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China's Property Developers Struggle to Deleverage

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Summary

Contracted sales to slow but remain overall robust: Property sales increased by 33% in the first seven months of 2021 on the back of a lower comparable base, also driven by the credit liquidity released during the coronavirus pandemic. In our view, the government's overall policy stance is expected to remain tight for the rest of 2021 and 2022, especially in terms of property prices and credit controls. However, we believe the chance for more credit tightening is low as the government is striking a balance between the financial stability and deleveraging. We expect property sales growth to slow for the rest of 2021 with the full-year residential property sales growth to be at 15%.

Challenges from funding structure change: The growth of property development funding increased by 18% in the first seven months of 2021. Despite a double-digit growth of the total property development funding, the financing environment has been challenging for the developers, as property development loans decreased 5% in the first seven months. The funding structure has changed with more bank loans replaced by lower seniority funding sources, such as payables and minority interests. The lower seniority funding sources are likely to result in a shorter tenor and more market-driven financing for developers. This is likely to strain the liquidity of Chinese property developers, and widen credit differentiation among individual developers.

Leverage to reduce with tight liquidity: We expect the leverage for Chinese property developers to reduce, while the liquidity condition remains tight. Although the cash to short term debt ratio of our sampled property developers has remained at a healthy level, the reliance on the other short-term financing channels has increased. In addition, bond maturity profile for the whole sector has been shortened. Percentage of shorter tenors of within one year has increased to 21% in the first half of 2021 from 4% in 2016 in the onshore property bond market. Such changes are more obvious within the property sector compared to the other sectors, highlighting the sector's difficulty in rolling over their debts for a longer duration with investors tending to avoid the exposure to longer-term risk.

Lower bond refinancing requirements in 2022: Year to date, net financing from property bond has declined sharply, in both the onshore and the offshore market. The onshore bond issuance had increased slightly, which was not enough to cover the maturities being almost doubled year on year in the first seven months of 2021. Offshore bond issuance declined 17% in the first seven months, in contrast to a 94% increase in the maturities in the first seven months of 2021. The refinancing pressure from bond is to ease in 2022, thanks to less maturities in the onshore market. In the offshore market, USD59 billion property bonds are due to mature in 2022, representing an increase of 71% and 1% from 2020 and 2021, respectively. In the onshore market, there are RMB391 billion worth of bonds to mature in 2022, representing a decline of 39% and 46% from 2020 and 2021, respectively.

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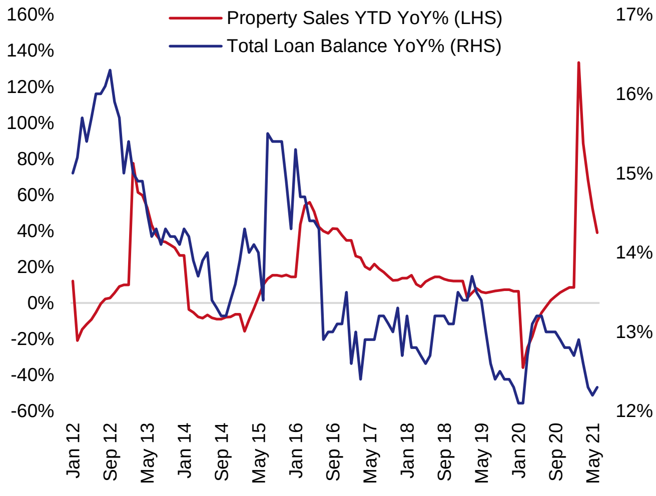
Property sales to slow but remain overall robust

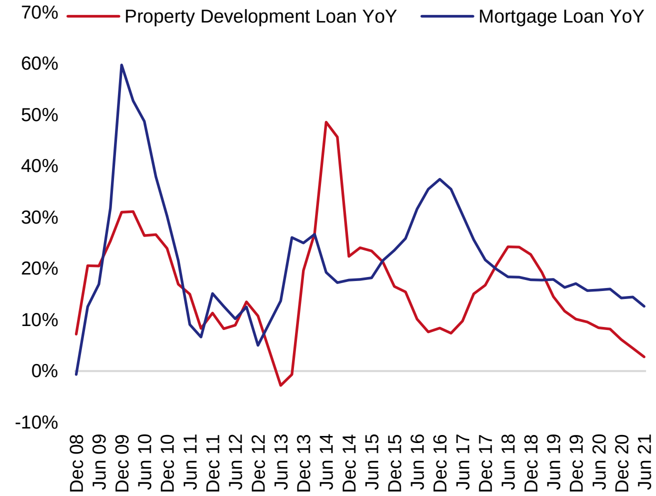
We expect China's monthly residential property sales value to slow to around 2% year over year in the rest of 2021 from its 42% growth in the first six months of the year (Exhibit 3). The residential property sales had recovered quickly since the second quarter of 2020, benefiting from lower mortgage interest rates and a marginal relaxation in some property policies. However, the rebound has raised concerns about the potential financial risk and the government has since then tightened property financing by introducing a threshold of property financing through the "Three Red Lines" policy and the caps on Chinese banks' property loans in December 2020. In addition, since May 2021, commercial banks across several cities have begun raising their mortgage rates. By doing this, the government was trying to direct the financing to the low leveraged developers and support a long-term sustainability of the industry.

