# Chinese Property Developers 2020 Outlook：Possibly A Watershed Year

## Summary and Outlook for 2020

### Tightened Policies Remain Intact

2020 may turn out to be a watershed year for Chinese property developers as they face a slowing economy, regulatory constraints both on financing and demand ends, as well as intensified competitions within the industry. Under the backdrop of tightened policies and regulations, we believe contracted sales growth rate may be gyrating around zero or even dipping into a negative territory in 2020. While we do not expect any material change of policy stance in 2020, we will not rule out any loosening of purchase restrictions under the "one city, one policy" stance.

### Refinancing Risk Persists

China's economic growth will likely slowdown in 2020 amid the ongoing deleveraging campaign. In addition, China's ongoing trade tension with the U.S. will further dampen the growth of its GDP and foreign currency reserves which put pressure on its currency RMB. Furthermore, many Chinese property developers are facing re-financing schedules of upcoming maturing bonds in 2020 and 2021. Bond investors shall pay close attention to the liquidity positions and debt maturity profiles of these Chinese property developers.

### Large and Quality Medium-sized Developers to Outperform

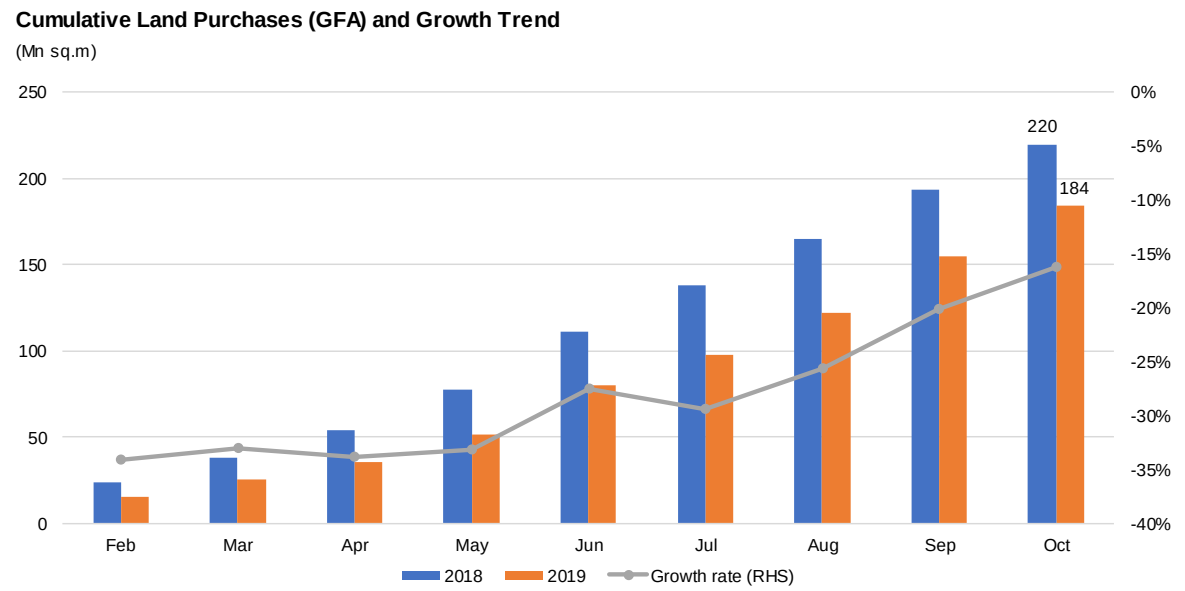
We also believe large property developers with leading market position, strong and diversified financing channels will continue to outperform. The same cannot be said for smaller property developers. Medium-to-small property developers with high operating efficiency (i.e. higher asset turnover, on-pace delivery of properties), sufficient land bank on balance sheet to support contracted sales growth, and improved debt maturity profile will likely outperform. We also expect polarization to intensify within the industry in which large-to-medium property developers will likely gain at the expense of small ones in terms of market share, funding, regional dominance, as well as land acquisitions.

