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RESEARCH ARTICLE

FINANCING RISKS AND COUNTERMEASURES IN REAL ESTATE INDUSTRY

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ABSTRACT

Under the supply-side regulation of the "The Three Red Lines", loan concentration management, pre-sale fund supervision and other policies, the asset-liability ratio and net debt ratio of China's real estate enterprises continues to improve. However, at the same time, there is a contrast between leverage ratio decline and risk increase, indicating that there's still serious capital problem in the real estate industry, and the existing high-cost financing risks, high-leverage operation risks, high-proportion indirect financing risks, and high-probability overseas financing default risks have not been properly addressed. In the long run, it is necessary to strengthen the structural and long-term regulation of financing in the real estate industry, clarify the differences in risk degree of real estate enterprises, improve the stable expectations of participants in the real estate industry, and fundamentally solve the problems of high-cost financing and high-leverage operations. In the short term, it's necessary to increase the direct financial support of high-quality real estate enterprises, standardize the external debt financing of real estate enterprises, and resolve the high-cost financing risks, high-proportion indirect financing risks and overseas financing default risks.

KEYWORDS

Real estate, financing, risk, structural improvement

1. The Status of Real Estate Financing

The real estate enterprises in China belong to capital-intensive enterprises. Land development and construction are the main costs of real estate operation. Whether the capital chain is broken is the key to the survival of real estate enterprises. Therefore, there's always high capital demand and leverage ratio among the real estate companies. From 2005 to 2021, the paid-in funds of real estate development enterprises increased steadily from 2139.8 billion yuan to 20113.2 billion yuan, achieving an increase of 840%. In 2019, the average operating cost of 96 listed real estate companies was about 36.684 billion yuan (Yixuan and Dua, 2020). Among them, real estate sales and land development costs accounted for 84.06% of Joy City's operating costs in 2019. Based on the capital-intensive characteristics of real estate enterprises, real estate industry in China started supply-side reforms since 2015. Under the control of policies such as "The Three Red Lines", loan concentration management, and pre-sale fund supervision, the inventory rate and leverage ratio of real estate enterprises continues to fall. As of July 2021, the balance of real estate loans in the banking industry has increased by 8.7% year-on-year, the growth rate generating an eight-year low, and was 3% lower than the growth rate of other loans. In addition, the financing structure of real estate enterprises in China is dominated by bank credit, and diversified channels such as non-standard, bonds, equity, and overseas are used simultaneously (Runyinz, 2020). From 2005 to 2008, the main financing channel was development loans. In 2006, other financing channels only accounted for 10% of the new financing that year. While A-share financing and non-standardized debt financing increased significantly from 2008 to 2010. Since 2011, two types of financing channels, overseas debt and domestic debt, have been added, and the method of equity financing has been extended to H-share equity financing and rights issue placement.

However, while there is a lower leverage and various financing tools, the industry risk is gradually increasing: real estate companies have excessive debt. From June to July 2022, the total maturity of domestic and overseas bonds of 200 core real estate companies is about 175.5 billion yuan; there's frequent risk-taking behaviors. From 2021, the risk-taking behavior of real estate enterprises has increased significantly, and that of the private enterprises in the top 100 real estate enterprises reached 41.4%; The operating conditions have declined seriously. Starting from the second half of 2021, the real estate industry sales, land purchases, and construction have all shown sharp declines. For example, from January to May 2022, the growth rate of the sales area and sales of commercial housing nationwide was -23.6% and -31.5% respectively, with the growth rate dropping by 59.9% and 83.9% year-on-year, respectively.

2. Existing Risks of Financing in the Real Estate Industry

By sorting out the financing cycle, financing structure and financing policy cycle since 2005 (see Table 1), it can be seen that the real estate industry financing has existing "four high risks", high-cost financing risk, high leverage operation risk, high proportion Indirect financing risk and high probability overseas financing default risk.

2.1 Risk of High-Cost Financing

On the one hand, after the tightening of formal financing channels such as credit, housing enterprises turned to high-cost financing such as trusts. In recent years, the cost of housing companies through non-standardized debt financing methods is mostly around 10%, some are as high as 13% or more. Some private housing companies even introduced private loans at high interest rates, with interest rates ranging from 20% to 30% (Xiaoshuang et al., 2021). Before the rectification of the real estate trust industry in 2019, trust loans once reached 8.5 trillion yuan. However, the cost of financing through trusts for real estate companies is usually higher than that of bank loans and credit bonds. According to data from the Youyi

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Trust Network, the yield of collective trusts invested in real estate has continued to increase from about 6% in early 2017 to about 8% in 2020. On the other hand, affected by environmental, social, epidemic, policy and other aspects, and the cycle of construction and sales is unstable, it is difficult for real estate construction projects to recover funds in a short time. Project development has been delayed repeatedly due to the epidemic, which in turn affects prepayments. From January to February 2020, the prepayments of central state-owned enterprises and private enterprises were close to zero, and the prepayments of local state-owned enterprises experienced negative growth. This makes real estate companies unable to repay bank loans in a timely manner and increases financial burdens, and financing costs continue to increase.