Exhibit 1: Total Loan Balance Growth and Property Sales Growth



Sources: PBOC, National Bureau of Statistics, Pengyuan International

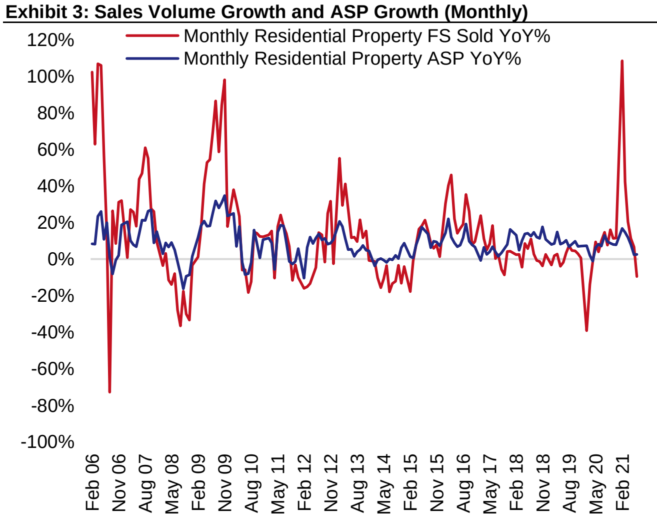
Exhibit 2: Property Development and Mortgage Loan



Sources: PBOC, National Bureau of Statistics, Pengyuan International

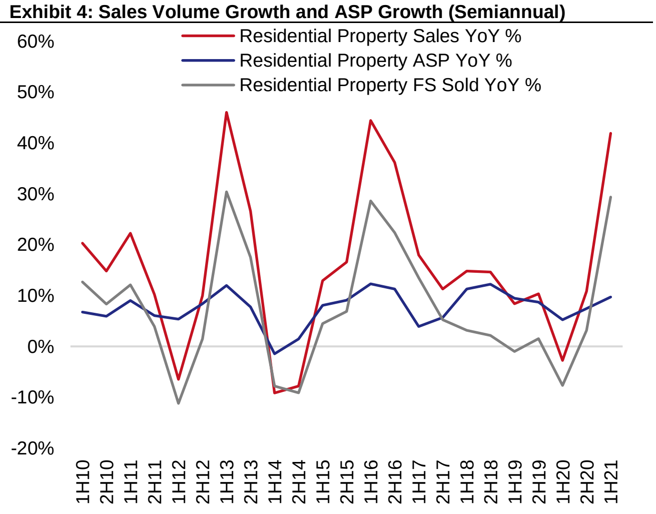
In the first six months of 2021, growth in Chinese banks' lending to the property sector narrowed as the new concentration management system （银行业金融机构房地产贷款集中度管理制度）had limited banks' property-related lending (Exhibit 1). China's total domestic loan balance （金融机构各项贷款余额）was about RMB185 trillion, with the growth dampened to 12% at June 2021 from 13% at September 2020. Total loan balance growth is expected to maintain at around 12% in the second half of 2021, the same level as the first half. Both property mortgage loan balance （个人住房贷款余额）growth and property development loan balance （房地产开发贷款余额）growth had slowed, with mortgage loan growth at 13% and development loan growth at 3% as of the end of June 2021 (Exhibit 2).

Exhibit 3: Sales Volume Growth and ASP Growth (Monthly)



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 4: Sales Volume Growth and ASP Growth (Semiannual)

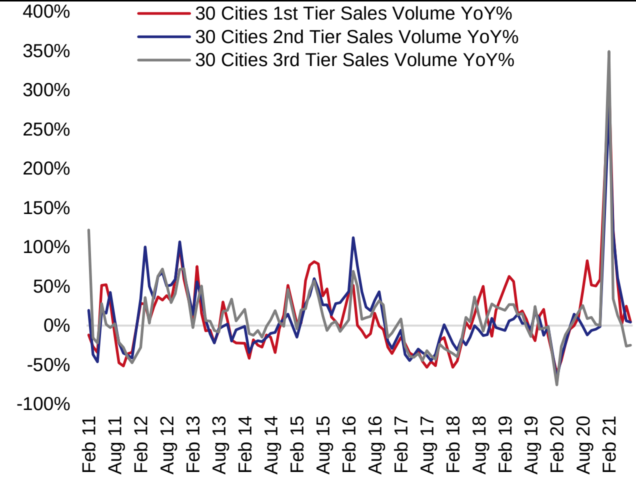


Sources: National Bureau of Statistics, Pengyuan International

Caused by a slower bank lending, epidemic control, and floods, the monthly residential property sales declined sharply by 7% in July in contrast to a growth of 20% in May and 144% in February. The sharp decline was mainly caused by a 10% decline of volume, while the average selling price (ASP) remained sluggish and grew by 2% in July.

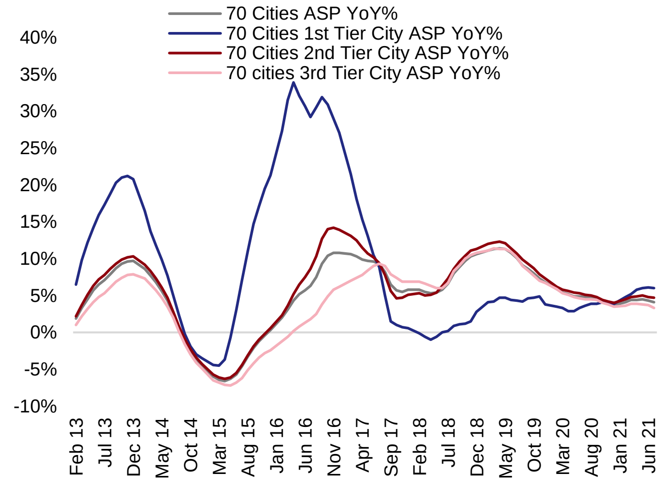
First-tier cities have fared better than lower-tier cities in terms of both the property sales volume growth and price growth in the first six months of 2021. However, both the price and volume growth have slowed in the first-tier cities, after the government tightened the relevant property policies. By our estimate, sales volume growth is expected to slow across all the cities for the rest of 2021 due to the tightening in financing and policy controls. (Exhibit 5 and Exhibit 6).

