Non-Rating Commentary
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China’s Domestic Spending Plans Underpin LGFVs and Property Developers’ Credit Story

In a bid to boost China's economy, the government has rembraced the investment-driven growth model. Lianhe Global lays out what this means for the country's property sector and LGFVs.

The ongoing trade war between the US and China has put pressure on China’s economic growth since late 2018. The Chinese central government subsequently announced initiatives to support economic growth by increasing investment in infrastructure projects, including affordable housing and rejuvenation of old communities.

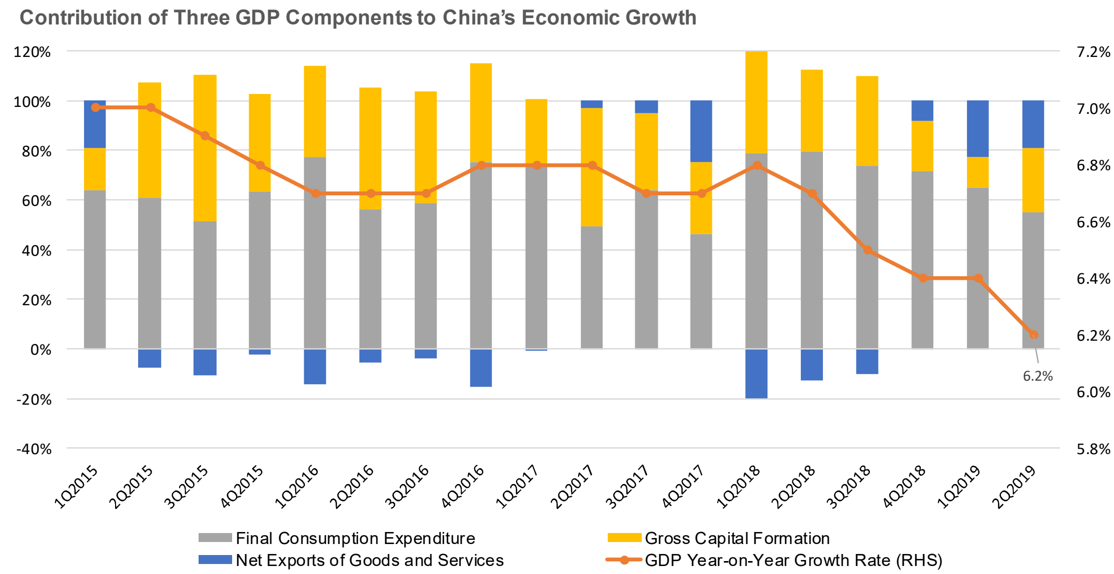
Chinese local government financing vehicles (LGFV) and property developers are likely to benefit from these stimulus measures. In addition, ongoing urbanisation in China is a supporting factor for China’s property market, while revenue from land sales are one of the main contributors to Chinese local governments’ fiscal revenue.

Investment-Driven Growth in China Reborn

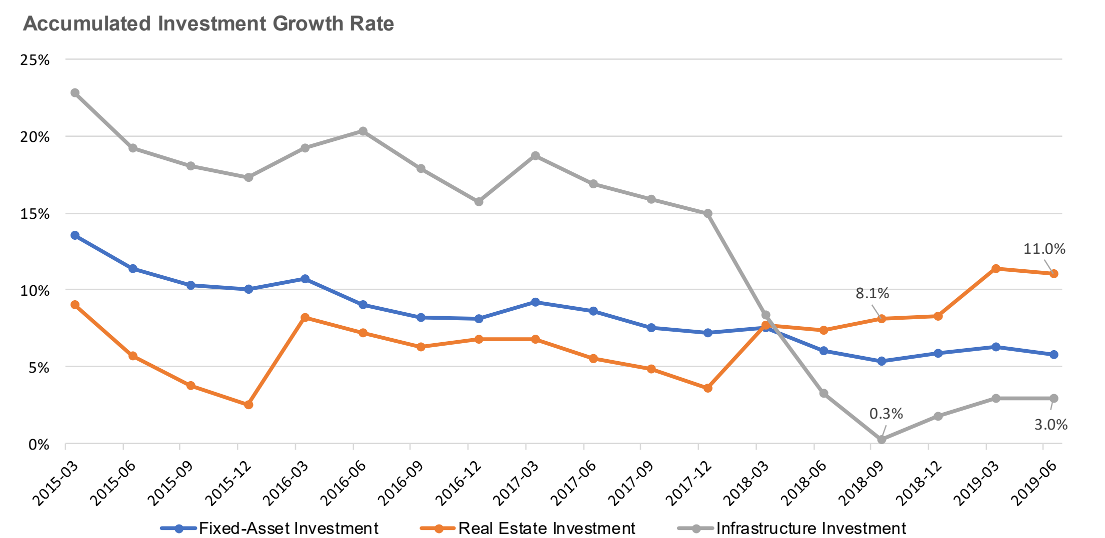
To boost China's economy, which saw the year-on-year GDP growth rate fall to a record low of 6.2% in the second quarter this year (since China started publishing quarterly data in 1992), China reembraced the investment-driven growth model since the second half of 2018

