鵬元國際 PENGYUAN

COVID-19 tests property developers' liquidity

Contents

Summary

Property sales hit by the COVID-19. The coronavirus infection (COVID-19) which broke out before the Chinese New Year has since spread rapidly throughout China and other countries. The Chinese government has banned property sales centres in many major cities to prevent contagion. Strict transport restrictions and closure of communities have put on hold property sales in February. Although the first quarter is normally the low season of property sales in China, how COVID-19 will play out will significantly affect Chinese developers' credit profile.

Chinese property developers' liquidity is under pressure. The suspension of property sales in mainland China will pressure developers' liquidity, since cash collection from contracted sales contributes around 50% of property funding in China. In addition, the delay in construction caused by the infection will lead to a decline in investment in construction. In tandem with the slowdown in construction, developers are likely to slow down property sales and land acquisition.

Profitability might be squeezed in the longer term. We expect developers to lower property sales prices, which is likely to squeeze profitability in the medium term. However, pricing might vary from city to city, depending on the property inventory. In the first-tier and key second-tier cities where demand is more certain, prices are likely to remain stable. In the third and fourth-tier cities where property inventories are high and economic recovery faces challenges, we are likely to see more weakness in price.

Property developers' credit profile will diverge. We maintain our view that credit profile will diverge among different property developers.(see China Property- Credit differentiation to expand) In our view, developers who have a low-cost landbank and conservative land banking strategy are likely to have a more flexible pricing strategy. Small developers who have tight liquidity and difficulties access funding will see credit profile deteriorate.

Base case scenario to see moderate policy easing. We believe if the epidemic can be effectively contained by late February and the productivities can be fully resumed in March, the damage on China's economy and property sector will be manageable. Under such a scenario, developers are able to speed up construction in the middle of 2020 to make up for the slowdown in the beginning of the year. Under this scenario, we may see marginal loosening of policies on property financing and land acquisition. Policies that might be implemented include allowing extensions of land premium and tax payments, earlier presale of projects and waiving land appreciation tax (LAT).

Pessimistic case scenario requires fiscal and monetary support. In our view, if construction activities are fully resumed in April, the country 's economic activities will be more severely disrupted than the base case. Continuing sluggish property sales coupled with weak economics will test the property developers' financing and the sector's sustainability. Should that happen, supportive fiscal and monetary policies will be crucial to the recovery of China's property sector.

Contacts

Name Winnie Guo
Title Director
Direct +852 3615 8344
Email winnie.guo@pyrating.com

Name Xinping Lin
Title Director
Direct +86 755 82872814
Email linxp@cspengyuan.com

Name Simon Lee
Title Analyst
Direct +852 3615 8307
Email simon.lee@pyrating.com

PENGYUAN 鵬元國際

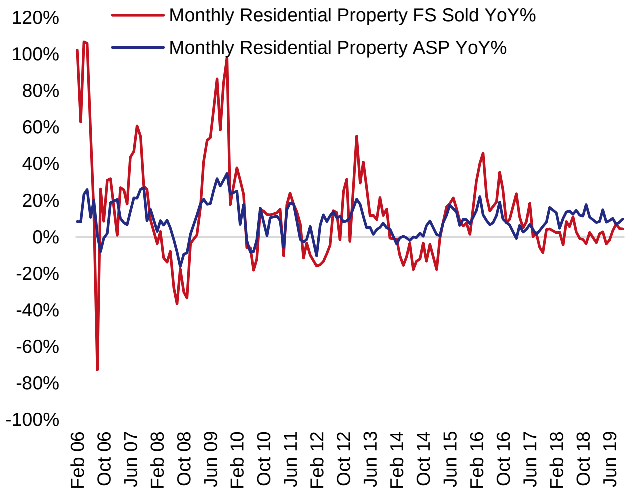
Suspension of property sales will test developers' liquidity

Property sales in mainland China have been slowing since 2019. COVID-19 has further dampened the property sales outlook in 2020. Except for some online sales, most property sales activities in mainland China were suspended in February.

The impact to property sales is likely to pressure developers' liquidity. Chinese developers' reliance on sales cash collection as a financing source has increased in recent years. As shown in exhibit 2, prepayments from contracted sales have been the single largest funding source for Chinese developers to finance their operations in recent years, followed by interest-bearing debt and alternative financing which includes equity financing. Therefore, suspension of property sales will put liquidity pressure on many developers. In addition, developers will defer construction in the face of a sharp decline of sales, which will lead to a decline in property investment.