## Industry Overview

### Contracted Sales Momentum to Recede

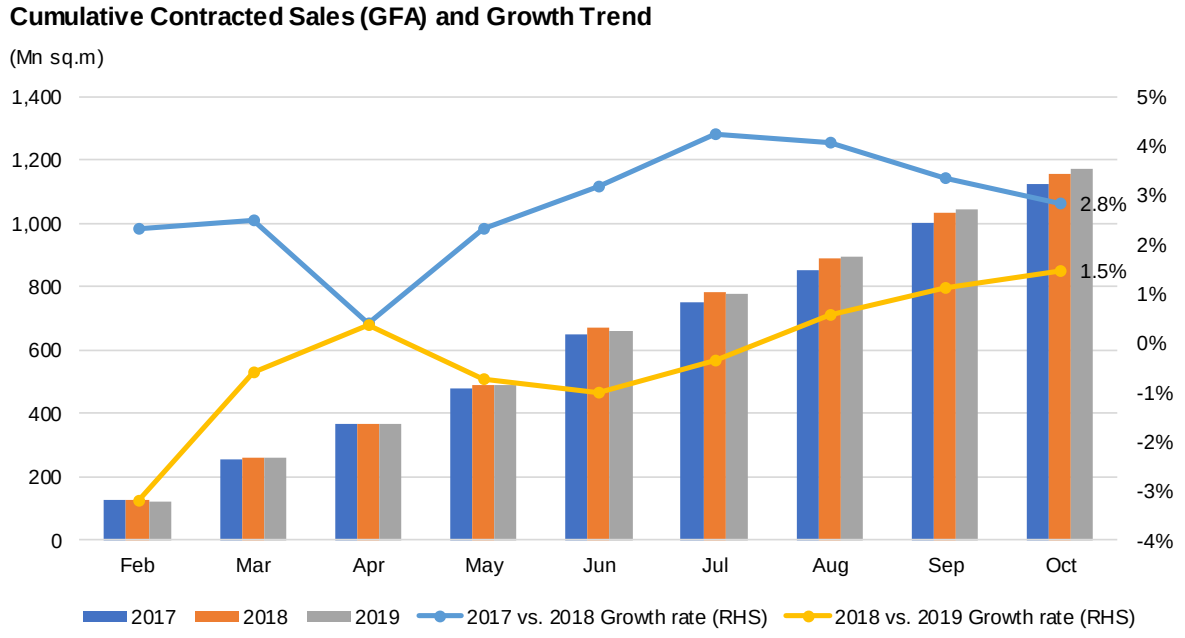
The Chinese government continued to enforce its policy stand of deleveraging and prevention of property flipping in 2019. The government has also become more flexible and effective on the execution of policies, such as the adaptation of "one city, one policy", all of which have shortened the contractionary and expansionary cycles. Nevertheless, as the financing channel for property developers tightens, the pace of land purchases slowed down (EXHIBIT 1). Subsequently, contracted sales GFA also showed signs of losing growth momentum (EXHIBIT 2), all of which lead us to believe that the Chinese property market is entering a new phase of normalized growth from the previous high-growth phase.

## EXHIBIT 1: Cumulative Land Purchases (GFA) and Growth Trend




*Source: National Bureau of Statistics of China*

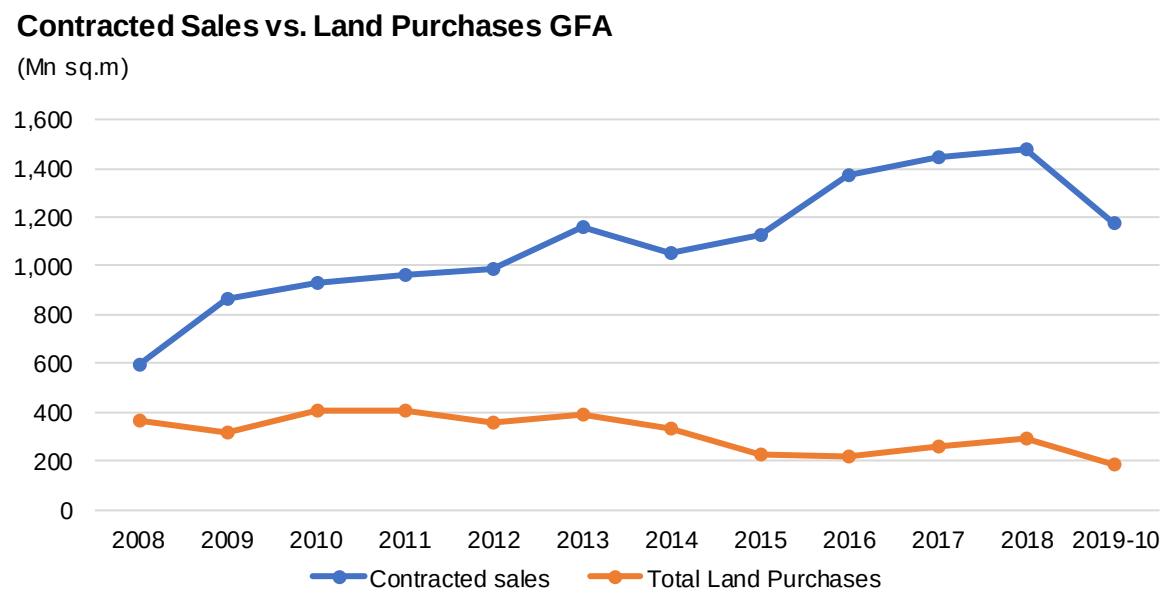
## EXHIBIT 2: Cumulative Contracted Sales (GFA) and Growth Trend




