31 March 2015

INDUSTRY OUTLOOK | China's Property Industry

Undergoing Downward Correction and Market Consolidation, Outlook Stable

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Executive Summary

China's property industry is under pressure. The outlook for China's property industry is stable in the tier 1 cities, but further correction is expected in the lower-tier cities. This outlook reflects our opinion on the credit conditions in the industry.

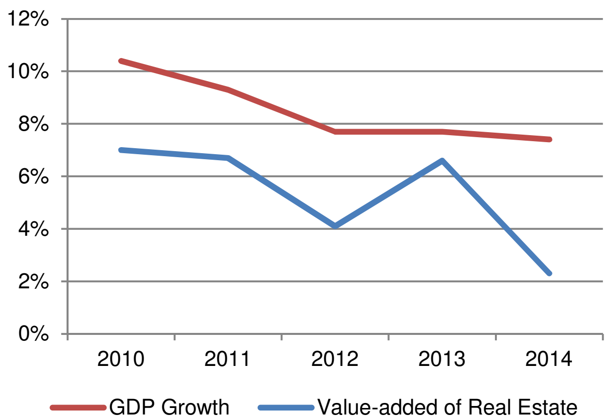
- The Chinese government moved to loosen its regulatory control over the real estate market, which helped relieve the pressure on home buyers and property developers. Since June 2014, more and more cities have lifted home purchase restrictions. In September 2014, the central bank eased mortgage lending rules and redefined first-time home buyers. In November 2014 and March 2015, the announced interest rate cuts will not only encourage demand from home buyers but also reduce financing costs for firms. Although the latest policies may prevent a huge slump, the downward trend will not be completely reversed.
- Overall, property sales in 2015 will be close to the 2014 level, but discrepancies are foreseeable for different cities. Property prices in tier 1 cities will remain stable, prices in lower-tier cities with excess supplies and high inventories will drop further. For these lower-tier cities, the prevailing situation of oversupply in properties and increase in inventories will continue in the short term. For property developers, heightened inventory levels will undermine their creditworthiness.
- The China's property market has been highly fragmented, and operating performance has diverged for developers in different sizes. The leading companies will maintain a strong operating performance, while smaller developers facing operating pressures will be marginalized by market consolidation. The financial ratios of selected companies deteriorated in the first half of 2014. Looking forward, contracted sales and profit margins will depend on the company's project locations and sales execution.

1. Industry Overview

Driven by massive investments in fixed assets, China's economy grew rapidly in the past decade. More than 20% of total investments were allocated to the real estate sector, driving up both housing and land prices significantly. Since 2003, the Chinese government has taken note of the problems of an overheated housing market, and therefore implemented control measures to curb an excessive rise in property prices and speculations in real estate sector. However, the outbreak of the global financial crisis in 2008 drove policymakers back to an economic stimulus model. In 2009, the property market recorded a strong recovery with an increase in both sales volume and housing prices.

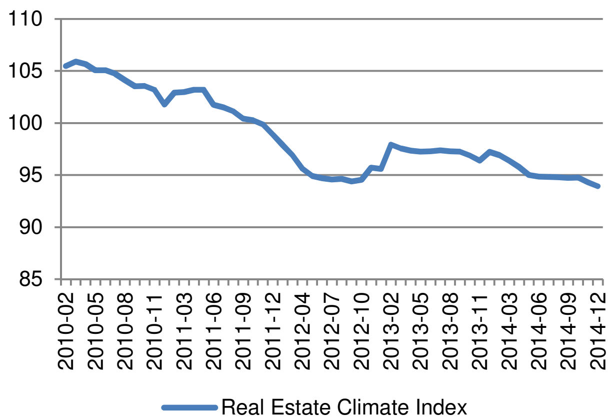
In 2010, the central government again tightened its regulatory control over the property market with a series of regulatory measures, including restrictions on home purchases and conditions on mortgage loans. China's GDP growth rate was 7.4% in 2014 and it is expected to further decline to around 7% in 2015. Together with the slowdown in economic growth, China's property market will undergo a deeper correction. The objectives of the latest government policies focus on stabilizing the property market for sustainable development.