2.2 Risk of High Leverage Operation

After the introduction of the "The Three Red Lines" policy, the asset-liability ratio, net debt ratio, and cash-to-short-term debt ratio of housing enterprises have all improved significantly. As of the end of 2020, the net debt ratio of 50 A+H-share benchmark housing companies selected by Yihan Think Tank has dropped significantly by 20.1 percentage points to 75.8%. However, the actual debt and cash flow of real estate companies has not been substantially improved, because real estate companies' statements has a lot of space for adjustment, and financial data can be beautified through behaviors such as debt "out of the statement". For example, from the perspective of the table, Evergrande's net debt ratio dropped to 99.8% in 2021, having a year-on-year decrease of 53.1, realizing the "red to green" of the net debt ratio, and the interest-bearing liabilities in the first two quarters of 2021 will be reduced by a total of 146.5 billion yuan.

In addition, in the whole process of real estate development, land use right transfer fee plus the construction and installation engineering fee takes up over 80% of the total development cost (Yu et al., 2021). From 2012 to 2021, the average urban land price accounted for more than 73% of the sales price of commercial housing, indicating that the land operation cost of real estate enterprises is extremely high. In 2021, most real estate companies failed to achieve the announced annual sales targets. The sales area of the top 10 100 billion real estate companies in 2021 dropped by about 3% year-on-year on average, but the average price of new projects was higher than that of 2020. The increase in land operating costs has further compressed the profit margins of real estate companies. Since land costs cannot be compressed and self-raised funds are limited, real estate companies can only operate with leverage, forming a risk transmission chain of "high cost - high debt - high turnover - high risk". According to the People's Court Announcement Network, in 2019, a total of 377 real estate companies went bankrupt in China. From January 1st, 2021 to June 16th, 2022, 569 real estate companies nationwide have been involved in bankruptcy proceedings. As of June 16th, 2022, 107 real estate companies have officially declared bankruptcy in 2022. It shows that the financing risk of real estate has seriously affected the national financial security and the stability of the real economy.

Table 1: Characteristics and Policy Background of Real Estate Financing at Different Time.

Time	Characteristics	Policy background
2005-2008	Real estate financing was mainly based on development loan financing	In 2003, the State Council pubulished the "Notice on Promoting the Sustainable and Healthy Development of the Real Estate Market" (Document No. 18), confirming for the first time that "real estate is a pillar industry of the national economy"
2008 -2010	Equity financing become popular and standardized, development loan financing plummeted to 58%.	In 2005, the China Securities Regulatory Commission issued the "Notice on Issues Concerning the Pilot Project of Share Merger Reform of Listed Companies", and the pilot work of the share structure reform was officially launched. In 2006, the reform was completed successfully, A-share IPO restarted.
2011 -2014	Equity financing was stagnated, and overseas debt and non-standardized debt financing gradually emerged. During the period, development loan financing accounted for an average of 75%.	The general office of the relevant department in the State Council issued the "Notice on Continue to Do a Good Job in Real Estate Market Regulation", which stipulates that for real estate development companies that violated laws and regulations, such as refusing to sell, driving up house prices, etc., the land and resources department shall prohibit them from participating in land bidding; the banking financial institutions shall not issue loans for new development projects, and the securities regulatory department shall suspend approval of their listing, refinancing or major assets. Restructuring, banking regulators want to prohibit it from financing through trust schemes.
2014-2016	The issuance of A-shares increased significantly, and the amount of domestic debt issuance increased significantly.	In 2015, the China Securities Regulatory Commission announced to cancel the prior review of the real estate refinancing business by the Ministry of Land and Resources. In 2015, the China Securities Regulatory Commission issued the "Administrative Measures for the Issuance and Trading of Corporate Bonds", which expanded the main body of bond issuers from listed companies to all corporate legal persons, and further relaxed the issuance methods.
2017 -2022	Additional issuance of A shares was stagnant, H-share IPOs and rights issue placements were stable, and non-standardized debt financing declined. During this period, overseas debt increased significantly, accounting for an average of 23%, and development loan financing accounted for an average of about 50%.	In 2015, the National Development and Reform Commission issued the "Notice on Promoting the Reform of the Recordation and Registration System for the Issuance of Foreign Debts by Enterprises", which simplified the overseas bond issuance procedures, cancelled the quota approval, and implemented the recordation and registration management. In 2016, the special training meeting of the sponsor agency of the China Securities Regulatory Commission required that real estate enterprises are not allowed to refinance to supplement working capital, acquire land and repay bank loans. In 2018, the People's Bank of China, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange issued the "Guidance on Regulating the Asset Management Business of Financial Institutions", which clearly prohibits fund pool business, multi-layer nesting of assets, and channel business.