Exhibit 5: Property Sales Volume by Cities



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 6: Property Sales ASP by Cities

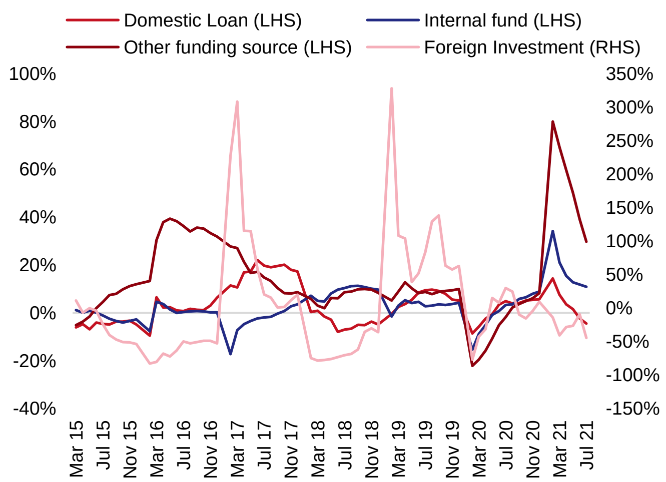


Sources: National Bureau of Statistics, Pengyuan International

Other financing sources emerge amid slowdown of bank loan

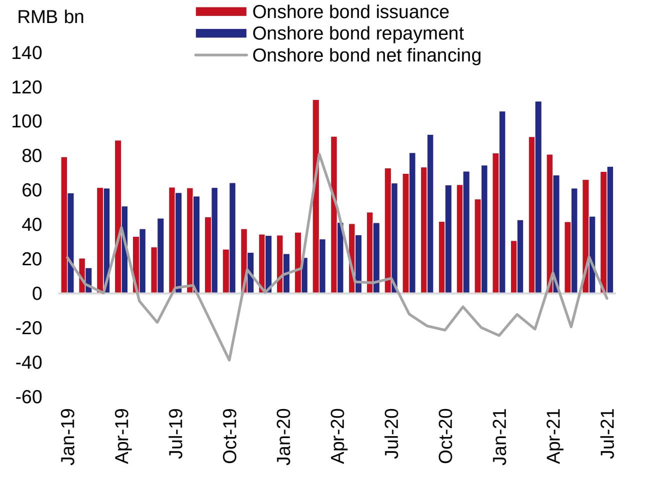
The growth in total outstanding property development funding （房地产开发资金来源）eased to 18% by the end of July from 51% by the end of February in 2021. We expect the total property development funding growth to narrow to 10% by the end of 2021. Despite a slowdown from the beginning of the year, it has still accelerated from the annualised growth of 8% in both 2019 and 2020. The total property funding was RMB11.8 trillion in the first six months of 2021, a 18% increase from the first six months of 2020 and 19% increase from the first six months of 2019. Despite a double-digit growth of the total property development funding, the financing environment had been challenging for the developers as bank loans decreased in the first six months of 2021. Domestic loans used for property development (房地产开发资金来源：国内贷款) decreased 5% in the first seven months of 2021. The driving forces for the property development funding came from other funding sources (房地产开发资金来源：其他资金来源), which increased 30% in the first seven months of 2021. In our view, the tough financing environment will strain the liquidity of Chinese property developers, and widen credit differentiation among individual developers. Developers with stronger sales execution are better positioned to weather through the challenging financing environment.

Exhibit 7: Property Funding growth



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 8: Onshore Property Bond Issuance and Repayments



Sources: National Bureau of Statistics, Pengyuan International

The property development loan balance （房地产开发贷款余额）extended its sluggish trend and narrowed to 3% by the end of June 2021 after the China's banking regulator imposed a cap on property lending by major banks in December 2020. Trust loan balance invested in property was at RMB2.173 trillion by the end of first quarter of 2021, declined 16% year on year. We estimate the trust loan balance invested in property to continue to decline for the rest of the year.

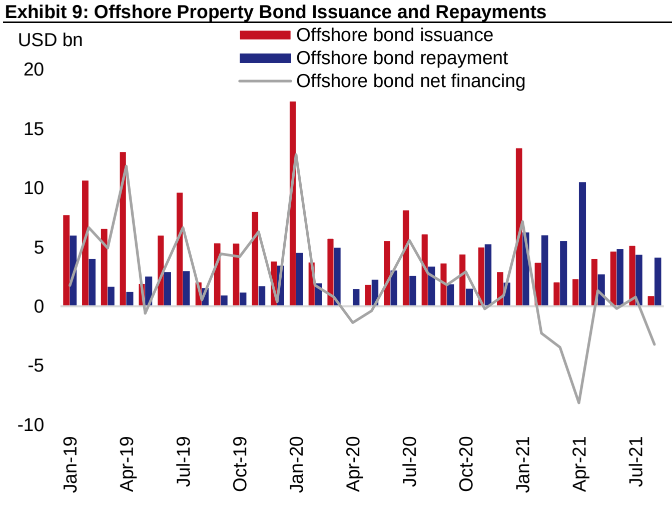
Other funding source had become the single largest funding segment for property development, which contributed 57% to the total property development fund and increased 30% in the first seven months of 2021. The primary component of the other funding sources is the prepayments from contracted sales. Despite a projected slower growth in the second half of 2021, the residential property sales growth is expected to accelerate to 15% in the full year of 2021 from 11% in 2020.