Exhibit 1. Growth Rate of GDP and Real Estate Sector



Source: NBSC, CCXAP Research

Exhibit 2. Real Estate Climate Index



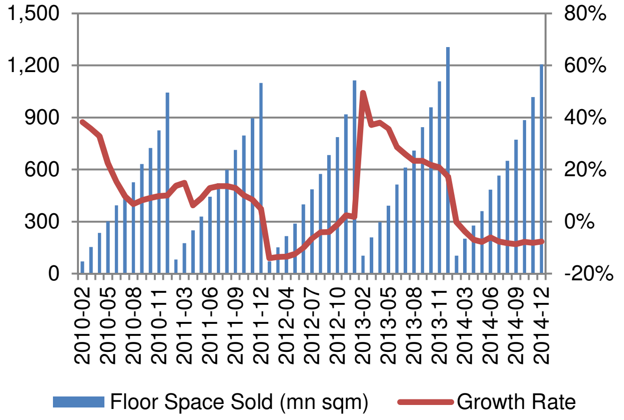
Source: NBSC, CCXAP Research

1.1 Sales Volume Will Stabilize

Under the strict regulation and control framework promulgated in 2010, national property sales have been slowing down. The year-over-year growth rates of sales volume and sales value declined to -14.0% and -20.9% in February 2012. Unlike the central government, local governments moved to implement policies encouraging reasonable home ownership. As the pent-up demand gradually released, property sales bottomed out and increased markedly in 2013.

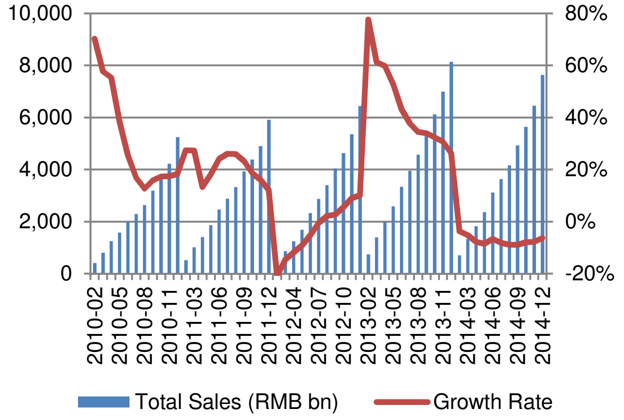
In the first half of 2014, slower economic growth and tighter credit supply resulted in sluggish property demand. Chinese property developers engaged in price wars to achieve sales targets and to increase market shares. In the second half of 2014, policymakers relaxed their regulatory control and launched accommodative monetary measures. Property sales have thus rebounded since September 2014. The sales volume recorded a 7.6% drop to 1,206 million square meters, and the sales value declined by 6.3% to RMB 7,629 billion in 2014.

Exhibit 3. Property Sales Volume



Source: NBSC, CCXAP Research

Exhibit 4. Property Sales Value



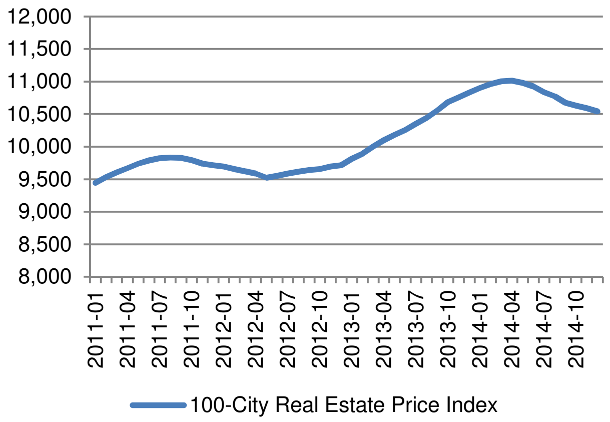
Source: NBSC, CCXAP Research

The Chinese government moved to loosen its regulatory control over the real estate market, which helped relieve the pressure on home buyers and property developers. Urbanization will further facilitate the growth of the property market in the long run. However, for some lower-tier cities, the prevailing situation of oversupply in properties and increase in inventories will continue in the short term. Overall, property sales in 2015 will be close to the 2014 level, but discrepancies are foreseeable for different cities.

1.2 Property prices Will Decline Modestly

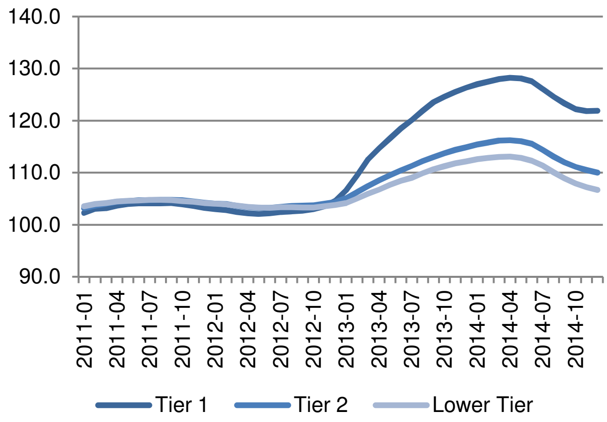
Given the tightened regulatory control, property prices represented a slowdown in growth and declined in absolute terms since September 2011. The supply and demand in the housing market have arrived at a new equilibrium, which has bolstered prices since the second half of 2012.

