Dilemma under the Pandemic: Real Estate Economy and Land Finance in China

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Abstract: China's real estate sector has taken a major hit since the outbreak of COVID-19, with the once-mighty sector reeling from capital outflows from the banking sector, the collapse of property companies, and the impact of the sector on gross domestic product. This paper will start from the current situation of real estate brokers in China, take Evergrande, other real estate enterprises and some local government policies as the entry point, analyzing the relationship between land finance and real estate finance represented by local governments and central policies and economic operation.

Keywords: Real estate economy; Public policy; Land finance; Risk management & entrepreneurship

1. Introduction

In China, which has built five times as many homes as the United States and Europe combined, the overall real estate picture has not only been grim for the past three years, but it also shows no sign of improving in the near future. The Chinese people generally regard the ownership of real estate as the most basic guarantee of life. And the real estate sector is an important pillar of the Chinese economy. Since COVID-19, the success or failure of policies to revive the real estate sector has been critical to mitigating the impact of COVID-19 on the Chinese economy. China's property market declined sharply in the first quarter of 2020 as nationwide lockdowns hit the industry on both supply and demand fronts. China's GDP contracted for the first time on record in the first quarter of 2020, with the property market slump playing a major role.

The spread of COVID-19 and lockdowns have also had a significant adverse impact on the supply side of China's real estate sector. In the first quarter of 2020, property investment fell 7.8 per cent from a year earlier to 2.2 trillion yuan. Investment in commercial property fell the most, down 14.8 per cent year on year, followed by office buildings (10.8 per cent) and residential buildings (7.7 per cent). Another sign of supply-side pressure on the sector is the rapid decline in new housing starts. In the first quarter of 2020, the area under construction for commercial housing fell 27.2% year on year, of which residential area fell 26.9% year on year, while office and commercial real estate area fell 38% and 29.7%, respectively.

2. Manuscript Preparation

2.1. The situation under the epidemic

2.1.1. Crisis of unfinished buildings

This year, China's real estate market is facing more difficulties than ever before, not only from the perspective of investment capital decline, but also the collapse of land finance. Since 2022, China's real estate market has continued to decline, and relevant indicators have declined across the board. Limited by the epidemic, capital and other factors, the decline in real estate investment, construction starts and completions continues to expand. The scale of land transfer fee, premium rate and floor price all fell sharply. The financial situation of real estate enterprises continued to deteriorate, and the maturity of all kinds of debts remained high. In the first half of this year, the pressure of payment became more concentrated and debt risks became prominent.

2.1.2. Banking and GDP

At the same time, this predicament and other countries have a certain difference, mainly in July this
year, China's national "shutdown wave". In recent years, especially since the outbreak of COVID-19, the capital chain of some real estate developers has been broken, and the real estate projects in many cities have been shut down, which makes the owners who have bought these unscheduled houses fall into the desperate situation of "unfinished buildings". In desperation, they announced a unilateral suspension of mortgage payments to the bank until the project fully resumed work. Although the phenomenon of substandard housing has always existed in China, the foreclosures that broke out in July this year and the bankruptcy crisis of Evergrande Real Estate, which had been widely concerned and even caused a certain degree of social unease, made the substandard housing and the decline of the real estate market once again become the focus of the society. The crisis will put pressure on banks and governments.

In terms of capital scale, in the first half of 2022, the scale of housing loans involved in the poor end of the country was 0.9 trillion yuan, accounting for 1.7% of the country's mortgage balance. The impact on banks is even more surprising. Property loans accounted for 25.7 per cent of total bank credit at the end of June. Total outstanding loans at the end of the first half of this year stood at 206 trillion yuan. As long as the supply freeze continues, China's banks will face a knock-on effect of a funding crunch that will drag down China's economy. China's gross domestic product grew just 0.4% in the second quarter, the slowest pace since 2020. Although various places have adjusted property policy, but still cannot restore market confidence. Property investment fell 12.3 per cent in July, the biggest drop so far this year, according to data released last week by the National Bureau of Statistics. Nationwide commercial housing sales area further expanded to 28.9 percent, 28.2 percent reduction in sales.

2.2. Details of interest

2.2.1. Evergrande management crisis

On September 24, 2020, the report on Evergrande Group Co., LTD. 's request for support for the Material Asset restructuring Project circulated online, but was quickly refuted by the official of Evergrande Group of China (hereinafter referred to as "Evergrande"). Since then, Evergrande has made high-profile efforts to reduce its debt, which has raised doubts about its operation. In particular, on June 29, 2021, Sankeshu Group disclosed the information that Evergrande was 51.3706 million yuan overdue in its reply to the CSRC announcement. More than half a month later, Guangfa Bank applied to the court to freeze the assets of Evergrande of 132 million yuan. In just one year, great changes occurred in high-quality real estate enterprises, which undoubtedly indicates the coming of a storm for Evergrande.

