

Research on Financial Risk Analysis and Early Warnings in the Chinese Real Estate Industry- Evergrande Real Estate as an Example

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Keywords: Financial risks, Chinese Real Estate Industry, Evergrande Real Estate

Abstract: With the development of the real estate industry in China, the market become more and more prosperous with some potential financial risks at the same time. This paper takes Evergrande Real Estate Group Limited as an example to define the financial risks of the real estate industry and analyze the operating conditions and financial issues of the company based on the analysis of the SWOT. Through real estate industry research and value chain analysis, cash flow analysis and multi-angle analysis of the financial risks brought by real estate industry participants (governments, banks, suppliers, consumers, etc.) to enterprises, the author summarizes the commonalities, gives potential financial risks and provide warnings to other enterprises in the real estate industry.

1. Introduction

The real estate industry is the basic industry of people's livelihood. The current commercial housing pre-sale system and existing housing transaction system in China contain financial risks for real estate companies. Evergrande Real Estate Group Limited, as a benchmark enterprise in China's real estate industry, had serious financial risks. It is an ideal case study object for the real estate industry. The author hopes to define the financial risks of the real estate industry and to analyze the potential financial risks to summarize commonalities so that the paper can give warnings to other companies in the real estate industry and promote the healthy and orderly development of the real estate industry.

2. Literature Review

2.1 Definition of Terms

Financial risk is the possibility of losing money on an investment or business venture and a type of danger that can result in the loss of capital to interested parties. Financial risks include credit risk, liquidity risk, asset-backed risk, foreign investment risk, equity risk, and currency risk. Evergrande Real Estate Group Limited faces the possibility of default on debt but may also experience financial burden on the business.

2.2 Literature Review

As for the Evergrande Real Estate Group Limited, there are research on its operation of the diversification strategy, methods of financing via perpetual debt financing, and financial risks in recent years, without especially presenting the potential crisis of the company according to financial problems in 2021. The author decides to make research on Evergrande Real Estate Group Limited combined with its previous operation and recent financial risks to present the company's behaviors of potential financial risks and give warnings to the firms in the real estate industry.

3. The Analysis of Evergrande Real Estate Group Limited and the Chinese Real Estate Industry

3.1 Company Profile

Evergrande Real Estate Group Co., Ltd. (hereinafter referred to as Evergrande real estate) was established in Guangzhou, Guangdong Province, China in 1997, with total assets of trillions, an annual sales scale of more than 400 billion, more than 80000 employees, employment of more than 1.3 million people, and more than 500 real estate projects in more than 180 cities across the country.

Since 2021, Evergrande real estate has faced severe financial risks, including the corporation's operation risks, government policy risks, supply chain risks, bank and investors' credit risks, consumers' market risks, etc.

3.2 SWOT Analysis

The situation of Evergrande Real Estate Group Co., Ltd. (hereinafter referred to as Evergrande real estate) based on SWOT is in the following aspects:

3.2.1 S-Strength

High industry status-top 5 Chinese company with real estate trading amount

Table 1: Rank of top 10 real estate enterprises

Rank	Enterprise abbreviation	Real estate trading amount (Unit: 100 million yuan)
1	Country garden	7588.2
2	Vanke	6203.0
3	Rongchuang China	5976.0
4	Poly developed	5439.0
5	China Evergrande	4612.2
6	CNOOC real estate	3677.3
7	Greentown China	3509.4
8	China merchant property development	3268.1
9	China Resources Land	3158.0
10	Greenland Holdings	2903.0

Data based on 2021 report from Beijing China Index Academy

There are abundant capital assets on Evergrande Real Estate Group Co., Ltd., including company equity, real estate projects, construction land use rights, office buildings, etc. The land reserve alone has 214 million square meters, worth 456.8 billion yuan, and 86.772 billion yuan in cash, which

adds up to 543.5 billion yuan From this point of view, Evergrande is positive with valuable assets.

3.2.2 W-Weakness

(1) Expanded excessively diversification strategy:

Many attempts at diversification strategy failed[1]. After three years of loss of 4 billion, Evergrande Bingquan, together with the milk powder, grain, and oil business, was reluctantly sold by Xu Jiayin for 2.7 billion.

(2) Severe problems of cash flow since 2021:

China's real estate giant Evergrande Group is in a major debt crisis. The information shows that Evergrande now has total debts of 1.97 trillion RMB, equivalent to 2% of China's GDP in a year, involving 155 banks, with interest payments of 300 million yuan a day, and only 86 billion yuan of liquidity on its books.

3.2.3 O-Opportunity:

(1) Relevant positive government policy:

In December 2021, at the request of Evergrande Real Estate Group Co., Ltd., to effectively resolve risks, Guangdong Provincial People's government sent a group to Evergrande real estate group to urge and promote enterprise risk disposal

(2) Other enterprise's successful practices of solving financial risks:

Since 2017, Wanda has started the life-saving road of "selling". For example, Wanda transferred all the equity of its 13 cultural tourism cities and 77 hotels to Rongchuang China and R&F group at the cost of 43.8 billion yuan and 19.9 billion yuan respectively. The successful practice of solving financial risks provided an example for Evergrande.

3.2.4 T-Threat

(1) Restricted government policy:

Since 2020, the central bank has drawn three red lines of financing for real estate enterprises to limit the scale of their loans. Evergrande, which had previously been crazy about land acquisition and expansion, must have stepped on all three red lines. As a result, the old way of paying off old debts with new debts influenced the company's cash flow and brought severe financial risks.

(2) Negative news influenced interest parties' confidence:

According to public news, Evergrande's sales decreased by 38% in 2021. With low income and large expenditures, Evergrande can only deal with it by constantly selling assets. The stock price of the company declined and the confidence of investors and consumers also decreased. These reactions can harm to Evergrande's financial situation.

3.2.5 SWOT Conclusion

According to a previous analysis of SWOT, Chinese real estate enterprises are confronted with opportunities and challenges[5].

As for the opportunities, they should take advantage of companies' strengths, accelerate asset flow, and provide sufficient cash flow to avoid financial risks[2]. Nowadays, governments' positive policies offer a chance of easing the enterprise's financial crisis. Evergrande group will earnestly fulfill its main responsibility, go all out and do everything possible to ensure project construction and complete real estate delivery with quality and quantity.

As for threats and weaknesses, the basic problem is the lack of cash flow to support the company's normal operation, no matter high debt or credit crisis. Evergrande can imitate Wanda and

sell assets or sell houses at low prices. Evergrande still has many assets, such as company equity, real estate projects, construction land use rights, office buildings, etc. These assets can be sold and paid back debts. The purpose is to obtain more cash flow to repay debts. Besides, facing three red lines, Evergrande should reduce liabilities, accelerate sales and promote cash return.