Exhibit 5. 100-City Real Estate Price Index



Source: CREIS, CCXAP Research

Exhibit 6. Newly Constructed Residential Price Indices[1]



Source: NBSC, CCXAP Research

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[1] Residential sales prices in 70 major cities are tracked by the NBSC (2010 level = 100).

Tier 1 cities are Beijing, Shanghai, Guangzhou, and Shenzhen.

Tier 2 cities are Tianjin, Shijiazhuang, Taiyuan, Hohhot, Shenyang, Dalian, Changchun, Harbin, Nanjing, Hangzhou, Ningbo, Hefei, Fuzhou, Xiamen, Nanchang, Jinan, Qingdao, Zhengzhou, Wuhan, Changsha, Nanning, Haikou, Chongqing, Chengdu, Guiyang, Kunming, Xi'an, Lanzhou, Xining, Yinchuan, Urumqi, Wuxi, and Sanya.

Lower-tier cities are the remaining cities on the list.

The 100-City Real Estate Price Index, published by the CREIS, reached RMB 11,013 per square meter high in April 2014, up for 23 consecutive months. Then it fell back because of the slide in property sales. As compared to the year before, the index decreased by 2.7% to RMB 10,542 per square meter in December 2014. Out of the 70 medium-to-large cities monitored by the NBSC, 68 had a fall in property prices in 2014. The prices of tier 1, tier 2 and lower-tier cities decreased by 3.5%, 4.2% and 4.9% respectively.

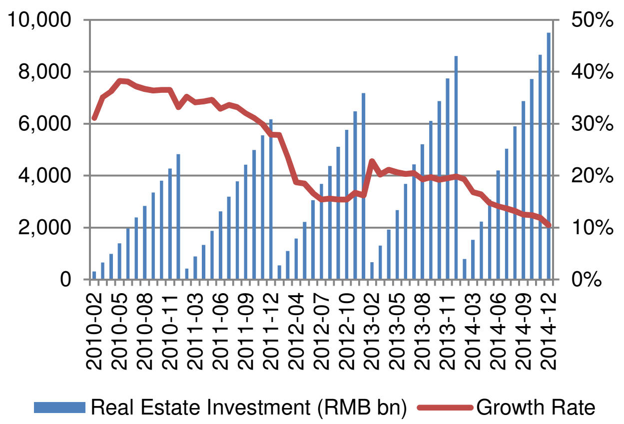
As property supplies in many cities have reached saturation, inventory reduction will be the theme of the Chinese property market. We expect that property prices will continue to decline, but the magnitude of the price movement will narrow in light of the stabilizing property sales. Property prices in tier 1 cities will remain stable, while for those lower-tier cities with excess supplies and high inventories, the prices will drop further.

1.3 Investments in Property Development Decelerates

Since the second half of 2011, real estate investments have decelerated for the following reasons. First, given the tightened regulatory control, property sales grew at a slower pace, which resulted in lower revenue growth for property developers. Second, developers found it more challenging in obtaining funding through domestic loans and bonds. In 2013, a rebound in property sales drove up property investments to a growth rate of 19.8%. However, as both property sales and housing prices turned south in 2014, the figure eased to 10.5%. Total investments in real estate sector amounted to RMB 9,504 billion, of which RMB 6,435 billion (68%) were allocated to the development of residential homes.

Despite policymakers loosening controlling rules, market sentiment remains lukewarm. Real estate investments are expected to grow at a moderate rate.

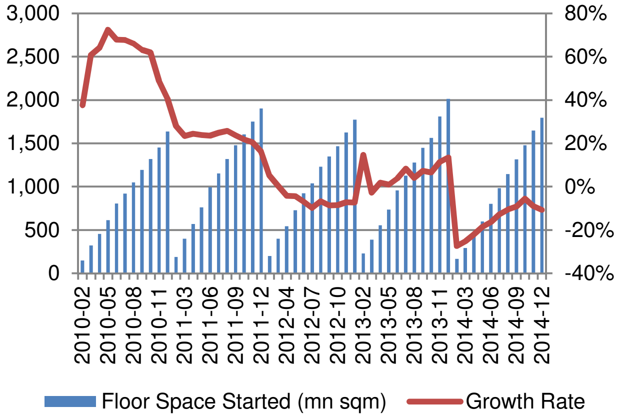
Exhibit 7. Investments in Real Estate Sector



