# EVERGRANDE: THE FALL OF A PROPERTY COLOSSUS

## Case overview

China Evergrande Group (Evergrande), one of China's largest property developers, found itself in hot water when China introduced the "three red lines" policy in August 2020. This policy comprised three financial metrics designed to encourage deleveraging in China's property industry. Evergrande, which had relied on an aggressive debt-financing strategy to fuel its rapid expansion into various sectors, failed to meet all three metrics due to its high financial leverage and was subsequently denied access to new bank loans.

By September 2021, Evergrande started missing coupon payments on its debt, including offshore bonds and wealth management products, leading to a series of liquidity crises. It reported net losses of RMB476 billion and RMB106 billion in 2021 and 2022 respectively, and was the world's most indebted property developer. Despite receiving multiple extensions, Evergrande was unable to finalise concrete debt restructuring plans. Consequently, on 29 January 2024, a Hong Kong court issued a liquidation order against Evergrande.

The objective of this case study is to facilitate a discussion of issues such as business environment in the Chinese real estate industry; reasons leading to Evergrande's downfall; corporate governance of founder-controlled companies; board composition; diversification into unrelated businesses; risk management; corporate culture; Chinese government's role in restructuring; and accounting fraud.

## Evergrande's meteoric rise

China Evergrande Group (Evergrande) was founded by Hui Ka Yan (Hui) in 1996, during a period of rapid urbanisation in China, as the Chinese government transitioned from state-provided housing to privatised urban housing. The company was incorporated in 2006 in the Cayman Islands and is headquartered in Guangzhou, Guangdong Province. While Evergrande's core business is property development, it diversified into other sectors

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such as electric vehicles (EVs), finance, healthcare, and tourism.[1] In November 2009, Evergrande went public and was listed on the mainboard of The Stock Exchange of Hong Kong Limited (SEHK).[2]

Evergrande entered the Fortune Global 500 in 2016, just two decades after its establishment, and remained on the list until 2022.[3] By 2020, it had become China's largest property developer by sales, generating an annual revenue of RMB507 billion and holding total assets valued at RMB2.3 trillion. Additionally, Evergrande managed more than 1,300 projects across 280 cities, created 3.8 million jobs annually, and employed over 200,000 people.[4]

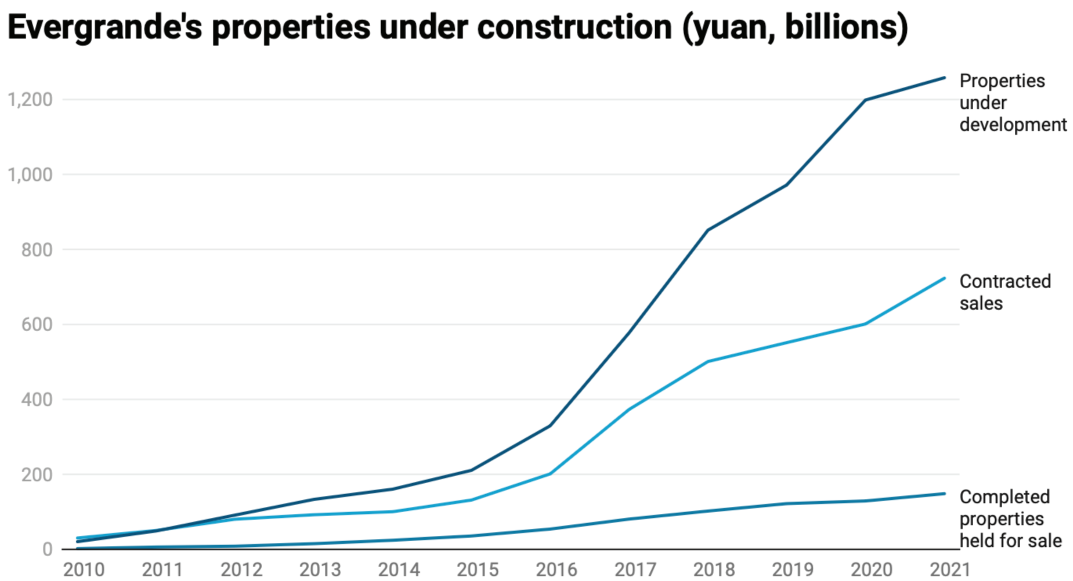
As of 30 June 2023, the public float for Evergrande's shares was 34.22%.[5] Hui had a deemed interest of 59.78% held through Xin Xin (BVI) Limited. Another substantial shareholder was Ding Yumei, the spouse of Hui, who a had deemed interest of 5.99% held through Even Honour Holdings Limited.[6]

### *The "build, build, build" model*

In response to the 2008 global financial crisis, China introduced a massive RMB4 trillion stimulus package, flooding the economy with money and enabling property developers to borrow at low costs.[7] Evergrande capitalised on the opportunity and bet on a continuous rise in housing prices. It sold properties still under construction to customers, using the generated cash to repay existing loans and taking up more loans to finance other projects.[8] This business model allowed Evergrande to continuously expand and take on more development projects while existing projects were still in progress, causing its debt to pile up.[9] By August 2017, Evergrande had the second-largest debt pile among China's corporations and pledged to reduce its net gearing ratio from 240% in June 2017 to 70% by June 2020.[10]

Fast forward to 2020, Evergrande had RMB1.26 trillion worth of projects under construction, but this was about 70% more than the RMB723.2 billion worth of properties the company was able to sell that year. Moreover, only about RMB148.47 billion worth of projects were eventually completed.[11] Figure 1 illustrates Evergrande's property development and sales trend from 2010 to 2021.