*Source: National Bureau of Statistics of China*

We also notice that the pace of land purchases has not been keeping in tandem with the pace of contracted sales for some property developers as the financing channel tightens, which leads us to believe that some of the property developers may face a shortage of land (EXHIBIT 3) and the pace of contracted sales may recede in 2020.

**EXHIBIT 3: Contracted Sales vs. Land Purchases GFA**




*Source: National Bureau of Statistics of China*

At the same time, as most tier 1 & 2 cities are saturated, many property developers are increasingly expanding to the outskirts of the cities. Coupled with the expansion of high-speed railroad networks and the linkages among cities and/or satellite cities, the concept of mega cities or metropolitan region (within 1 or 2-hour radius by railroad) was born. The concept of cluster of cities and/or satellite cities connected by railroads or highways to form a singular economic region continues to dominate the development landscape. Meanwhile, as some property developers expand their footprint to satellite cities, their average selling price ("ASP") takes a hit. We notice an increase in the volatility of reported ASP across the board which may trickle down to adversely affect gross margins and EBITDAs of Chinese property developers.

## Operating Efficiency Plays A Bigger Role

As home price appreciation rate slows and financing channel tightens, many property developers adopt a higher asset turnover to manage their cash flow. Increasingly, property developers are relying on cash collections from contracted sales to finance land purchases. Meanwhile, as land price remains elevated, property developers continue to form joint ventures ("JVs") and/or through mergers-and-acquisitions ("M&As") to acquire land to keep cost under control. Inevitably, the industrywide contracted sales gross margins are under pressure as home price appreciation rate slows, land price remains elevated, and offering of discounts on home purchases to maintain higher asset turnover.

Given the current status, we expect a few smaller and lowly-rated property developers will likely be forced out as competition intensifies. Some smaller players may either put themselves up for sale or sell their property development segments to other large-to-medium-sized players. Isolated incident of defaults may occur but contagious and systemic risks are unlikely to materialize. We believe the Chinese government and Central Bank will likely change towards a moderate policy stance as soon as there is any hint of contagious risk.

## Policies & Regulations

### Tightened Policies and Regulations to Remain

The most prominent regulation promulgated by the NDRC is the No. 778 announcement which prohibits the use of net proceeds from offshore debt issuance to finance Chinese property developers' capital expenditure and further restricts debt issuance to refinance maturating debt within one year. This regulation was an extension of the 2018 No. 706 regulation and the 2019 No.778 regulation clarifies the ambiguity of the 2018 regulation. In our view, it was an indication of the Chinese regulator's ambition and commitment to control the runaway property market.

The second prominent regulation is the clampdown on trust loans. We notice a general decrease of trust loans across the board. The clampdown on trust loans has direct impacts on medium-to-small Chinese property developers than the larger ones.

In addition, the Chinese government continued to roll out various forms of purchase restrictions. Across China, only a handful of provinces/autonomous regions do not have any purchase restrictions. These purchase restrictions range from limiting the number of home purchases by residents, length of social security payments, lockout period/year to transact and even marriage status etc. In general, tier 1 cities require permit residents to show proofs of 5 years of social security payments to qualify for one home purchase while registered residents are allowed to purchase two homes. Meanwhile in tier 2 and 3 cities, permit residents must show proofs of at least 2 years of social security payments to qualify for one home purchase. In some cities, a lockout period/year in the range of 2 to 5 years has been placed to prevent property flipping. The Chinese government is committed to keeping home prices in check through various administrative measures.