Source: NBSC, CCXAP Research

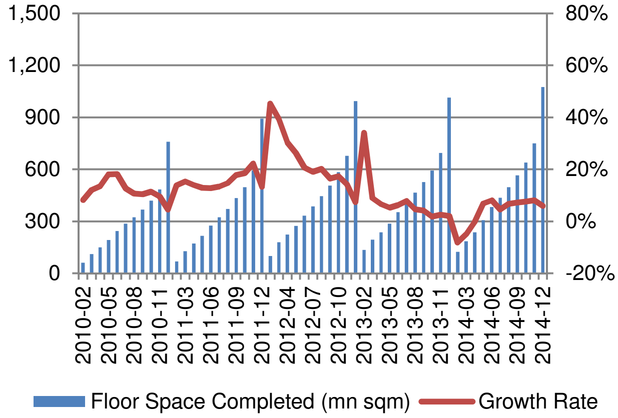
From 2010 to 2012, the growth rates of new development projects underwent a dramatic decline, which affected properties completed in subsequent years. Most developers have become more prudent in launching new projects in order to control costs. In 2014, total floor space decreased by 10.7% and projects completed increased by 5.9%. Since property supply usually lags for two to three years, the property market will expect fewer property supplies in the near term.

Exhibit 8. Floor Space Started



Source: NBSC, CCXAP Research

Exhibit 9. Floor Space Completed

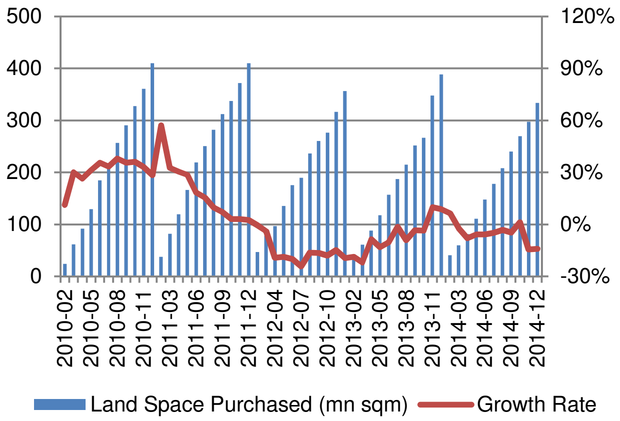


Source: NBSC, CCXAP Research

1.4 Developers Becomes More Selective in Land Acquisitions

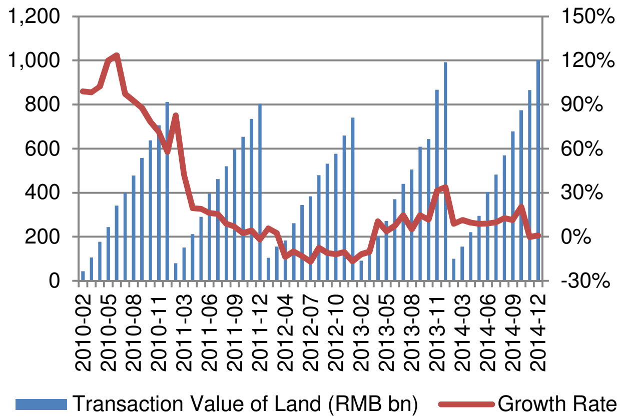
Due to the challenging operating environment, land acquisitions represented a slowdown in growth in 2011 and declined in absolute terms in 2012. As the property market recovered in 2013, property developers tended to expand their land reserves. Moreover, since land sales accounted for the bulk of government revenues, some local governments with rising debt burdens tended to increase land supplies. In 2014, the volume of land acquisitions declined by 14.0% year-over-year to 334 million square meters. Since property developers focused on land purchases in tier 1 and tier 2 cities with higher prices, the transaction value stabilized at RMB 1,002 billion.

Exhibit 10. Land Acquisition



Source: NBSC, CCXAP Research

Exhibit 11. Transaction Value of Land Acquisition



Source: NBSC, CCXAP Research

Property developers need to balance their sales collection and land purchases. Currently, they have become more selective in land acquisition, focusing on prime locations in large cities. The land market will flatten, but aggressive bids by property developers will be less likely.

1.5 Financing Environment Is Improving

Funding of property developers mainly relied on themselves and other sources (such as customer deposits, advance receipts, and mortgage loans), altogether accounting for over 80% of the total amount. In 2014, the amount of new funding for property development remained stable at RMB 12,199 billion. Property developers stepped up their loan borrowing by 8.0% and fund raising by 6.3%, while funds from other sources dropped by 8.8%.