**Figure 1: Evergrande's property development and sales trend (RMB, billions)[12]**




*Source: Cheng, E. (2021, October 20). How Evergrande found itself on the wrong side of China's regulators.*

## Fuel or burden for growth?

China's meteoric economic rise had been fuelled in large part by substantial debt financing, propelling it to the status of a global economic powerhouse.[13,14] In 2021, the nation's corporate debt amounted to US$27 trillion, accounting for 31% of the global total. Additionally, China's debt-to-gross domestic product (GDP) ratio stood at 159%, significantly higher than the global average of 101% and nearly double that of the United States (US).[15]

This reliance on debt was particularly noticeable in the real estate industry. Real estate contributed approximately 30% to China's GDP, making it the single biggest contributor to the world's second-largest economy.[16] According to research conducted by S&P Global Ratings, 45% of the sampled corporate debt in China was in construction, engineering, and real estate.[17] This was largely due to the favourable borrowing conditions such as lower capital requirements and interest rates, which resulted in a continual rise in real estate prices.[18]

Between 2010 and 2018, Evergrande made the bulk of its acquisitions and investments, a period during which its debt soared from around RMB31 billion in 2010 to approximately RMB800 billion in 2019.[19,20] In comparison, its year-over-year revenue growth has slowed considerably, dropping from a high of around 50% between 2015 and 2018 to just 2% and 6% in 2019 and 2020, respectively.[21]

Evergrande's gross profit margin (GPM) showed a steep decline of 12% over just three years, from 2018 to 2020.[22] According to Evergrande's 2020 annual report, "Gross profit for the Year decreased mainly due to a decrease in the average selling prices caused by nationwide sales promotion activities and sales price concessions of the Group as a result of COVID-19."[23] Similarly, the 2019 annual report stated, "Gross profit rate was 27.8% for the Year, which was mainly due to the lower selling prices of clearance stock properties and slight increases in construction and installation costs per square meter for delivered properties, land costs, and interest capitalized."[24] These statements indicate that in the years following Evergrande's acquisitions, the decline in GPM was due to sharp cuts in selling prices to boost property sales. Moreover, Evergrande's days payables outstanding jumped from 379 days in 2016 to 553 days in 2020.[25]

## "Three red lines" policy

Amid the persistent specter of COVID-19 and the real estate industry's reliance on highly leveraged strategies, significant concerns arose regarding the potential for a property bubble to burst. In response, Chinese regulators convened a meeting in August 2020 with 12 major property developers, including Evergrande, to introduce new caps for three different debt ratios, collectively termed the "three red lines" policy.[26] The policy aimed to improve the financial health of the real estate sector by reducing developers' leverage, enhancing debt coverage, and increasing liquidity.[27]

The "three red lines" policy imposes three criteria that property developers must satisfy in order to obtain financing:

1. "A 70% limit on liability to assets which excludes early payments from contractual projects;
2. a 100% limit on net debt to equity; and
3. a cash to short-term borrowing ratio of at least one."[28]

Property developers will be evaluated based on the number of criteria they fail to meet. Generally, the more criteria they fall short on, the stricter the restrictions placed on their ability to access financing for the following year. Developers meeting all three criteria are allowed to increase their debt by a maximum of 15% in the subsequent year.[29]

### *The strangling of Evergrande*

Due to its business model, Evergrande experienced mostly negative cash flow from operating and investing activities between 2016 and 2020, as seen in Figure 2. Consequently, it relied heavily on financing activities as the primary source of cash flow, obtaining new loans to sustain its operations.[30]

**Figure 2: Changes in Evergrande's cash flows over the years[31,32,33]**

| (RMB in million) | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| CF from operating activities | -58,610 | -150,973 | 54,749 | -67,357 | 110,063 |
| CF from investing activities | -119,559 | -47,482, | -60,363 | -55,308 | -24,128 |
| CF from financing activities | 273,079 | 152,913 | -17,651 | 143,163 | -76,885 |
| Cash and cash equivalents at end of year | 198,420 | 152,008 | 129,364 | 150,056 | 158,752 |

*Source: Evergrande Group. (2021). 2017, 2019, and 2020 annual report.*

With the enforcement of the "three red lines" policy, Evergrande found itself in breach of all three criteria, significantly limiting its ability to secure new loans.[34] The insufficient financing made it challenging for Evergrande to sustain construction and other assets that could be sold, thereby triggering the onset of the company's liquidity crisis.[35]

## Blueprints for survival

On 24 September 2020, Evergrande's financial struggles became public with the circulation of a letter dated 24 August 2020, seeking government assistance for a corporate overhaul.[36] Allegedly sent by the company to the government of southern Guangdong province, the letter pleaded for assistance in gaining approval for a restructuring plan involving Evergrande's subsidiary Hengda Real Estate (Hengda). This plan aimed to list Hengda on China's A-share market through the acquisition of a Shenzhen-listed company, a move announced in 2016 but still awaiting regulatory approval. Evergrande warned of potential systemic financial risks if the proposed restructuring failed, citing the need to repay RMB130 billion to strategic investors by 31 January 2021 and the risk of cash flow collapse.[37] However, Evergrande swiftly denied the letter's authenticity, terming it defamatory and pledging legal action to safeguard its interests. At that time, Evergrande had outstanding liabilities and interest amounting to RMB835.5 billion, involving 128 banks and 121 non-banking institutions.[38] Despite these efforts, Evergrande ultimately terminated the reverse takeover in November 2020.[39]

To raise cash and reduce debt to meet the "three red lines" policy, Evergrande began exploring alternative means of raising cash.[40] These measures included offering a 30% discount on all real estate properties,[41] selling the company's shares at a 14.7% discount,[42] and divesting stakes in some of its subsidiary businesses, such as the EV unit China Evergrande New Energy Vehicle Group, and the online home and car sales platform FCB Group.[43]

S&P Global Ratings analysts also assessed Evergrande to be in a highly precarious position due to its extensive reliance on supplier commercial bills, particularly using transferable payment contracts to pay their suppliers and developers. Additionally, most of Evergrande's ongoing developments were situated in smaller Chinese cities where economists believed there was an oversupply of properties and a lack of demand. This situation prevented Evergrande from raising the selling prices of its developments to meet its cash requirements.[44] Between 2017 and 2021, Evergrande's write-downs for properties under development and completed properties held for sale increased by 4,353%, from RMB1,034 million in 2017 to RMB46,048 million in 2021.[45,46]

