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Financing Constraints and Firm Performance —Take Evergrande Group as an Example

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Abstract

With the introduction of the "Three Red Lines" policy, real estate companies that rely on the "high leverage, high turnover" model have gradually fallen into debt crisis. Taking the Evergrande Group, which is deeply in debt crisis, as an example, this paper analyzes and studies the influencing factors of financing constraints and the relationship between financing constraints and corporate performance, and discusses the reasons why Evergrande is in debt crisis. Finally, this paper puts forward reasonable suggestions.

Keywords: financing constraints, corporate performance, high leverage, three red lines

1. Introduction

With the rapid advancement of urbanization, China's housing prices have continued to rise. In the past 20 years, China's housing prices have increased by nearly five times. Rapidly rising house prices have driven the rapid development of the real estate industry, making the real estate industry a pillar industry of the national economy and making a significant contribution to the rapid development of China's economy. The real estate industry, which has become a pillar industry of the national economy, has also contributed a huge amount of fiscal revenue to local governments at all levels, which enables local governments to have strong financial resources to carry out construction of people's livelihood security and urban infrastructure. The dependence of local governments on the real estate industry and the high profit margin of the real estate industry attract more and more people to join the real estate industry. However, as a capital-intensive industry, the real estate industry is characterized by long capital turnover cycle, high risk and large capital demand. In order to seize the dividend period of rising house prices in time, many real estate developers have expanded financing, increased leverage, and used the pre-sale system of commercial housing to speed up capital turnover. This "high leverage, high turnover" strategic model is most typical of Evergrande Group, which greatly improves the financialization of the real estate industry. During the period of rising house prices, Evergrande Group can make high profits by virtue of this model. However, in order to effectively curb the rise in housing prices and prevent and resolve the systemic financial crisis, and promote the sound development of the real estate business, the Ministry of Housing and Construction of China and the People's Bank of China jointly issued the "Three Red Lines" policy on real estate business on August 20, 2020. This policy has greatly restricted the financing channels, financing amount and financing availability of real estate developers. The financing constraints on real estate developers have been further strengthened, which makes it difficult for Evergrande Group to rely on the "high leverage, high turnover" strategic management model to operate and the Evergrande Group is gradually facing a debt crisis. On the basis of fully studying the relationship between financing constraints and corporate performance, this paper analyzes the reasons for Evergrande's development and growth and gradually falling into crisis, so as to provide feasible suggestions for the healthy development of the real estate industry.

2. Review of Domestic Literature

Liu Han and Zhao Li studied the factors that affect financing constraints. They believe that the nature of property rights and political connections will affect financing constraints (Liu Han & Zhao Li, 2021). Su Xu believes that the scale of an enterprise will significantly affect the financing constraints it is subject to (Su Xu, 2022). Liu Pengcheng found that the degree of government fiscal decentralization will affect the financing constraints of enterprises (Liu Pengcheng, 2021). Zhang Xueying, Liu Yinwei believe that macroeconomic conditions and the liquidity of financial markets will significantly affect the financing constraints of enterprises (Zhang Xueying & Liu Yinwei, 2020). Wang Canxia believes that the fulfillment of corporate social responsibility will effectively reduce the financing constraints received by oneself (Wang Canxia, 2020). Ding Shufen found that There is a correlation between the financial information disclosure of an enterprise and the financing constraints imposed by the financing enterprises. The better the information disclosure, the smaller the financing constraints (Ding Shufen, 2018).

The empirical analysis of Zhang Lianbiao and Guo Siyu proves that there is a negative correlation between financial constraints and company performance (Zhang Lianbiao & Guo Siyu, 2022). Qin Yihui (2021) believes that the stronger the financing constraints, the worse the performance of the company, but improving the quality of the company's internal control has a certain relationship with the company's overall operating performance, which can reduce the adverse effects of financing constraints on companies (Qin Yihui, 2021). Ma Yuxuan found that with the strengthening of financing constraints, the profits of enterprises will show a downward trend (Ma Yuxuan, 2021). Gong Xue believes that policy uncertainty will affect financing constraints, which in turn affects the operating performance of enterprises (Gong Xue, 2021). Lin Ye believes that financing constraints will increase the financing cost of real estate developers, which in turn affects the profits of real estate development companies (Lin Ye, 2020). Yang Xin found that the credit status of enterprises will affect the financing constraints of enterprises and then affect the business performance of enterprises (Yang Xin, 2021). Kong Yichao, Zhou Dan found that when the financing constraints imposed on China's manufacturing enterprises continue to strengthen, the production, operation and capital turnover of some manufacturing enterprises will be adversely affected, thereby reducing the company's performance (Kong Yichao & Zhou Dan, 2019) .