Exhibit 12. Sources of Funds for Real Estate Development

Sources of Funds for Real Estate Development	2012			2013			2014		
	RMB bn	% of Total	Growth	RMB bn	% of Total	Growth	RMB bn	% of Total	Growth
Total	9,654	100%	12.7%	12,212	100%	26.5%	12,199	100%	-0.1%
Domestic Loans	1,478	15.3%	13.2%	1,967	16.1%	33.1%	2,124	17.4%	8.0%
Foreign Investment	40	0.4%	-48.8%	53	0.4%	32.8%	64	0.5%	19.7%
Self-raising Funds	3,908	40.5%	11.7%	4,742	38.8%	21.3%	5,042	41.3%	6.3%
Others	4,227	43.8%	14.7%	5,449	44.6%	28.9%	4,969	40.7%	-8.8%

Source: NBSC, CCXAP Research

As of December 2014, outstanding loans to the real estate sector amounted to RMB 17,370 billion, an increase of 18.9% year-over-year. The majority of these property-related loans were taken out by individual home buyers. Recently, banks have channeled more funds to affordable home development and shanty town redevelopment. Outstanding loans in these areas have grown by 46.6%, 26.7%, and 57.2% in the past three years, and reached RMB 1,140 billion at the end of 2014.

Exhibit 13. Outstanding Loans to Real Estate Sector

Outstanding Loans to Real Estate Sector	2012			2013			2014		
	RMB bn	% of Total	Growth	RMB bn	% of Total	Growth	RMB bn	% of Total	Growth
Total	12,110	100%	12.8%	14,610	100%	19.1%	17,370	100%	18.9%
Property Development	3,000	24.8%	10.7%	3,520	24.1%	16.3%	4,280	24.6%	21.7%
Land Development	863	7.1%	12.4%	1,070	7.3%	9.8%	1,350	7.8%	25.7%
Individual Mortgage	8,100	66.9%	13.5%	9,800	67.1%	21.0%	11,520	66.3%	17.5%

Source: PBOC, CCXAP Research

Amid declining property sales, the Chinese government has announced measures to strengthen financial support to the property market. The domestic financing environment has been improving for property developers.

2. Future Development

2.1 Market Measures Instead of Regulatory Controls

Under a centralized regulation framework, discrepancies in the property market emerged for different regions with different economic strength. Tier 1 and some tier 2 cities registered a surge in housing prices, whereas lower-tier cities faced the situation of excess supply and weak demand. The control mechanism needs to be decentralized at the local government level.

Following the National People's Congress held in March 2014, the central government allowed local governments to have more flexibility in implementing housing policies. Since June 2014, more and more cities have loosened or completely lifted restrictions on home purchases. There are now 41 out of 46 cities which no longer have restrictions. The remaining cities with restrictions are Sanya and the four tier 1 cities (i.e. Beijing, Shanghai, Guangzhou, and Shenzhen). However, the effects of this relaxation were far beyond expectations.

Local governments implemented stimulus measures to boost the mass property market, including housing provident fund loans, real estate taxes, housing subsidies, and residence registration.

Exhibit 14. Cities That Have Announced Relaxation on Home Purchase

Announcement	Cities
Jun 2014	Hohhot
Jul 2014	Jinan, Haikou, Wenzhou
Aug 2014	Changsha, Foshan, Guiyang, Hangzhou, Harbin, Hefei, Jinhua, Kunming, Nanchang, Ningbo, Shaoxing, Taiyuan, Taizhou, Wuxi, Xuzhou, Yinchuan, Zhengzhou
Sep 2014	Dalian, Fuzhou, Lanzhou, Nanjing, Qingdao, Shenyang, Shijiazhuang, Suzhou, Wuhan, Xi'an, Xining, Zhuhai
Oct 2014	Nanning, Tianjin, Urumqi
Dec 2014	Yongkang
Jan 2015	Xiamen
(not officially)	Changchun, Chengdu, Quzhou, Zhoushan

Source: Public information, CCXAP Research

In September 2014, the People's Bank of China (PBOC) eased mortgage lending rules, which redefined first-time home buyers and lowered down payment requirement and preferential mortgage rate. Those who have fully repaid the mortgage from first purchase are now considered first-time buyers. This measure was to encourage demand from the mass market and upgraders.

In November 2014, the PBOC lowered benchmark interest rates in the face of slow economic growth and weak domestic consumption. In March 2015, the central bank announced a further interest rate cut, where the one-year lending rate is 5.35% and the one-year deposit rate is 2.5%. Low inflation and falling commodity prices will allow further room for Chinese policymakers to ease monetary policy. An accommodative monetary policy will boost liquidity and support growth. For the property sector, the interest rate cut will not only encourage demand from home buyers but also lower financing costs for corporates.

China's property market weighs on the broader economy, having an impact on industries such as steel, cement, and construction. The Chinese government has implemented measures to facilitate a healthy and stable property market. Although the latest policies may prevent a huge slump, the downward trend will not be completely reversed. We expect correction in the property market will continue in the foreseeable future.