4. Research of Financial Risks at the Evergrande Real Estate Group Limited

4.1 Financial indicators of the Evergrande Real Estate Group Limited and Comparisons

4.1.1 Basic Analysis

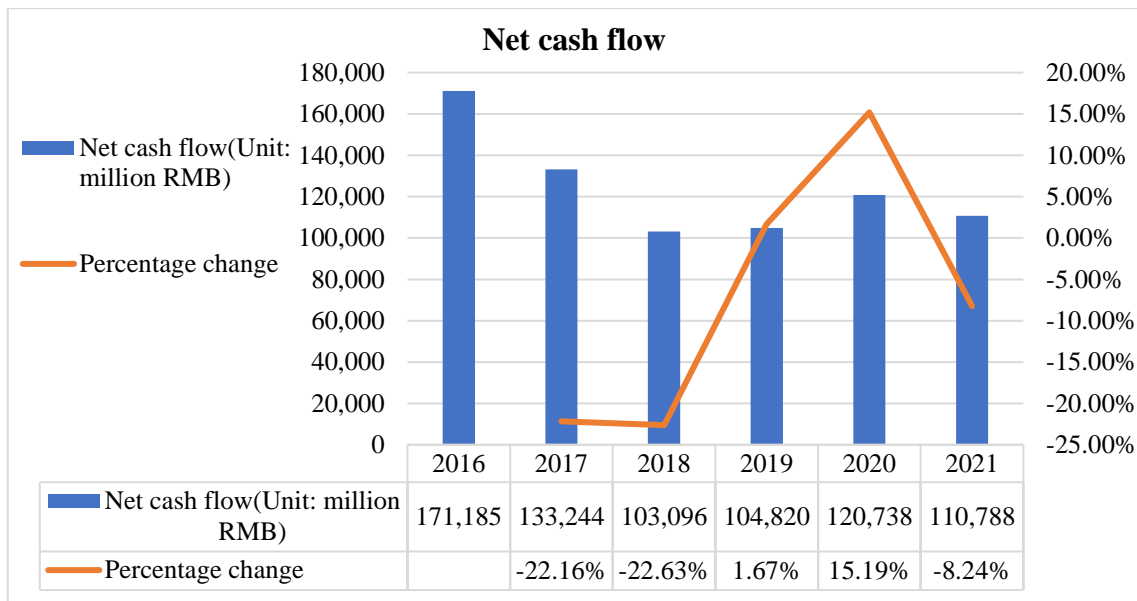


Figure 1: Net Cash Flow of the Evergrande Real Estate Group Limited

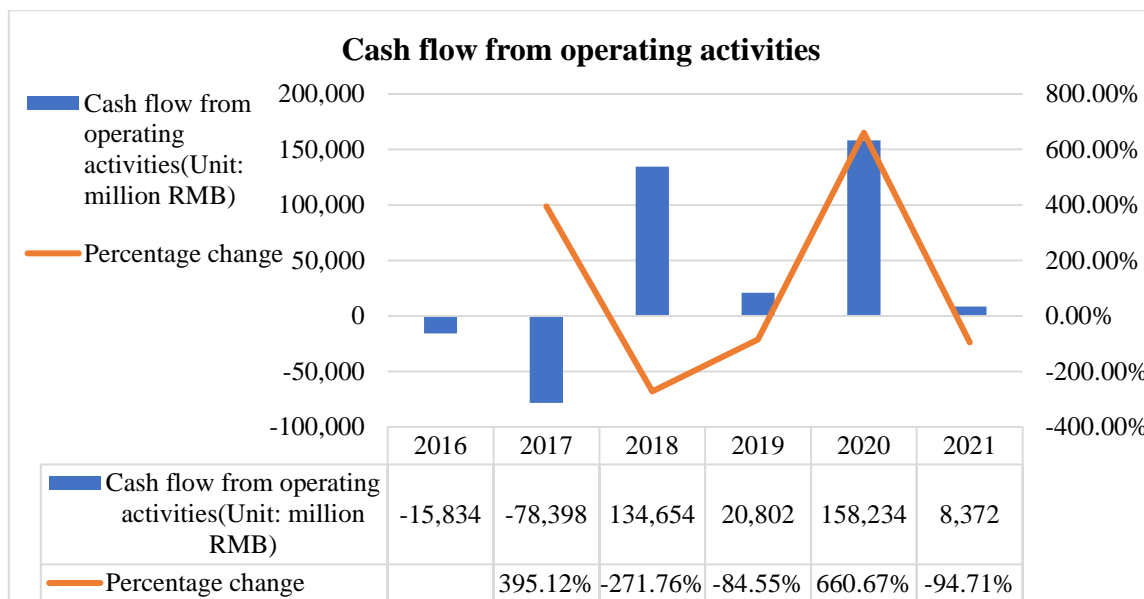


Figure 2: Cash Flow from Operating Activities

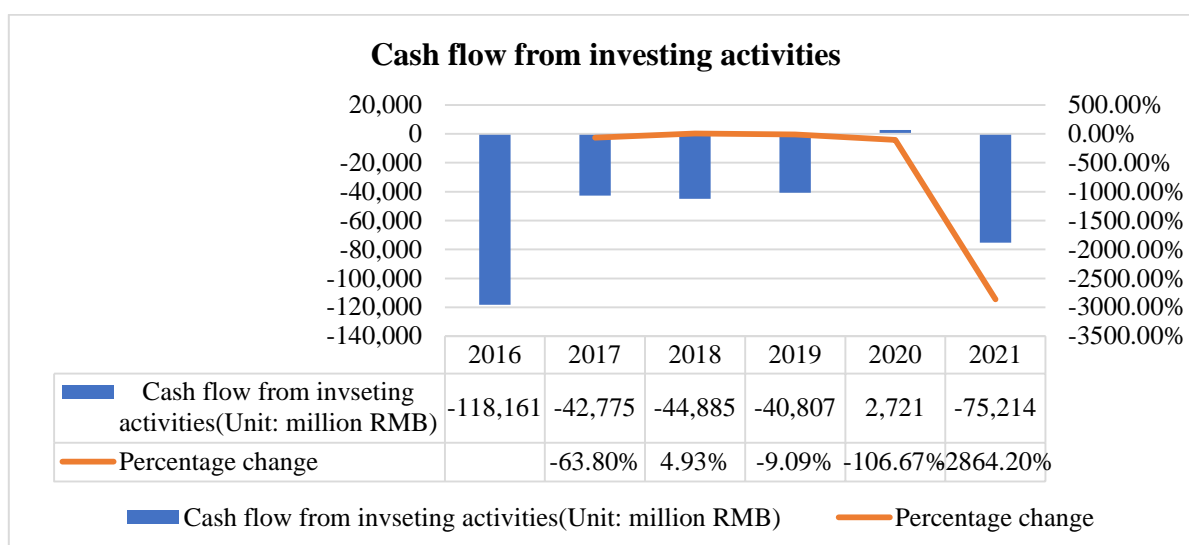


Figure 3: Cash Flow from Investing Activities

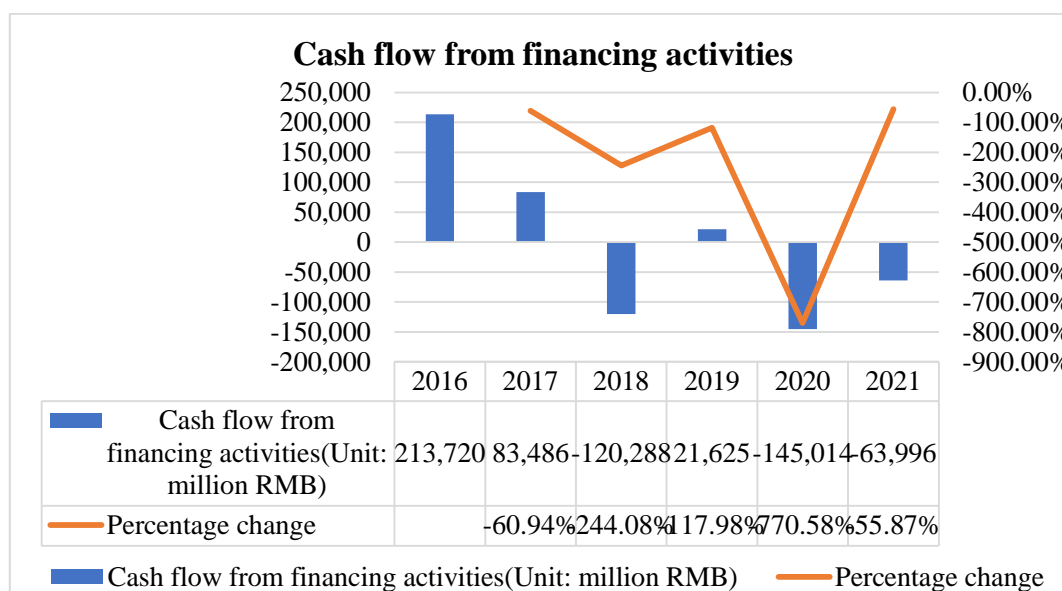


Figure 4: Cash Flow from Financing Activities

Since Evergrande's 2021 financial statements were not publicized at the writing stage, all relevant company's 2021 financial data are forecasted from the financial statements for the first half of 2021.

Cash flow reflects the impact of business activities, investment activities, and financing activities on cash and cash equivalents within a certain accounting period. From the above figure, we can see that the net cash flow from the operating activities of Evergrande Group Co., Ltd. increased from 2018 to 2020. It shows that the Evergrande group's operation is relatively good, and the company has strong cash creation ability in operating activities. And there is still a certain surplus. However, the Evergrande group should also focus on observing its operating conditions. The lack of vigilance against financial risks led to the outbreak of Evergrande risk in 2021, especially in cash flow from investing activities.

4.1.2 Short-Term Liquidity

According to the specific indicators of Evergrande Group Co., Ltd., its inventory and other non-current assets are relatively small. Therefore, there is little difference between its current ratio and quick ratio. Both are above 1. Therefore, from the short-term debt repayment capacity table of Evergrande Group Co., Ltd. in the above table, the company has good debt repayment capacity, which is also corresponding with SWOT-strength: affluent assets.