At present, there are many studies on the influencing factors of corporate financing constraints and the relationship between financing constraints and corporate performance, but there are few studies on the use of financing constraints and corporate performance mechanisms to explain real business cases. This leads to the lack of profound practical research significance in this study. Therefore, I use this mechanism as a theoretical basis to explore the reasons why Evergrande Group fell into the debt crisis.

3. The Relationship Between Financing Constraints and Firm Performance

3.1 Channels of Corporate Financing

The financing channels of enterprises can be divided into debt financing and equity financing. Equity financing can not only raise capital for the enterprise, but also can avoid that a single founder bears the business risks of the enterprise. The enterprise achieves sustainable operation, but to a certain extent. The equity of the enterprise will be gradually diluted and it may even cause the actual controller to gradually lose control over the enterprise. Therefore, for enterprises, in the early stage of establishment, they can consider raising the capital required for production and operation through equity financing. Compared with equity financing, debt financing can reduce the tax burden of enterprises through interest tax deductions while raising the capital required by the enterprise. In addition, debt financing can largely avoid equity dilution, but debt financing increases the company's debt risk. Therefore, for mature enterprises, debt financing will be a good choice.

3.2 Influencing Factors of Financing Constraints

3.2.1 Enterprise Size

The size of an enterprise's assets is closely related to the financing capability of an enterprise itself. The larger the asset scale of the enterprise itself, the lower the asset-liability ratio of the enterprise, which means that the enterprise has more assets to repay debts. It indicates that the company has a stronger solvency. This means that the investment risk is lower for investors, and investors are more willing to invest their free capital in larger enterprises. As a result, large-scale enterprises are more likely to raise funds and face less financing constraints.

3.2.2 Property Rights

The nature of property rights will profoundly affect the financing constraints of an enterprise. For a large number of private enterprises, due to various factors in the capital market, it is difficult for them to raise enough funds. Small and medium-sized enterprises are difficult to obtain financing, and financing is expensive. This phenomenon is widespread, indicating that compared with large state-owned enterprises, the majority of private enterprises are subject to stronger financing constraints. Therefore, the nature of property rights has a profound impact on the financing constraints of enterprises.

3.2.3 Political Connection

When the external financial environment of the enterprise is not perfect, especially when the financing environment of the external financial market faced by the enterprise is not perfect, the informal system will play a huge role in the financing process of the enterprise, bringing convenience to enterprise financing and Alleviating the financing constraints of enterprises. For example, the political resources of senior managers of enterprises can produce information acquisition and resource acquisition functions, so that enterprises can reduce the financing constraints faced by the degree of information asymmetry and improve the success of corporate financing and reduce corporate financing costs. On the one hand, China's entire financial system is dominated by state-owned banks, relying on the "blood" ties between the government and state-owned banks. The political connections will effectively help financing companies build a network of relationships, and political connections help financing companies build this kind of network. The special network greatly increases the degree of information sharing between enterprises that are financing and financial institutions that can provide funds, thereby effectively alleviating the financing constraints imposed on enterprises. On the other hand, political connections can help financing companies gain advantages in resource allocation to a certain extent, and improve the possibility of their own access to debt financing. Political connections can effectively diversify the operational risks faced by financing companies and reduce the risks of debt financing through the government's support for financing companies in terms of tax relief, financial assistance, market access, property rights protection and business opportunities. In this way, capital owners are attracted to lend funds to financing enterprises, and the constraints of financing enterprises are relieved.

3.2.4 Financial Environment

The overall situation of the financial environment will profoundly affect the financing constraints that enterprises face in the financing process. The overall development of the financial environment is embodied in the following: the number of banks and other financing institutions in the market has increased. Financial instruments have become more abundant, and the financial system has become more and more perfect and the quality of services received by market entities in financial activities is getting higher and higher. The better the financial environment of a country, the more sufficient the total capital supply in the financial market, then the availability of financing will increase and the cost of financing will be reduced when enterprises are financing, which effectively reduces the financing constraints on enterprises. On the contrary, the worse the financial environment of a country, the more difficult it is for capital holdings to supply its own capital to the financial market and the capital supply in the entire financial market will be significantly insufficient, which will greatly reduce the availability of financing for enterprises and make financing more difficult. The cost will also increase significantly, which will strengthen the financing constraints of enterprises.