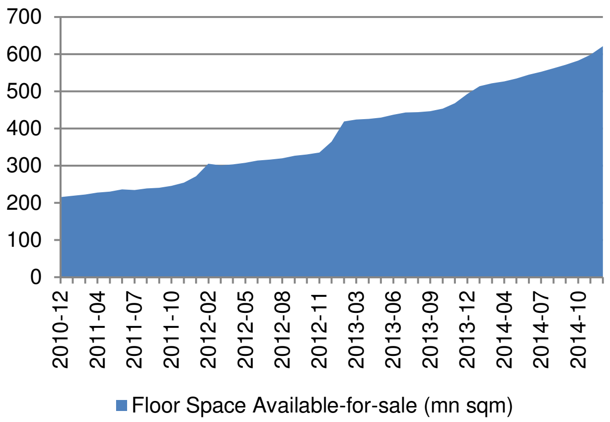
2.2 Heightened Inventory Levels Exerts Operating Pressures

Excess supply and slow sales have pushed up inventory levels. As of December 2014, the floor space of unsold properties recorded 622 million square meters, showing a 26.1% year-over-year increase.

There are two indicators to measure the current inventory level and turnover capability. The first is property inventory measured by number of months, which shows the short-term pressure to clean up current inventories. The second is land reserve measured by number of years, which underlines property development in the medium-to-long term.

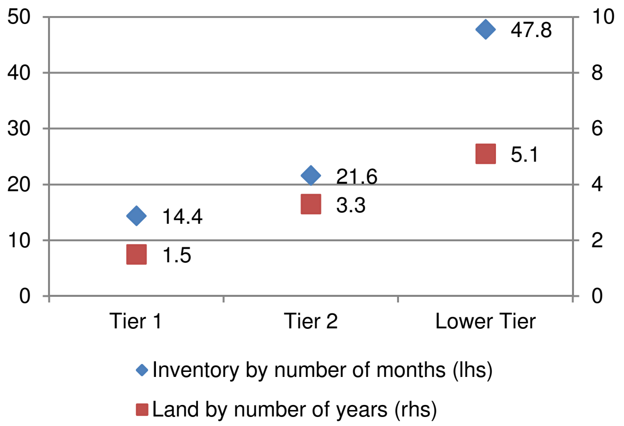
The inventory levels and land reserves in tier 1 cities and some tier 2 cities such as Chengdu, Hefei, Nanchang, Nanjing, Suzhou, and Xiamen remained healthy. However, the inventory levels in some tier 2 cities such as Dalian and Tianjin and many lower-tier cities were particularly high, requiring more than 30 months to sell. Some tier 2 cities such as Qingdao, Zhengzhou, and Changchun and many lower-tier cities even have land reserves of more than five years. A long land reserve life will hurt future investment in local property markets.

Exhibit 15. Property Available-for-sale



Source: NBSC, CCXAP Research

Exhibit 16. Property Inventory and Land Reserve (Nov 2014)



Source: CREIS, CCXAP Research

For property developers, heightened inventory levels will undermine their creditworthiness. They will face liquidity pressures due to slow cash collection from property sales. As a result, many developers have to offer promotions and discounts, which weaken their profit margins.

2.3 Sources of Funding Become More Diverse

Since 2010, property developers have been facing a tightened credit environment. Many developers borrowed from the shadow banking market and paid high financing costs. In 2014, the situation became worse because of falling property sales and rising inventory levels. In response to the difficult situation, Chinese regulators eased credit rules and diversified the funding sources for developers.

Starting from March 2014, several listed developers have received approval from the China Securities Regulatory Commission (CSRC) to launch refinancing plans in the stock exchange. This relaxation will replenish the financing needs of listed developers, in particular those of small-to-medium size.

In September 2014, the National Association of Financial Market Institutional Investors (NAFMII) allowed property developers to issue medium-term notes (MTN) in the interbank market. Large well-known developers are most likely to benefit from this credit loosening. The financing costs of MTN are usually lower than those of trust products and development loans, and the financing tenor can be extended for a longer period.

Exhibit 17. MTN Issuance of Property Developers (Sep 2014 – Jan 2015)

Issuer	Issue Date	Maturity Date	Amount (RMB bn)	Coupon (%)	Tenor (year)
China Vanke Co., Ltd.	2014/12/24	2017/12/26	1.8	4.7	3
Poly Real Estate (Group) Co., Ltd.	2014/12/25	2019/12/26	1.0	4.8	5
Financial Street Holdings Co., Ltd.	2015/01/27	2020/01/29	2.8	4.8	5

Source: Chinamoney, CCXAP Research

Although innovative financial products have a positive impact on the property market, detailed regulations and guidelines have not yet been finalized. In the past ten years, only three residential mortgage-backed securities (RMBS) were issued in the domestic bond market. Securitization can help banks to reduce their exposure to property sector risk. Real estate investment trusts (REITs), as an alternative source of financing, can help property developers reduce their reliance on bank loans.

