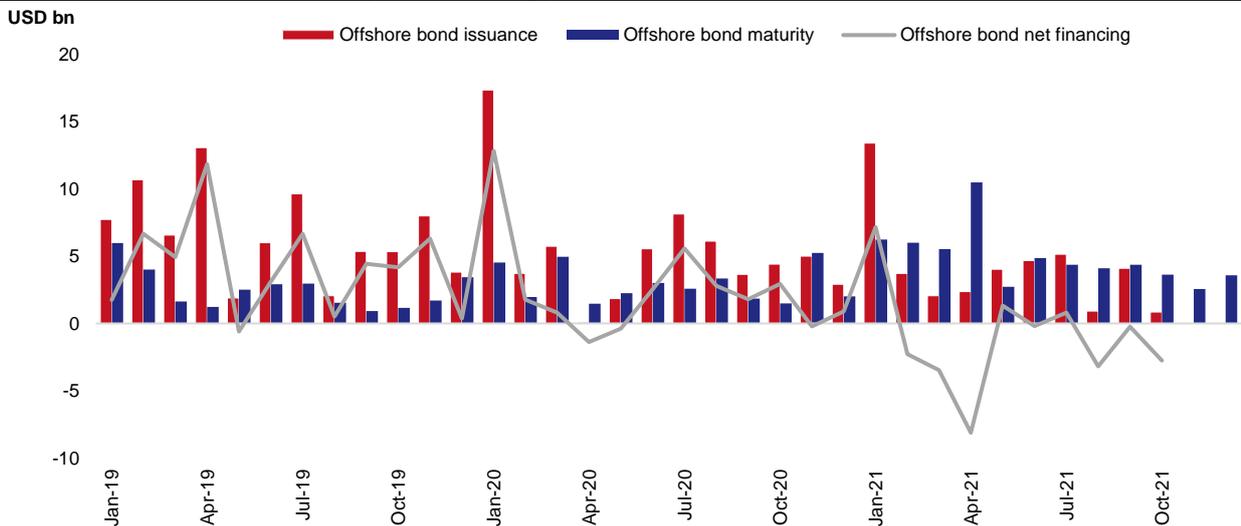


Non-rating Action Commentary: China's Property Market at 'Darkest Moment Before the Dawn'

Narrowing access for refinancing channels: Chinese property developers are facing increasing refinancing pressure amid continued credit control, tight regulatory oversight and weak sentiment in the offshore capital markets. Typically, property developers have various financing channels, including loans, onshore or offshore corporate bonds, mezzanine debt, equity financing, project financing, supply chain financing and asset-backed securities. Although the offshore bond issuance only contributes a small portion to the total Chinese property developers financing, the reported negative credit events from the offshore markets have broadly influenced the Chinese property financing. Many Chinese property developers have encountered refinancing risks as credit channels tighten and investor confidence weakened. In the first nine months of 2021, the total property bond issuance was USD40.3 billion, which accounted for only 69% of the total bond maturing in 2021, in the offshore markets. This is in contrast to a positive net financing of USD50.1 billion and USD29.9 billion of offshore property bond issuance in 2019 and 2020 respectively. Funding access has been further constrained for weak property developers, especially those with shorter tenors offshore.

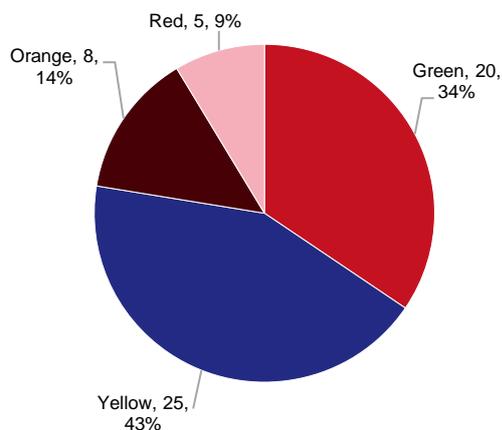
Exhibit 1: Offshore bond issuance, maturity and net financing (2019-2021)