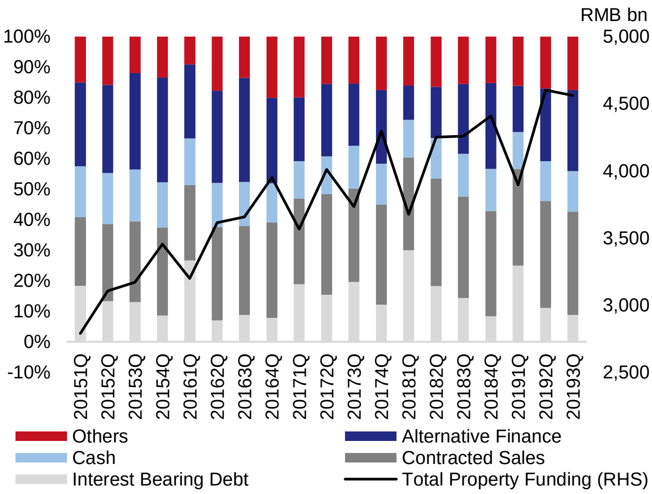
Property developers are likely to push sales at lower prices. However, their pricing strategy might vary from city to city depending on the property inventory. In the first-tier and key second-tier cities where demand is more certain, prices are likely to remain stable. In the third and fourth-tier cities where property inventories are high and economic recovery prospects are challenging, we are likely to see more property price decline. In our view, property developers who have a low-cost land bank and conservative land banking strategy are likely to have a more flexible pricing strategy. A lower price will have a negative impact on the profitability of developers.

Exhibit 1: Property Sales Volume Growth and ASP Growth



Source: National Bureau of Statistics, Pengyuan International

Exhibit 2: Composition of property funding source



Source: National Bureau of Statistics, PBOC, CTA, Pengyuan International

How COVID-19 will play out will affect property sales, construction, and investments in the year. We did a scenario analysis on the coronavirus impact to the property industry and the potential policies that the government might implement. First quarter is the traditional off-season for property sales in China, accounting for 17% of the full year sales in the past ten years.

Exhibit 3: Growth forecast for property sector under different scenario

	Floor square sold	Property sales	Construction new start volume	Property development investment
Base case scenario	-5% to -3%	-1% to 2%	0% to 3%	3%- 6%
Pessimistic case scenario	-7% to -5%	-4% to -1%	-3% to 0%	1%- 3%

Source: Pengyuan International estimates

Under our base case scenario, the epidemic is effectively controlled by February. The short-term suppression of demand will be released soon after and a recovery of sales will offset the weakness in the first two months of the year. With construction returning to full capacity in March, the negative impact from the epidemic to China's property sector will be manageable. However, the overall impact of the epidemic on the Chinese economy is still going to be substantial. Investment appetite will be constrained by lower household income, which is caused by lower employment. We expect China's property sales volume to fall by 3% to 5% and the year-on-year change in property sales to vary between a decline of 1% and growth of 2%. Property developers are expected to catch up on construction soon after and industrial activity to recover rapidly. The growth rate of property development investment for the whole of 2020 is expected to be 3% to 6%, and the growth rate of construction start will be 0% to 3%, by our projection.

In our pessimistic case scenario, the epidemic cannot be controlled while the construction and sales cannot resume by March. Should this happen, we will see wider decline in property sales which will lead to weakening of developers' liquidity, which in turn will delay construction and land acquisition. It is expected that the growth rate of property development investment for the year will range from 1% to 3%, and the growth rate of construction start will be -3% to 0%.

Base case scenario: Policy on property financing and land acquisition to loosen marginally

If the epidemic is contained in the first quarter, the impact on China's property sector will be limited. Property sales will be temporarily suppressed, and a rebound will be seen later in the year. In this context, we might see regulatory policies on property financing and land acquisitions loosen marginally. The potential policies that the government might implement include:

Lower interest rates: The central bank is likely to lower borrowing costs and ensure ample liquidity. Measures such as reducing the loan prime rate (LPR) can offset the adverse impact of the epidemic on property developers' cashflow. A lower LPR will reduce financing costs and mortgage rates.

Controls on property financing to ease: Substantially lower cash collection from sales together with refinancing pressure have aggravated pressure on property developers' liquidity. Due to the extension of the statutory holidays of the Chinese New Year across the country and tighter travel restrictions including quarantine owing to the infection, the domestic corporate bond issuance has declined sharply. According to China Real Estate Information Corporation (CRIC), 95 property developers issued less than RMB10 billion (US$1.4 billion) of onshore bonds from January 25 to February 10, a significant drop of 86% year-on-year. Recently, we have seen approval of debt financing for property developers has been moderately relaxed. For regions that have suffered more severe impact from COVID-19 such as Hubei and its capital Wuhan, the epicenter of the epidemic, special financing channels might be opened to facilitate faster financing.

