The Financial Risk Warning: Comparing Cash Flow Risk and Financing Risk Between Real Estate Industry and Internet Industry in China

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Abstract
In recent years, many scholars have studied the theory of financial early warning and designed financial early warning systems to predict and reflect the potential cash flow risk and financing risk. At present, many literatures have studied the capital structure and cash flow of the real estate industry. In addition, the Internet industry, a rapidly developing emerging industry, also arises some scholars' curiosity about their financial situation. In fact, now many real estate tycoons have turned to invest in the Internet industry. Currently, few literatures compare the cash flow and financing decisions of the two industries. Investors also lack some comparative information about the two industries to assist them in making investment decisions. Therefore, this paper: (1) Summarize the current situation of cash flow and financing in the real estate industry and the Internet industry; (2) Compare the similarities and differences between them by using some financial indicators in the financial early warning system, and put forward suggestions for their development; (3) Provide a comparison and reference for those who want to invest in these two industries.

Keywords
Capital Structure; Cash Flow Risk; Financing Risk; Real Estate Industry; Internet Industry.

1. Introduction
It is widely accepted that any decision has risks. Financial risk refers to those caused by unreasonable capital structure and financing issues, then may making companies lose debt paying ability and reducing investors’ expected return. It is full of financing, investment and other activities of enterprises, and has uncertainty. Although financial risk is widespread, it can be prevented and reduced. Therefore, what enterprise management should do is to reduce and control financial risk within a certain range, which is also the role of financial risk early warning. Real estate industry and Internet industry are two main decisive industries in developing Chinese economy. Since implementing housing reform from 1988, real estate industry has swiftly developed and promoted national economy remarkably. However, the growth rate of investment in real estate development in China fell rapidly, reaching a new low in the past decades in 2014. Currently, real estate industry is still capital-motivated and has enormous demands on cash. Meanwhile, with the impact of Chinese macro environment, the problems of financing and profitability are gradually serious. The rising price of houses makes people give up buying houses, so that commercial houses are over stocking. The development of China’s real estate industry seems to enter a bottleneck period.

Under such background that traditional industries are getting down, even facing transformation issues, Internet industry is burgeoning following with the progress of Chinese emerging technologies. Surprisingly, Chinese Internet industry could achieve amazing results just within decades. However, it is fast changing industrial characteristics that makes Internet companies falling into fierce competition in the early stage of development. Compared with
common industries, Internet enterprises require large amounts of cash inflows to nourish customers in the early stage, then they also need resources and capital for customer stickiness afterwards. So, great cash is also demanded by this industry and payback period is quiet long. Thus, no matter for the objectivity of livelihood or development, good financial conditions of Internet companies are indispensable and it is vital to have a well-functioned financial risk management system.

Recent years, although the speed of Chinese economic development has declined, many emerging industries are still developing rapidly, such as the Internet industry. The Internet industry has become a hot industry in China at present, and its development momentum is like as that of early real estate industry development. Here is an interesting phenomenon: recent years, many established real estate groups have moved into and invested in the Internet industry. Greenland Group will cooperate with Ali baba and Ping An, the two Internet financial giants, to launch the Internet financial product "real estate treasure"; Country garden, a real estate tycoon, will start to enter the robot industry......So, the integration of real estate industry and Internet industry may be a tendency. However, as an old and popular industry in China, the real estate industry inevitably has many problems and financial risks now. While the Internet industry, although it has a good momentum of development, actually has many financial risks, and there may be similar problems with the real estate industry in many aspects. Through searching for existing literature, it is noted that many scholars have studied the problems of the real estate industry and the Internet industry on financial risk and their capital structure respectively. But it is a pity that less studies put the two industries together and make a comparison between them. This allows my research have a breakthrough point and innovation. So far, we have a rough understanding of the present situation of Chinese real estate industry and Internet industry. In the following parts, I will summarize existing theories on details of the two industries’ capital structure and faced financial risks. Then, compare the index on cash flow, financing and solvency between them. Finally, by combining our findings with current development of these industries, I try to provide some constructive suggestions on financial risk warning and the development of Chinese real estate industry and Internet industry.

