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Asset and Debt Management of Chinese Development Company Evergrande

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Abstract

Evergrande, a real estate giant with a presence in over 280 Chinese cities, was the most prominent developer. With over \$300 billion in debt, it teetered on the brink of default for months, bouncing back from the brink each time thanks to last-minute repayments. In 2020, the world's most indebted developer, Evergrande, has liquidity problems. Evergrande warned officials that payments due from 2021 could trigger a liquidity crunch and potentially lead to cross defaults in the broader financial sector. Real estate in China is the main investment for most investors. This is about 75% of the wealth of a typical household. For comparison: in the US, real estate is about 35% of the wealth of the average household. All this led to an indecent increase in real estate prices and speculation in the housing sector. It can be assumed that the banking sector and the company's suppliers will be the least affected in the event of a default. Under the greatest impact are the company's customers, both buyers of unfinished housing, and consumers of financial products. It is worth paying attention to China's policy towards developers. China, aware of the debt burden of developers, limited access to debt financing with the "three red lines" policy, which caused the real estate market to cool significantly. This results in less construction and less demand for raw materials, which directly hurts Chinese developers and miners due to China's high share of raw material consumption.

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Keywords

Assets, debts, real estate, construction, liquidity, default, bonds.

Introduction

China Evergrande Group is an investment holding operating in various fields, as well as the largest residential real estate operator in Guangdong province and one of the largest real estate operators in China. It is ranked 31st among the largest companies in China in the global Forbes list [The collapse of the developer Evergrande..., [www](#)]. In addition to real estate operations, Evergrande is engaged in construction, tourism, hospitality, theme parks, healthcare, electric vehicle manufacturing, sports and entertainment businesses. The company's minority shareholder is Jack Ma, CEO of Alibaba Group. The company expanded "in debt" and actively invested in football and electric cars.

Evergrande expanded for many years due to debt. The company's dollar bonds had a very generous coupon rate – for example, 8.75% per annum. The company accumulated a lot of debts, because it had to borrow more and more.

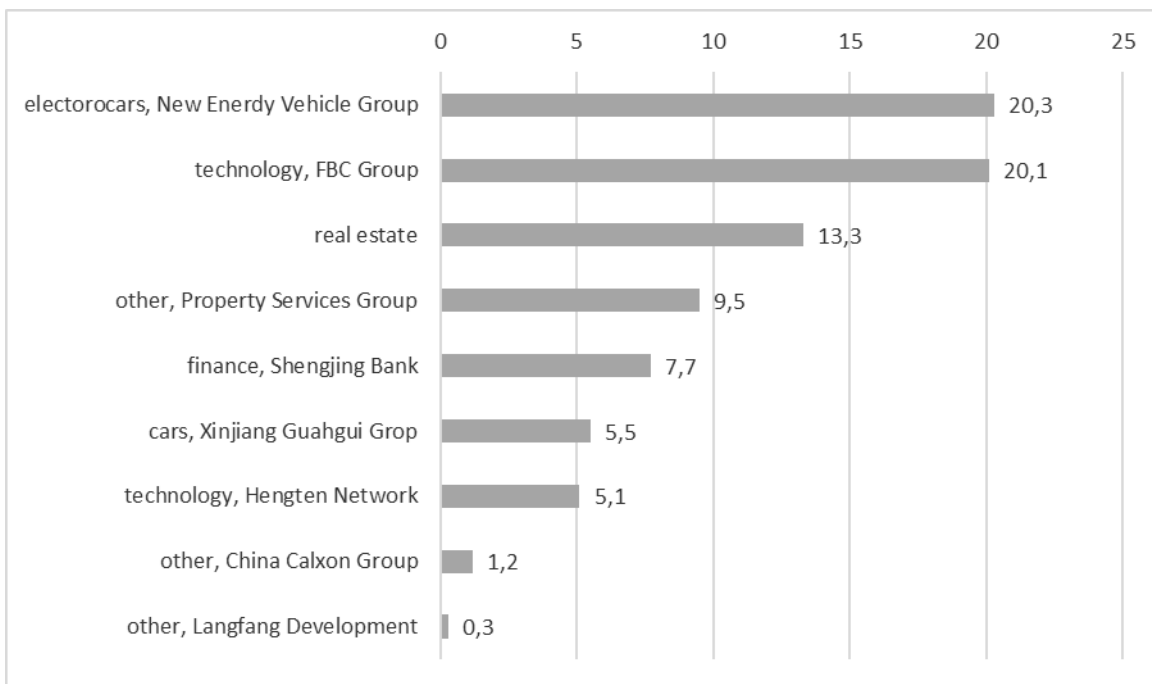


Figure 1 - Evergrande assets in different industries, billion dollars [History of Evergrande, [www](#)]

Evergrande's problems were obvious to everyone a long time ago: Western observers called the company a pyramid scheme back in 2017. So, almost a year ago, she had to pay \$13 billion in penalties to investors, but they refused to exercise their right. During this period, the connections of the company's management in high echelons helped.