2.4 Credit Events Highlights the Risks of Property Developers

The housing market has experienced explosive growth in the past years. To take advantage of the rising prices, many developers have adopted a fast growth model with high leverage. As the property market is undergoing correction, some developers are at risk of default.

Exhibit 18. Recent Credit Events of Chinese Property Developers

Date	Company	Location	Credit Event
Mar 2014	Zhejiang Xingrun Real Estate Co.	Fenghua	The company collapsed and could not repay its creditors. It was estimated that the company owed RMB 3.5 billion of debts, with only RMB 3 billion of assets on hand.
May 2014	Shenzhen GUANG Real Estate Group Co., Ltd	Huizhou	The company failed to deliver projects to home buyers on time, due to aggressive expansion and financial pressures.
Jan 2015	Kaisa Group Holdings Ltd	Shenzhen	Followed chairman resignation and pre-sale restriction, the company defaulted on its loans and offshore bonds. Project assets will be sold to other developers.

Source: Public information, CCXAP Research

The major causes of credit events in the property market are poor financial control and management execution. As the anti-corruption campaign is spreading to real estate sector, legitimate business and management integrity is crucial for property developers. The failures of these developers are isolated events, having limited impact on the market as a whole. Nevertheless, they highlighted mounting risks in the property market.

Small regional developers with weak sales execution and high refinancing needs will struggle due to vulnerable cash flows from operations, tightened access to capital markets, and potential regulatory/financial troubles. On the other hand, though risk events occurred on a few nationwide developers, large nationwide developers with strong brand name or government ownership will continue to show robust operating performance and maintain a healthy financial position.

3. Company Analysis

3.1 Market Consolidation Is a Long-term Trend

China's property market has been highly fragmented, and operating performance has diverged for developers of different sizes. The leading companies have competitive advantages because of their nationwide geographic coverage, diverse product mix, and sufficient land reserves. Meanwhile, smaller developers facing operating pressures will be marginalized by market consolidation.

Exhibit 19. Market Share of Top Chinese Property Developers

Year	2010	2011	2012	2013	2014
Market Share of Top 100	25.2%	26.2%	28.0%	29.5%	35.4%
Market Share of Top 10	9.7%	10.0%	11.5%	11.9%	15.6%

Source: CREIS, CCXAP Research

Since the domestic property market is in the doldrums, some Chinese developers have sped up their investments in overseas projects. For example, Vanke teamed up with US developers on residential buildings in San Francisco and New York; and Greenland issued offshore bonds through its subsidiary to fund overseas property development. This trend of Chinese developers expanding into global markets will continue.

Large companies also diversify into ventures other than property development in order to hedge against declining returns from property sales. These non-property businesses include consumer goods, e-commerce, energy, financial, hotel, and movie industry.

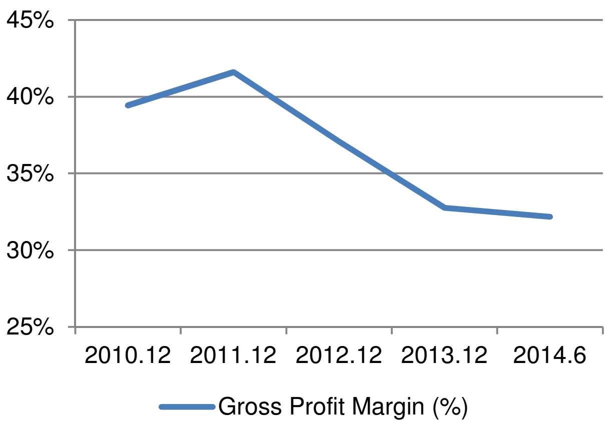
3.2 Financial Ratios Deteriorates Due to Weak Sales

We selected 30 Chinese property developers listed in Hong Kong to form our sample base (see Appendix). The financial ratios of these companies deteriorated in the first half of 2014. Looking forward, contracted sales and profit margins will depend on the company's project locations and sales execution. The majority of listed developers will remain liquid given their ability to access capital markets.

As mentioned above, in order to boost sales and reduce inventories, Chinese property developers engaged in price competition and thus recorded lower gross profit margins. Due to higher inventory levels and lower sales growth, average inventory turnover also slowed down in the first half of 2014. As the whole property market is in correction, there will be a trade-off between sales profitability and inventory turnover.