2. Theories summary

The universality of financial risk early warning has aroused the interest of many scholars from all over the world, carrying out thousands of research papers focused on the topic of prevention and control of financial risk. Unfortunately, although growing attention is paid to industrial financial risk in China, few paper tries to apply the idea of differentiation into the research field of comparing different industries' financial risk on capital structure, especially in Chinese real estate industry and Internet industry. In this section, I will summarize the existing literature from both real estate industry and Internet industry as a support for later comparison.

2.1. Financial risk early warning theory

There is a period of time to break serious financial crises for all companies, including germination and development stage. The longer this period is, the more beneficial for companies to cope with risks. During this time period, financial risks are exposed directly or indirectly through some financial indexes. According to Ali Serhan Koyuncugil and Nermin Ozgulbas [1], financial risk early warning is based on the accounting data of the financial statements, and utilizes mathematics and statistics to detect, monitor and analyse changes in indicators, thus predicting immediately faced risks. Strengthening control may effectively reduce risks, so financial risk early warning are widely used within enterprises.
2.2. Financial situation on real estate industry

Since 2014, China’s real estate industry has been decadent. Under the pressure of strict debt policy, real estate industry, as a capital-oriented industry, are more struggled to develop. Zhou Xia, Chen Guangming stated [2] that the governance raised the deposit reserve ratio, which not only increased enterprises’ finance cost but also made their financing uneasier. Zhang Jie [3] indicates the financial risks of real estate companies are the expression of all kinds risks on operating cash flows to some degree. Xiang Xiaolu [4] said many real estate enterprises, such as Vanke, have negative net cash flow and low level of capital management. Finally, we conclude some characteristics on the financial risks of real estate industry: (1) Industrial capital structure is unreasonable, with high debt and high asset liability ratio. The channels to finance looks single, which is an enormous risk; (2) As a capital intensive industry, various costs and expenses are difficult to control, and the cash recovery cycle is long, which is prone to fund fracture.

2.3. Financial situation on Internet industry

Recent years, Chinese Internet industry are rapidly growing. However, still many Internet companies have great financial problems for the increasing competition. According to Liu Bingxing [5], Internet industry characterizes as low asset liability ratio, low cost and expense, but long payback period, high demand and risk on cash. Huang yu [6] represents that the growth rate of equity financing in the Internet industry is higher than that of debt financing presently. So I summarize the features of financial risks on Internet industry: (1) Industrial capital structure is unreasonable, with relatively low asset liability ratio. Companies prefer equity financing, ignoring debt financing, which causes the wastage of leverage’s adjustment function; (2) There is a large risk of cash flow. The Internet industry needs a lot of capital, whether in the initial stage of the product or in the subsequent maintenance of customers. And the payback period is long.

2.4. Research focus

My central research question is to compare some ratios of cash flows and financing between real estate industry and Internet industry, then draw conclusions on the differentiation and similarity of financial risks between them.

3. Comparasions

Having knowing about some basic financial situations of real estate industry and Internet industry, I will separately select some financial ratios from these two industries to reflect subliminal financial risks later, and propose some ideas for their financial risk early earning. Then make a comparison between them to reach some results.

3.1. Sample

3.1.1. Data on real estate industry

We are based on Zhangjie’s study[3], she selected: in the A-shares and B-shares of Shanghai and Shenzhen stock exchanges, she selected 125 firms, which includes 112 normal ones and 13 endangered firms. And use their financial reports from 2010 to 2013 to continue research.

3.1.2. Data on Internet industry

For the comparability, we use the same way to find data on Internet industry. Finally, there are total 76 enterprises satisfy our needs.

3.2. Method

Risk on financing and cash flows can be measured by ratios(see table1) and we will calculate the average to represent the industry, which will easier to make a comparison between the two different industries.
### Table 1: Financial risk evaluation index

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Symbol</th>
<th>Calculation formula</th>
</tr>
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<tbody>
<tr>
<td>Current ratio</td>
<td>X1</td>
<td>Current assets/current liability</td>
</tr>
<tr>
<td>Quick ratio</td>
<td>X2</td>
<td>(current assets-inventory)/current liability</td>
</tr>
<tr>
<td>Asset liability ratio</td>
<td>X3</td>
<td>Total liability/total assets</td>
</tr>
<tr>
<td>Cash ratio of Revenue</td>
<td>X4</td>
<td>Net operating cash flows/revenue</td>
</tr>
<tr>
<td>Cash flow per share</td>
<td>X5</td>
<td>Net incremental cash and cash equivalent/total shares</td>
</tr>
</tbody>
</table>