But this did not help the company much: limited access to loans led to delays in payments to counterparties, and in a year the situation reached its current state. In the process, by the way, the company's management forced employees to invest in Evergrande projects.

Not so long ago, on accounts totaling \$ 34 million, Evergrande paid off with unfinished properties – and it became clear that a default was very likely.

Many investors and large funds rely on coupon payments from Evergrande and eventually redemption of their bonds. If they receive less of them, this may affect their investment activity: it will become more conservative.

The company owes about \$110 billion in bonds and loans, which is already a very large amount. But that's not all. If we count Evergrande's debts to employees and contractors, then the total amount of debt is approximately \$300 billion.

There are other companies in the Chinese construction market with large debts at high interest rates. The situation with them will depend on how things develop with Evergrande. There are risks of major bankruptcies of a succession of companies in the sector.

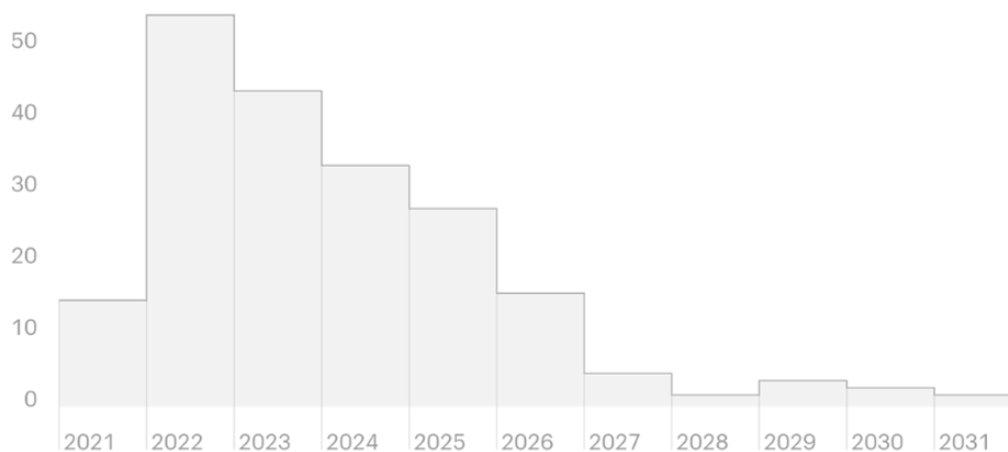


Figure 2 - The amount of dollar debts of Chinese construction companies that need to be repaid (billion dollars) [Crisis from China..., www]

According to Bloomberg, Chinese authorities have already warned lender banks that the planned interest payments on Evergrande loans should not be expected. At the same time, the company hired external consultants to help restructure the debt – from the American company Houlihan Lokey, who had already worked with the bankrupt businesses of Enron, Lehman Brothers, Luckin Coffee, and Admiralty Harbor Capital.

Looking for a solution, the company's management considered selling its stake in the electric vehicle business, as well as real estate management. Negotiations are also underway to sell the 26-story China Evergrande Center, which serves as an analogue of the company's headquarters in Hong Kong. If Evergrande fails to find new funding, it will be unable to pay suppliers or complete major projects. Now most of the company's working capital is directed exclusively to the completion of projects that have been started, but the available money is not enough even for this.

Evergrande did acknowledge the possibility of defaulting on the debt if it fails to find buyers for the assets, and noted that it has not yet been able to sell the office buildings put up for auction in Hong Kong as scheduled. To solve the problem, the company is actively selling off its assets, including investment properties, hotels and other property.

Until recently, Evergrande seemed to have weathered the corona crisis well, boosting sales in 2020, up 51.3% year-over-year in June. However, in 2021, the company reported an 88% decline in summer real estate sales, with sales of \$11.12 billion in June, \$6.8 billion in July and \$5.91 billion in August, down 26% than in August last year. The company forecasts a further decline in real estate sales, which will affect the company's cash flow and liquidity.

At the end of June 2021, Evergrande's annual debt was \$37.27 billion (bills and trade payables due to contractors over the next 12 months), down 28.5% from the same period in 2020. At the same time, the amount of the company's cash (\$13.48 billion) was three times less than this amount.