Foreign investment only contributed 0.04% to the total property development funding source, representing a 44% decline in the first seven months of 2021. Foreign investment includes offshore IPO, offshore bond and syndicated loan. The demand for offshore syndicated loan has increased in the recent two years with some Chinese property developers seeking to tap offshore financing for a longer tenor. We believe the sharp decline of foreign investment was caused by the weakness in offshore bond issuance. Net financing of offshore syndicated loan has increased 21% in the first six months of 2021.

In addition, there was an increase in the demand for internal funding, which includes cash, onshore corporate bond, enterprise bond, medium-term note (MTN) and commercial paper, asset-backed security (ABS), equity financing and other financing sources. This segment contributed 29% to the total property development fund and increased 11% year on year in the first six months of 2021.

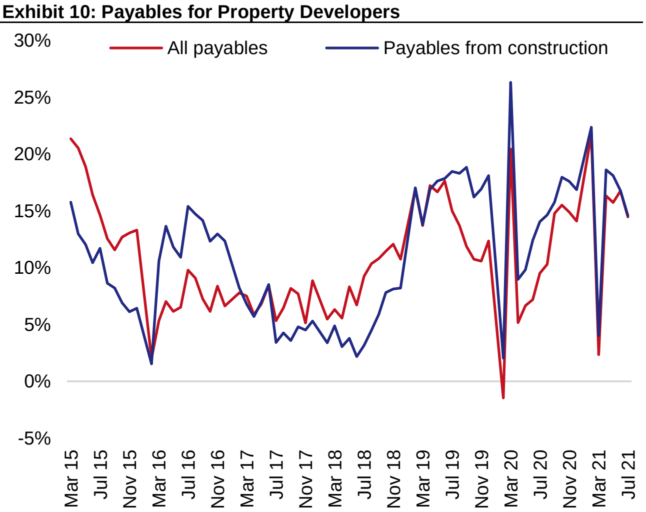
Year to date, the demand in net financing from bonds has declined sharply, in both the onshore and the offshore markets. The onshore bond issuance (including corporate bond, enterprise bond, MTN and commercial paper) were RMB463 billion, translating to a 7% year-on-year increase, while the maturities increased by 99% year on year. As a result, the net financing from onshore bond market was equivalent to an outflow of RMB46 billion in the first seven months of 2021, in contrast to an inflow of RMB78 billion during the same period of 2020. Offshore bond net financing registered an outflow of USD5 billion, in contrast to an inflow of USD22 billion during the same period of 2020, with issuance decreased 17% and maturities increased 94% year on year in the first seven months of 2021.

Exhibit 9: Offshore Property Bond Issuance and Repayments



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 10: Payables for Property Developers



Sources: National Bureau of Statistics, Pengyuan International

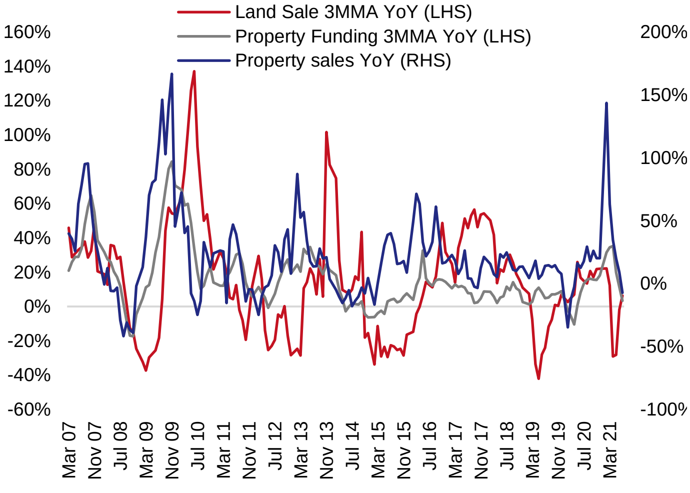
In addition to the aforementioned property development funding sources, the payables have also increased substantially and become an important financing source for property developers. All the payables from the property development companies increased 14% in the first seven months of 2021. The significant increase in payables was due to the tight financing for property developers, which had delayed the payment. In addition, the pandemic had slowed the construction progress which caused the delay of payments.

Land replenishment has slowed driven by lower land sale volume

Chinese property developers have reduced their land replenishment since the end of 2020, impacted by the new centralised land bidding rules which targeted to force developers to rationalise their land acquisitions. The land sale value (土地成交价款), which is viewed as an indicator of the primary land market acquisition and tends to lag the funding for property investment and property sales by six to twelve months (Exhibit 11), declined 5% to RMB512 billion in the first seven months of 2021. In the rest of 2021, the policies related to land auction are expected to remain tight, with land sale volume projected to increase modestly, especially in the lower-tier cities, in our view.