Among the 12 companies present at the initial meeting in 2020, only Evergrande and Greenland Holdings, another major property development firm in China, remained in violation of the "three red lines" policy by August 2021.[47] Evergrande breached all three lines, while Greenland Holdings breached only one.[48]

### *Evergrande's debt woes*

In May 2021, an online complaint platform run by Sina Corporation revealed that at least four commercial paper holders reported they had not received payments from various Evergrande units. One post, which included images of six commercial papers, highlighted that four Evergrande units in Kunming had delayed payments totalling nearly RMB4 million for three months. Commenting on the post, Evergrande said it had instructed its project companies to resolve the repayment on the day it discovered the problems, and the four Kunming units had already completed the payments.[49] On 7 June 2021, Evergrande announced it was arranging payment for overdue commercial paper from some of its project companies.[50]

However, in August 2021, Evergrande once again failed to pay some overdue suppliers. Advertising firm Leo Group applied to a Chinese court to freeze RMB356 million in Evergrande's assets due to overdue payments. This follows similar legal actions by other companies, including Huaibei Mining Holdings' construction unit which sued Evergrande for RMB400 million in overdue fees. Additionally, a court ordered the freezing of Evergrande's shares in Langfang Development for three years due to another lawsuit.[51] Meanwhile, China's central bank summoned Evergrande's executives and issued a rare warning, emphasising the need for the company to reduce its debt risks and prioritise stability.[52]

With liabilities exceeding US$300 billion and having borrowed approximately US$88.5 billion from financial institutions, nearly half of which was due in less than a year, cash-strapped Evergrande was struggling to meet its loan and interest payment obligations on time.[53] In total, Evergrande had US$669 million of coupon payments to be disbursed in 2021, and by 2022, it had to repay US$7.4 billion of maturing bonds.[54] Evergrande had missed interest payments to at least two of its largest bank creditors. Banks were expecting Evergrande to miss the deadline after China's housing ministry had told them the company would be unable to pay on time.[55] US$131 million bond interest payments on 23 September 2021 and 29 September 2021 were missed, both of which triggered 30-day grace periods for these payments.[56]

On 7 October 2021, it was reported that JPMorgan estimated Evergrande and several major Chinese property rivals had billions in off-balance sheet debt, significantly increasing their leverage ratios. Analysts believed this tactic was used to appear compliant with the "three red lines" policy, with Evergrande's case being the most extreme. "Instead of true deleveraging, we think Evergrande has shifted some of the interest-bearing debt to off-balance sheet debt,"[57] JPMorgan's analysts stated, referring to commercial papers, wealth management products, and perpetual capital securities. They estimated Evergrande's net gearing was at least 177% at the end of the first half of 2021, compared to the 100% reported, suggesting real gearing could be higher due to undisclosed off-balance sheet debt.[58]

Evergrande's woes also extended to the local market, where the credit stress level for China's bond market increased throughout 2021. The higher the level, the greater the market stress relative to historic averages. This adversely impacted the Asian high-yield bond market, from which real estate companies primarily obtained most of their bond sales. Despite being the largest issuer of high-yield bonds, Evergrande did not conduct any bond sales since January 2020, which was one of the ways they typically sought to repay their debt.[59]

### *A slight relief*

Evergrande managed to avoid default on its offshore bonds by making last-minute payments on 21 October 2021 and 28 October 2021, just before the 30-day grace periods expired. Failure to pay within the 30-day grace period would have triggered cross-defaults on all of the company's US$19 billion worth of bonds in international capital markets, potentially resulting in the world's second-largest emerging market corporate debt default.[60]

### *Last-ditch efforts*

> "Evergrande has tried its best to solve liquidity problems, but it's a little bit difficult to gather enough capital to pay all the debt,"
>
> – *Cliff Zhao, Chief Strategist at China Construction Bank International*[61]

Evergrande attempted various methods to resolve its liquidity crisis These included divesting its entire stake in the film and TV streaming company HengTen Networks Group for US$684 million,[62] the sale of its 26-storey China headquarters in Hong Kong that was purchased for US$1.61 billion in 2015,[63] off-loading a US$1.55 billion stake in Shengjing Bank Co. by transferring a 20% share to the local Shenyang government,[64] and selling numerous other non-core assets.[65]

However, Evergrande's situation remained bleak due to its enormous debt and looming maturities. The company's debt had been downgraded several times, with both Fitch Ratings and S&P Global Ratings indicating a high likelihood of default.[66] In September 2021, Fitch Ratings downgraded Evergrande from 'CCC+' to 'CC', suggesting "very high levels"[67] of credit risk and a probable default.[68] Three months later, in December 2021, it downgraded Evergrande again to 'Restricted Default' due to the company's failure to pay its coupons due on 6 November 2021, after the grace period had lapsed.[69] This marked the first time Evergrande defaulted on its bond debt.[70] Since then, Evergrande had announced its intention to engage with creditors to formulate a "viable restructuring plan" to address its offshore debts.[71]

By September 2021, Evergrande shares had lost nearly 85% of their value, plummeting from HKD14.10 on 4 January 2021 to HKD2.30 after news broke about a missed payment on an onshore bond.[72] Following its default in December 2021, the shares hit a record low of HKD 1.72, the lowest since Evergrande's debut in November 2009.[73]

## Relentless diversification

Evergrande diversified into several areas which were unrelated to its core business.

