

Study on the Financial Impact of Perpetual Debt--Based on the Case Analysis of Gezhoubu Company

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Abstract. Perpetual debt is a new thing in China's capital market, and China's listed companies have only started to issue perpetual debt financing in recent years. When perpetual bonds are classified as equity instruments, they have the advantages of increasing the company's equity without diluting the shares and reducing the gearing ratio. This is very attractive to the listed companies that are in urgent need of high costs and have restrictions on debt issuance due to high gearing ratios. As a result, this paper selects the case of Gezhoubu's perpetual debt issuance as the research object, and conducts an in-depth study on the financial impact of listed companies' perpetual debt financing.

Key words: perpetual bonds, Financial implications.

1. Introduction

The construction industry has a long project cycle, slow return of funds and other characteristics, enterprises can not rely on their own funds to get better development, the need for external financing to meet the needs of enterprises. However, a large amount of liabilities will cause a high gearing ratio, while high financial leverage will also cause difficulties in subsequent financing. As perpetual debt can be included in the owner's equity, it can meet the financing needs of the enterprise while also reducing the enterprise's gearing ratio, based on this, perpetual debt has become one of the financing methods favoured by many construction enterprises. However, the introduction of a series of policies means that the regulations on the inclusion of perpetual bonds in equity instruments and the conditions for pre-tax deduction of income tax will become more and more stringent.

Based on the above background, this paper chooses Gezhoubu, one of the eight central enterprises in the construction industry, as a case study on the effect of its several times of perpetual debt financing, in order to provide reference for Gezhoubu and other construction enterprises that choose perpetual debt financing.

2. Overview of Gezhoubu's perpetual debt financing

From 2016 to 2020, Gezhoubu issued perpetual bonds 12 times, with a total issuance amount of RMB33 billion. The maturities of the perpetual bonds issued by Gezhoubu are categorized into two, three and five years, which are cases with maturity date but renewable. The perpetual bonds issued by Gezhoubu were medium-term notes and corporate bonds. Three issues of perpetual medium-term notes totaling RMB11 billion were issued with an average interest rate of 4.07%, and nine issues of perpetual corporate bonds totaling RMB22 billion were issued with an average interest rate of 3.78%. Since the Securities and Futures Commission does not restrict the issuance of perpetual bonds for companies with ratings up to AAA, Gezhoubu issued more corporate bonds, accounting for 75% of the total issuance. From the use of funds raised, the company raised funds in the previous period, 11.5 billion clearly stated that the use of funds for supplementary liquidity, 14.5 billion for repayment of maturing borrowings and debt, while the 7 billion perpetual bonds issued by the company in 2020 did not specify the use of funds in detail.

3. Analysis of the Direct Financial Impact of Gezhouba's Perpetual Debt Financing

3.1. Cash flow analysis

Gezhouba's bank debts from July 2016 to year-end 2016 totaled 5.835 billion yuan, of which 6 billion was used to repay maturing debts, which was enough to pay off the maturing debts of the year, according to the use of proceeds stated in its perpetual bond issuance announcement in 2016. Therefore, the issuance of perpetual bonds by enterprises can help them pay off their maturing debts and avoid the risk of default.