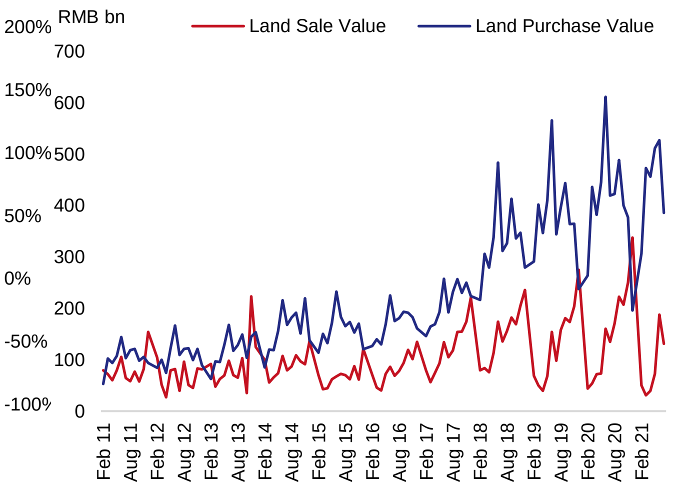
More land replenishment were conducted through mergers and acquisitions (M&As) rather than the primary land acquisition. This is being reflected in the gap between the land sale value (土地成交价款, or the total value of the land acquired from the primary market) in the current year and the land purchase value (土地购置费, or the cash paid for the land replenishment) in the current year. Though part of the gap comes from the lagging of the instalments, the expanding gap is primarily driven by the increasing M&As in the recent years (Exhibit 12), in our view. Although M&A projects sometimes have better value and can get easier financing with less policy constraints, they tend to have longer cash cycle than other channels through the primary land acquisition. We expect the land replenishment activities to slow for the rest of 2021, on the back of tight financing and increased inventories.

Exhibit 11: Property Sales and Property Funding Lead Land Sales



Sources: National Bureau of Statistics, Pengyuan International

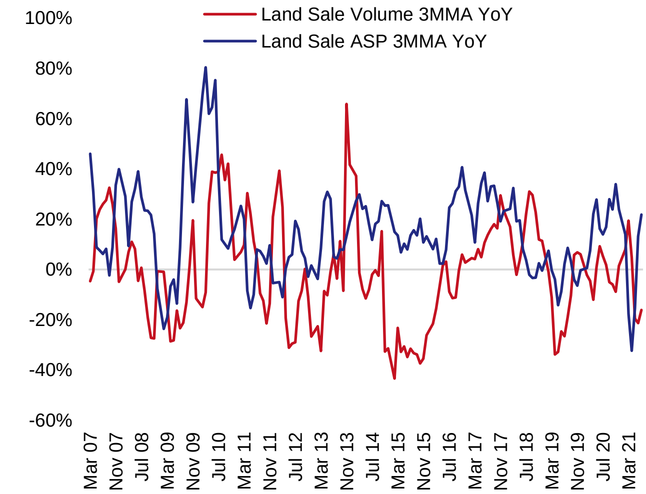
Exhibit 12: Monthly Land Sale Value vs. Land Purchase Value



Sources: National Bureau of Statistics, Pengyuan International

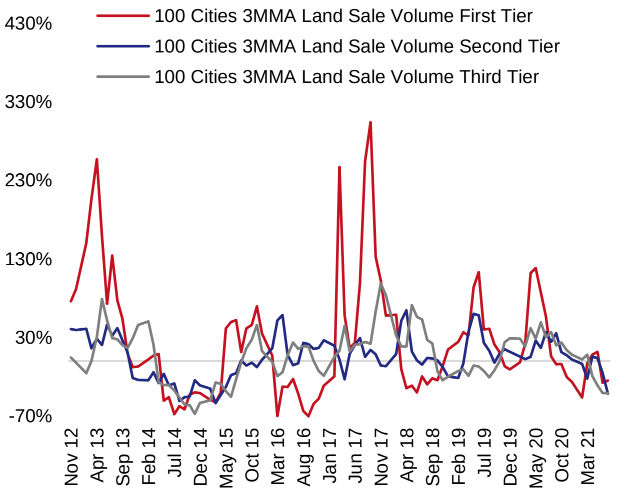
The weakness in the land sale value was mainly driven by the decline in the land sale volume, which declined 9% in the first seven months of 2021. On the other hand, land price growth has increased 5% in the first seven months of 2021 (Exhibit 13).

Exhibit 13: Land Sale Volume vs. ASP



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 14: Land Sale Volume by Cities



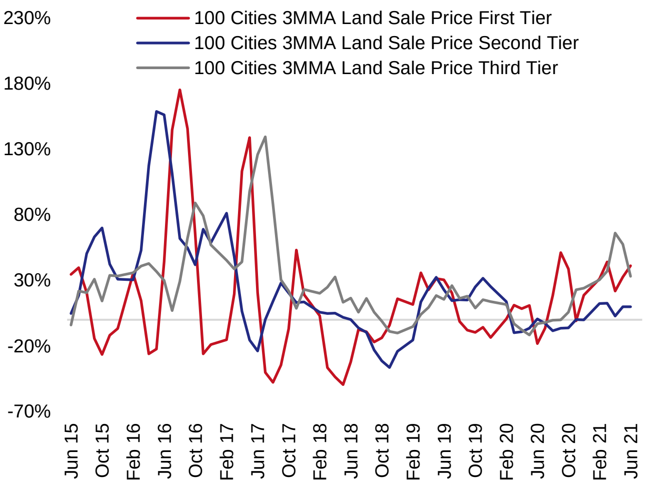
Sources: Wind, Pengyuan International

Regarding the different tiers of the cities in China, a cool-down in the land sale volume has been observed across all the cities, as the centralised land sale policy has limited room for further land acquisition, although a pick-up has been observed in the first-tier and the second-tier cities in March 2021, based on our analysis of the data of the 100 cities (Exhibit 14).