Infrastructure and property investments have exerted a high influence in driving China’s economic growth and have a significant impact on upstream and downstream industries such as steel, cement and durable goods. According to the National Bureau of Statistics, investments in infrastructure and real estate accounted for 27% and 23% of total fixed-asset investment, respectively, in 2017, while gross capital formation contributed to about one-third of China’s GDP growth in recent years.

To add, investments in infrastructure and real estate both increased in the first half of 2019. The year-on year growth of infrastructure investment rebounded to 3% in the first six months of 2019 from 0.3% in the first nine months of 2018. Real estate investment reported 11% year-on-year growth in the first six months of 2019, 2.9% being higher than that in the first nine months of 2018.



Source:National Bureau of Statistics



Note: Infrastructure investment includes investment in production and supply of electricity, gas and water , transport, storage and post and management of water conservancy, environment and public facilities
Source:National Bureau of Statistics and Wind

Cautiously Optimistic on Chinese Property

The Chinese land sales market has been thawing and land auction prices have enjoyed a renewed rise in some higher-tier cities since the first quarter of 2019. As such, we expect that gross margins of Chinese property developers will be under pressure in 2019 largely due to moratoriums placed on home purchases, sales, prices, and mortgages.

In addition, the Chinese government is expected to maintain control on external non-traditional financing channels, which will increase the funding costs for some property developers, especially smaller and financially weaker property developers, for the remainder of 2019. For medium-sized regional players with more concentrated land portfolios than their peers, we believe they will increase leverage to expand operating scales beyond their home bases.

Investment in land has rebounded after bottoming-out in the second half of last year and the land acquisition price in the market has increased, especially in the second-tier cities with intense competition among property developers.

For larger property developers, we expect financial metrics to improve in the coming six months; most of them have been deleveraging since 2017. In addition, the larger players have competitive advantages in acquiring low-cost land and acquiring funding, as well as strong sales and cash collection execution allowing them to maintain high operating efficiency to support operations and growth. Both operating efficiency and funding ability will play an increasing role to differentiate the credit profiles of the larger players in the future.

At the time of this publication, many leading Chinese property developers have delivered revenue and presales results better than or largely on par with their expectations for first half of this year, with the exception of China Evergrande Group in terms of its revenue. Developers tend to deliver more than half of their contracted sales in the second half of their fiscal year, based on prior observations. The leading developers were able to deliver their presold projects and recognise them as revenue. Meanwhile, many of them continued to report solid contracted sales figures and thereby ensured their future revenue stream. Contracted sales figures are a good barometer of the health of the Chinese property market.

LGFVs' Credit Profiles Increasingly Diverge

The Chinese government has recently introduced several measures to ease financial and monetary conditions amid a slowing economy, sluggish stock markets and renminbi depreciation pressure. This has somewhat alleviated LGFVs' financing issues, although we do not foresee a reversal of the regulatory authority's ambition to de-risk the financial system as China continues to grapple with the fallout from the rapid credit expansion caused by the huge stimulus measures a decade ago. The government's commitment to deleverage and regulate LGFVs' implicit debt would remain intact by pushing forward the reform and commercialisation programmes for some Chinese LGFVs.

We expect the stringent regulation on LGFV financing would remain largely intact to prevent systematic risk but may lead to a credit divergence among LGFVs. Also, large LGFVs carrying important policy roles, such as improving local residents' livelihoods and boosting the economic should remain in a better position because of stronger expected government support.

On the other hand, liquidity pressure would continue to challenge those LGFVs with insignificant government functions or located in areas with weaker economic conditions or fiscal positions. We note that defaulted non-standard financial products have been mainly issued by LGFVs in districts with low administrative levels or with weak economic conditions.

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