are either to take on more debt or sell unfinished assets. Evergrande chose to do both.

It's common for customers in Evergrande's housing projects to make 30% of the payments upfront. Using this money as down payments on new projects and land acquisitions, the company proceeded to expand its balance sheet. This type of debt is also a way to raise both liquidity and investment capital when banks and other institutions say no. From Evergrande's perspective it's actually an even cheaper kind of debt, as the interest is paid by the customer instead.

As a way to temporarily boost cashflow, Evergrande issued "Wealth management products" for its own employees. These were made up of short term obligations, and were said to help finance short term supply chain payments. Around 70-80% of employees in different Evergrand subsidiaries were more or less ordered to invest in the wmp's, running the risk of missing salary payments and bonuses if they refused. Departments and subsidiaries within the company also had their own quotas to fill. (2021-09-19, Stevenson, A., Li, C., *Evergrande Gave Workers a Choice: Lend Us Cash or Lose Your Bonus*)

Three Red Lines

In 2020 the Chinese government introduced a set of criteria for taking on debt directed at the real estate sector, called the "three red lines". This was China's response to the aggressive and irresponsible property firms, like Evergrande, and an attempt to place restrictions on their ability to take on more debt.

As the name suggests, the "three red lines" include three requirements that the borrowers must take into consideration:

1. The liability to asset ratio must be less than 70%

2. The net gearing ratio must be less than 100%. Net gearing is the ratio between the total debt and total shareholder's equity. This means that the total debt must not accumulate to more than the shareholder's equity.
3. The cash to short-term debt ratio must be more than 100%.

However, a real estate company will still be able to increase its debt if it does not violate all three red lines. Based on how many red lines their balance sheet violates, all firms in the property sector are categorized and their allowable annual growth in debt will be determined accordingly. (2022-01-14, Bloomberg, What China's Three Red Lines Mean for Property Firms)

Categorization	Number of lines breached	Allowable annual growth in debt
Green	0	15%
Yellow	1	10%
Orange	2	5%
Red	3	0%

Fig. 3: Categorization of property firms, according to the three red lines.

The Crisis

The crisis media coverage took off in the summer of 2021, but Evergrande themselves acknowledged its high debt for the first time in 2017, and set the goal to reduce it to 70% by June 2020. Conveniently, that would occur just a month before the three red lines were introduced. However, the company still faced liquidity issues in September 2020 and tried to increase its sales by having a 30% discount during September.

During the spring of 2021, Evergrande sold a lot of its subsidiaries and raised capital by IPO's in different parts of the company. This was done in order to meet the three red lines criteria. Several rating agencies began to downgrade the company's credit ratings, in small increments.

Then comes the summer of 2021. In June, homebuyers are denied loan extensions for Evergrande's projects, and a special court is appointed to handle the vast amounts of lawsuits that follow. Two projects have their constructions interrupted, and the company warns investors of a near 30% decrease in profits.

In September, Evergrande asks for extensions on loans and interest payments. Homebuyers, employees and investors storm the lobbies of its headquarters and demand to be paid. At the same time Fitch warns of a "probable default", which is profusely denied by Evergrande who promises to pay the entirety of expired wmp's. On the 23:d, Evergrande fails its obligation on a \$85.3m bond. although the company once again claims that the transaction was done. (2021-09-24, Reuters, *Timeline: China Evergrande's snowballing debt crisis*)

Evergrande was declared as a defaulting company on the 9:th of December by Fitch, who put them in “restricted default”-rating. Despite that, Evergrande is still trying to get back on its feet. With many different possible paths ahead. These are made possible on account of the company's sheer size, and the consequences an operational default would bring. There still remain 1.6 million unfinished properties on Chinese ground, and the company owes \$300B.

Consequences

Looking from China’s government point of view, a risk is the potential of a spillover effect, where a collapse of Evergrande could hit the wider economy. For instance, if Evergrande collapses it could result in the domestic banks lending less and at a higher interest rate. Smaller companies might not afford to borrow from banks and therefore slow down their growth rate. In short this could lead to a deceleration of China’s growth (Ni, V. (2021-09-21, *Evergrande: will it collapse and what would happen if it did?*)).

A fair question to ask is if Evergrande is too big to fail? Will the government help Evergrande or not? The government should only step in and help Evergrande if there is a potential of systemic risk, meaning that a collapse of Evergrande is likely to cause severe instability of the entire property sector in China. A collapse of Evergrande is not likely to cause this much of a risk. Moreover, China would contradict themselves if they bailed out Evergrande. It would send a signal of acceptance of risky behavior. And China has lately wanted to cut down debt in the real estate sector by for instance adding the three red lines restriction mentioned above (Huang, E., 2021-09-21, *China likely won’t bail out Evergrande directly unless there’s ‘far-reaching contagion’*).

Evergrande has during their years of adding debt also accumulated several stakeholders which consists of domestic banks, foreign holders of dollar bonds, private investors and employees. If Evergrande goes into bankruptcy its creditors will take different levels of hits. The first creditors to get paid will be the domestic banks since most of them are state owned and Evergrande’s biggest creditors. The creditors that will take the biggest hit are the people who have paid deposits on their home that have not yet been built and also employees who have lent money to Evergrande. This could easily lead to public protests and anti government movements. Furthermore, Evergrande is inadvertently responsible for 3.8 million jobs that will be affected or lost if Evergrande goes into bankruptcy (Subramanian, S., 2021-09-20, *To bail out or not to bail out: China’s Evergrande dilemma*).

Personal conclusions

The chinese property crisis that started in 2020 and that is still ongoing is the fault of several parties' reckless behavior over the last 20 years. Chinese politics laid the foundation on which Evergrande took advantage of lenient banking regulation in order to acquire unprecedented amounts of leverage. To prevent similar crises from happening in the future, further regulations, such as the three red lines, should be implemented. Of course, that is difficult, since China is a dictatorship and you have to spot the problem before it grows too large.

Reading guide

[Evergrande bondholders threaten to sue after being blindsided by \\$2bn claim | Financial Times](#)

[Evergrande: will it collapse and what would happen if it did? | China | The Guardian](#)

More in depth about Evergrande.

[The Truth About Chinese Corruption - Carnegie Endowment for International Peace](#)

To better understand the structure of the Chinese economy and government.

[untitled \(lincolninst.edu\)](#)

The urbanization of China and the rise of it's middle class.

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