Land price growth has expanded since the second half of 2020 across different tier cities before cooling down in May 2021. Land price growth of tier-3 cities has narrowed to -5% in June from 88% in April this year, while that of the second-tier cities has narrowed to a modest single digit, and that of the first-tier cities has accelerated to 87%, recovering from a negative territory in June 2020 (Exhibit 15).

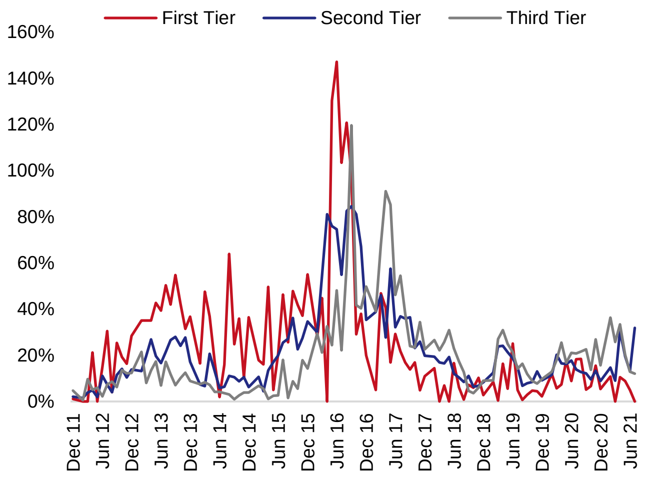
The land auction premium over the base prices, which is viewed as an indicator to measure market sentiment, has narrowed in the first-tier cities. In the recent second round of centralised land supply auction in August, the land auction premium in many third-tier cities has further narrowed, showing the cautiousness of the developers with tight financing and policy controls.

Exhibit 15: Land Sale ASP by Cities



Sources: Wind, Pengyuan International

Exhibit 16: 100 Cities Land Price % Premium to Auction Base Price

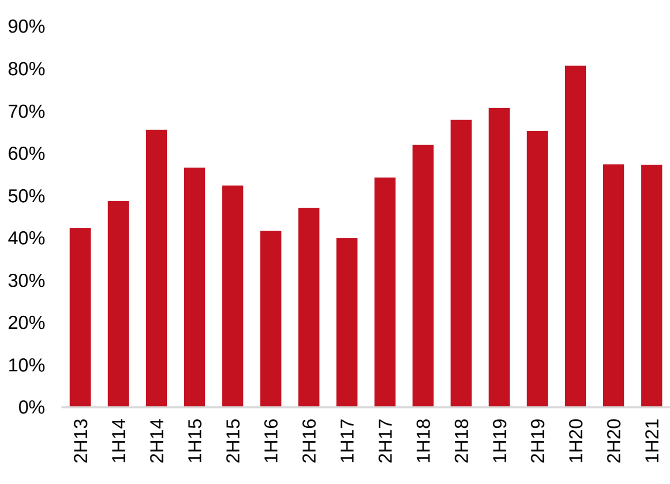


Sources: Wind, Pengyuan International

Improved working capital to offset tight bank financing

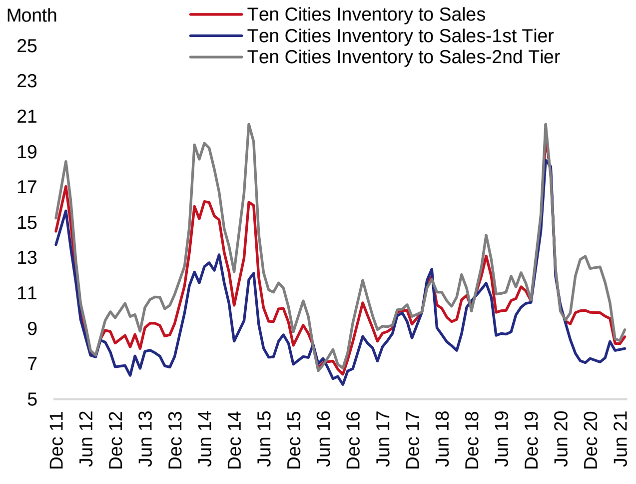
We believe Chinese property developers working capital has improved in the first half of 2021. Inventory, land purchase and contracted sales are the major components of working capital changes for Chinese property developers. We estimate land purchase to contracted sales for the industry was around 57% in the first half of 2021(Exhibit 17), which is recognised as a healthy level, in our view. Residential property sales growth has accelerated to 33% with land purchase increased 4% in the first seven months of 2021.

Exhibit 17: Land Purchase as Percentage of Prepayments



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 18: Inventory turnover across different tier cities

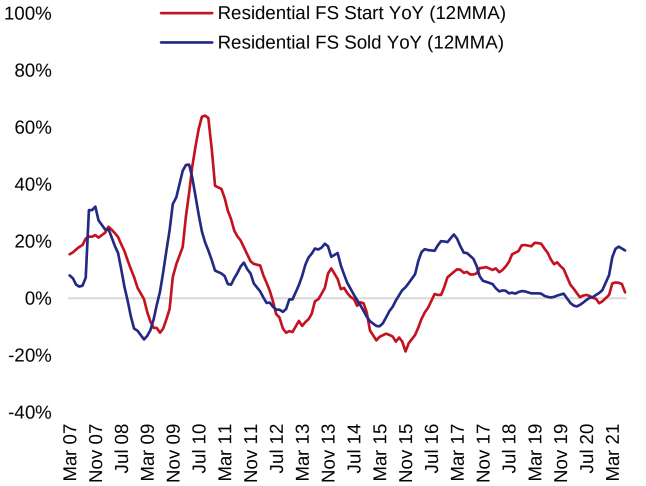


Sources: Wind, Pengyuan International

On the back of strong property sales, the property inventories have decreased across different tier cities in China from its historical high in February 2020. We expect property inventories to increase slowly during the rest of 2021, with property sales growth slowing down and new house starts growth rate accelerating (Exhibit 18).