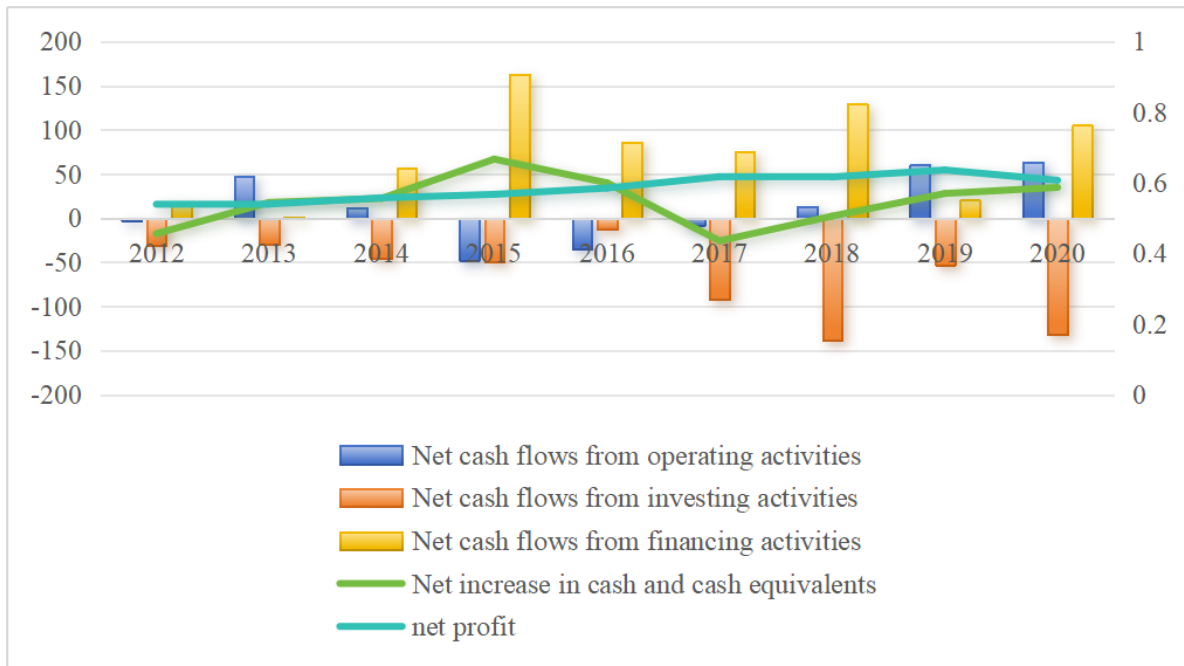


Fig. 1 Changes in cash flow of Gezhouba (in billions of yuan)

By analyzing Gezhouba's cash flow in recent years in the above chart, it can be found that Gezhouba's cash flow from operating activities was at its lowest in 2015, improved after the issuance of perpetual bonds in 2016, and reversed to be positive in 2018, but it is still much smaller than the cash flow from financing activities. Gezhouba's cash flow from investing activities has been negative, improving in 2016 and 2019. It can be seen that the funds raised by the issuance of perpetual bonds in the repayment of the current year's debt, the remaining funds for the cash flow has a slight improvement, but a drop in the bucket, a large number of financing borrowing after the enterprise's net increase in cash and cash equivalents is not significantly better.

In summary, the enterprise issued perpetual debt for the enterprise cash flow is mainly to repay the maturity of the debt, so as to avoid the risk of debt default, but for the enterprise's overall cash flow impact is not obvious, which is mainly due to the enterprise's large amount of debt. The current issuance of perpetual debt to repay debt "debt to debt" behavior, resulting in increased financial risk of enterprises. Once the enterprise obtains new funds, the enterprise will fall into a liquidity crisis.

3.2. Profitability analysis

For listed large construction enterprises, in order to continue to explore whether perpetual debt financing can have a positive effect on the profitability of the enterprise, this paper selects net sales margin, return on net assets, and return on total assets as indicators for evaluating profitability. Because China experienced a new crown epidemic in 2020, which had a greater impact on the data of enterprise-related indicators, this paper focuses on analyzing the impact of perpetual debt financing on profitability indicators in 2016 and 2019. The trend chart of Gezhouba's relevant profitability indicators from 2012 to 2020 is shown in Figure 2.