#### 3.3. Analysis

From the table two, we can clearly see the situation of the two industries. For the real estate industry, companies are in relatively low current ratio, even the negative quick ratio, which means that they have problems in short-term Liquidity, even hardly to financing. Besides, their cash flows also have great risks, it need to be paid attention. For the Internet industry, it seems well in current ratio and quick ratio. But we need to be clear that they prefer finance in equity other than debt, which would be a reason that their short-term liquidity is good. More interesting, the ratio of assets to liabilities in the real estate industry is almost three times that of the Internet industry, it also confirms that as capital-intensive industry, there are problems in the financing mode of Internet industry. Then, their cash flows also seems better than real estate industries' ones. But they are still at the low level.

### Table 2: The average of tested financial index

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Average on real estate industry</th>
<th>Average on Internet industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>X1</td>
<td>15.5%</td>
<td>5.18</td>
</tr>
<tr>
<td>X2</td>
<td>0.7%</td>
<td>4.79</td>
</tr>
<tr>
<td>X3</td>
<td>61%</td>
<td>29.8%</td>
</tr>
<tr>
<td>X4</td>
<td>-0.5%</td>
<td>12.5%</td>
</tr>
<tr>
<td>X5</td>
<td>1.7%</td>
<td>9.9%</td>
</tr>
</tbody>
</table>

#### 4. Conclusion

##### 4.1. Conclusion

After studying a great deal of existing papers, we found some research gaps in the financial early warning of real estate industry and Internet industry. Based on prior papers, we analyse some financial indicators so that we can find some similarities and differences of the two industries.

There are two types of similarities:

1. Their financial structure is unreasonable and they all have problems in financing methods. There is still room for improvement in their capital structure;
2. Both are capital-oriented enterprises and their cash payback periods are very long, thus demanding a lot of capital to operate. So they are easy to have problems in capital flows, which is a high financial risks.

And differences:

1. The financing channels of the real estate industry are very single, and most of them rely on bank loans. In contrast, although the Internet industry has much financing channels, it is extremely inclined to equity financing, and only a very small percentage of funds come from debt financing;
The assets to debt ratio in real estate industry is high and that in Internet industry is relatively low, which reflects their unreasonable model of financing;

(3) The real estate industry are hard to control cost and expense, which are great amount and really complex. However, for the Internet industry, it is much easier to control because of their less cost and expense;

(4) The reasons caused long payback period are not the same: Real estate industry is may because of their inventory-stock, but in Internet industry, whether the initial stage of the product or subsequent maintenance of customers, they all need a lot of money.

4.2. Suggestions

I put forward some suggestions for the real estate and Internet enterprises in China on the basis of the previous analysis and summary of the existing literature. We hope that these suggestions could provide more entrepreneurs with a reference when they invest in them and provide references for scholars who follow up on this issue.

Both real estate industry and Internet industry should think highly of their financial risks, especially in their cash flows and capital structures.

For real estate industry, companies may consider:

(1) Seek several new channels to finance, so that financing risks can effectively be diversified and reduced. For example, Real Estate Investment Trusts is an good attempt to finance;

(2) Appropriately plan the time to debt and cash flow budget is significant,

(3) Joint reorganization is also worthy to have a try for some enterprises who are in the trouble of cash flows.

For Internet companies, it is needed that:

(1) Strengthen debt consciousness and try to finance more by debt instead of equity, which will improve the capital structure;

(2) Improve the product innovation consciousness of enterprises profitability, utilization efficiency of fund so that the cash flow risks will be decreased.

For the two industries, part of financial risks can be detected through fluctuation of the financial ratios, so I think setting up a financial risk early warning system is necessary, which will give enterprises enough time to respond risks. Actually, some real estate companies have constructed, this system in the Internet industry is uncommon, hope that this system will be widely used in the future. Apart from it, according to their financial situation, improving internal control, cash management and the amount of financial risk reserve are suggested.

References