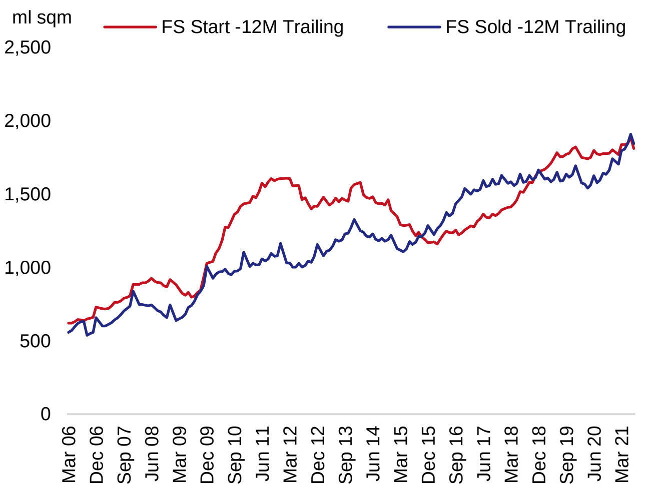
The growth of new started floor space has outpaced the floor space sold since the second half of 2020, with construction resumed. New housing starts usually lag sales by six months in China (Exhibit 19). The growth of property sales has slowed since early 2017 and started to accelerate in second half of 2020, but the new starts volume has continued to trend up from its bottom in November 2015 before slowing down in May 2019. We expect the new starts volume growth to continue to accelerate for the rest of 2021 (Exhibit 20).

Exhibit 19: New Start Volume Growth Lagging Sales Growth by 6 Months



Sources: National Bureau of Statistics, Pengyuan International

Exhibit 20: Floor Square Sold Catches Floor Square New Starts

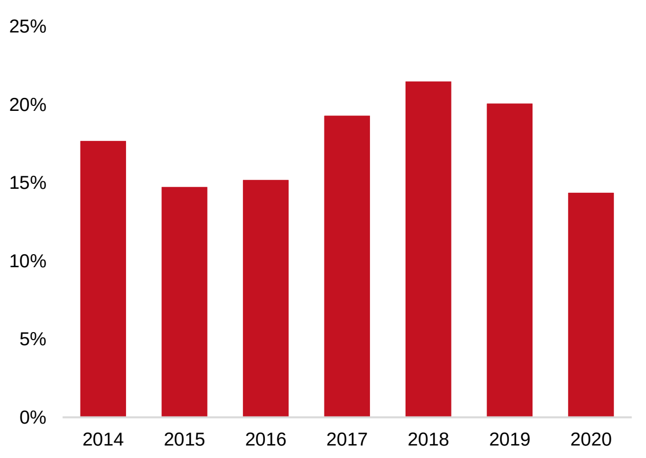


Sources: National Bureau of Statistics, Pengyuan International

Profitability to further narrow with lower leverage and tight liquidity

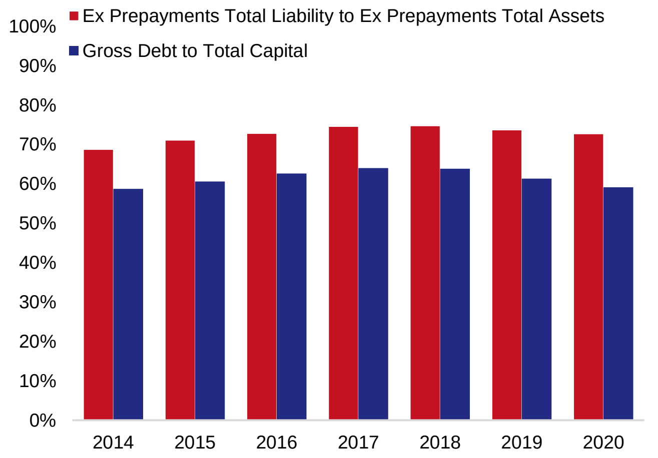
Chinese property developers have seen revenue growth slowed with margin narrowed in 2020, with our sampled developers' EBITDA margin decreased to 14% from 20% in 2019 (Exhibit 21). Our sample includes top 100 property developers listed in A-share and H-share. The decline of profitability was caused by the high cost of lands which were acquired at the market's peak. Beside the lower margin, we have also seen property companies' impairment loss increased as a result of writing off the high land value in 2020. We expect developers' margin to continue to be under pressure in 2021 and 2022, driven by the low ASP. Despite a strong property sales growth in the first half of 2020, property sales ASP did not have much meaningful growth. In addition, with tight financing, we have seen many developers reducing prices to promote sales since July.