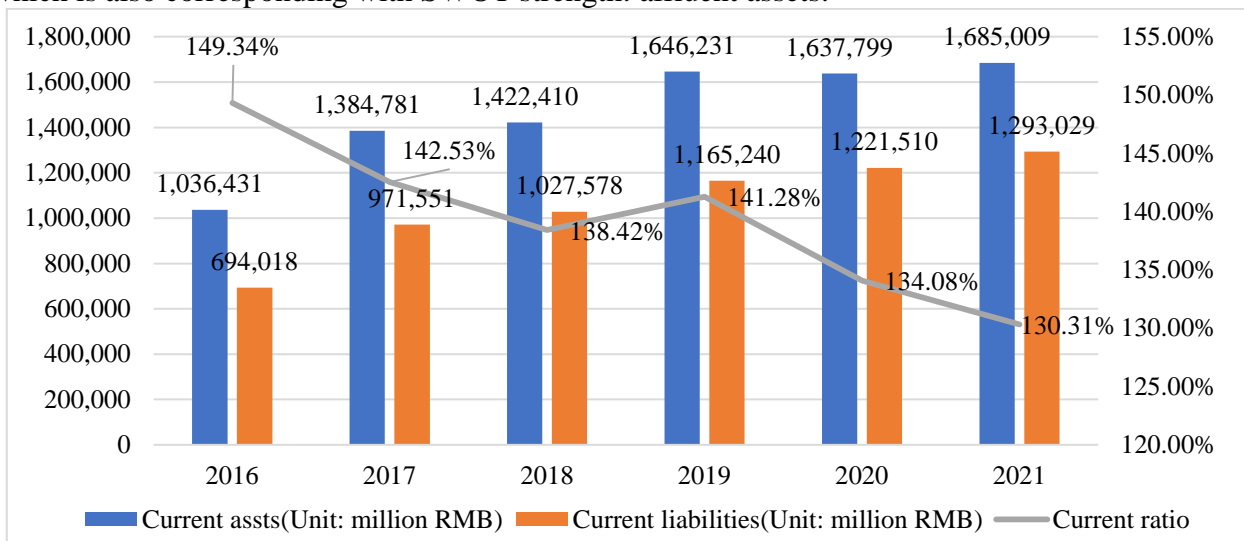


Figure 5: Current Ratio of Evergrande Group

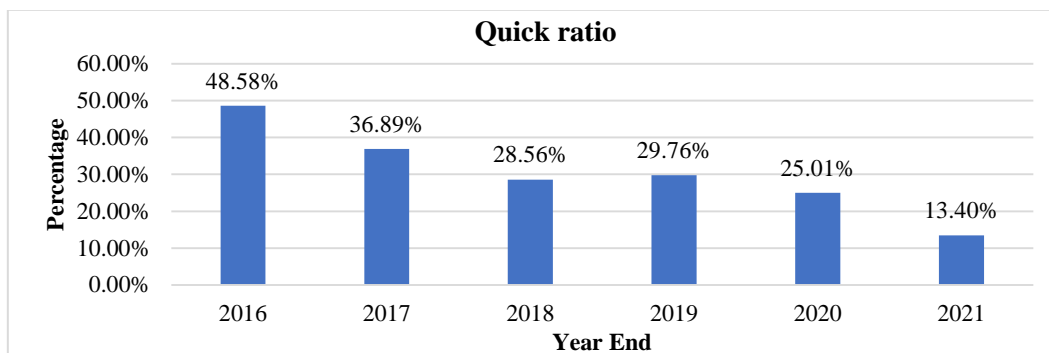


Figure 6: Quick Ratio of Evergrande Group

4.1.2 Long-term Liquidity

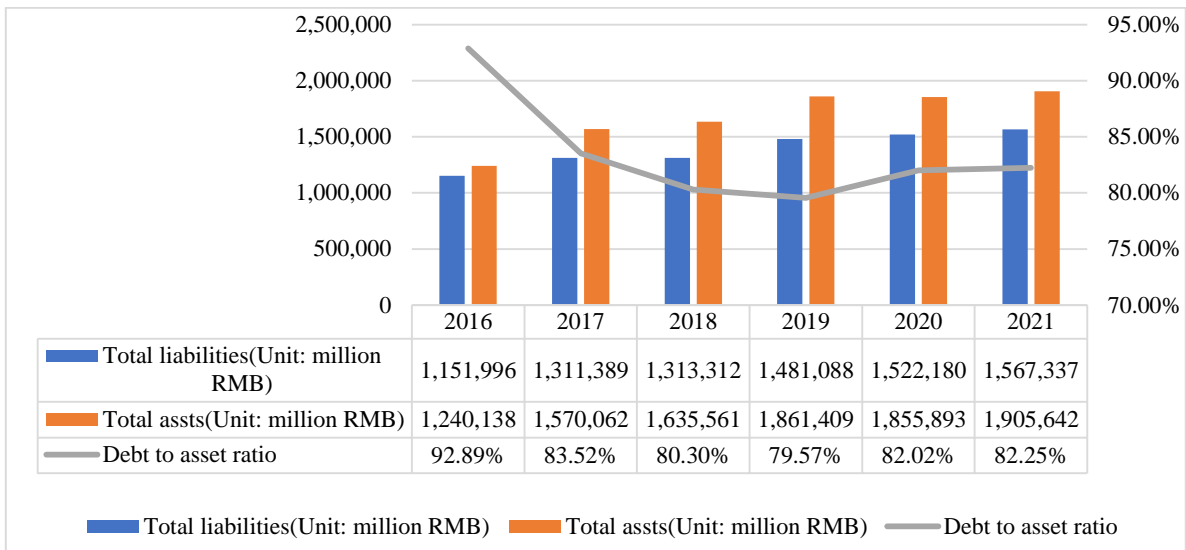


Figure 7: Debt to Asset Ratio of Evergrande Group

As can be seen from the above figure, the asset-liability ratio of Evergrande Group Co., Ltd. remains between 0.8 and 0.9, and the equity ratio fluctuates around 6. Therefore, the enterprise managers of Evergrande Group Co., Ltd. emphasize the suitability of the asset-liability ratio, because the liability ratio is too high with high risk, and the proportion of property rights is higher than 1. It is generally believed that the asset-liability ratio is higher than 0.5. Therefore, from the asset-liability ratio index and property right ratio index, Evergrande Group Co., Ltd. has weak long-term solvency.