## 2019 Credit Review

Year-to-date 2019, we noticed an increasingly pronounced polarization among Chinese property developers in terms of their delivery of revenue, execution of contracted sales, control of financial leveraging, land purchase pace, and management of liquidity. Many medium-sized property developers continued to acquire land just to keep in pace with their strong contracted sales through loan/debt financing. JVs and M&As continued to be the preferable way to conduct business which decreased financial transparency. As land became scarce in certain cities, we noted an increasing use (though at a small percentage) of shantytown redevelopments as a way to acquire premium land within city limits. However, shantytown redevelopments encompass lengthy negotiations, compensations and resettlements etc. which are often difficult to quantify and analyze in terms of timeline and certainty.

We also notice a decrease in interest coverage ratios as a result of increased debt issuance or bank borrowing but trailing revenue recognitions (or EBITDA) for many medium-sized property developers. But we believe as long as the delivery of properties is kept on pace, the interest coverage ratios would likely to improve. Meanwhile, small property developers continued to face challenges in terms of higher cost of funding and land acquisition cost.

Overall in 2019, Chinese property developers operated under the general theme of "properties are for living not for speculation" (房住不炒) in the industry guided by the Central Government. We have seen various policies gearing towards managing price increases and tightening access to financings coming out during the year (Please refer to the "Policies & Regulations" section above). The combination effect of these led to a few key trends emerging during 2019:

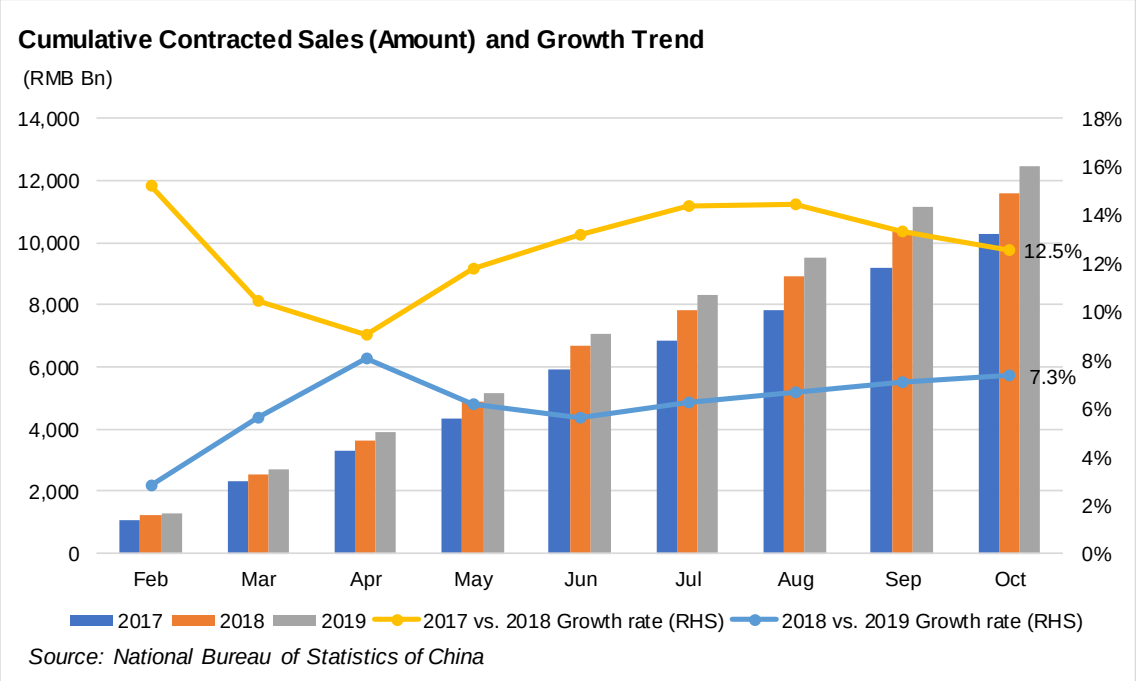
- Cash collection from sales more important; revenue recognized increased in tandem
- Slowing down in land acquisitions and increase in deleveraging to manage debt growth
- Polarization of the industry became more pronounced, with tougher environment for smaller scale developers

## Increase in Contracted Sales and Cash Collection More Important; Revenue Recognition on An Upward Trend

*Contracted sales increased year-over-year at a slower pace in the first ten months of 2019*