Exhibit 21: EBITDA Margin



Sources: Wind, Pengyuan International

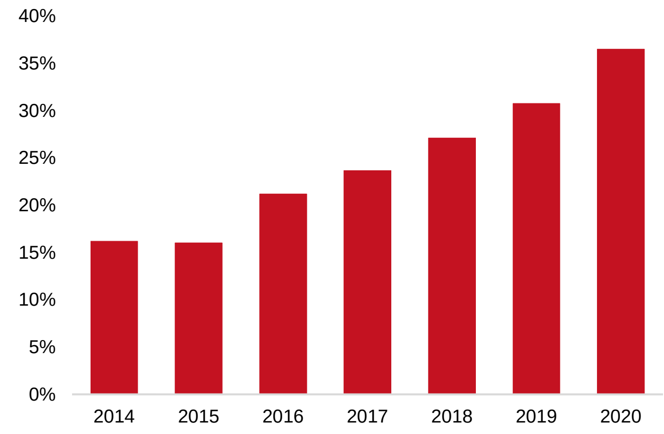
Exhibit 22: Leverage



Sources: Wind, Pengyuan International

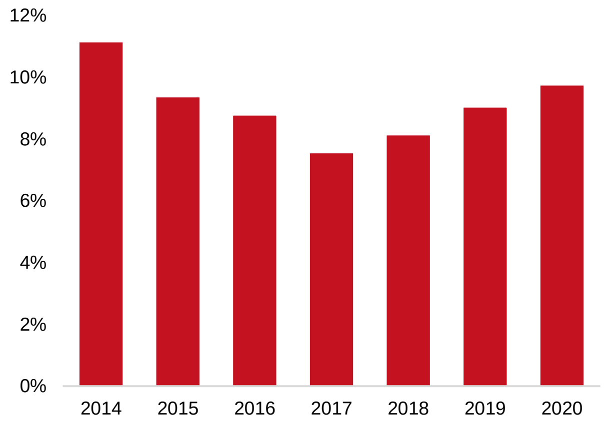
In response to the "Three Red Lines" policy, Chinese developers have scaled back their total debt. As a result, the leverage has been lowered. Excluding prepayments, the liabilities to assets ratio was reduced to 73% in 2020 from 74% in 2019. We expect property developers' leverage to further lower for the rest of 2021 with both bond issuance and bank loans reduced significantly.

Exhibit 23: Minorities as % of Total Shareholder Equity



Sources: Wind, Pengyuan International

Exhibit 24: Payables (including bill payables) as % of Total Liability

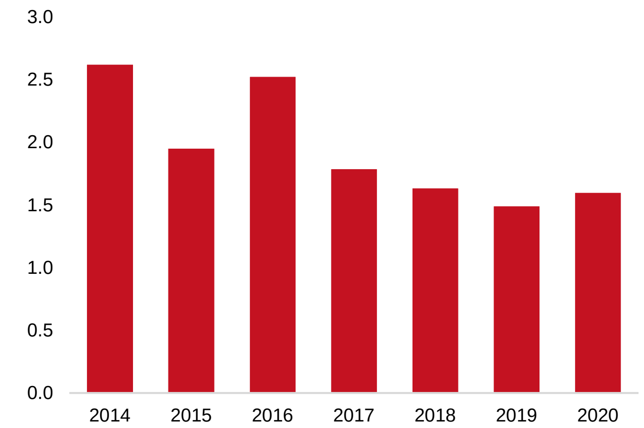


Sources: Wind, Pengyuan International

We believe a lower leverage was mainly caused by a lower interest-bearing debt, which does not translate into a better solvency. More and more financing for property developers has been channelled to the other sources such as payables, commercial paper, or even minority interests. The ratio of payables (including bills payable) to total liabilities increased to 10% in 2020 from 9% in 2019, according to data from our sampled developers. In addition, more and more property developers enlarged their equity base through a substantial increase in the minority interests on their balance sheet. The sector's average of minority interests as a percentage of total equity has risen sharply over the past five years, from 16% in 2015 to over 35% as of the end of 2020. The guarantees have also increased, indicating a potential expanding off-balance sheet financing. We believe there are chances that some of the payables or minority interests are debt disguised. Unlike debts, these financing sources have short tenors and might be difficult to refinance.

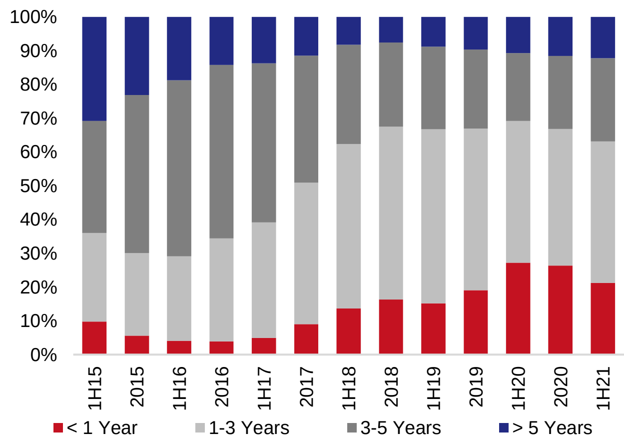
We project that the liquidity for the sector to remain tight. Although the cash to short-term debt ratio of our sampled property developers remained at a healthy level at the end of 2020, the reliance on the short-term financing channels has increased. In addition, the bond maturity profile for the whole sector has been shortened. Tenors of below one year has increased to 21% in the first half of 2021 from 4% in 2016 in the onshore bond market (Exhibit 28). Such changes are more obvious within the property sector compared to the other sectors, suggesting the sector's difficulty rolling over their debt to a longer duration with investors avoiding the exposure to longer-term risk. We expect that the liquidity of the large developers with financing capability to remain adequate, while the small developers with aggressive expansion previously to face tighter liquidity during the rest of 2021 and 2022.

Exhibit 25: Cash to Short-Term Debt Ratio (x)



Sources: Wind, Pengyuan International

Exhibit 26: Onshore Bond Maturity Profile



Sources: Wind, Pengyuan International

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