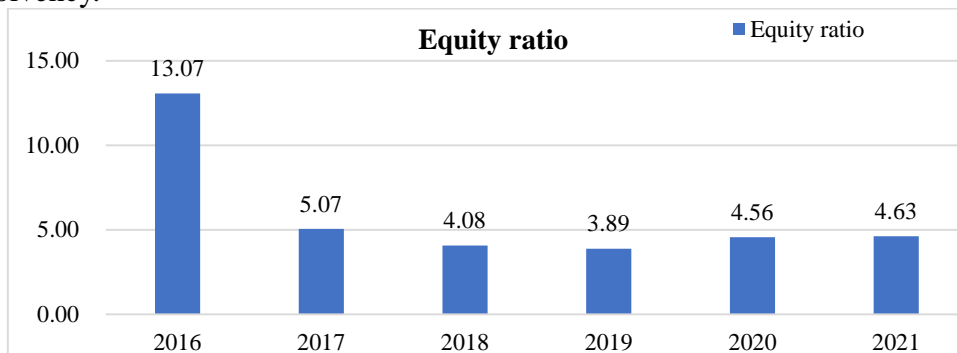


Figure 8: Equity Ratio of Evergrande Group

4.1.3 Operational Capacity Analysis

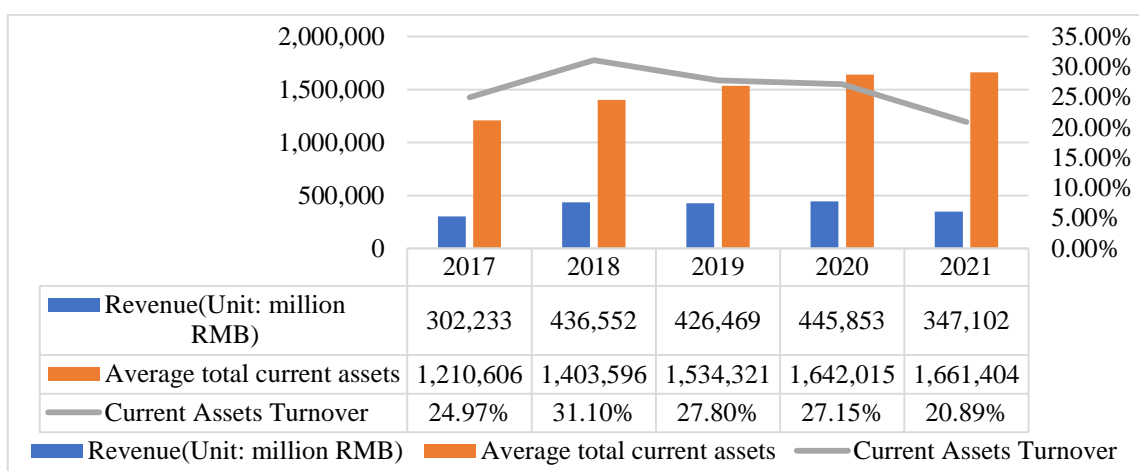


Figure 9: Current Assets Turnover of Evergrande Group

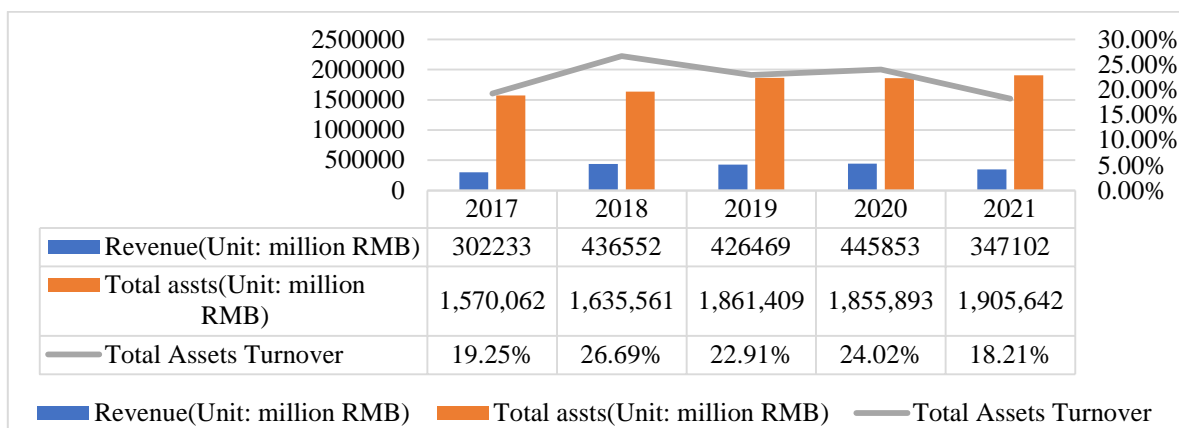


Figure 10: Total Assets Turnover of Evergrande Group

The author mainly evaluates the company's asset operation ability from the operation status of current assets and total assets, which reflects the efficiency of the company's asset use. The higher the efficiency, the better the sales of the company's products and the better the recycling policy of the company's products. Enterprise needs to improve their short-term solvency and improve their capital utilization. If the cash remittance is overdue, the cash flow will shake. Based on the charts, Evergrande has faced severe operation risks since 2021 because of sudden low assets turnover.

4.1.4 Profit Index Analysis

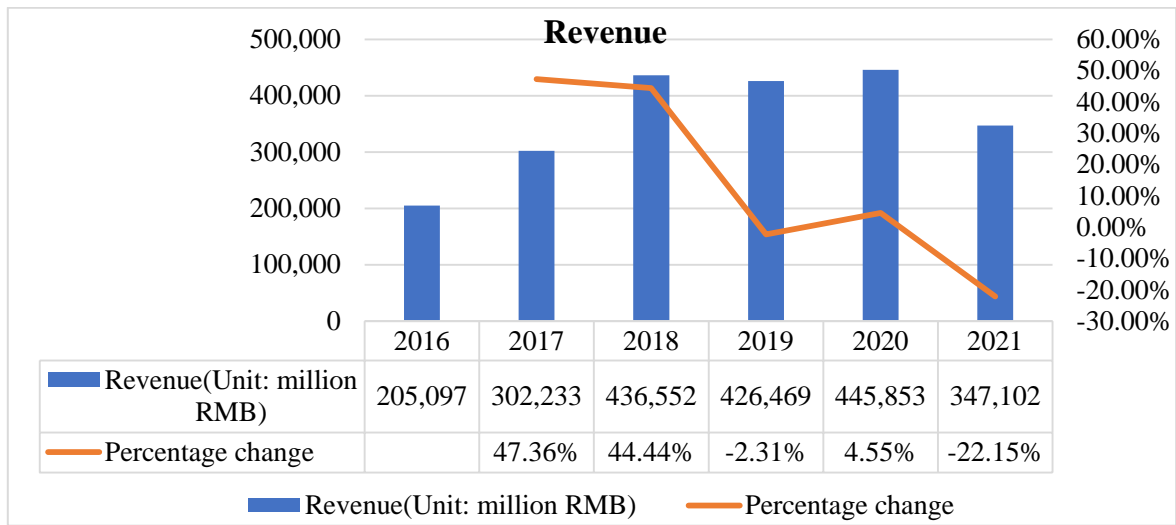


Figure 11: Revenue of Evergrande Group

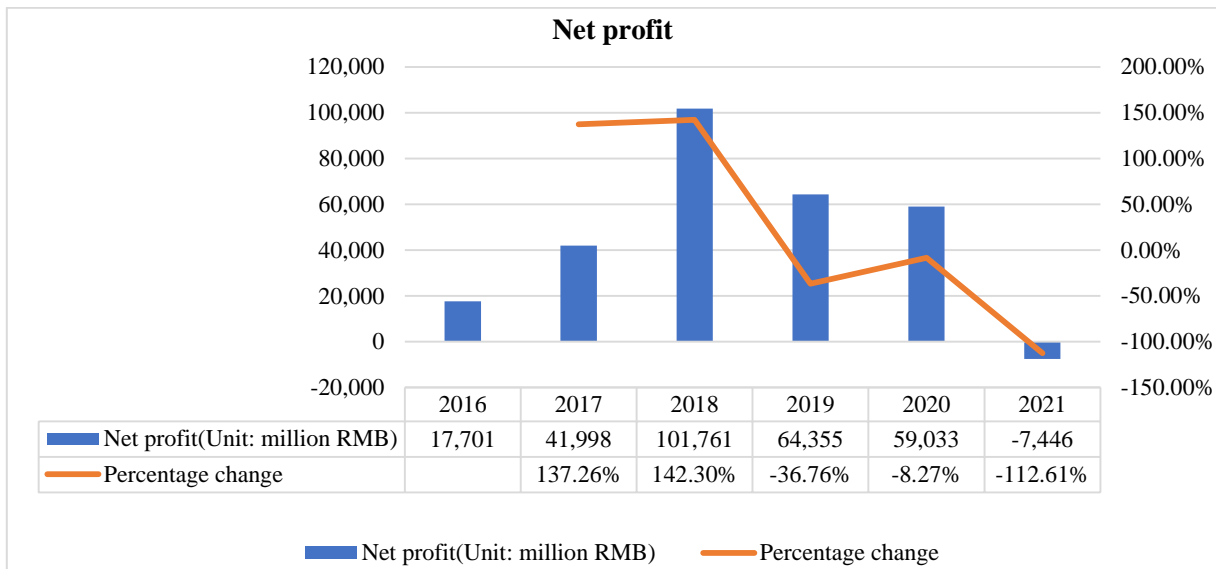


Figure 12: Net Profit of Evergrande Group

The gross profit margin reflects the profitability of the enterprise. It can be seen from the above figure that the operating profit margin of Evergrande Group Co., Ltd. maintained an increasing state from 2017 to 2018, indicating that the company's product profitability and corporate financial status were strong in the past two years. However, during 2019-2021, the operating revenue, profit, and gross profit margin, the profitability of the company's products, and the company's financial situation are poor.