2.3 High Proportion of Indirect Financing Risks

Domestic indirect financing of real estate enterprises is divided into bank loans (bank development loans, merger and acquisition of goods, operating property loans, working capital loans, etc.) and non-standardized debt financing tools (entrusted loans, trust loans, etc.). Domestic real estate companies rely heavily on traditional indirect financing channels, mainly bank loans. From 2005 to 2021, the source of real estate development investment funds, the scale of domestic loans in China increased from 315.8 billion yuan to 2,329.6 billion yuan, of which the maximum scale in 2020 was 2,667.5 billion yuan. During 2005 to 2020, development loan financing accounted for nearly 90% of the new financing scale over the years at the highest and over 30% at the lowest. Since 2008, due to the central bank and various banks' limits on development loans, the proportion of domestic loans has shown a downward trend as a whole, but it has remained stable at more than 11% . The reliance of real estate enterprises on bank loans will transfer real estate risks to financial institutions, which will easily lead to systemic risks and endanger social stability.

Before 2017, due to weak supervision, short term, high coupon rate, and low threshold, etc., non-standardized debt financing instruments have become the real estate industry financing tools in order to circumvent supervision by real estate enterprises in the context of stricter loan policies, becoming an important unconventional means of financing among real estate companies. However, some parts of non-standardized debt financing instruments such as entrusted loans and shadow banking also bring about problems like long business chains, complex structures, overlapping responsibilities, risk correlation and transmission, etc. These problems will lead to the contagion and superposition of real estate risks to other industry risks, covering up the risks. The authenticity of the asset quality of real estate enterprises has seriously affected my country's economy "from the virtual to the real", and it is also easy to induce systemic risks.

2.4 High Probability of Default Risk of Overseas Financing

Real estate is the industry with the second highest proportion of foreign debt financing in my country. From 2011 to 2016, the scale of overseas bond issuance by China's real estate enterprises was generally low, remaining below US$30 billion, but the overseas debt gradually increased from 2012 to 2014. The scale of overseas bond issuance grew rapidly in 2017, from US$17.2 billion in 2016 to US$54.5 billion. As of 2021, the balance of overseas real estate debt is US$205.6 billion (about 1.31 trillion yuan). 2022 will be the peak of the maturity of overseas debts of real estate enterprises. In June and July 2022, real estate enterprises' dollar bonds will reach US$7.804 billion and US$6.557 billion respectively (Zheng, 2022). It should be noted that special attention should be paid to the potential repayment and default risks of small and medium real estate enterprises (Guobin, 2021).

Since 2016, a large number of small and medium-sized real estate companies have entered the overseas dollar bond market for financing. The proportion of foreign debt issuance by the top 20 real estate companies also dropped from 94% in 2015 to 54% in 2019. Under the background of tightening real estate financing policies and shrinking sales revenue, and the special reality that small and medium-sized real estate enterprises are difficult to obtain refinancing, the liquidity pressure of small and medium-sized real estate enterprises is more prominent. In addition, the operation, investment and financing activities of domestic real estate enterprises are basically all domestic, and there is a lack of risk hedging means for overseas financing defaults, which will increase the transmission risk from the international financial cycle to the domestic economic cycle.

3. Improvement Paths for Real Estate Industry Financing

3.1 Strengthening Structural and Long-Term Regulation

In the past real estate financing regulation, the government tends to aggregate and short-term regulation, such as the "The Three Red Lines" of aggregate regulation and short-term relaxation of overseas financing. This way is more effective under the background of the rapid development of the real estate industry and the difficulty of risk classification and identification in the past (Pukhara, 2021). However, China's real estate industry has shifted from an incremental to a stock development stage. There is a large difference in the accumulation of debts among housing enterprises, and there is a huge hidden debts off-balance sheet. Therefore, it is necessary to adhere to a structured and long-term control thought, with the principle of " Housing is for living in, not for speculation" (Vimpari, 2020). With the fundamental orientation of "speculation", conduct a structural grading assessment based on the real debt situation of real estate enterprises, clarify the differences in the degree of risk of real estate enterprises, improve the stable expectations of participants in the real estate industry, and promote the healthy development and virtuous circle of the real estate industry.