3.2.5 Macroeconomic Policy

Macroeconomic policy, as one of the important means for the state to control the economic operation, will have a profound impact on the economic environment, and then affect the financing activities of an enterprise. Macroeconomic policies include monetary policy, fiscal policy, industrial policy, etc. When the country wants to support the development of a certain industry, the industry will gain resource advantages due to the inclination of monetary policy, fiscal policy, industrial policy and other related policies, so that the financing activities of enterprises in this industry will be easier to carry out and the financing constraints will be less and the possibility of obtaining a large amount of financing will be higher and the financing cost will be lower. On the contrary, when the state wants to restrict the development of a certain industry, then the industry will be difficult to achieve further expansion due to the constraints of various economic policies, which also makes it more difficult for the financing activities of enterprises in this industry to start, and the financing constraints are limited. Therefore, enterprises should fully consider changes in national economic policies when financing.

3.2.6 Audit Opinions

As an important institution for evaluating the business performance of an enterprise, the audit opinion issued by an accounting firm will have an important impact on the subsequent financing activities of the enterprise. When the accounting firm issues a non-standard audit opinion, the financing company will face greater financing constraints in subsequent financing activities. When the accounting firm issues an unqualified audit report, it means that the company has not falsified when it provides financial reports to the outside world, which objectively shows that the business credit of the company is good, and the financing constraints faced by enterprises in subsequent financing activities will be alleviated.

3.3 The Mechanism of Financing Constraints and Corporate Performance

3.3.1 Financing Constraints Affect Firms' Investment Activities

In order to make foreign investment activities to earn investment income, enterprises must have sufficient capital. When the financing constraints of an enterprise in the process of financing are further strengthened, the availability of financing, financing costs and the amount of funds raised by the enterprise may be affected, which will lead to adverse effects on the company's foreign investment activities. Faced with this situation, corporate decision-makers will reconsider investment projects to avoid serious economic losses. Therefore, financing constraints can have a profound impact on the investment activities of enterprises. The stronger the financing constraints of enterprises when financing, the more difficult it is for enterprises to carry out foreign investment activities, and the business performance of enterprises will be further reduced.

3.3.2 Financing Constraints Affect a Firm's Cash Flow

When an enterprise is severely constrained by financing, it is difficult for the enterprise to obtain more financing, and it is difficult to raise the funds required for production, operation and investment activities through external channels. Even if funds are raised, the financing cost will be very high. Enterprises often pay more attention to internal accumulation of funds, such as reducing dividends, increasing retained earnings, strengthening management, and reducing operating costs. In this way, the internal cash flow of the enterprise is kept unimpeded, and the enterprise is prevented from falling into the trap of insufficient liquidity because it cannot obtain enough financing. Therefore, financing constraints can affect a firm's cash flow.

3.3.3 Financing Constraints Affect the Solvency of Firms

In order to seize the bonus period of industry development, many enterprises continue to occupy the market through debt financing and at the same time adopt various methods to speed up capital turnover. This "high-leverage, high-turnover" business model will enable enterprises to obtain high profits during the period of rapid industry growth. At the same time, due to less financing constraints, enterprises can easily raise the required funds. After-tax profits and lower financing costs enable companies that make full use of leverage to maximize excess profits. Therefore, in the rising period of industry development, enterprises with less financing constraints often adopt the mode of "high leverage and high turnover" to operate. However, with the strengthening of financing constraints and the tightening of financing channels, companies that use this model to develop can easily fall into the predicament of insufficient liquidity, which affects the solvency of the company, and then triggers a debt crisis and even leads to bankruptcy.

4. Analysis of the Strategic Model of Evergrande Group

As one of the real estate companies, Evergrande Group started its business mainly in real estate development. Since land in Chinese cities and towns is owned by the state, real estate developers must obtain land from the government through the bidding, auction and listing system, and pay the government land transfer fees and related taxes. However, the amount of free funds for real estate developers is not enough to support them to acquire more land, so the intervention of the banking system is required. Real estate developers obtain land use rights, then mortgage the land use rights to banks, and obtain loans. These loans are mainly used for Pay local government land transfer fees and related taxes. After acquiring the land, the real estate developers began to design and build commercial houses and then sell them. At this time, the real estate developers mainly made profits by selling commercial houses.