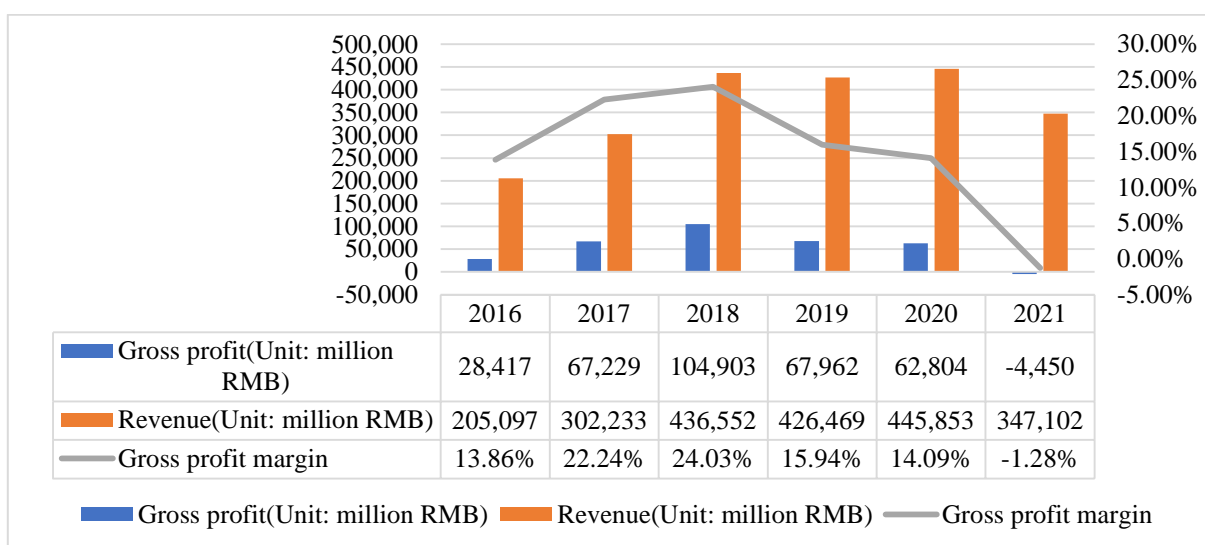


Figure 13: Gross Profit Margin of Evergrande Group

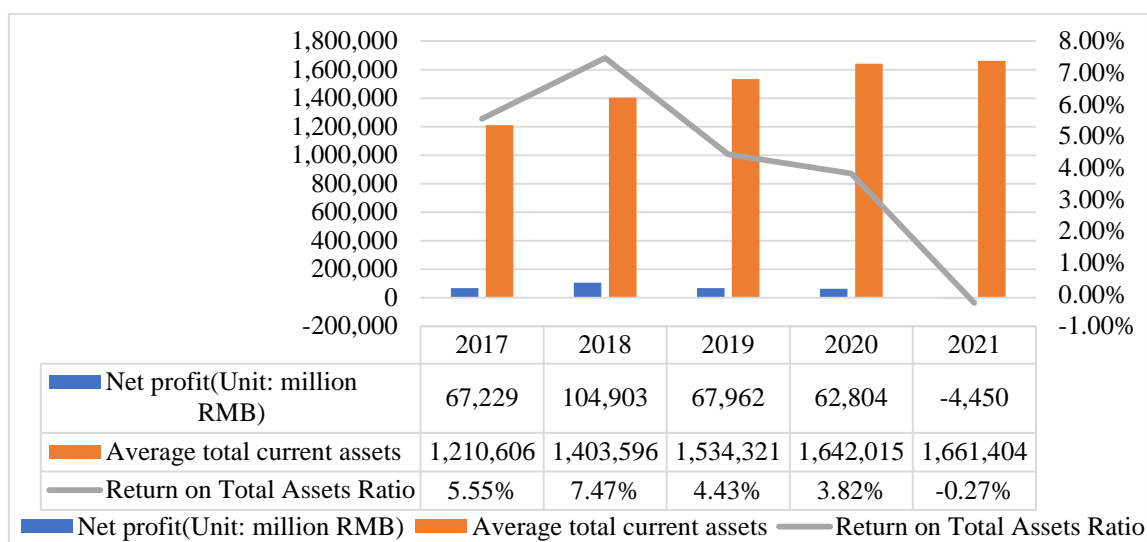


Figure 14: Return on Total Assets Ratio of Evergrande Group

The rate of return on total assets is the ratio of the rate of return on total assets to the average amount of assets, which reflects the overall profitability of the enterprise. According to the analysis in the above table, the return on total assets of Evergrande group increased by two percentage points in 2018 compared with 2017, indicating that the higher the input-output level of the enterprise, the more effective the asset operation and the stronger the profitability. However, since then, the rate of return on total assets has been falling, indicating that Evergrande's profitability has deteriorated.

4.1.5 Growth and Development Capability Analysis

Based on the basic analysis of total assets growth rate in recent years, Evergrande's enterprise-scale continues to expand. The rapid asset growth shows that the company has good growth and still has the potential to continue to grow in the future.

The decline of net asset growth rate is accompanied by fluctuations, indicating that the Evergrande group has a low-income level, the expansion speed of enterprise capital scale is slow, and the enterprise operation has weak development potential.