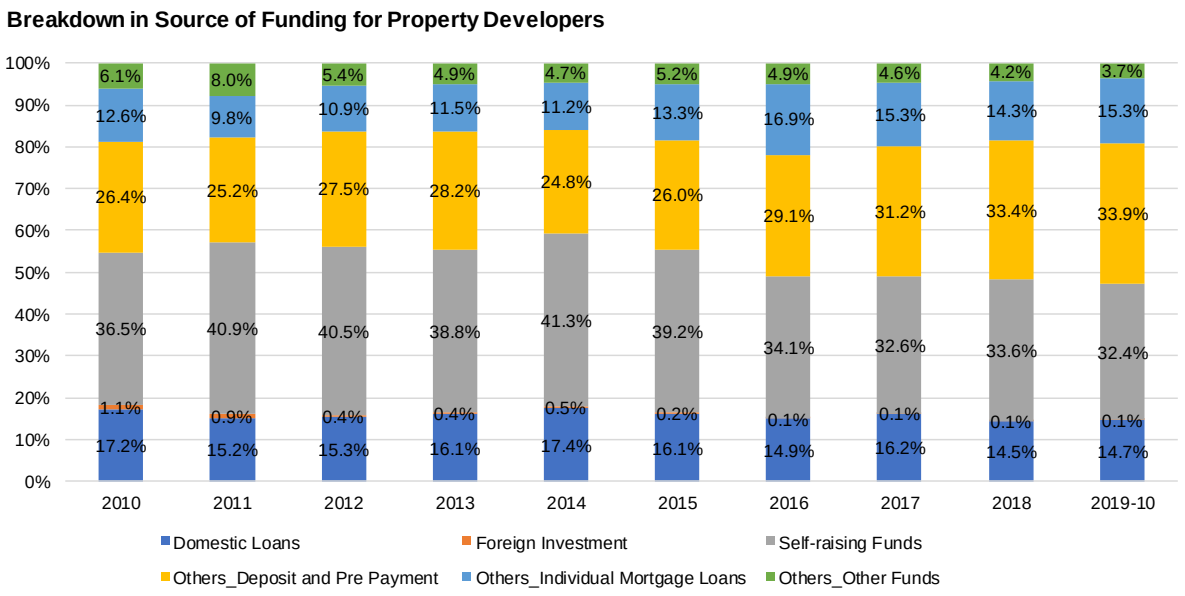
Property developers experienced strong momentum in contracted sales growth in the past two years. But in the first ten months of 2019, contracted sales only increased 7.3% year-over-year comparing to 12.5% increase in the previous year (EXHIBIT 4). This momentum showed signs of losing steam in 2019. Meanwhile, property developers strived to maintain a healthy source of funding through cash collected from contracted sales, in light of the tightening financing environment. In the first ten months of 2019, cash collected from contracted sales accounted for 33.9% of the total source of funding for Chinese property developers, an increase of 7.9 percentage points vis-à-vis 2015 (EXHIBIT 5). Despite the slowing trend in contracted sales growth, large-to-medium-sized developers focusing on tier 1 and tier 2 cities were exhibiting higher growth, while smaller developers were struggling to meet sales target or even experiencing drop in contracted sales year-over-year.

**EXHIBIT 4: Cumulative Contracted Sales (Amount) and Growth Trend**



*Source: National Bureau of Statistics of China*

## EXHIBIT 5: Breakdown in Source of Funding for Property Developers




*Source: National Bureau of Statistics of China*

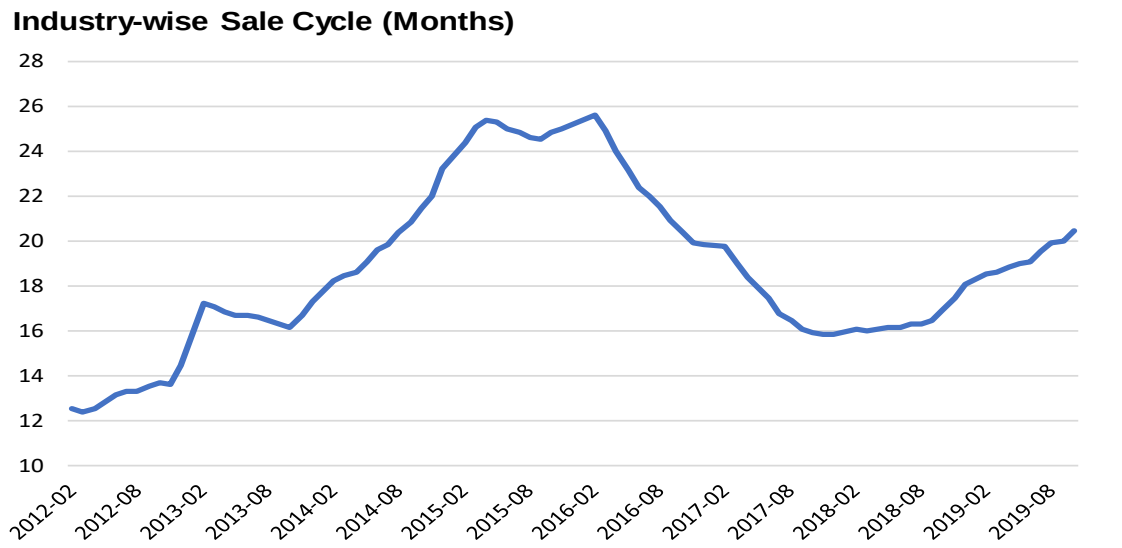
*Revenue recognition grew thanks to previous contracted sales momentum*

