Chinese real estate developers under pressure as real estate demand slows down

by Zheng Chencheng

Chinese homebuilders are increasingly turning to alternative revenue streams such as property management and services as sales have been declining since Jun 2017. The real estate market in China, managed by more than 100,000 private and public developers covers nearly 17.5bn square meters of residential properties. Lower real estate demand, increased regulatory burdens and vigorous competition have forced developers to change their business strategies.

China is developing its home-rental market to ensure housing availability in crowded cities to solve an affordability problem among key cosmopolitan areas. The government may increase the supply of houses for renting and create business opportunities for homebuilders who are focusing on the property leasing and management market. However, some developers may still struggle as the industry's ability to service its debt is at its weakest in three years.

China's real estate sales growth rate has started to decline after the country intensified efforts to contain risks coming from a long stretch of excessing borrowing in June 2017. The growth rate of land acquisition by developers fell to an annual rate of 21.9% in June this year, much slower than the annual rate of 40% in June last year. In addition, according to CREIS's (China Real Estate Index System) monitoring data, failed government land auctions between January and July 2018 climbed to 16.63mn square meters, 20% higher than the total number during 2017. Together, the slower growth of land acquisition and higher unsuccessful government land auctions cast a shadow on China's real estate investment. The RMI-CRI 1-year Aggregate Probability of Default (PD) for China's real estate firms climbed to about 80bps in August, up from 60bps early this year, showing that developers' credit profiles have been weakening following the slowdown in the real estate market.

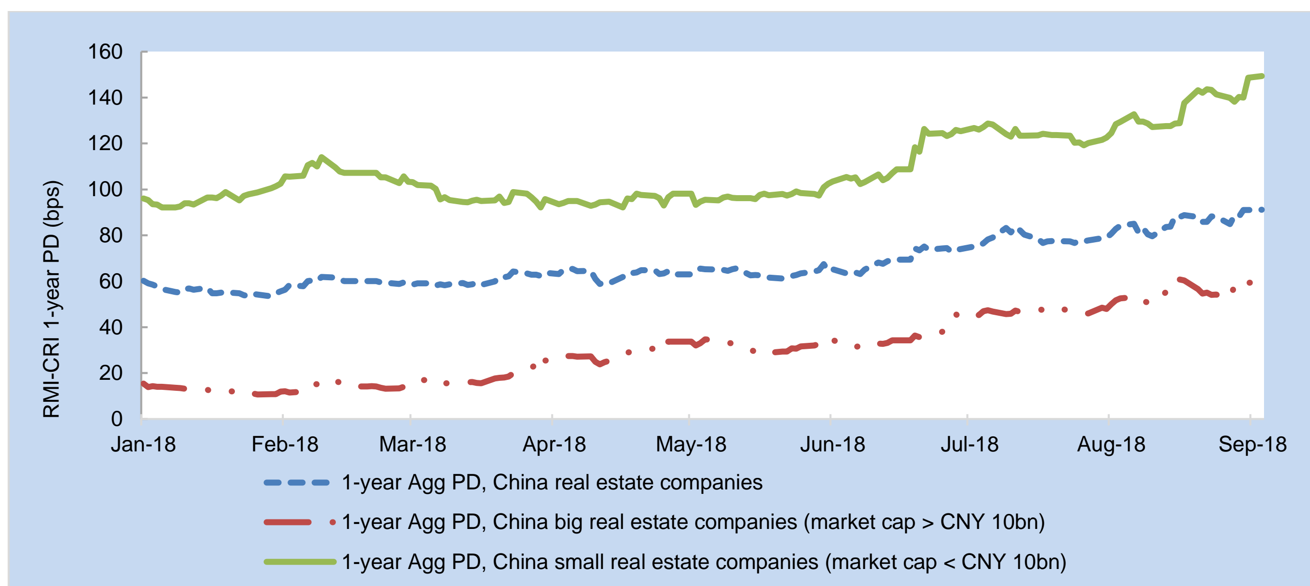

Figure 1: RMI-CRI 1-year Aggregate PDs for real estate companies, including large and small firms. *Source: RMI-CRI*

Developers are facing pressure both in operational capacities and profitability. For small players such as Guangzhou R&F Properties (R&F) and Sino-Ocean Group Holding Ltd, yearly changes in property sales have slowed down to single digit percentages or even turned negative in the first half of 2018, compared with industry leaders such as China Evergrande Group and Country Garden Holdings Co Ltd, who achieved about 60% property sales growth. The profitability of small-cap developers is under pressure as increasing competition compelled players to differentiate their services to retain market share.