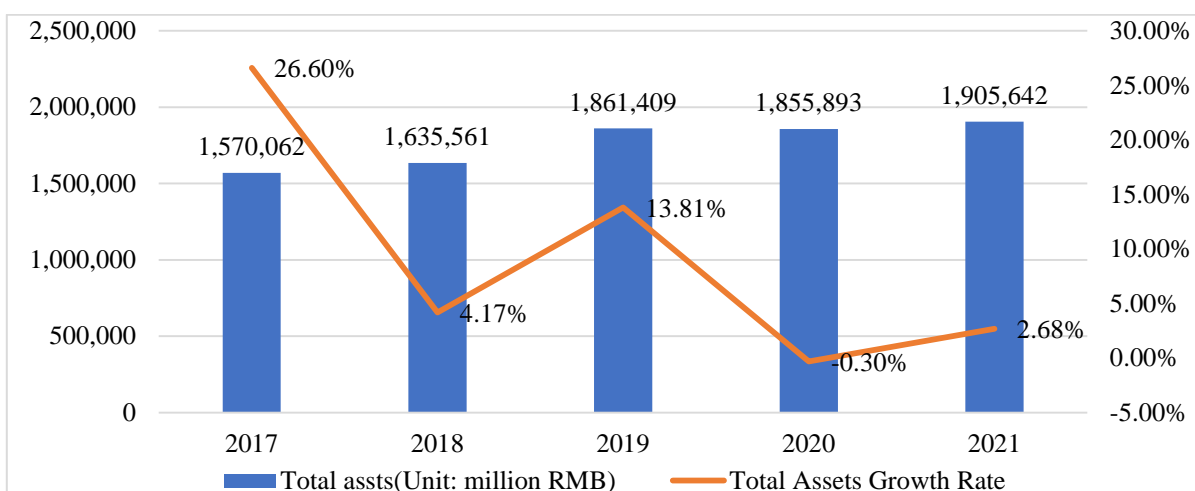


Figure 15: Total Assets Growth Rate of Evergrande Group

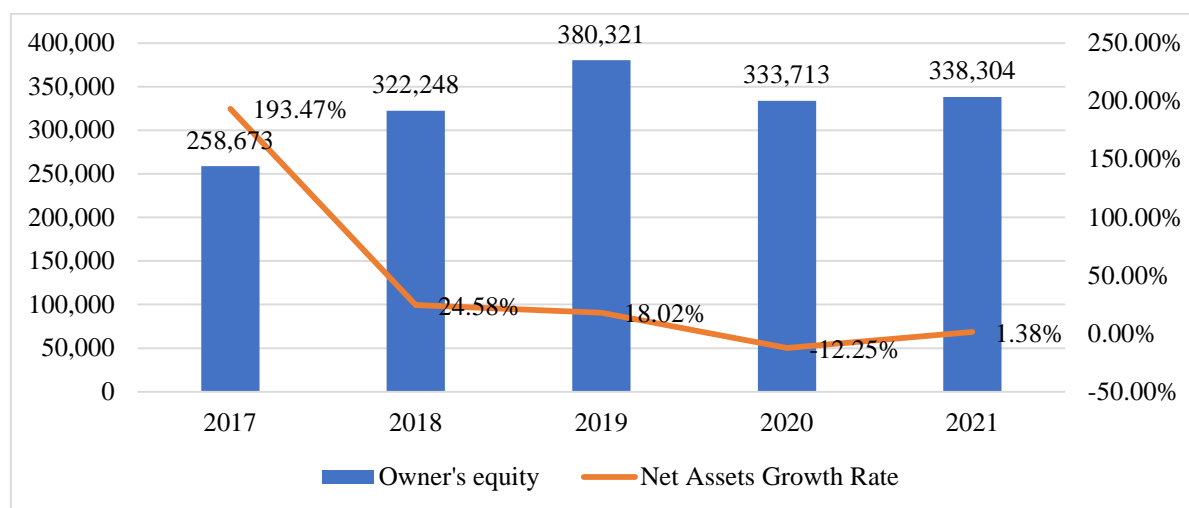


Figure 16: Net Assets Growth Rate of Evergrande Group

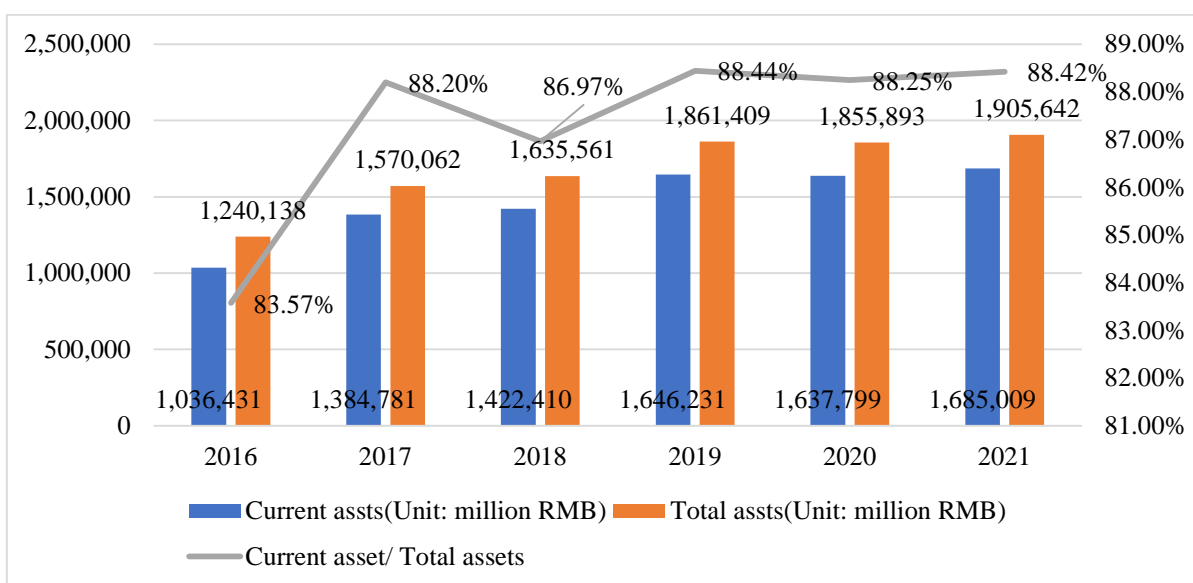


Figure 17: Current Assets/ Total Assets of Evergrande Group

4.2 Financial Risks at the Evergrande Real Estate Group Limited

Corporation's operation risks. The risk of the Evergrande group mainly comes from its poor management and blind expansion.