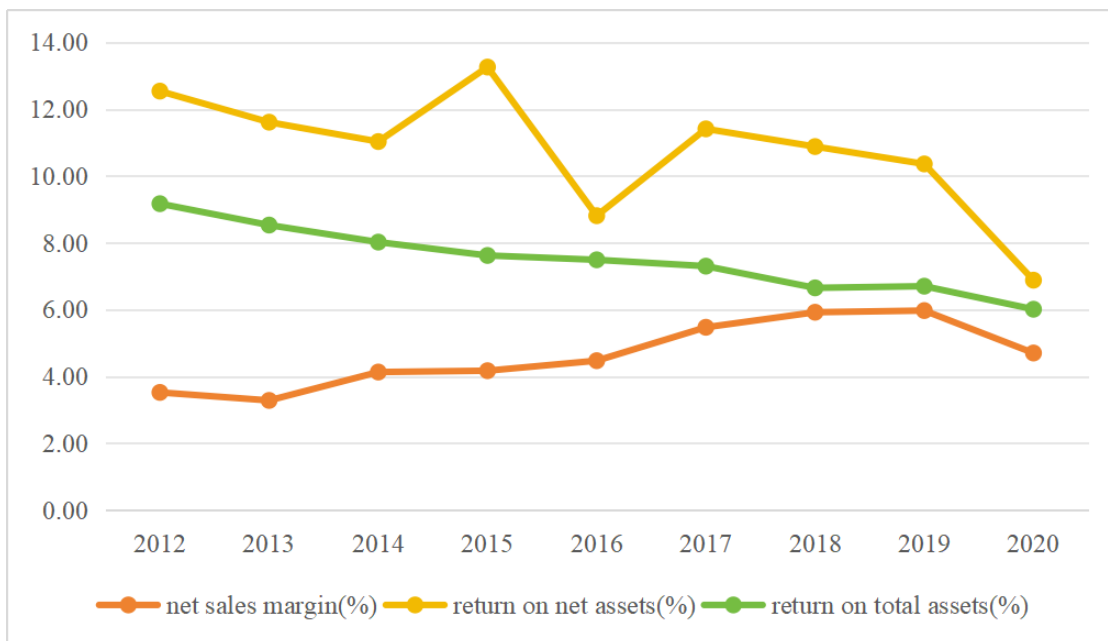


Fig. 2 Profitability Trend Chart

3.2.1 Net sales margin analysis

The higher the net sales margin, the better the company's operating condition and the stronger its profitability. After the issuance of perpetual bonds in 2016 to 2019, the net sales interest rate has increased, which indicates that the profitability of the company has increased after the issuance of perpetual bonds, and the operating condition has improved. Of course, the impact of the epidemic in 2020 on the profitability of Gezhouba cannot be ignored.

3.2.2 Return on net assets analysis

Return on net assets is used to analyze the efficiency of the use of assets, and the higher the index, the more the enterprise makes full use of its own assets to achieve profitability. According to Figure 2, it can be found that Gezhouba's return on net assets as a whole has been on a downward trend, although in 2017, although there is an improvement, but in 2018 and 2019 is still a downward trend. It can be seen that the issuance of perpetual bonds has a negative impact on the overall performance of the enterprise's return on net assets, and the issuance of perpetual bonds does not improve the enterprise's ability to realize profitability with its own assets.

3.2.3 Total return on assets analysis

The total return on assets is used to evaluate the efficiency of the company's use of all assets. According to Figure 2, it can be seen that Gezhouba's total return on assets has been consistently low, and after 2016 the decrease was slightly moderated, but still in a decreasing trend until 2019 when the total return on assets had a small increase, and then still decreased. It can be seen that the issuance of perpetual bonds does not have a great impact on the efficiency of the use of all the company's assets, and it depends more on the company's decision-making as well as the changes in the external market.

From a comprehensive point of view, the funds obtained from the issuance of perpetual bonds alone will have a small and short-lived impact on the profitability of the enterprise, and it is more crucial to enhance the operating ability of the enterprise to see whether there is an advantage in the strategic decisions of the enterprise, whether the strategic decisions are reasonable, and whether the cultivation and utilization of talents are in place.

3.3. Solvency analysis

It is known that Gezhouba issued perpetual bonds to raise funds of which 14.5 billion are specified for the repayment of maturing debt and perpetual debt issuance whether it really positively affects its overall solvency, through the changes in gearing and equity ratio to analyze its solvency. 2012 to 2020 Gezhouba solvency trend changes are shown in Figure 3 below.