Although the sale cycle continued to be on an upswing level from an industry-wise perspective (EXHIBIT 6), developers were still increasingly adopting a more high-turnover strategy to increase cashflow from property sales. This strategy, together with the policies in curbing property prices, inevitably led to some sacrifice in margins as developers no longer had the luxury of "timing" the market when launching their projects to the market. Overall, property developers, usually larger-sized and some medium-sized ones, were able to execute its sales plan in accordance with market sentiment and record better margins versus the industry average.

On the revenue front, growth was in tandem with the contracted sales trend (EXHIBIT 7). Given the strong contracted sales momentum seen in the past few years, property developers were reporting higher revenues in 1H 2019. The increase in revenue partially offset the squeeze in margins, which resulted in an improved EBITDA/interest coverage and debt/EBITDA ratios for those which were maintaining their leverage at a relatively stable level this year.

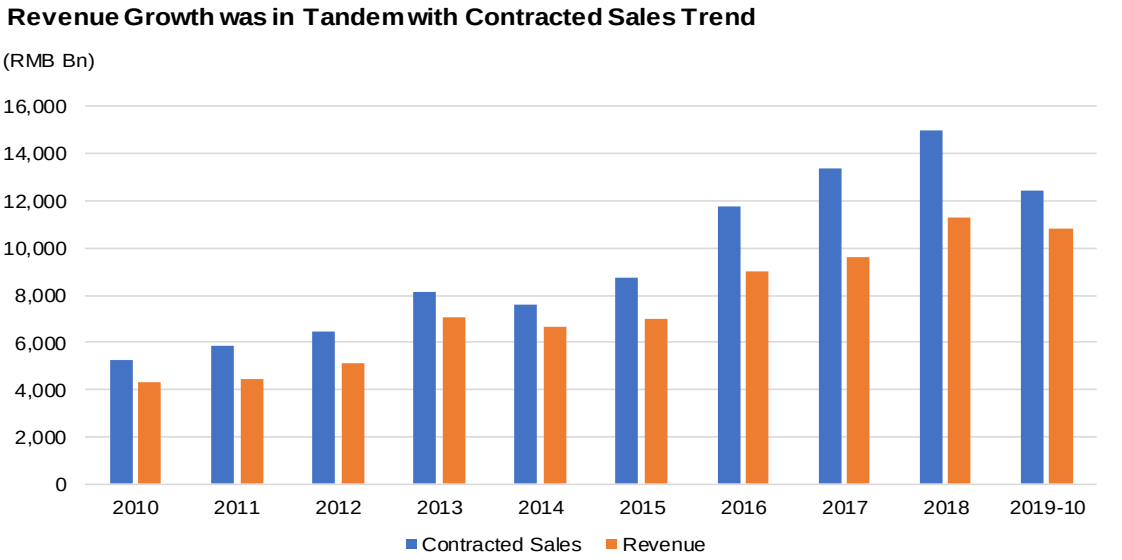
However, some medium-sized and a few larger property developers were ambitious in achieving contracted sales target for 2019 and 2020, and have been spending on debt-funded land acquisitions, which pushed up their leverage to a high level at end-June 2019. Although an increase in leverage alone would lead to a more negative view from a credit perspective, we believe property developers who showed a properly executed sales and delivery plan together with signs of gradual deleveraging (such as lengthening debt maturity profile and re-financing of short-tenor debts) could act as mitigants to the financial pressure.