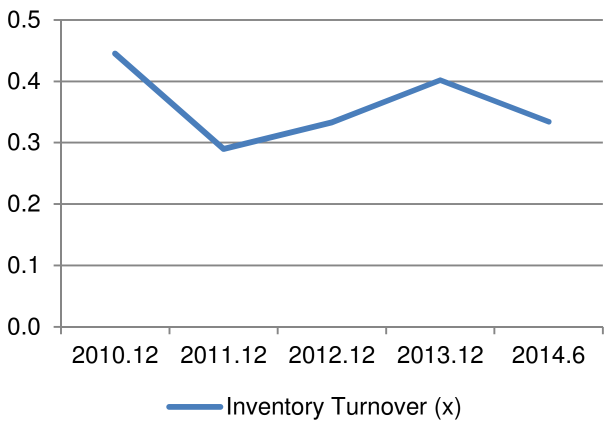
For the capital structure, the average financial leverage of the selected companies is trending upwards. Given higher costs of land purchases and project constructions, Chinese property developers need to raise capital from debt financing. In addition, due to negative operating cash flows resulting from weak sales in the first half of 2014, average cash to short-term debt ratio declined as compared to the 2013 fiscal year. Nevertheless, since average cash on hand is still sufficient to repay debt obligations within one year, liquidity positions of selected companies remained healthy.

Exhibit 20. Profitability



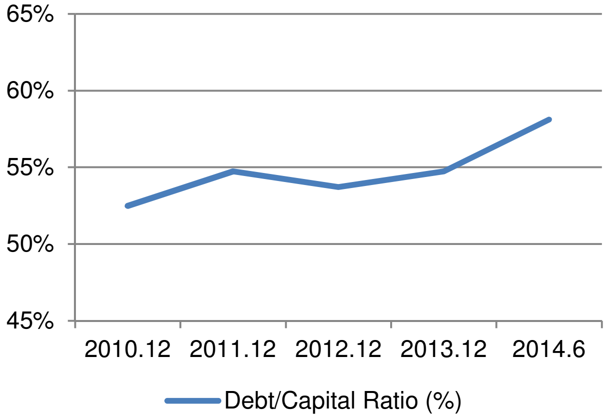
Source: Company data, CCXAP Research

Exhibit 21. Inventory Management



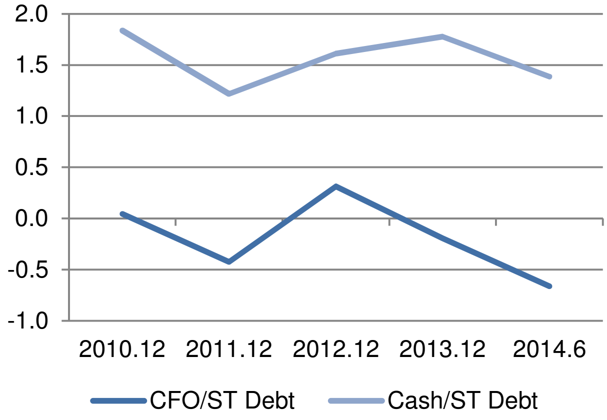
Source: Company data, CCXAP Research

Exhibit 22. Capital Structure



Source: Company data, CCXAP Research

Exhibit 23. Liquidity Position



Source: Company data, CCXAP Research

Conclusion

China's property industry is undergoing downward correction and market consolidation. The central government has introduced supportive measures to boost the housing market, and the recent interest rate cuts helped restore market sentiment. Local governments have lifted the home purchase restrictions in 41 cities. These measures have sent a signal of the government's intention to stabilize the property market. Tier 1 cities will continue to outperform the others as they are supported by strong demand. However, in lower-tier cities, inventory levels will remain high.

Appendix. List of Selected Chinese Property Developers

We select 30 Chinese property developers listed in Hong Kong to form our sample base.

Exhibit 24. List of Selected Chinese Property Developers

0081.HK	CH OVS G OCEANS	1238.HK	POWERLONG
0123.HK	YUEXIU PROPERTY	1628.HK	YUZHOU PPT
0337.HK	GREENLAND HK	1638.HK	KAISA GROUP
0410.HK	SOHO CHINA	1668.HK	CHINASOUTHCITY
0672.HK	ZHONGAN REALEST	1777.HK	FANTASIA
0688.HK	CHINA OVERSEAS	1813.HK	KWG PROPERTY
0754.HK	HOPSON DEV HOLD	1918.HK	SUNAC
0813.HK	SHIMAO PROPERTY	1966.HK	CHINA SCE PPT
0817.HK	FRANSHION PPT	2007.HK	COUNTRY GARDEN
0832.HK	CENTRAL CHINA	2777.HK	R&F PROPERTIES
0845.HK	GLORIOUS PPT H	3333.HK	EVERGRANDE
0884.HK	CIFI HOLD GP	3377.HK	SINO-OCEAN LAND
0960.HK	LONGFOR PPT	3383.HK	AGILE PROPERTY
1109.HK	CHINA RES LAND	3883.HK	CHINA AOYUAN
1232.HK	GW TIANDI	3900.HK	GREENTOWN CHINA

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