### *China, the rising World Cup superstar*

In China, owning a football club was seen to be able to foster valuable 'guanxi,' or special relationships with politicians and businessmen. President Xi Jinping (Xi) had expressed a clear desire to see China qualify for, host, and eventually win the World Cup,[74] laying out a strategic plan for China to become a "true football nation".[75]

Evergrande's acquisition of Guangzhou Football Club (FC) marked a significant foray into football. Since 2015, Guangzhou FC had consistently reported losses, including a RMB1.9 billion loss in 2019.[76] In 2020, Evergrande began construction of the RMB12 billion Guangzhou Evergrande Football Stadium, which was set to be the world's largest upon completion in 2022. However, construction halted in 2021 due to a lack of funds and Evergrande facing a liquidity crisis.[77] The stadium was ultimately taken over by a subsidiary of China State Construction.[78] Evergrande reportedly invested RMB2.1 billion in construction cost for the stadium and was seeking a RMB5.52 billion refund by returning land use rights to four parcels of land in Guangzhou.[79]

### *Farmers market*

Evergrande also ventured into agribusiness, including grain and oil, spring water, and dairy products. In 2014, Evergrande launched its mineral water brand "Evergrande Spring", investing RMB5.54 billion in the venture. The company also launched a marketing campaign featuring Jackie Chan to promote the brand.[80] The agribusiness sector resulted in a loss of approximately RMB4 billion, leading to the sale of these businesses for RMB2.7 billion in 2016.[81]

### *The next 'Tesla'?*

In January 2019, Evergrande acquired 51% of the shares in NEVS AB, a Swedish car manufacturer through Evergrande Health Industry Group Limited, marking its transition from health management to the EV market.[82]

On 20 August 2020, Evergrande Health Industry Group Limited changed its name to China Evergrande New Energy Vehicle Group Limited (Evergrande Auto),[83] aiming to become the world's largest and most powerful green energy car company within the next three to five years.[84]

In 2020, Evergrande Auto introduced six electric car models, including sedans, minivans, and SUVs, with plans to begin mass production in 2021. However, as of April 2021, it had not sold a single car under its own brand.[85] It reported a RMB4.8 billion loss for the six months to 30 June 2021. By September 2021, facing a severe cash crunch, Evergrande Auto struggled to pay its employees and halted EV production.[86] This led to a rapid exit of investors, causing the stock price of Evergrande Auto to plummet from an all-time high of HKD72.25 in February 2021 to HKD3.20 by 11 April 2022.[87]

In March 2022, Evergrande Auto received official approval for two of its car models to be sold under the brand name "Hengchi".[88] The Hengchi 5 was launched in July 2022, began production in September 2022, and delivered its first batch of EVs to 2022 to 100 customers on 29 October 2022.[89,90] The launch of the Hengchi 5 was a great success with 37,000 vehicles ordered within 15 days of the start of pre-sales. However, Evergrande Auto once again suspended production in April 2023 due to insufficient funds. It was revealed that only 900 units of the Hengchi 5 had been delivered by then.[91]

## Allies count their losses

Wealthy investors who supported Chinese billionaire Hui's empire faced significant losses due to growing concerns about Evergrande's ability to repay its debts. Hui had relied on his close associates who supported Evergrande by buying stakes, purchasing bonds, or not calling in debts.[92]

One of Evergrande's closest business allies was Hong Kong property tycoon Joseph Lau (Lau). Along with his wife, Lau held just over a 9% stake in Evergrande, making them the company's second-largest shareholder as of August 2021.[93] However, in September 2021, the couple offloaded 48% of their shares in Evergrande and indicated plans to sell their remaining 4.68% stake in the near future, expecting to incur losses of HKD10.6 billion.[94,95] Another close associate was billionaire Zhang Jindong, who lost control of the retail arm of his Suning empire after a state-backed bailout in July 2021. In September 2021, he waived his right to a RMB20 billion payment from Evergrande, helping Hui save his company but raising concerns among investors about Suning's cash flow.[96]

### *House of cards*

Facing payment deadlines, China government authorities urged Hui to use his fortune to pay Evergrande's debt.[97] In a desperate bid to save Evergrande, Hui raised about US$1.1 billion by pledging assets, shares, and selling off his personal assets, injecting the funds into Evergrande to "improve liquidity and sustain its day-to-day operations".[98] In December 2021, after Evergrande was officially labelled a defaulter for the first time, Hui was forced to sell 277.8 million of his shares in the company, worth US$64 million, decreasing his stake in Evergrande from 61.88% to 59.78%.[99] It was believed that Hui might need to contribute more of his personal wealth to pay back Evergrande's debts.[100]

## Superheroes of Evergrande

During the year ended 31 December 2020, Evergrande's board consisted of nine directors, with Hui serving as the Executive Chairman. The board also established three committees: the Audit Committee (AC), Remuneration Committee (RC), and Nomination Committee (NC).[101] A brief breakdown of the board is shown below.

**Figure 3: Evergrande's board of directors**[102]

| Name | Age | Gender | Role | Board committee memberships, Experiences, and Qualifications |
|---|---|---|---|---|
| Hui Ka Yan | 62 | Male | Founder and Executive Chairman | • Chairman of Nomination Committee and member of Remuneration Committee.<br>• Over 36 years of experience in real estate investment, property development, and corporate management.<br>• Graduated from Wuhan University of Science and Technology and was awarded an honorary doctorate degree in commerce from the University of West Alabama. |
| Xia Haijun | 57 | Male | Vice Chairman and CEO | • Over 32 years of experience in property development and corporate management.<br>• A senior economist in China.<br>• Graduated from Jihan University with a master's degree in business administration and doctor's degree in industrial economy. |
| Shi Junping | 37 | Male | Executive director | • Over 14 years of experience in marketing and management for property development and brand image strategic operations for multiple industries, including real estate and finance.<br>• Has a bachelor of arts degree and a bachelor of laws degree, and a master's degree in engineering management. |
| Pan Darong | 48 | Male | Executive director and CFO | • Over 26 years of experience in auditing, accounting, and finance.<br>• Graduated from the investment and economic faculty of Zhongnan University of Economics. |
| Huang Xiangui | 50 | Male | Executive director | • Over 24 years of experience in marketing, human resource management, foreign capital and funds operation, and management.<br>• Graduated from Harbin Engineering University with a bachelor degree in chemical engineering and obtained a master degree of science in banking and finance from the University of Stirling. |
| Lai Lixin | 41 | Male | Executive director | • Over 27 years of experience in operation and management of real estate projects.<br>• Holds a master's degree in engineering management. |
| Chau Shing Yim, David | 57 | Male | Independent non-executive director | • Chairman of Audit Committee and member of Nomination Committee.<br>• Over 20 years of experience in corporate finance and was formerly a partner of the big four accounting firms in Greater China.<br>• A member of the Institute of Chartered Accountants of England and Wales and the Hong Kong Institute of Certified Public Accountants. |