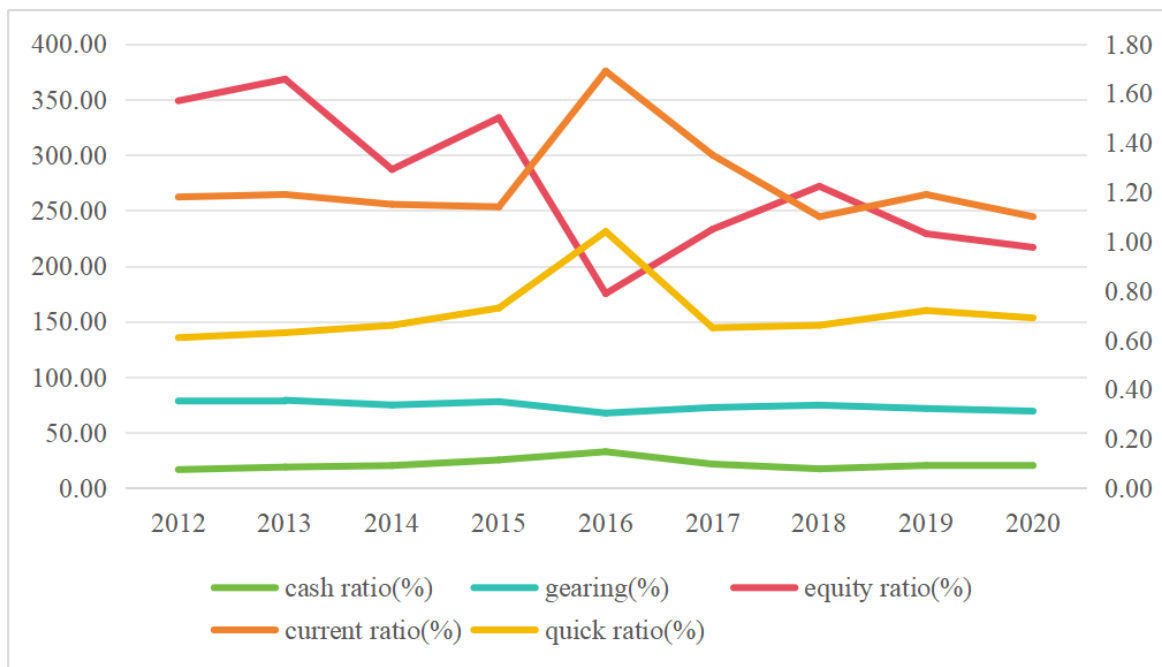


Fig. 3 Trend chart of solvency

3.3.1 Short-term solvency analysis

According to Figure 3, it can be seen that Gezhouba's current ratio, quick ratio and cash ratio have a small increase or decrease from 2012 to 2015, but overall there is no obvious change trend. After the issuance of perpetual bonds, its current ratio and quick ratio have a significant increase, indicating that the issuance of perpetual bonds for the enterprise's short-term debt servicing ability has a significant role in improving. However, all three indicators then declined significantly and returned to the pre-issuance period, until the reissuance. Accordingly, it can be seen that the issuance of perpetual bonds can provide enough cash flow for Gezhouba, and the short-term solvency is improved, but due to the higher debt of the enterprise itself, as well as the characteristics of the operation lead to the temporary nature of the improvement on the solvency.

3.3.2 Long-term solvency analysis

The figure shows that Gezhouba's gearing ratio has been high from 2012 to 2015, and in 2013, it seriously exceeded the key regulatory line of the State-owned Assets Supervision and Administration Commission (SASAC). After the issuance of perpetual bonds in 2016, the gearing ratio dropped significantly to 67.67%, which was due to the fact that perpetual bond financing could be accounted for as an equity instrument, which improved the capital structure of the enterprise to a certain extent. However, when the perpetual bonds were not issued in 2017 and 2018, the enterprise's gearing ratio rose sharply again, and did not fall again until after the issuance of perpetual bonds in 2019 and 2020. And Gezhouba's equity ratio has been on a downward trend, and in the year when the perpetual bonds were issued, the decline in the equity ratio was more obvious, which is also due to the nature of the perpetual bonds counted as equity instruments. Therefore, the issuance of perpetual bonds has a certain positive impact on the long-term solvency of the enterprise, and also optimizes the capital structure of the enterprise and reduces the financial risk.

Taking a comprehensive view of the impact of the issuance of perpetual bonds on Gezhouba's solvency, it can be found that the company's issuance of perpetual bonds for the company's short-

term solvency is significantly improved, but due to the company's long-term high debt problem, the advantages of perpetual bond issuance on the short-term solvency enhancement are also declining. The impact of the issuance of perpetual bonds on the company's long-term solvency is also obvious, due to the fact that the equity instruments are included in the drawdown, which largely reduces the enterprise's gearing ratio and optimizes the capital structure.

4. Conclusion

In the case, Gezhouba issued a total of 33 billion yuan of perpetual bonds in 2016, 2019, and 2020. Although the issuance scale is large, the impact on the company's cash flow, profitability, and solvency is temporary and does not fundamentally change the company. Although the perpetual bonds appear to have no duration and can continue to survive, but when they survive, they have to face the high interest rate brought by the jump-up mechanism, so Gezhouba has chosen to redeem them at the end of the first cycle in order to prevent the subsequent heavier interest pressure. Therefore, enterprises in the issuance of perpetual bonds, is not suitable for its long-term financing tools, for the project cycle of the longer funding gap, corporate financing should be considered when other financing methods with a longer term, in order to prevent in the project is not completed when we have to face the pressure of perpetual debt maturity or renewed to face the pressure of high interest rates. At the same time, enterprises should also assess their own capital strength when issuing perpetual bonds, and match the issue scale with their debt-servicing ability. If the scale of issuance is too large, not only will it face a high interest burden, but it will also face the risk of default or even bankruptcy if it does not have sufficient funds to repay the debt. Although the perpetual debt can be credited to equity on the gearing ratio has a beautifying effect, but the cure is not the root cause, but also face the pressure of policy changes, want to really solve the problem of high financial leverage or should be from the enterprise itself in addition to the law, to improve the endogenous growth capacity, in order to truly lift the crisis.

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