**EXHIBIT 6: Industry-wise Sale Cycle (Months)**




*Source: National Bureau of Statistics of China and Lianhe Global's calculations*
*Note: Sale Cycle = Saleable GFA / Average 12-month monthly contracted sales GFA*

**EXHIBIT 7: Revenue Growth was in Tandem with Contracted Sales Trend**



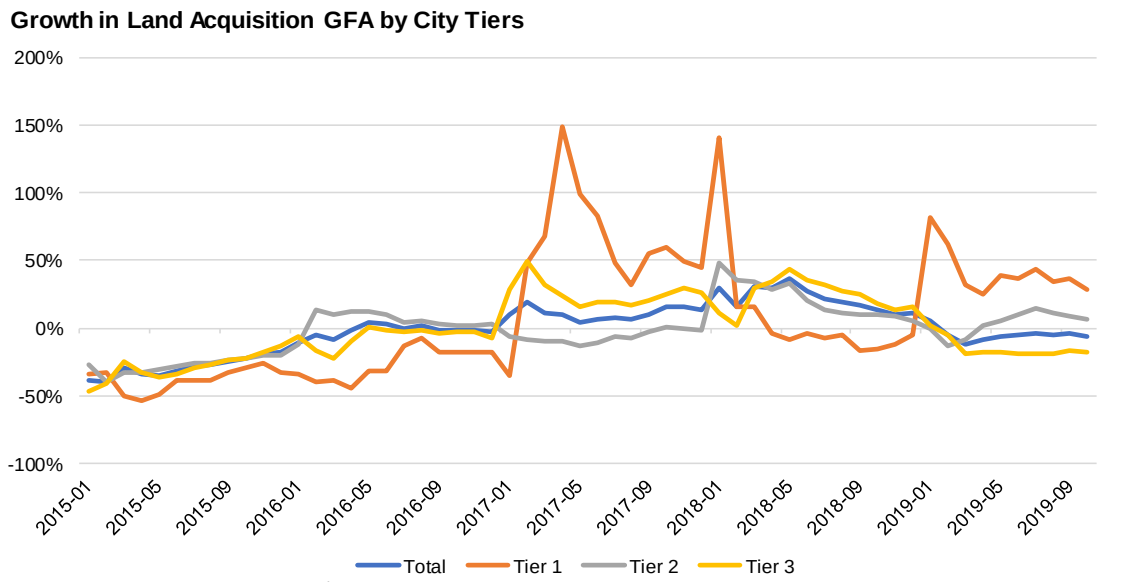

*Source: National Bureau of Statistics of China and Lianhe Global's calculations*
*Note: Revenue for the ten months ended October 2019 is an estimation for illustrative purpose*

## Slowing Down in Land Acquisitions and Increase in Deleveraging to Manage Debt Growth

As the effect of credit tightening started emerging from 1Q 2019, many property developers have become more cautious in debt-funded land acquisitions in order to manage the pace of their debt growth. Since 1Q 2019, growth in terms of land acquisition GFA in various city tiers has plateaued or even experienced a slightly decreasing trend (EXHIBIT 8).

Debt level for some medium-sized and a few larger property developers rose significantly in 1H 2019, but we have seen a gradual reduction in leverage through increasing sales proceeds and decreasing pace of land acquisitions.

**EXHIBIT 8: Growth in Land Acquisition GFA by City Tiers**




*Source: WIND and Lianhe Global's calculations*

## Polarization of the Industry More Pronounced, with Tougher Environment for Smaller Scale Developers

Large and medium-sized property developers who were well-managed with strong execution capabilities and operating efficiency increased their market shares at the expense of smaller players which led to further market polarization (and consolidation) in 2019. Property developers who were well-positioned (in tier 1 & 2 cities), nationally diversified with multiple projects were able to achieve better operating efficiency and manage cashflow more evenly, which made them outperformers to smaller regional players with a few projects on hand. The table below illustrates the increasing market share of the top 20 listed Chinese property developers from 61.8% in 2010 to 79.3% as of end-June 2019 (EXHIBIT 9).

As abovementioned, the tightening financing environment, price curbs as well as rising land cost led to an overall squeeze in margins for the Chinese property sector. Nevertheless, the magnitude of margin contractions largely was dependant on developer-specific land cost control measure, focus of city tiers and project locations, as well as sales execution capability. Most large property developers and some medium-sized property developers which focused on disciplined land acquisitions and maintained operating efficiency were able to demonstrate a better margin protection than smaller ones.