| Name | Age | Gender | Role | Board committee memberships, Experiences, and Qualifications |
|---|---|---|---|---|
| He Qi | 65 | Male | Independent non-executive director | • Chairman of Remuneration Committee and member of Audit Committee .<br>• Currently the secretary of Circulation and Leasing Committee of China Real Estate Association.<br>• Previously an executive of the Development Center of the China Real Estate Association and an executive deputy mayor of Ji'an City of Jiangxi Province. |
| Xie Hongxi | 62 | Female | Independent non-executive director | • Member of Audit Committee and Remuneration Committee.<br>• Currently the deputy director, senior engineer and master degree instructor at the Engineering Training and National Experiment, Education and Demonstration Center of South China University of Technology. |

*Source: Evergrande Group. (2021). 2020 annual report.*

The Company Law of China mandates that all registered companies, including foreign-invested enterprises, adopt a two-tier board structure consisting of a board of directors managing the company and a supervisory board overseeing the management.[103] However, Evergrande was not required to follow this mandate as it was incorporated in the Caymen islands and listed on the SEHK. Consequently, Evergrande did not have a supervisory board. Nonetheless, Hui is the legal representative of the company,[104] as required by the Company Law. This position made him the primary signatory of the company, granting him the power and authority to enter into binding agreements on behalf of the company in accordance with the law and the company's articles of association. Essentially, this role provides him with broad control over the company, its business activities, bank accounts, and assets.[105]

Xie Hongxi (Xie) was the only female member on the board, having been elected as an independent non-executive director on 28 June 2012.[106] Shortly after Xie's appointment, Hong Kong Exchanges and Clearing Limited (HKEX) released a consultation paper on board diversity in September 2012, which highlighted the importance of gender diversity on corporate boards.[107] In December 2021, HKEX mandated that boards must include at least one director of a different gender, allowing firms a three-year transition period to comply.[108] While Evergrande's board met these new regulations, it remained predominantly male.

### *Captain China*

Born in Henan Province, Hui was raised by his grandmother in rural poverty after his mother died when he was eight months old.[109] Despite early hardships, including attending a thatched schoolhouse and eating moldy cornbread, Hui aimed to become a bricklayer to secure a regular salary. However, with universities reopening after the Cultural Revolution, he enrolled at the Wuhan University of Science and Technology and later worked for a decade in a state-owned steel mill before he founded Evergrande.[110]

In 2017, Hui set an ambitious target of achieving RMB1 trillion in sales within three years, approximately five times Evergrande's total sales in 2016.[111] He was reportedly quoted as saying that he wanted Fairyland, Evergrande's amusement park arm, to "outperform Disneyland".[112] Hui had also made similar statements about his EV business, aiming to "become the world's leading electric vehicle provider within five years",[113] directly challenging Tesla.[114] His wealth primarily stems from the capital appreciation of Evergrande's stock price and the dividend payouts he received from the company. In 2017, Hui was crowned "China's richest man" on the year's

Forbes China Rich List after his net worth surged to RMB42.5 billion.[115] The majority of his net worth, up to RMB32 billion, was attributable to his holdings in Evergrande's shares, which saw a dramatic increase in share price from HKD5.04 at the start of 2017 to a high of HKD32.33 in October 2017.[116] Forbes estimated that as of November 2021, Hui had received a total dividend payout of RMB8 billion from Evergrande.[117]

### *Superhero turned villain*

As the Chief Executive Officer (CEO), Xia Haijun (Xia) oversaw the day-to-day activities of the business, managed the group's financing activities, and was responsible for shaping the corporate culture and tone within the company. According to Evergrande's 2020 annual report, Xia held an 8.75% senior note worth US$28 million due in 2025 and an11.5% senior note worth US$50 million due in 2023.[118] On 9 February 2022, media reports revealed that Xia sold his entire stake in these bonds in a series of transactions between July and August 2021, just before Evergrande's debt crisis worsened.[119] However, Xia notified the HKEX of these transactions only in February 2022, six months after the transactions were made, without providing any explanation for the delay in reporting.[120]

Additionally, a common trait among China's wealthiest tycoons is to make their deputies the highest-paid executives.[121] Xia's remuneration was substantially higher than that of his peer directors, exceeding theirs by more than tenfold. In 2017, his recorded remuneration was RMB298 million, nearly 20 times his 2009 salary of RMB15 million. Of his total remuneration package, RMB280 million, or 94%, was in cash. This high remuneration came as he led Evergrande to achieve a record profit of RMB37 billion in 2017, an increase of 110% compared to 2016.[122]

In July 2022, Xia and Chief Financial Officer (CFO) Pan Darong (Pan) were forced to resign following a preliminary probe that uncovered their involvement in diverting loans secured by Evergrande's publicly listed subsidiary, Evergrande Property Services, back to the parent group.[123] The investigation revealed that deposits worth RMB13.4 billion, belonging to Evergrande Property Services, were used as collateral to guarantee a series of loans. These funds were then "transferred and diverted back to the group [Evergrande] via third parties and were used for the general operations of the group".[124] When the loans were not repaid, banks seized the deposits from Evergrande Property Services, threatening to wipe out most of its cash reserve.[125]

### *Jack of all trades, master of none?*

Back in 2016, Siu Shawn (Siu) was Evergrande's executive vice president and Chairman of Evergrande Tourism Group. He was responsible for managing the tourism group, overseeing projects such as Ocean Flower Island Hainan, Evergrande Venice, and Fairytale Land.[126] In 2019, Siu was appointed Chairman of Evergrande Auto and took on the responsibility for the overall business management of Evergrande.[127]