However, with the introduction of control policies for the property market by the state, especially the implementation of the policy of restricting sales and purchases in many cities, the price of commercial housing has been restrained to a certain extent, and the land transfer fee, the main cost of commercial housing development, is difficult to reduce and it shows a trend of increasing year by year. This has led to lower and lower profit margins for real estate developers. In order to make more profits, it must be large-scale, and in order to be large-scale, more land must be hoarded, and in order to hoard more land, financing must be carried out. The financing method adopted by Evergrande Group is mainly debt financing, that is, external financing. Specifically, through the following five channels: First, Evergrande Group uses the real estate pre-sale system to provide financing to home buyers. At present, the sales of commercial housing in major cities in China mainly adopt the pre-sale system. Since the development of real estate generally takes 2 to 3 years, the implementation of the pre-sale system allows Evergrande Group to use the real estate it holds during this period of time. Further financing, in addition to this, the implementation of the pre-sale system has greatly improved the capital turnover speed of the real estate industry. Second, financing from domestic and foreign banks and other financial institutions. On the one hand, Evergrande Group mortgages the real estate it holds to domestic banks to make loans, and on the other hand, it will issue bonds to the US capital market to introduce US dollar capital. Third, Evergrande Group uses wealth management products to raise funds to employees in the company and the public in the market. Fourth, Evergrande Group uses commercial acceptance bills to pay when paying for goods to its suppliers, which fully reduces cash outflows. Fifth, Evergrande Group used real estate trusts for financing.

Through financial operations, Evergrande Group has enlarged its leverage by a factor of 29. Taking into account the amount of funds that Evergrande Group has cashed out of its listing, a leverage of 35 times is the norm for real estate development companies headed by Evergrande Group. Theoretically, as long as Evergrande Group holds real estate, and the financing constraints are not tightened. Evergrande can use the real estate held in its hands to continuously cash out, and use the raised funds to continue hoarding land, and then use the hoarded land to continue to cash out, as long as the more real estate you hold in your hands, the more funds you can raise, and this cycle can continue. The “high leverage, high turnover” model has made Evergrande’s business not just selling commercial housing, but a financial turnover game. During the dividend period of rising house prices, Evergrande Group used this “high leverage, high turnover” strategic model to continuously improve the operating performance of the entire company. In the past, Evergrande’s annual sales exceeded 400 billion yuan, and its assets exceeded 1 trillion yuan, and has become one of the top 500 companies in the world.

Evergrande’s “high leverage, high turnover” strategic model proves that under the circumstance that when the company is very weakly constrained by financing, the company can use its own small amount of capital to leverage more capital and continuously expand its assets through financing. It can continue to expand the scale of its own assets, open up the market, and then improve the performance of the enterprise and develop and strengthen itself.

5. The Reason Why Evergrande Fell into Crisis—Financing Constraints

Evergrande Group became a Fortune 500 company in one fell swoop by virtue of the strategic model of “high leverage and high turnover”, but this model also laid hidden dangers for Evergrande Group to fall into trouble later. In order to limit the rapid expansion of the real estate industry and prevent systemic financial risks, the “three red lines” policy for the real estate industry will be fully implemented from January 1, 2021. The so-called “three red lines”, one is that the asset-liability ratio after excluding advance receipts is greater than 70%. The second is that the net debt ratio is greater than 100%, and the third is that the cash-to-short-term debt ratio is less than 1 (Zhou Fang & Chang Zhifang, 2022). The first red line requires real estate developers to ensure that their equity capital ratio reaches 30%. At this time, if the house price is reduced by 30%, then the creditor’s money will not suffer losses, which requires enterprises to have a certain amount of self-determination. There is capital, which is used to repay debts. The key to the second red line is to limit the equity multiplier, and you cannot increase leverage indefinitely, resulting in serious debt default risks. The third red line requires real estate developers to make good cash withdrawing preparations, retaining a certain amount of cash flow, to avoid enterprises falling into the crisis of insufficient liquidity.

The “Three Red Lines” policy has had a significant impact on real estate developers like Evergrande Group. The “Three Red Lines” policy restricts the financing of real estate development companies that completely step on the three red lines, tightens their financing channels, and restricts their development. Large-scale financing activities. The introduction of this policy has made it difficult for real estate developers to fully play the role of financing tools, causing some real estate companies to gradually fall into the crisis of insufficient liquidity.

As a real estate development company with high leverage and high turnover, Evergrande Group fully relies on loose financing policies. Once the financing policies are tightened and financing constraints are strengthened, the entire capital circulation model of Evergrande Group will not be able to continue. The “Three Red Lines” policy imposes financing constraints on real estate development companies that completely step on the three red lines, and tightens their financing channels. Under the influence of this regulation, Evergrande Group gradually fell into trouble, unable to continue to rely on “high leverage” for turnover, and had to actively repay its debts, which further reduced Evergrande’s corporate performance.

6. Conclusions and Implications

Financing constraints and corporate performance are negatively correlated. When the financing constraints faced by the company are small, it is easier for the company to raise capital, so as to use leverage to improve the business performance of the company. When the financing constraints faced by the company are strengthened, it will be more difficult for the company to raise capital. The required funds may even fall into a serious debt crisis. Therefore, enterprises must adjust their capital structure reasonably and reduce various risks caused by the strengthening of financing constraints, and prevent enterprises falling into trouble due to corporate debt default.

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