On December 3, 2021, China Evergrande Group announced that it was unable to fulfill a guarantee obligation of USD 260 million. After that, Evergrande's wealth was "thundering" and commercial paper defaulted on a large scale, thus Evergrande's liquidity crisis rapidly grew. What started as a liquidity crisis of concern among suppliers and creditors quickly became a crisis of confidence, and the trust scare in Evergrande spread to local governments and customers. Evergrande is so "big", with millions of current customers, more than 163,000 employees and a large number of suppliers, Evergrande's liquidity crisis directly affects a large number of people. Therefore, Evergrande crisis quickly aroused the attention of all circles. How to deal with these debts reasonably to prevent the emergence of systemic financial risks is a severe test for the current financial system and regulators.

Indeed, a few months ago, when investors began to talk about the troubles of Evergrande Real Estate, one of China's largest developers of real estate, many economists dismissed them as an isolated problem, not a big deal. There is a general consensus that the real estate crisis is manageable and that Evergrande's default will be an isolated case, a decision made by its founder, Xu Jiayin. Unfortunately, the reality is decidedly different, and the company has recently been considered a potential bankruptcy. Evergrande is not alone, but rather symptomatic of a model based on leveraged growth that seeks to increase gross domestic product at all costs, including China's familiar land finance problems of ghost cities, unused infrastructure and rapidly expanding buildings. Evergrande's debt-chain model is not uncommon in China.

From Evergrande real estate and other real estate enterprises collapse, not their investment projects out of the problem, the key is to curb the real estate financialization measures, gradually force "high leverage, high turnover" real estate enterprises to reduce the debt ratio; And with the crackdown on the shadow banking system, the financing channels of real estate companies are increasingly restricted. As a result, the gap between gross profit and financing cost of real estate development is narrowing day by day, and it is no longer feasible to obtain excess profit by relying on high leverage. In addition, as the degree of financing constraints gradually increased, the debt repayment pressure of real estate enterprises increased exponentially, which eventually led to the concentrated outbreak of previous accumulated problems and the collapse of the mighty empire. After the concentrated outbreak of this round of real
2.2.2. Default dilemma

Evergrande's management and financial loopholes cannot be remedied in a short time. If the net profit is less than the promised amount, Evergrande will pay the difference in dividends with its own funds. At the end of 2018 to 2020, and 68% of the annual net profit shall be distributed to shareholders. If the net profit shall be no less than 50 billion yuan, 55 billion yuan and 60 billion yuan respectively in the three years of each round, which resolved the crisis of perpetual debt.

Evergrande to successfully obtain a total of 130 billion yuan of investment from strategic investors in addition 50% of Evergrande Real Estate's shares based on the existing shareholding ratio. This enabled Evergrande Real Estate to complete the restructuring by January 31, 2021, otherwise it is obligated to buy back the strategic investor's shares, or compensate the strategic investor with an additional 50% of Evergrande real Estate's shares based on the existing shareholding ratio. This enabled Evergrande to successfully obtain a total of 130 billion yuan of investment from strategic investors in three rounds, which resolved the crisis of perpetual debt.

The second crisis stems from the "interest rate jump" mechanism of perpetual debt. Evergrande adopts the "2+N mode" to issue perpetual bonds, which means that in the five-year cycle of the issuance of perpetual bonds, the interest rate is 8.2%-9% in the first two years, but then the interest rate gradually jumps to 18% with an annual growth rate of 30%. This forced mechanism makes Evergrande have to issue new perpetual bonds to repay its old debt even after two years. Evergrande will face a huge risk of interest rate jump or redemption once the permanent bond market moves. But Evergrande opportunely borrow "Bao Wan contention" opportunity, launched the real estate plate and deep housing reorganization plan. The strategic investor obtains about 36.50% of Evergrande Real Estate shares through capital increase. Evergrande Real Estate promises that the net profit excluding non-recurring gains and losses shall be no less than 50 billion yuan, 55 billion yuan and 60 billion yuan respectively in the three years from 2018 to 2020, and 68% of the annual net profit shall be distributed to shareholders. If the net profit is less than the promised amount, Evergrande will pay the difference in dividends with its own funds. At the same time, Evergrande commits to complete the restructuring by January 31, 2021, otherwise it is obligated to buy back the strategic investor's shares, or compensate the strategic investor with an additional 50% of Evergrande real Estate's shares based on the existing shareholding ratio. This enabled Evergrande to successfully obtain a total of 130 billion yuan of investment from strategic investors in three rounds, which resolved the crisis of perpetual debt.