In 2021, despite significant losses and the fact that Evergrande Auto had not yet sold a single EV, Siu announced that Evergrande Auto would open 36 flagship showrooms. He emphasised that a vast sales network was vital for laying a solid foundation to capture significant market share.[128] Meanwhile, most of Evergrande's fairytale-themed amusement parks under Fairytale Land were abandoned and left derelict due to Evergrande's debt crisis.[129] Additionally, a scandal emerged concerning the RMB81 million Ocean Flower Island project. Bribes were given to ZhangQi, a former party secretary of Danzhou government, in exchange for construction projects approvals.[130] Upon the discovery of the scandal, ZhangQi was jailed for life and Evergrande was ordered to demolish 39 buildings under the project due to illegally obtained permits and other factors such as "environmental and constructions violations"[131]

### *Evolving superheroes*

On 23 January 2022, Evergrande announced the resignation of Lai Lixin (Lai) and Huang Xiangui (Huang). Lai resigned to "devote more of his time to his other duties with the Group" and will remain with Evergrande. Huang cited "health reasons" for his resignation but will also stay with Evergrande. Consequently, Siu and Liang Senlin (Liang) were appointed as executive directors to replace Lai and Huang. Siu brings over 28 years of extensive commercial experience, while Liang has over 30 years of experience in banking and asset management.[132]

Further changes to the board included the appointment of a new CEO and CFO. On 22 July 2022, Liu Zhen (Liu) was appointed as the new CEO, replacing Xia, while Qian Cheng (Qian) was appointed as the new CFO, replacing Pan. Liu joined Evergrande in 2011 and has served in various positions, including Chairman of Xinjiang Company of Evergrande Real Estate Group and Vice President of Evergrande Auto. Qian joined Evergrande in 2008 and has experience serving in various financial management positions.[133]

## Too late for risk management?

In the years leading up to its liquidity issues, Evergrande did not establish a dedicated Risk Committee. Instead, the board was tasked with evaluating and determining the nature and extent of the risks the company was willing to take to achieve its strategic objectives. It also oversaw the establishment and maintenance of appropriate and effective risk management and internal control systems. Management, on the other hand, was responsible for designing and maintaining these systems and providing the board with assurances regarding their effectiveness.[134] Given the absence of a Risk Committee, the AC was responsible for reviewing the structure of risk management, continuously monitoring its effectiveness, and overseeing the fundamental risk management system.[135]

Evergrande's disclosures regarding risk management consisted largely of broad, general statements.[136] In the company's 2020 annual report, the state of the risk management system was briefly discussed. While the report indicated that Evergrande had revised its risk assessment criteria for each business segment, it offered scant detail on the specifics of these updates. It explained that "the risks that are most likely to affect the achievement of objectives have also been assessed using commonly recognized assessment methods and assessment criteria."[137] However, the report failed to disclose the specific key risks, assessment methods, or criteria involved,[138] and this lack of transparency persisted in the subsequent annual reports for both 2021 and 2022.[139,140]

### *The birth of Risk Management Committee*

On 6 December 2021, Evergrande announced the formation of a Risk Management Committee (RMC) in response to its operational and financial challenges. The company clarified that the RMC was an external committee, distinct from a board or management committee, tasked with addressing Evergrande's current situation and playing a key role in mitigating and eliminating future risks for the company.[141] Chaired by Hui, the RMC primarily consisted of members from state enterprises and was led by the Guangdong provincial government to facilitate Evergrande's restructuring.[142]

The RMC's responsibilities included restructuring Evergrande's offshore public bonds and private debt. For its offshore public bonds, the committee planned to actively engage with offshore creditors by listening to their suggestions and opinions, aiming to formulate a workable solution for refinancing the pending debts.[143] The RMC asked Evergrande's bondholders to source potential investors to commence communications with Evergrande. Additionally, Evergrande had engaged more financial and legal advisors to aid in mediating the demands of its current creditors.[144] For its private debt obligations, the restructuring would likely include bonds of joint ventures such as Jumbo Fortune and the unit Scenery Journey.[145]

Figure 4 shows the members of the RMC and their respective backgrounds.

**Figure 4: Members of Evergrande's Risk Management Committee**[146]

| Name | Position in RMC | Background |
|---|---|---|
| Hui Ka Yan | Chairman | Chairman of Evergrande and Executive Director |
| Liu Zhihong | Co-Chairman | Deputy General Manager of Guangdong Holdings Limited |
| Pan Darong | Member | Chief Financial Officer of Evergrande and Executive Director |
| Zhao Limin | Member | Vice President of China Cinda Asset Management Co., Ltd. |
| Li Feng | Member | Chief Capital Officer of Guangzhou Yuexiu Holdings Limited |
| Chen Yong | Member | Compliance Director of Guosen Securities Co., Ltd. |
| Hao Han | Member | Partner of Beijing Zhonglun Law Firm |

*Source: Evergrande Group. (2021, December 6). Inside Information.*

## Transparency in China

Regulatory transparency has long been a challenge in China, and progress remains inconclusive.[147] Concerns regarding financial transparency in China's real estate industry have also been growing, as numerous auditors have resigned from Chinese real estate companies due to a lack of access to information. All the property developers whose Big Four auditors have resigned have opted for smaller and in some cases local audit firms.[148] Credit research firm CreditSights noted that the recent changes in auditors were a "cause for concern as they could be a sign of potential accounting irregularities".[149]

In January 2022, PricewaterhouseCoopers (PwC) resigned from Hopson Development (Hopson), citing insufficient information from management on matters such as the valuation of Hopson's investment properties.[150] Shortly after, Shimao Group Holdings, one of China's largest property companies, also announced PwC's resignation as its auditor after it failed to provide information related to "trust loan arrangements".[151] Since then, the Accounting and Financial Reporting Council (AFRC), Hong Kong's audit watchdog, has initiated probes into the financial reports of companies and auditors it deemed of "high public interest," including Evergrande.[152] In an interview, Kelvin Wong Tin-Yau, Chairman of the AFRC, stated, "If we are conducting an investigation in a case that involves high public interest, then we should maintain high transparency and announce the investigation once we start the process."[153]