Company Name	Market Cap (CNY mn)	Property Sales YoY change (%)		EBITDA YoY change (%)		Net Debt/ Equity (%)	
		2018 S1	2017 S2	2018 S1	2017 S2	2018 S1	2017 S2
Evergrande	298,780	60.80	-0.90	81.90	-4.40	158.00	237.80
Vanke	257,921	57.09	6.19	107.06	72.90	37.40	14.10
Country Garden	208,220	70.40	57.00	128.00	137.40	65.40	45.30
R&F	41,781	-83.90	10.30	82.40	179.60	213.50	188.80
Agile	38,907	5.70	20.80	47.00	69.20	101.80	93.80
Sino-Ocean	24,814	-14.70	14.60	-6.40	14.20	83.90	66.50

Table 1: Financial figures of real estate companies. *Source: Bloomberg*

In addition to operational pressure, many developers have high leverage ratios and face tight liquidity conditions. Many developers had high leverage ratios because they used borrowed money to acquire land, pushing their net debt to equity higher by 4.6% in 2017. Real estate companies have large debt repayments this year because of large-scale bond issuances in 2016, most of which are USD denominated floating-rate debt. CIFI Holdings Group Co Ltd and Agile Group Holdings Ltd for example, with 63% and 56% debt in floating-rate bonds, would be affected by the increase in USD interest rate. China developers have sold CNY 8bn of dollar bonds in April, the highest since June 2017, to ease their near-term refinancing needs. Agriculture Bank of China also said that non-performing loans within the real estate industry increased from CNY 5.79bn to CNY 8.54bn, lifting the non-performing loan ratio from 1.13% to 1.45% in the first half of 2018. Moving forward, lenders may raise financing requirements for developers to reduce the level of non-performing assets on their balance sheet.

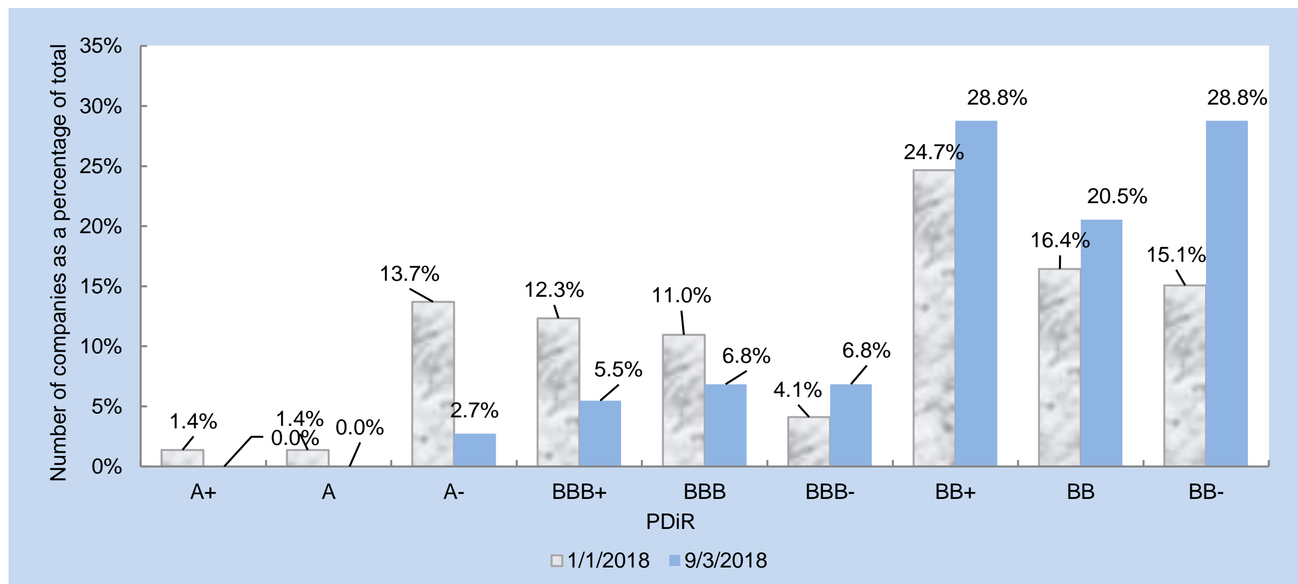

Figure 2: Percentage change of Chinese real estate firms within their implied rating categories in 2018. *Source: RMI-CRI*

Keeping in mind the negative effects of high leverage ratio, high regulatory burden, elevated non-performing loans and weakened profitability faced by developers, the RMI-CRI 1-year Probability of Default Implied Ratings (PDiR) shows that the proportion of investment grade firms within the real estate sector has declined since Jan 2018. The PDiR provides an alphabetic grade to a firm's 1-year forward looking credit quality, using the S&P classification. Junk-rated firms, or companies carrying implied ratings 'BB+' and below accounted for nearly 56.17% of the sector in Jan 2018 but this proportion has climbed to 78.09% in Sep 2018. The fraction of firms with the 'A-'implied ratings on their debt has also decreased from 13.70% to 2.75% over nine months.