As for its diversification strategy, the main risks are as follows. First, internal integration risk. The implementation of the diversification strategy will disperse the original financial flow, logistics, decision-making flow, and personnel flow within the enterprise. There are objections and conflicts due to participation in different business areas, and Evergrande has internal integration risk. Secondly, there is a squeeze risk with the original operating industries. Evergrande implementing a diversified management strategy must enter new fields and operate new industries, which will disperse some resources to new industries and fields. The resources of enterprises are limited in essence, which will inevitably lead to the reduction of resources owned by the original industry, so there is a squeeze risk with the original industry. There are exit risks when enterprises implement diversified management strategies. To implement the strategy of diversification, Evergrande must investigate new fields and industries. Even through rigorous research, Evergrande may make investment mistakes and fail in operation, so it needs to exit and generates exit risks.

Besides, in terms of Evergrande's financial risks, cash flow is significant for its development[3]. Based on previous analysis of financial indicators of the Evergrande real estate group limited and comparisons, Evergrande's crisis of finance occurred in 2021 because of the lack of cash flow. Evergrande's commercial tickets were not cashed when they were due. Financial companies exploded, commercial tickets could not be cashed, real estate was shut down, employees left, and stocks fell.

5. Government Policy Risks

Evergrande risk is the inevitable result of adhering to the national positioning of housing, housing, and non-speculation, superimposing three red lines and a loan concentration management system.

Since the government issued "three red lines" for real estate enterprises, the financial pressure of the Evergrande group has been burdened. Because the three red lines have broken through and Evergrande belongs to the "red" file, developers can no longer increase "interest-bearing liabilities".

6. Supply Chain Risks

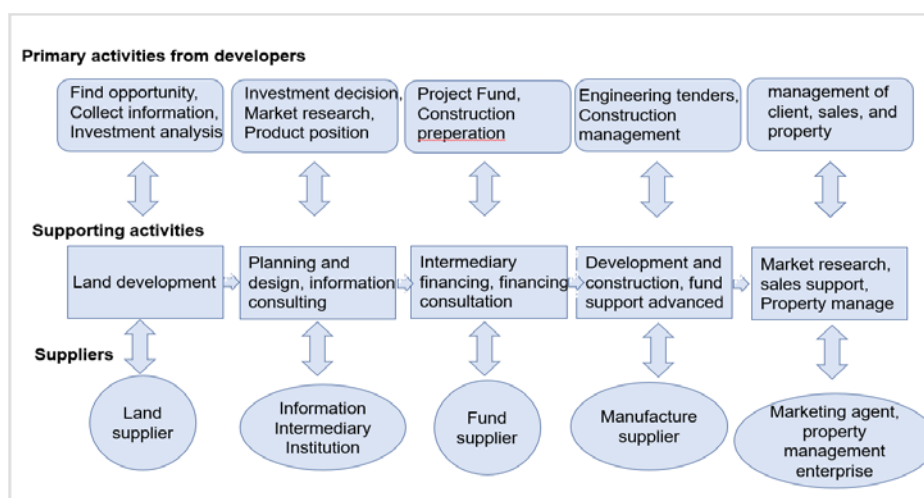


Figure 18: Supply chain analysis of Evergrande Group

Evergrande's own business has been seriously affected. Evergrande group said in its announcement on August 31 that some projects of the group were suspended because some payables related to real estate development were overdue. In addition to the projects under construction, the land previously photographed by companies under the Evergrande group was also recovered due to failure to pay fees in time.

7. Credit Risks

Financial debt accounts for about one-third of the total debt of the Evergrande group, with a relatively decentralized structure and a small amount of financial investment. When an enterprise bears huge debts, the most terrible thing is not the lack of cash in its hands, but the run, loan interruption, and business suspension caused by the credit collapse.

The Evergrande group is unlikely to raise a large number of funds through public bond issuance, and it is more difficult to obtain financing from banks, trusts, and funds. Evergrande was threatened by shares and debts.

8. Consumers' Market Risks

Consumers are losing confidence in the auction house rental and sale systems. The Evergrande incident has made ordinary people dare not buy future houses. Financial institutions are connected to developers at one end and buyers at the other. The funds of financial institutions come from the deposits of the broad masses of consumers, which requires absolute safety. Once developers faced a financial crisis, not only the development loan cannot be recovered, but also the bank loan of home buyers.

9. Warnings and Suggestions of Financial Risks in the Chinese Real Estate Industry

9.1 Suggestions and Warnings to the Real Estate Enterprises

These companies ought to pay attention to financial indicators, including sudden large amount number's change, trends, and requirements of financial policies. For instance, the recent issued "Three Red Lines" policy restricted the liabilities of companies and promoted their positive development. Real estate enterprises need to adjust their financial situation to avoid being selected into the range of red line. Real estate enterprises form stable financial policy expectations, reasonably arrange their business activities and financing behavior, correct the blind expansion of some enterprises and enhance their anti-risk ability.

High leverage is a common feature of China's real estate enterprises. Restricting financing is to limit the external "blood supply" of real estate enterprises. In the future, real estate enterprises can only rely more on their own "hematopoietic function". In terms of reducing the scale of liabilities, in addition to selling houses and land, real estate enterprises reduce loans, there is another way: cooperative operation projects. From the real estate data in 2021, Evergrande, Greenland, and R & F, the three real estate enterprises with heavy debt, have a sales equity ratio of more than 90%. This shows that there are few cooperation projects. In the past, almost relying on their power to get land, real estate enterprises naturally had to shoulder higher leverage. Under the condition of tightening financing policies, more real estate enterprises may consider project cooperation in the future.

10. Conclusions

The paper takes Evergrande Real Estate Group Limited as an example to define the financial

risks of the real estate industry. Through real estate industry research, cash flow analysis, various financial indicators, and relevant risks brought by real estate industry participants (governments, banks, suppliers, consumers, etc.) to enterprises, the author summarizes the commonalities, gives potential financial risks, and provide warnings to other enterprises in the real estate industry.

Confronted with various financial risks, including the enterprise's operation risks, credit risks, government's policy risks, and consumers' market risks, real estate enterprises should take advantage of strengths and opportunities, make improvements for the weaknesses, and avoid threats according to the condition of politics, economy, society, and technology development[6]. The author made a research on these financial indicators via the annual financial report of Evergrande Real Estate Group from 2017 to 2021. Based on the analysis of financial data, such as cash flow change, profitability, short-term and long-term liquidity, operation capacity, and growth and development capacity, the typical financial problems of real estate enterprises are presented.

As for these problems and industrial structure, the author provided relevant warnings and suggestions to real estate enterprises and the whole industry. High leverage is a common feature of China's real estate enterprises. In terms of reducing the scale of liabilities, in addition to selling houses and land, real estate enterprises reduce loans, there is another way: cooperative operation projects[4].

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