### *Financial probe*

The AFRC initiated an investigation into Evergrande's 2020 accounts and its audit by PwC, expressing concerns about whether Evergrande had properly disclosed its ability to continue operating as a going concern.[154] By the end of 2020, Evergrande's books showed cash and cash equivalents of RMB159 billion, which were insufficient to cover its existing liabilities of RMB1.5 trillion, with additional borrowings of RMB167 billion maturing in 2022.[155] Additionally, Evergrande's access to loans and borrowings was significantly restricted due to its excessively high debt-to-equity ratio and the implementation of the "three red lines" policy. These warning signs underscored doubts about Evergrande's ability to operate as a going concern. Despite these concerns, PwC issued an unqualified audit opinion on the 2020 financial statements without referencing material uncertainties regarding Evergrande's ability to operate as a going concern.[156]

Earlier, in 2017, Hong Kong-based accounting research firm GMT Research conducted site visits to 40 of Evergrande's projects in 16 cities across China.[157] Based on its findings, GMT Research opined that PwC had failed to take a sufficiently robust stance by allowing Evergrande to overcapitalise interest, misclassify commercial premises and treat car parking spaces as investment properties, and overvalue assets such as unsold properties and empty investment properties without requiring write-downs.[158] The research firm estimated that a realistic assessment of asset values would necessitate RMB150 billion in asset write-downs, effectively wiping out Evergrande's shareholders' equity almost three times over, suggesting insolvency.[159]

## Escalating troubles

On 22 March 2022, Evergrande announced that it would not be able to publish its 2021 audited results by the end of March as required by the Hong Kong Listing Rules. The company cited several reasons for the delay: drastic changes in the operating environment since the second half of 2021, an increased number of additional audit procedures, and the impact of COVID-19.[160] Consequently, Evergrande's shares were suspended for trading indefinitely until it could publish an announcement containing the requisite financial information.[161]

Unexpectedly, on 16 January 2023, Evergrande announced that its auditor PwC had resigned due to disagreements over auditing its 2021 accounts. The announcement explained: "The Company and PwC have not been able to agree on the timetable and the scope of work in respect of the assessment on the Group's going concern basis and implications of the relevant disclosure, as well as the additional audit work and procedures required for the assets impairment assessment. As such, the Board is of the view that it is in the best interests of the Company and its stakeholders to appoint another auditor to complete the audit work as soon as practicable, and therefore the Board recommended PwC to resign as the auditor of the Company."[162] On the same day, Evergrande's board resolved to appoint Prism Hong Kong and Shanghai Limited as the new auditor to replace PwC.[163]

On 17 July 2023, Evergrande finally released its 2021 and 2022 annual report, which revealed total net losses of RMB812 billion over the two years.[164] Following a 17-month suspension, Evergrande announced on 26 August 2023 that it had "adequately" fulfilled the resumption guidance issued by the SEHK and applied to resume trading on 28 August 2023.[165] However, just a month later, Evergrande's shares were once again suspended until further notice after it received notification from relevant authorities that its Chairman, Hui, had been subjected to "mandatory measures in accordance with the law due to suspicion of illegal crimes."[166] Bloomberg reported that it was unclear why Hui was placed under residential surveillance, a type of police action that falls short of formal detention or arrest and does not mean Hui will be charged with a crime.[167]

## China's Lehman Brothers?

Concerns arose over the systemic risks posed by Evergrande's crisis and its extensive implications for both the Chinese and global economies.[168] Evergrande's significant involvement in the Chinese economy had led it to be considered "too big to fail."[169] The crisis severely affected China's job market, putting many positions at risk.[170] This impact also extended beyond Evergrande's direct employees to those of contractors and suppliers reliant on Evergrande for business and payment to meet their payroll obligations.[171]

While Evergrande's crisis had been compared to the collapse of the US investment bank Lehman Brothers, financial analysts believed Evergrande's debt issues were unlikely to cause a similar fallout. This was due to major differences in the assets held by the two companies, Evergrande held land while Lehman Brothers held financial assets. In Lehman Brother's case, the global financial crisis caused the bank's financial asset prices to falling towards zero, leading to cash flow issues and eventual bankruptcy. However, Evergrande's situation involved a property development firm that took on substantial debt. Ultimately, Evergrande faced a liquidity crunch, with its main problem lying in cash flow issues. These can potentially be resolved if Evergrande can channel cash flow into its physical assets, allowing the company to complete development projects, sell properties, and pay down its debt.[172]

Additionally, China's strong government control in the real estate sector played a significant role in distinguishing Evergrande's situation from past financial crises. Unlike in many Western economies where market forces predominantly dictate outcomes, China's government exerts considerable influence over its industries, particularly real estate. This control extends to both state-owned enterprises and non-state entities, with the government often directing lending and financial activities. Commercial bankruptcy, therefore, becomes more of a strategic decision by the state rather than a purely economic outcome. This centralised control gives the Chinese government the ability to intervene in crises and manage risks more directly, shaping the response to Evergrande's debt woes.[173]

### *Mixed messages*

Amid the backdrop of Evergrande's liquidity issues during the COVID-19 pandemic, Chinese authorities reportedly instructed local governments to prepare for the potential downfall of Evergrande, a move described by officials as "getting ready for the possible storm".[174] Local-level government agencies and state-owned enterprises received instructions to intervene only as a last resort if Evergrande fails to manage its affairs in an orderly manner.[175]

These actions signal Chinese authorities' intent to manage debt and curb property speculation. Moreover, the implicit government guarantees that once protected highly leverage firms are now defunct, with financial markets expected to enforce discipline on borrowers.[176] This aligns with China's effort to crackdown on debt. Nonetheless, economists hypothesised that while the Chinese authorities may allow property developers to face the consequences of their actions, they would step in to safeguard the stability of the banking and broader financial systems.[177]