Evergrande shares on the Hong Kong stock exchange have been falling since February 2021 and have already fallen by more than five times (from \$15.8 to \$2.97, which is even lower than the stock quotes during the company's IPO in 2009, when they were \$4.05) [How the collapse of a Chinese developer threatens a new global crisis, [www](#)].

Due to the company's threat of default, credit rating agency Fitch downgraded its long-term debt rating to the lowest level of 'CC', which is four notches lower than investment grade debt. The company's specialists believe that the downgrade reflects the developer's approaching default, the credit risk is high due to a lack of liquidity, and a decrease in contract sales. Moody's Investors Service also downgraded Evergrande to its lowest 'C' rating.

Thus, Evergrande's problems and its possible bankruptcy could lead to problems for other sectors of the Chinese economy, including banking.

Analysts see the similarity of the Evergrande case with the situation preceding the 2008 crisis in the fact that the Chinese developer, like Lehman Brothers then, accumulated a large amount of so-called junk bonds, being their largest issuer in Asia, while the company's "hidden" debt may exceed the "official" one.

Analysts at SC Lowy say that if Evergrande defaults on its debts and starts the restructuring process, there is no reason to think that this will be the end of it. There are other indebted developers who have the same liquidity problems [The Central Bank of China will rescue domestic investors Evergrande, [www](#)].

The Chinese government will now have to develop new mechanisms to manage the debt crisis in companies like Evergrande. In the past, Chinese authorities have bailed out firms with bad debts that mattered to the economy. For example, China Huarong is the largest financial asset and debt management company. Its debt amounted to \$15.9 billion, and state-owned enterprises brought it out of the crisis through recapitalization, so this did not entail a large-scale collapse of the industry. True, Evergrande's debt is 20 times greater than that of China Huarong. In addition, a significant part of Evergrande's assets currently consists of 60% unfinished objects. According to Bloomberg, the company could have been saved if these assets were bought from them by a state-owned enterprise that has a lot of cash, but no one is willing yet.

Evergrande is really too big to fail (too big to fail), however, that's what they said about Lehman Brothers. The company builds 600,000 homes annually, projects in 229 cities, and generates more than 3 million jobs. This means that the possible bankruptcy of the company will lead to the collapse of the Chinese labor market, leaving a significant part of the population without work. The consequences of not paying the debt could also hit the country's economy: Evergrande owes money to 171 banks and 121 financial institutions.

However, in the short term, we can expect not a financial crisis, but a collapse in the real estate sector. Evergrande's sell-off, which is in urgent need of cash, could trigger a collapse in prices and serious problems for other Chinese developers. In addition, they note that the Chinese authorities are more in control of their financial system than the US in 2008. Most experts predict a managed bankruptcy of the company, during which the authorities will try to protect the interests of small investors. We do not think that the government is interested in buying Evergrande and pushing the company to the fall, it will not either.

Methods

In the study, the authors used some methods such as analysis and synthesis, induction and deduction, historical and logical, abstraction and concretization.

Results

We can say for sure that inside China, after the whole story with Evergrande, the standards for issuing loans will begin to tighten. And this is a problem, because the Chinese corporate sector is heavily indebted, even when compared to the US. This means that the pace of development of the Chinese economy depends on the ease of obtaining loans within China.

In fact, the rate of issuance of loans began to fall even before everyone started talking about Evergrande, which led to a recorded slowdown in the Chinese economy. Inside China, if lending standards are further tightened, it will become harder to borrow money. The same will apply to loans outside of China: investors will demand higher returns from all borrowers from China due to increased risks. All this may negatively affect the plans of the Chinese corporate sector for investment and business development.

The default of Evergrande with its 1,300 properties will certainly lead to a serious drop in property prices, as there is no lack of supply in the market. If Evergrande goes bankrupt, a huge amount of unfinished housing will flood the market, and this will drop housing prices even more. Given that many Chinese households have invested in real estate and tied their financial aspirations to speculating in it, one can expect at least a strong decline in consumption, and at the most a string of individual bankruptcies.

By the way, sales of land for construction account for 30% of the income of local municipalities in China, so the worsening situation in the construction industry will also affect them and will affect the level of investment in the regions.

Many of Evergrande's competitors – such as China Resources Land, Country Garden Holdings, China Overseas Land & Investment and Longfor Group Holdings - are doing better. But the tightening of credit standards within China and the fall in property prices could lead to the bankruptcy of weaker developers, which will further lower housing prices and, again, will affect the economy as a whole.