3.2 Increase Direct Financial Support for Housing Enterprises with Excellent Qualifications

Real estate financing channels can be divided into exogenous financing activities and endogenous operating activities. Receipts from sales in endogenous financing channels have been one of the main sources of development funds for housing enterprises over the years. However, its endogenous nature determines that the scale of the sales collection of housing companies cannot be the fundamental method to solve the financing problems of housing companies (Sarnakov and Khrebtov, 2020). From January to June 2022, due to the impact of the epidemic on construction and sales, deposits and advance receipts fell by 37.9% year-on-year. Even it is difficult for housing companies with strong operating capabilities and great bargaining power in the supply chain to deal with this situation. Therefore, the financing improvement plan for housing enterprises should also focus on exogenous financing activities. In overseas financing activities, equity financing and debt financing channels continue to be tightened, and overseas bond issuance costs are high (Guan, 2019). For example, in the first half of 2019, the cost of overseas bond financing reached 8.34%, which was 1.68 times that of domestic financing.

In domestic financing activities, due to policy regulation and tightening of bank loans, the scale of non-standard financing has gradually declined, and the acquisition of equity capital has continued to be weak. The scale of credit debt financing was sluggish due to the continuous thunderstorm events of housing enterprises. In the case of the high operating cost of the real estate industry itself, more attention should be paid to reducing the financing cost of real estate enterprises and resolving high-cost financing risks and high-proportion indirect financing risks. Real estate enterprises should be encouraged to increase the proportion of direct financing, reduce the excessive reliance of real estate enterprises on traditional indirect credit resources. It's essential to guide real estate enterprises to actively expand funding sources, encourage real estate enterprises to revitalize existing assets, substantially improve their assets and liabilities, and enhance asset liquidity of real estate enterprises. New standardized financing tools represented by asset-backed securities shall be enriched, and the development of real estate trust investment funds REITs shall be promoted.

3.3 Regulating the Foreign Debt Financing of Real Estate Enterprises

Due to the high financing needs of real estate enterprises, domestic bond issuance cannot cover the maturity of bonds and cannot meet the financing needs of real estate enterprises, many real estate enterprises use overseas capital markets to issue bonds. 2022 will be the peak of the overseas debt maturity of real estate companies. Since 2018, the potential risks of foreign debt financing of real estate enterprises have been noticed and been controlled, and corresponding control policies have been issued (Ma, 2018). The People's Bank of China and the State Administration of Foreign Exchange issued Yinfa (2021) No. 5 "Notice on Adjusting the Macro-prudential Adjustment Parameters of Enterprises' Cross-border Financing", which lowered the macro-prudential adjustment parameters of enterprises' cross-border financing from 1.25 to 1. However, there are still two outstanding problems: First, the management of overseas bond issuers is relatively loose, and many small and medium-sized real estate companies can use overseas bond issuance to raise funds.

The US Securities Regulatory Commission only sets certain conditions for operating conditions and corporate information disclosure when conducting bond issuance reviews (Eichholt et al., 2014; Tao, 2016; Eichholtz et al., 2021). If small and medium-sized housing enterprises rely on overseas bond issuance, in order to solve the problem of repayment, they can only continue to "borrow the new to pay off the old", but cannot solve the financing problem in a long-term, and it is difficult to achieve their own healthy and sound development. Second, there is a lack of basic data on overseas bond issuance by housing companies. The existing overseas debt data relies on Bloomberg, an American financial information company, while the domestic database lacks special statistics and research to support detailed analysis and trend forecast regarding scale, structure, characteristics, etc., which is averse to the precise management of regulatory agencies.

4. Conclusion

China's real estate enterprises are capital-intensive enterprises, with high capital demand and leverage ratio. Therefore, the financing risk of real estate will seriously affect the national financial security and the stability of the real economy. As of July 2021, the growth rate of real estate loan balances in the banking industry hit a new 8-year low. At the same time, the real estate industry financing has existing "four high risks", high-cost financing risk, high leverage operation risk, high proportion Indirect financing risk and high probability overseas financing default risk. The contrast between the decline in the leverage ratio of real estate enterprises and the rise in financing risks shows that the financing structure of the real estate industry needs to be optimized urgently. In order to fundamentally solve the problems of high-cost financing and high-leverage operation, it is necessary to change the totalization and short-term regulation and control ideas to the structured and long-term regulation and control ideas. In response to the now prominent problem of foreign debt, consideration can also be given to increasing direct financial support for well-qualified real estate enterprises and standardizing foreign debt financing for real estate enterprises.

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