

# INSIGHTS

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## CHINESE PROPERTY SECTOR UPDATE

Domestic liquidity tightening, slowing sales momentum and more recently, the insolvency of a Chinese property developer have afflicted China's property sector, leading to widespread fears over the sector's health. We look to address some of these concerns and offer reasons to keep a positive medium-term outlook on Chinese properties.

### China defaults are unsettling stock and bond markets

Stock and bond prices of Chinese developers have come under pressure on the back of domestic liquidity tightening, the recent default of a property developer, and slowing sales momentum in the first two months of the year. While these are the key challenges faced by the Chinese property sector in 2014, we believe that the companies we invest in are in a good position to withstand these headwinds.

Markets were spooked by the default of Zhejiang Xingrun Real Estate, an unlisted Ningbo-based property developer with Rmb3b total assets and Rmb3.5b of debt<sup>1</sup>. The insolvency is attributable to a drop in its land bank's value (making it difficult to refinance its loans), and the high cost of shadow banking debt. With the recent tightening of onshore liquidity, banks have become more selective in granting credit. As such, small homebuilders have had to rely on non-traditional funding channels, including trust loans that come with double digit interest costs.

This comes at a time when land and property prices in some lower-tier cities are softening due to oversupply. Higher down payments and increased difficulty in obtaining mortgages have also led home buyers to become more selective and adopt a 'wait and see' approach. As a result, sales are slowing and margins are being compressed. Nevertheless, while we can expect to see more defaults in the property sector, it is our view that they will be limited to smaller, unlisted and highly geared companies such as Zhejiang Xingrun.

### Chinese developers that issue USD bonds are listed companies

Separately, developers that have issued USD bonds are all listed, much larger in size, and have diversified funding sources. The smallest developer in this space is Modern Land with total assets of Rmb8.8b, followed by Xinyuan (Rmb12b) and Wuzhou (Rmb13b)<sup>2</sup>. Our fixed income funds do not have exposures to these issuers. Further, the total debt/total assets (proforma new bonds issued) for these three names are only 18-31%<sup>3</sup>. Potentially, there could be no liquidity issues as their debt maturity profiles have recently been lengthened by tapping the offshore bond market and as such, default risk is low.

### China property markets will consolidate further

Most of the Chinese developers in the USD bond market are still generating strong gross margins of around 30%<sup>4</sup> due to their land bank's low cost; less than 25%<sup>4</sup> of their selling price. They have also met or exceeded their sales targets in 2013 and are expected to grow at a healthy pace this year. Exposure to high cost trust financing is also manageable (0-25% of total debt)<sup>4</sup> as they are able to access various sources of funding including the offshore loan and equity market. Our view is that these stronger developers will benefit from the industry consolidation as they gain market share at the expense of the smaller players; a process which has been underway for a while now.

## **Chinese government stresses continuity of property control measures**

The property sector will encounter volatility in the near term due to slowing sales momentum (coming off the high base in 2013), tightening liquidity conditions, more news of small developer defaults, and to top it off, weaker economic data. Nevertheless, we continue to remain positive in the medium term. The Chinese government over the past few years has proactively implemented various measures (e.g. increasing the supply of affordable housing, implementing home purchase restrictions and higher down payment) to stem the sharp rise in property prices and curb speculative demand. In the long run, these will help to ensure more sustainable growth of the property sector which remains a key pillar of the economy. Urbanization and rising income levels will also continue to drive end user demand for properties.

In addressing near term concerns of a collapse of the sector, the government has adopted a differentiated policy approach by allowing cities that face oversupply problems to selectively relax their measures. There have also been some positive news in recent weeks for the Chinese property sector; in particular, a delay in the nationwide implementation of property tax, and the approval for two A share listed property companies to issue equity in order to finance property development— a first since 2010.

## **A positive medium-term on the Chinese property sector**

In conclusion, while we are mindful of the potential volatility of the China property sector in the next few months, we continue to adopt a positive medium-term bias. Our investments in this sector will remain focused on larger developers with more geographically diversified land banks, strong established brand names, and proven track records of accessing offshore funding channels.

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