Deferring or waiving tax payments on land auctions: Since the fourth quarter of 2019, the number of failed land auctions has increased, and the land auction premium over the base price, an indicator of market sentiment, has been declining. Considering the slower fiscal revenue growth and increased budget caused by the epidemic, local governments might increase land supply at lower prices to encourage investment in land acquisition. In order to reduce the burden of land auctions on developers, local governments might consider lowering the land auction deposit or bidding deposit.

Pessimistic case scenario: more fiscal and policies are required

In pessimistic case scenario, the epidemic cannot be controlled by March, then national economic activities will be more severely disrupted than the base case. Under such assumptions, property sales and investment are expected to be affected more. The Chinese government might consider more monetary and/or fiscal easing to support the economy. We expect the following policies might be implemented:

Loosen controls over property sales in first or second-tier cities: We expect the first or second-tier cities that are severely damaged by the epidemic might see relaxation on sales controls. Taking Wuhan for example, the launch of one additional property purchase quota for registered residences might increase property sales by 9.94 million square meters (sq m), representing 38% of property sales in Wuhan in 2018. Should such policies be implemented, we expect some supplemental policies, such as higher mortgage rates, in these cities to prevent speculation and market overheating.

Lower down payment requirements in third or fourth-tier cities: Third and fourth-tier cities have been more affected by the epidemic. By February 18, 32 of the 46 Chinese cities which reported more than 100 confirmed COVID-19 cases are third and fourth-tier cities. By our estimate, property sales in third and fourth-tier cities account for more than 70% of residential property sales by area in China. Thus, supportive policies for the third and fourth-tier property market are more practical and likely. However, simply increasing the property investment quota or lowering mortgage rates might not be enough to encourage property investment in the third and fourth-tier cities, given the earlier measures to restrict purchases and sales have not been fully rolled out there. Therefore, more effective policies such as reducing the down payment ratio and lowering the threshold for buyers might be implemented in these lower tier cities. However, these policies are not likely to be implemented across the country to prevent overheating in property investment.

Financial support for land acquisition: Land purchases, though contributing only around 30% of property development fixed asset investment (FAI) in mainland China, is considered the ultimate driver of property investment. The Chinese government might relax supervision of or constraints on land acquisition or provide financial support to encourage investment.

Encourage property construction projects to start soon: There may be fiscal policies such as tax reduction or exemption to encourage property construction to be completed on time. The relevant government bodies might help property projects to start early through various measures. For real estate companies that have not fully paid land transaction fees, faster and easier administrative processes might be implemented to help construction get started and finished on time.

DISCLAIMER

Pengyuan Credit Rating (Hong Kong) Company Ltd ("Pengyuan International", "Pengyuan", "the Company") prepares various credit research and credit research related commentary (collectively "research") in compliance with the established internal process. The Company reserves the right to amend, change, remove, publish any information on its website without prior notice and at its sole discretion.

The research is subject to disclaimers and certain limitations. RESEARCH AND CREDIT RATINGS ARE NOT FINANCIAL OR INVESTMENT ADVICE AND MUST NOT BE CONSIDERED AS A RECOMMENDATION TO BUY, SELL OR HOLD ANY SECURITIES AND DO NOT ADDRESS/REFLECT MARKET VALUE OF ANY SECURITIES. USERS OF RESEARCH AND CREDIT RATINGS ARE EXPECTED TO BE TRAINED FOR INDEPENDENT ASSESSMENT OF INVESTMENT AND BUSINESS DECISIONS.

This research is based solely on the public data and information available to the authors at the time of publication of this research. For the purpose of this research, the Company obtains sufficient quality factual information from public sources believed by the Company to be reliable and accurate. The Company does not perform an audit and undertakes no duty of due diligence or third-party verification of any information it uses in the research. The Company is not responsible for any omissions, errors or inconsistencies of the public information used in the research.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS OR COMPLETENESS OF ANY INFORMATION GIVEN OR MADE BY THE COMPANY IN ANY FORM OR MANNER. In no event shall the Company, its directors, shareholders, employees, representatives be liable to any party for any damages, expenses, fees, or losses in connection with any use of the information published by the Company.

This research focuses on observing trends from the credit markets. This research has not been made available to any issuer prior its distribution to the public. The Company does not receive compensation for its research.

The Company reserves the right to disseminate its research through its website, the Company's social media pages and authorised third parties. No content published by the Company may be modified, reproduced, transferred, distributed or reverse engineered in any form by any means without the prior written consent of the Company.

The Company's research is not indented for distribution to, or use by, any person in a jurisdiction where such usage would infringe the law. If in doubt, please consult the relevant regulatory body or professional advisor to ensure compliance with applicable laws and regulations.