In principle, taking into account all of the above, an economic crisis within China is quite possible, with a drop in activity in almost all sectors. In addition, Evergrande has 200,000 employees – and every year it hires 3.8 million people as subcontractors. The immediate disappearance of such a large enterprise will negatively affect the situation for everyone who worked with Evergrande and simply depended on the demand from those who worked for Evergrande.

First, the quotes of all Chinese companies may fall sharply. Second, US companies with a significant share of sales in China could be hit hard, as their stocks have already been hit, if it comes to a full-blown recession in China.

Thirdly, a noticeable drop in prices for raw materials, in particular for iron ore, is likely due to investors' expectations regarding a decrease in demand in China. This will be bad for companies involved in the extraction of raw materials. However, here everything will depend on the duration and severity of the recession in China – provided that such a recession does happen.

Fourth, investors may take the news in China as a reason to set up a massive sell-off in the US in anticipation of a new economic crisis.

Fifth, the cost of borrowing for the corporate sector will rise not only in China, but also in other developing countries. The fall of Evergrande has already led to a decrease in investor interest in bonds from China.

If the company goes bankrupt, default rates for Chinese bonds will rise from 3% to 14%. Such a spike would hurt the reputation of all Chinese borrowers and make it harder to access Western capital markets for all Chinese companies: Chinese bond yields are now at 14% per annum – well over 7.4%

this year. Surely this will indirectly affect the bonds of all developing countries, including the Russian Federation: in such situations, Western investors usually get rid of all non-Western assets [What is the Evergrande debt crisis and why does it matter for the global economy, [www](#)].

Recommendations and conclusions

The situation in the construction market depends on the position of the Chinese government. It can be assumed that it is unlikely that it will redeem the company's debts: this will set a bad example for all other indebted borrowers.

Evergrande has assets, and with skillful management of the bankruptcy process, the consequences of a default will be leveled. But serious damage to the company cannot be avoided [Why the Fate of Troubled Property Developer Evergrande Group Is Posing a Huge Headache for China, [www](#)].

The situation with the company was not a secret to anyone. Everyone knew about her problems, but continued to lend to her. How many more of this Evergrande the Chinese economy is fraught with for all investors is a mystery. 99% of those who talk about Evergrande now learned about it just the other day [How the collapse of a Chinese developer threatens a new global crisis, [www](#)].

These problems exist throughout the industry. Evergrande has only the most debt.

Four other major Chinese property developers are in a precarious position. Their dollar-denominated bonds collapsed due to fears from foreign investors that these bonds could not be refinanced after expiration, which would mean a default. These concerns have further limited the ability of these developers to issue new bonds to refinance maturing bonds and pay current investors.

When investors belatedly freaked out after years of being greedy for hype and hype, debt-laden companies found themselves in a vicious cycle. And suddenly the denouement begins, and everyone is wondering what will be left for them when the time comes to sort out the ruins.

The four developers in question are Fantasia, China South City Holdings, Guangzhou R&F and Xinyuan Real Estate Co. Their bonds fell below 60 cents on the dollar, and in some cases below 50, indicating a high probability of default [What will happen if Evergrande collapses..., [www](#)].

Other developers have already defaulted. Since the beginning of 2022, developers have defaulted on \$6 billion of debt, which is about 5 times more than in 2021 [ibid.].

So far, developers with less leverage and lower ratings are doing better.

Perhaps the biggest losers will be the foreign investors buying these bonds, not the Chinese banks; and for a financial crisis to occur, the Chinese banking system must collapse.

In addition, China has unique tools to prevent a classic financial crisis.

The government controls almost everything, including the Central Bank, the four state-owned commercial banks that are the largest in the world, NPL-buying banks, large investment funds, most of the largest companies, and most of the media, including social media, especially when it comes to financial news.

In other words, the government controls money, lenders, borrowers, buyers, markets, and information.

The government can order the four big banks to swap defaulted loans for equity and forget about them. It can order the People's Bank of China to do its best. It can order state-owned investment and pension funds to buy stocks and bonds to prop up prices and fund companies. It can order the banks it controls to buy bad debt from other banks.

The Chinese government has a long history of bailing out bondholders. And he also has an extensive history of bailing out investors in failed risky schemes, including ordinary people chasing hot gambles such as Evergrande's wealth management products and apartments in unfinished homes.

When enough of these people start protesting in Beijing because they lost money on one or another massive scam they fell for, including real estate investments, the government, fearful of public unrest, will step in and take care of everything. It has done this in the past.

The now-failing real estate bonds have funded economic growth, massive projects, and millions of jobs for years. And foreign investors were quite sure that they would be helped when the situation escalated [ibid.].

So far, these special tools have helped the government avoid a financial crisis.