Credit News

Italian bond yield spread to fall as government starts to act: Tria

Sep 9. Italian Economy Minister, Giovanni Tria, said that the Italian bond yield will fall to more normal levels as the government starts to implement its fiscal measures. He reassured investors that some of the coalition's more radical budget plans are to be introduced gradually, ensuring compliance with the EU fiscal rules. The new government will focus on stimulating the economy through measures such as introducing minimum income to the poor and cutting income taxes to reduce the gap in the economic growth between Italy and the rest of the Eurozone. (Reuters)

Global catastrophe bond market size climbs to a record USD 30bn

Sep 7. Despite losses caused by last year's run of natural disaster, a research from Aon Securities found the total size of the catastrophe bond market has grown to a record size USD 30bn in the first half of this year. The strong bond market was rallied by the issuance of USD 9.7bn bonds across 29 transactions as investors are attracted by the prospect of a yield return around 7% and from an asset class that is not correlated with other financial markets. The increasing amount of capital coming into insurance linked securities (ILS) has pressured prices for traditional reinsurance. Insurance and reinsurance companies have responded to this trend by buying up companies that manages ILS funds on behalf of investors. (FT)

Cash-flush investors zoom in on DBS' SGD 1bn of perps

Sep 6. With orders over SGD 4bn, DBS Group Holdings priced its SGD 1bn perpetual at 3.98%, down from the initial price guidance of 4.375%. OCBC bank which put up a SGD 1bn perpetual deal last month also received strong demand as it priced from 4.375% to 4%. Fixed income players find these banks' perpetual to be highly sought after as they are regarded as safe assets amid volatile markets and a dearth of SGD bond issuances. Singapore's local bond market saw lower liquidity and trade volumes as it only see SGD 13bn in issuances so far in 2018, down 23%. Bond issuances from financial firms and sovereign issuers dominated the bond market with higher than normal issue sizes. (Business Times)

Greek banks' bad loan reduction in line with target

Sep 6. Reducing non-performing loans has been a top priority for Greek banks as a stronger and healthier banking system would ensure a supply of credit that would support economic growth. Non-performing exposures in Greece, consisting of restructured loans and non-performing loans climbed to EUR 106bn at the end of June 2016. The country's debt crisis pushed the unemployment rate to 28% which resulted in an economic recession and stopped many borrowers from servicing their loans. Banks are aiming to lower NPEs to EUR 64.6bn by end-2019, which declined 4.1% in the second quarter to EUR 88.6bn. (Reuters)

Lloyds becomes first bank to sell Sonia-linked bond

Sep 5. Lloyds Banking Group has become the first bank to price a bond using Sonia, which is an alternative to the scandal-tarnished LIBOR, by selling GBP 750mn of debt that is linked to the new benchmark. The move to use a new benchmark comes after financial institutions, under pressure from global regulators, have begun to test and construct deals using the new benchmark instead of LIBOR. Authorities have been keen to move off LIBOR, which is mostly priced according to judgements rather than actual transactions. Demand for Lloyd's bond was strong, with orders topping GDP 1.4bn, as Lloyd had strong investor demand from bank treasury and asset managers across UK and Europe. (FT)

Debenhams may close stores as it draws up restructuring plans (FT)

S&P Global plans custom credit-ratings scale for China (Reuters)

Tesla's USD 1.8bn of junk bonds hit lowest since 2017 sale (Bloomberg)

Regulatory Updates

Federal Reserve considers a new tool to avert crises

Sep 9. The Fed uses either regulation or interest rate to stamp out financial bubbles and some Fed officials are discussing about using the countercyclical capital buffer which has been used in countries like the UK and Hong Kong. If implemented, big banks will need to put up additional capital during good times. Questions have been raised on the need to implement at current stage given that bank capital levels are high and financial-stability risks appear to be in check. One reason for the concern is that asset prices are increasing as US household net worth was nearly seven times of household income as of Q1 2018, higher than the tech-stock boom in the late 1990s and the real-estate boom in the 2000s. Forcing banks to build up additional capital might help to take some pressure off the Fed to increase interest rates aggressively in the event of overheating economy. (WSJ)

UK, US urge EU not to lock out foreign banks

Sep 7. Britain's top market regulator, backed by the United States, urged the European Union to soften its stance and grant broad access to UK banks after Brexit to avoid hitting investors and harming markets. Under the bloc's current system of market access, "equivalence", the EU would decide if a foreign country's rules are close enough to its own to grant access. Proposing a much broader form of "equivalence", Britain has said the current system does not cover all activities and lacks certainty, leaving it with limited access to its biggest export market for financial services in the future. The United States has also criticized EU plans for tighter supervision on foreign clearing houses and urged the EU to expand the use of "equivalence" to avoid "rule-by-rule exactitude". (Reuters)

Bank fines surge in China as watchdog battles rising bad loans (Bloomberg)

Banks push to close credit union, payday lender 'loophole' (Sydney Morning Herald)

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