**EXHIBIT 9: Top 20 Listed Chinese Property Developers' Market Share by Revenue**

| Year | Market Share |
|---|---|
| 2010 | 61.8% |
| 2011 | 62.5% |
| 2012 | 67.5% |
| 2013 | 68.8% |
| 2014 | 70.7% |
| 2015 | 74.3% |
| 2016 | 73.3% |
| 2017 | 73.5% |
| 2018 | 76.3% |
| 2019-06 | 79.3% |

*Source: WIND and Lianhe Global's calculations (out of a sample size of total Chinese property developers listed in A-share market)*

**Appendix: List of Lianhe Global's Rated Chinese Property Entities**

| Issuer | Long-term Issuer Credit Rating | Outlook |
|---|---|---|
| Yuzhou Properties Company Limited | BB | Stable |
| CIFI Holdings (Group) Co. Ltd. | BB+ | Stable |
| Logan Property Holdings Company Limited | BB+ | Stable |
| Jingrui Holdings Limited | B+ | Stable |
| Redsun Properties Group Limited | BB- | Stable |
| Yango Group Company Limited | BB- | Stable |
| China Aoyuan Group Limited | BB+ | Stable |
| Radiance Group Co., Ltd. | BB- | Positive |
| *Source: Lianhe Global* | | |

## Analysts

Alex Kung
Senior Director
(852) 3462 9577
alex.kung@lhratingsglobal.com

Ben Yau
Director
(852) 3462 9586
ben.yau@lhratingsglobal.com

Jessie Liu
Analyst
(852) 3462 9585
jessie.liu@lhratingsglobal.com

Business Development Contact
Joyce Chi
Managing Director
(852) 3462 9569
joyce.chi@lhratingsglobal.com

## Disclaimer

Credit rating and research reports published by Lianhe Ratings Global Limited ("Lianhe Global" or "the Company" or "us") are subject to certain terms and conditions. Please read these terms and conditions at the Company's website: www.lhratingsglobal.com

A credit rating is an opinion which addresses the creditworthiness of an entity or security. Credit ratings are not a recommendation to buy, sell, or hold any security. Credit ratings do not address market price, marketability, and/or suitability of any security nor its tax implications or consequences. Credit ratings may be subject to upgrades or downgrades or withdrawal at any time for any reason at the sole discretion of Lianhe Global.

All credit ratings are the products of a collective effort by accredited analysts through rigorous rating processes. No individual is solely responsible for a credit rating. All credit ratings are derived by a credit committee vesting process. The individuals identified in the reports are solely for contact purpose only.

Lianhe Global conducts its credit rating services based on third-party information which we reasonably believe to be true. Lianhe Global relies on information including, but not limited to, audited financial statements, interviews, management discussion and analysis, relevant third-party reports, and publicly available data sources to conduct our analysis. Lianhe Global has not conducted any audit, investigation, verification or due diligence. Lianhe Global does not guarantee the accuracy, correctness, timeliness, and/or completeness of the information. Credit ratings may contain forward-looking opinions of Lianhe Global which may include forecasts about future events which by definition are subject to change and cannot be considered as facts.

Under no circumstances shall Lianhe Global, its directors, shareholders, employees, officers and/or representatives or any member of the group of which Lianhe Global forms part be held liable to any party for any damage, loss, liability, cost, expense or fees in connection with any use of the information published by the Company.

Lianhe Global receives compensation from issuers, underwriters, obligors, or investors for conducting credit rating services. None of the aforementioned entities nor its related parties participate in the credit rating process aside from providing information requested by Lianhe Global.

Credit ratings included in any rating report are solicited and disclosed to the rated entity (and its agents) prior to publishing. Credit rating and research reports published by Lianhe Global are not intended for distribution to, or use by, any person in any jurisdiction where such use would infringe local laws and regulations. Any user relying on information available through credit rating and research reports is responsible for consulting the relevant agencies or professionals accordingly to comply with the applicable local laws and regulations.

All published credit rating and research reports are the intellectual property of Lianhe Global. Any reproduction, redistribution, or modification, in whole or part, in any form by any means is prohibited unless such user has obtained prior written consent from us.

Lianhe Global is a subsidiary of Lianhe Credit Information Service Co., Ltd. The credit committee of Lianhe Global has the ultimate power of interpretation of any methodology or process used in the Company's independent credit ratings and research.