But now, it seems that the authorities are initiating a severe reduction in leverage in the real estate sector in order to reduce risks and moderate wild speculation and price increases. It looks like an attempt to rebalance the economy by reducing the weight of real estate development.

Apparently, investors are being invited to absorb the costs of this forced leverage reduction. The government probably wants to teach them a lesson by showing them that they may not be saved and that the influx of liquidity into the real estate sector was a mistake and should stop.

And it looks like the government is ready to take the risk that this could carry over to the entire economy and credit markets in general. And if the government really refuses to bail out bondholders and allows investors, especially foreign ones, to suffer massive losses in order to reduce the amount of debt in the economy, it will be a drastic change for those who invest in China.

The collapse of Evergrande could have a domino effect on China's real estate sector, according to AllianceBernstein, an international asset management company [China demanded that the founder of Evergrande pay his debts from his own funds, [www](#)].

The China Evergrande Group crisis could spread to other parts of the economy and could become a systemic problem. If the refinancing channel is closed for a long period of time, then small developers, which make up 10-15% of the entire Chinese market, will not survive. From a policy point of view, it will take much more effort to stop it than to prevent it [What will happen if Evergrande collapses, [www](#)].

The financial situation of many Chinese property developers has already deteriorated after the introduction of government rules aimed at reducing the cost of borrowing for real estate companies. These measures involve setting a limit on debt in relation to cash flows, assets and the level of capital of the company.

Taken on their own, the financial or social risks associated directly with Evergrande itself are actually "quite manageable" due to the fragmentation of the Chinese real estate market.

Despite Evergrande's size as the largest real estate developer in China, possibly the largest in the world, it still accounts for only 4%, and now even less, of the total annual sales market.

So, Evergrande is a large and important company for the Chinese economy. It ranks 13th in China in terms of revenue and provides jobs for at least 0.87% of the economically active population [Evergrande Gives China an Impossible Equation to Solve, [www](#)].

The situation with Evergrande is still uncertain. Credit agencies downgraded Evergrande's rating, which implies the possibility of default not only on market obligations, but also on other debts, such as accounts payable.

However, it can be assumed that the banking sector and the company's suppliers will be the least affected in the event of a default. Under the greatest impact are the company's customers, both buyers of unfinished housing, and consumers of financial products. The former are likely to get off lightly due to the high likelihood of other developers buying out Evergrande's assets at a discount. The latter are the last in line for repayment of debts to them in the list of creditors, since they initially took on large risks.

To a greater extent, it is worth paying attention to China's policy towards developers. China, aware of the debt burden of developers, limited access to debt financing with the “three red lines” policy, which caused the real estate market to cool significantly. This results in less construction and less demand for raw materials, which directly hurts Chinese developers and miners due to China's high share of raw material consumption.

A default would also hurt investors in the company's offshore debt. With a high exposure to the developer sector, such companies are already suffering losses due to the massive sale of assets. This may lead to the risk of a lack of liquidity in the Chinese market, but the People's Bank of China has increased the injection of funds into the economy in recent months, so the default of Evergrande will not have a serious effect on financial markets in China and the world.

It is worth noting that Evergrande prepared its clients for high market volatility and backed up its flagship strategies.

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Управление активами и долгом китайской девелоперской компании Evergrande

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Аннотация

Компания Evergrande, гигант недвижимости, присутствующий в более чем 280 китайских городах, был самым известным застройщиком. Имея более 300 миллиардов долларов долга, он месяцами балансировал на грани дефолта, каждый раз удерживаясь благодаря погашению в последнюю минуту. В 2020 году у Evergrande возникли проблемы с ликвидностью. Evergrande предупредила чиновников, что дивиденды, причитающиеся с 2021 года, могут вызвать кризис ликвидности и потенциально привести к перекрестным дефолтам в более широком финансовом секторе. Недвижимость в Китае является основной инвестицией для большинства инвесторов. Все это привело к неприличному росту цен на недвижимость и спекуляции в сфере жилья. Можно предположить, что в случае дефолта меньше всего пострадает банковский сектор и поставщики компании. Наибольшему воздействию подвергаются клиенты компании, как покупатели недостроенного жилья, так и потребители финансовых продуктов. Стоит обратить внимание на политику Китая по отношению к застройщикам. Китай, осознавая долговое бремя застройщиков, ограничил доступ к долговому финансированию политикой «трех красных линий», что привело к значительному охлаждению рынка недвижимости. Это приводит к меньшему строительству и меньшему спросу на сырье, что напрямую вредит китайским застройщикам и горнодобывающим компаниям из-за высокой доли Китая в потреблении сырья.

Для цитирования в научных исследованиях

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Ключевые слова

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