Sources: Wind, Pengyuan International

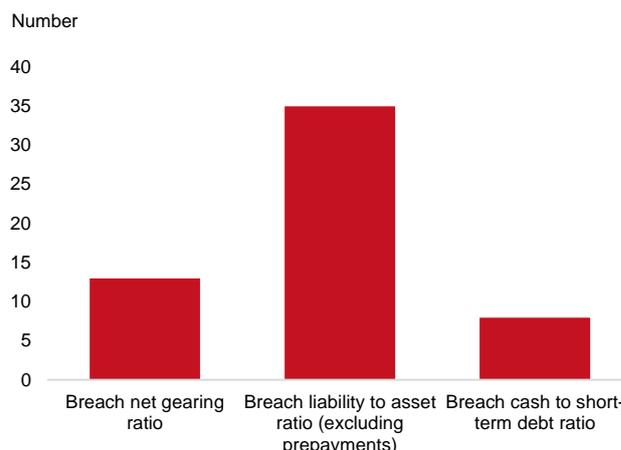
Chinese property developers struggle to deleverage: Under China's 'Three Red Lines' policy, Chinese developers are taking deleveraging as the first priority or key mission in 2021 and 2022. According to our sampled 58 property developers, as of 30 June 2021, while 'green zone' accounted for 34% of the sample, 66% of property developers at least breached one red line, of which the 'yellow zone' accounted for 43%, followed by the 'orange zone' of 14% and the 'red zone' of 9%. This indicates that over half of the property developers are still crossing the red lines and will be placed limits on the debt growth, although the rules and the scope of coverage have not been officially announced. The majority of our sampled developers were in breach of at least one red line, mainly with regard to liability (excluding prepayments) to asset ratio. Based on our analysis, 35 out of 58 property developers breached the liability (excluding prepayments) to asset ratio, while 13 breached the net gearing ratio, followed by 9 breached the cash to short-term debt ratio. Many property developers have taken steps to deleverage by improving sales efficiencies, introducing strategic investors and increasing off-balance sheet financing. We expect the deleveraging trend to continue amid the backdrop of continued credit control and ongoing property regulation in the mid to long term.

Exhibit 2: Color zone of sampled 58 property developers



Sources: Company, Pengyuan International

Exhibit 3: Sampled developers breaching the three red lines



Sources: Company, Pengyuan International

Credit differentiation to widen substantially: Recent occurrence of property default cases has caused negative market sentiment in the capital market. Property developers are expected to face more refinancing challenges in tight credit environment, especially for the highly leveraged property developers and developers with tight liquidity, irrelevant of the operating scale. We expect those property developers with lower land bank quality, weaker sales execution capability and higher leverage to face substantial increase in credit spread as the credit risk and default risk have been escalated. We also observe an increasing number of negative rating actions in the market. However, we believe those property developers who are scored as green have the competitive advantage in accessing bank loans and other funding channels. They are more likely to maintain the funding access in the capital market, including offshore bond issuance, in our view. We expect the challenges from funding channels will widen credit differentiation in the next three to six months. Credit differentiation could be narrowed by changes in property regulation and improvement in investor confidence in capital markets in the future.

Land bank and debt structures are crucial: Under the credit control and property regulation, the majority of property developers have to manage the scale and pace of land acquisition in order to reduce the debt. According to China National Bureau of Statistics, in the first nine months of 2021, the total land purchased by property developers was 137 million square metres, representing a year-on-year decrease of 8.5%. The total transaction value was RMB934.7 billion, with a growth of 0.3% only. We expect many developers will maintain conservative land acquisition in the next six months given the tight funding conditions. Property developers who have abundant land bank might choose to improve sales efficiencies to speed up the cash cycle, while those with limited quality land bank and shorter land bank life might have the pressure to expand land bank amid tight liquidity or to dampen the new starts and sales. We also expect those property developers with higher short-term debt ratio and concentrated bond maturity profile might have difficulties to refinance their maturing debt in the next 6 to 12 months.

Government to control the systematic risk while support the sustainable development: Since the introduction of the 'Three Red Lines' policy in 2020, the Chinese government has implemented tighter control on the property sector in the various aspects. These include restrictions on banks' property loan exposure to tighten the property financing, managing land acquisitions by strictly investigating the funding sources for land purchase and implementing the new land auction rules to reduce malignant competition and set the price ceiling, as well as regulating the pre-sale proceeds by requesting developers to put the proceeds in regulated bank accounts. In addition, some major cities have imposed restrictions on the purchase and capped the selling price of residential properties. We anticipate that the Chinese government will keep a tight grip on shadow banking and unregulated financing. With the slow China GDP growth of 4.9% in the third-quarter in 2021, the prevailing government policy's is expected to focus on controlling the systematic risks of China property market and maintaining property sector as one of the key supporting sectors for China's GDP. In our view, the recent statements delivered by the top PBOC officials indicate that the government is closely monitoring the market condition of the property sector and will provide necessary measures to maintain a stable and healthy development of the industry. PBOC governor Yi Gang recently attended the 2021 G30 International Banking Conference and mentioned that central bank would prevent Evergrande's credit risks from spreading over to other property developers and expected the property giant's impacts on the country's banking sector are controllable. In addition, Pan Gongsheng, the deputy governor of PBOC stated that the excessive contraction of risk appetite of financial institutions and financial markets to China's property market has been gradually corrected.

Further credit tightening is unlikely: Government officials stated that the prevailing government policy focus is to control the systematic risks to support sustainable development of China's property market. The government's overall policy stance is expected to remain tight for the rest of 2021 and 2022, especially in terms of property policies and credit controls. However, we believe the chance for more credit tightening is low as the government is striking a balance between the financial stability and deleveraging. We also believe the market concentration for Chinese property development to increase after the industry consolidation. We regard deleveraging trend of China's property market as a long-term credit positive to the sector.

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