The third crisis arose from the threat of buybacks by strategic investors in 2020. Since Evergrande and strategic investors take the successful restructuring before January 31, 2021 as the bet condition, if the restructuring is not completed, Evergrande will either choose to redeem the investment of strategic investors, which will make the investment of strategic investors into a huge amount of current debt; If the ratchet clause is triggered, Evergrande's stake in Evergrande falls to 45.18 per cent, thereby losing control of the company. Unfortunately, Evergrande announced the failure of restructuring on November 8, 2020. However, only 4.3 billion yuan of strategic investor funds withdrew after negotiation between Evergrande and various parties, and the remaining 125.7 billion yuan of fund providers declared to be long-term investors, giving up the right to buyback and share compensation. But this huge debt crisis, let Evergrande's management and financial loopholes cannot be remedied in a short time.

2.2.2. Default dilemma

But it is not just property companies and governments that are suffering. Chinese people are also facing threats to their property. The so-called "default" refers to the mortgage debtors, homeowners who buy houses, and property owners who, for various reasons, cannot continue to pay regular loan payments and cannot provide monthly payments. Many are comparing it to the U.S. subprime mortgage crisis of 2008, and even think it could be China's biggest "gray rhino.” Admittedly, financial real estate has always been the largest underlying asset in all countries, and there is no room for error, but this "supply shortage wave" is more likely to reflect weak demand and the middle class crisis after three years of the pandemic. The reasons may be a decrease in the buyer's income, a family member's job loss, illness, career failure, a rise in interest rates that makes the monthly mortgage payments unaffordable, and so on and so forth. The consequence of defaulting is the loss of the property as collateral because the loan cannot be continued. Because of a default, the property is preemptively repossessed by creditors such as banks and
loan companies. The house is auctioned off, and the proceeds are used to pay off all or part of the original loan, or other loans that have been prioritized. The final homeowner may still owe the bank or go into personal bankruptcy because the proceeds from the auction will not pay off the mortgage in full. The homeowner's credit rating would then be so damaged that it would be difficult for many years to borrow money, rent a house, do many sensitive jobs, and so on. After the outbreak of the subprime mortgage crisis in the United States, many people defaulted on their mortgage payments and lost their homes. Many people and the banking industry went bankrupt. After the production of a large number of dilapidated houses, in the case of China's real estate market downturn, capital flow fracture, construction companies have no willingness and ability to complete those dilapidated projects. It was inevitable that the Chinese people would find out and stop lending.

2.3. Local government and land finance

2.3.1. Analysis of real estate finance

Judging from the current situation, it is difficult for China to solve the real estate predicament, especially the problem caused by defaulting and unfinished buildings. China's mortgage crisis has spread to 25 provinces. But the overall trend is now trying to downplay the wave of loan suspension, in promoting the resumption of work. But many property owners in China have discovered that some of the construction projects that claimed to have resumed were actually fake ones, with the authorities directing some workers to the site to shout slogans and pose for pictures, then nothing happens. The reason behind this is that the land economy is tied to local finance, and the failure of developers leads to bad debts, runs on banks and bankruptcies far beyond the control of financial stability, affecting at least 300 million Chinese people. In China, land finance actually represents real estate finance. This finance includes not only huge land use rights transfer income, but also various tax revenue related to land use and development.

China's local governments have come under intense pressure this year from the Communist Party Central Committee to invest more to stabilize the economy, but the most important source of revenue, land sales, has gone awry[1].In 2020, the worst year of the pandemic in China, China's land sales revenue soared to a record 8.4 trillion yuan, equivalent to Australia's annual gross domestic product, which supported the fiscal budget for that year. Suddenly at the same time, in view of the real estate market policy tightening, such as setting up house clinch a deal the price, to focus on enterprise financing put forward "three line", and auction of land concentration and a series of profound change in policy housing finance pattern, the hot property market sudden encounter cold, real estate enterprises, including Evergrande which has been mentioned, are in trouble, The corresponding local government's land transfer income also appears unusually sharp decline.

2.3.2. Forecast

The Chinese Academy of Social Sciences [2] pointed out that the real estate market is likely to continue to be under pressure in 2022, and the growth of land sales revenue will face great challenges, which will directly affect the disposable financial resources of local governments, and then have an impact on the risk of local debt. In the past, local governments were squeezed in economic development and other aspects, which eventually led to the emergence of land finance. So in the long run, when faced with real estate financial difficulties, local governments may seek other sources of revenue, such as property taxes, to offset the fluctuations in the real estate market. In fact, China has been mulling a nationwide property tax for more than a decade, but has faced resistance from stakeholders, including local governments themselves, who fear it will erode property values or trigger market sell-offs.

3. Conclusion

In the context of the central decision-making of China government, if leading group wants to make a smooth transition with stability, he needs to pay attention to real estate, the fiscal aspect that has dominated China's economy in the past. At the same time, increasing control over real estate policies and finances will at least to some extent enhance people's confidence in housing and real estate. The recent requirement of the the leadership of China to "guarantee the delivery of unfinished buildings" (Meeting of the Political Bureau, July28, 2022) also confirms their urgent need for a smooth transition to the following policy and situation. But after all, it should be noted that the Chinese government has a strong financial background, and it has the possibility of concentrating financial resources to relieve local incidents.
References