In January 2023, it was reported that China would ease its "three red lines" policy, which restricts borrowing by property developers, as part of a plan to support the struggling real estate industry. This policy relaxation will apply to 30 well-performing developers deemed systemically important based on their scale and operations, signalling a shift towards prioritising economic stability over addressing excessive debts.[178] Beijing may allow some property firms to increase their leverage by easing borrowing caps and extending the grace period for meeting the policy's debt targets.[179] Additionally, China's financial regulators have instructed the country's state-owned asset management companies (AMCs) and approximately 20 banks to assist a dozen Chinese real estate developers facing financial difficulties, which may include purchasing their liabilities.[180]

## The end of an era?

Since its default in 2021, Evergrande had proposed several restructuring plans. However, the process encountered various obstacles. While preparing its restructuring proposal, Top Shine Global Limited, an offshore creditor, filed a winding-up petition against Evergrande in the High Court of the Hong Kong Special Administrative Region in June 2022, over a financial obligation of HKD862.5 million.[181] The petition for Evergrande's liquidation was heard six times. Between September 2022 and March 2023, Evergrande secured multiple adjournments in court by demonstrating progress in restructuring its offshore debts through schemes of arrangement (Scheme) aimed at restoring solvency. However, in late September 2023, Evergrande halted its Scheme meeting, stating that the latest plans required reassessment, leading to the dismissal of the scheme proceedings.[182]

On 30 October 2023, during the fourth hearing, the court warned of a potential winding-up order unless Evergrande presented a fully developed restructuring plan at the subsequent hearing. At the fifth hearing on 4 December 2023, Evergrande provided an update on a revised restructuring proposal.[183] Lawyers for Evergrande argued that no creditors were "actively seeking" its liquidation. Hong Kong High Court Justice Linda Chan (Chan) accepted that argument but stipulated that significant advancements were expected by the next hearing.[184]

On 29 January 2024, Evergrande was ordered to be liquidated by the Hong Kong High Court, after failing to convince the court that it had a viable restructuring plan. Justice Chan delivered the ruling, stating: "It would be a situation where the court says enough is enough. It seems to me that the interests of the creditors will be better protected if the company is wound up by the court, so that independent liquidators can take control over the company".[185,186]

Nevertheless, even with the winding-up order, the liquidator is expected to encounter challenges when dealing with Chinese developers. Many of Evergrande's projects are managed by local entities, posing difficulties for the offshore liquidator to take control. Furthermore, construction, housing deliveries, and other operations in mainland China are likely to persist throughout the unfolding process.[187]

### *More to uncover*

On 1 December 2023, GMT Research released a report alleging that Evergrande had "inflated revenue and profits for years,"[188] adding that the company was "never profitable."[189] Evergrande responded three days later stating that the research firm's report was "without basis".[190] In a subsequent clarification announcement, Evergrande concluded that GMT Research's report failed to provide substantive evidence supporting its claims, relying instead on conjecture and suspicion. Furthermore, the report incorrectly used 2023 results to support its 2016 forecast, lacking substantive basis. Evergrande also mentioned that it reserved the right to take legal action against GMT Research.[191]

However, on 18 March 2024, the China Securities Regulatory Commission (CSRC) charged Evergrande's main onshore unit, Hengda, with inflating revenue by nearly RMB214 billion in 2019 and RMB350 billion in 2020. These falsified numbers were used to raise money. The CSRC fined Hengda RMB4.18 billion and imposed a RMB47 million fine on Hui, who also received a lifetime ban from the securities market. Former CEO Xia and several executives also faced fines and bans.[192] The CSRC attributed much of the fraudulent activity to Hui alleging that he directed personnel to "falsely inflate" Hengda's annual results for those two years. Additionally, Hengda was accused of fraudulently issuing a combined RMB20.8 billion in bonds using these inflated figures in marketing.[193]

Meanwhile, on 16 April 2024, an open letter titled "Who brought PwC into the fire pit of Evergrande?" was widely circulated on social media.[194] Written by "some PwC partners," the letter accused Raymund Chao (Chao), Asia Pacific and China Chairman of PwC China, and his team of overlooking issues in Evergrande's financial statements. The letter claimed that some senior PwC executives had suggested discontinuing Evergrande as a client in 2014, but Chao insisted on retaining the business. PwC responded on 16 April 2024, stating that the letter contained false allegations that damaged the firm's reputation.[195] Nonetheless, on 19 April 2024, the Hong Kong AFRC announced an investigation into PwC's quality management system and the audits of Evergrande following the concerns raised in the open letter. On 31 May 2024, it was reported that PwC is expected to face a fine of at least RMB1 billion in China for allegedly overlooking misconduct Evergrande for over a decade. PwC will also have some of its local operations in China suspended.[196]

## Discussion questions

1. What are benefits and risks associated with founder-controlled companies? Discuss this in the context of Evergrande.
2. What were the key contributing factors that led to Evergrande's liquidity crisis? Evaluate which were the most significant factors and explain why.
3. Critically evaluate the composition of the Evergrande board. To what extent do you believe the (1) board of directors, (2) executive chairman, and (3) audit committee are responsible for Evergrande's downfall?
4. Evergrande was very aggressive in pursuing diversification into unrelated businesses. What are the risks and benefits, if any, of such diversification? What is the role of the board in overseeing diversification?

5. Critically evaluate Evergrande's response to the challenges it encountered. How effective were their strategies in managing the crisis, and what could they have done differently?
6. Considering Evergrande's risk profile, risk appetite, and highly leveraged capital structure, analyse whether the company's rapid expansion was justified. What alternative strategies could Evergrande have pursued to manage its growth more sustainably?
7. What are the essential characteristics of an effective risk management framework? Assess whether Evergrande had an adequate risk management framework in place to oversee and manage the risks that led to its crisis.
8. Assess the effectiveness of PwC China, Evergrande's external auditor, in identifying and pre-empting potential issues within the company before they escalated. To what extent do you believe PwC China failed in fulfilling their responsibilities regarding Evergrande?
9. Analyse the impact of the Chinese government's "three red lines" policy on the financial stability of real estate companies. How has this policy influenced debt management strategies within the industry, and to what extent has it contributed to financial distress among property developers?

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