WHAT HAPPENED TO CHINA'S REAL ESTATE DEVELOPERS?



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> **"China's real estate developers are highly leveraged… [They] depend heavily upon early-stage external financing, delayed payments to contractors during the construction phase and using pre-sale proceeds in the later stages of development"**

Background

Since the second quarter of 2021, there have been increasing levels of concern in respect of the debts owed by China's real estate developers, leading to a number of questions: What caused the debt crisis? How will this crisis impact on China's economy, its real estate market and its banking and financial system? Will the government step in and rescue distressed developers? What should investors and shareholders expect as the crisis unfolds?

China's real estate market has experienced strong growth since 2000, as a result of a number of factors including:

1. China's economic growth since its entry to the World Trade Organization in 2000;
2. local provincial governments relying on the assignment or sale of land-use rights as a major source of revenue;
3. China's quantitative easing in 2008; and
4. China's monetary easing policies in 2015.

China's regulators have been using policy and regulations to attempt to slow down the booming real estate market, including the following in the last 12 months:

Parties being regulated	Policies and Regulations
Real estate developers	The "three red lines" policy – new interest-bearing liabilities will be limited/restricted for those real estate developers who cross the following "red lines": 1. asset liability ratio is greater than 70% after excluding advance collection; 2. net debt ratio is greater than 100%; 3. ratio of cash to short-term debt is less than 1. By reference to the number of "lines crossed", real estate developers are categorised into four levels – red, orange, yellow and green and developers' annual growth of interest-bearing liabilities are capped at 0%, 5%, 10% and 15%, respectively.
Banks and financial institutions	1. Notice on Establishment of Centralized Management System of Real Estate Loans of Banking Financial Institutions: this notice sets upper limits on the proportion of the balance of real estate loans and the proportion of the balance of personal housing loans for different levels of banks and financial institutions; transitional periods for those exceeding upper limits; and adjustment mechanisms for different regions. 2. Notice on Preventing Business Purpose Loans from Flowing into the Real Estate Sector in Violation of Regulations: this notice aims to investigate and prevent commercial loans from flowing into the real estate sector. 3. Miscellaneous guidance and instructions by the People's Bank of China to banks in relation to loans and other credit facilities to real estate developers.

Following the roll-out of these policies and regulations, the real estate market cooled down rapidly. Statistics for the period between January and November 2021 released by the National Bureau of Statistics indicate that:

1. residential land transactions totalled RMB4.98 trillion, a year-on-year decrease of 11.2% from 2020, and the corresponding planned floor area was 13.43 trillion square meters, a year-on-year decrease of 30.1%;
2. residential real estate investment in the first 11 months in 2021 was RMB10.36 trillion, a year-on-year increase of 8.1% from 2020, marking the lowest rate of increase since 2017; and
3. the area of residential construction newly commenced in the first 11 months of 2021 was 1.35 billion square meters, a year-on-year decrease of 8.4% compared with 2020.

Impact on USD bonds

China's real estate developers issued US dollars-denominated bonds of hundreds of billions of dollars over the last decade - a market readily available to them and many others over that time.

Since 2021, the total nominal amount of the defaulted bonds at the time of issuance by the following 15 real estate developers exceeded USD50 billion, and the total nominal amount of the outstanding balance of these bonds at the time of default exceeded USD6 billion, involving a total of 93 bonds:

2021	USD Bonds Defaulted Chinese Real Estate Developer	Defaulted Bond Nominal Amount USD million
January	Macrolink Holdings	210
February	China Fortune Land Development	4,560
May	Oceanwide Holdings	340
June	Tus Holdings	300
July	Languang Development	1,050
August	Sunshine 100	560
September	Suning Group	600
October	Fantasia Sinic Holdings Modern Land	3,960 690 1,350
December	China Evergrande Kaisa Aoyuan Yango Golden Wheel	19,240 12,170 3,200 1,400 460

From January to November 2021, real estate developers defaulted on domestic RMB bonds totalling RMB73.5 billion (a year-on-year increase of 187%), involving 67 bonds (a year-on-year increase of 131%). Statistics from the China Real Estate Association show that the current total debt balance of China's real estate developers is RMB19 trillion, including USD bonds of RMB120 billion which will be due in the first quarter of 2022, being one-third of USD bonds due in 2022.

Impact on real estate market

A very high percentage of China's real estate developers are highly leveraged and their cash cycle depends heavily upon early-stage external financing, delayed payments to contractors during the construction phase and using pre-sale proceeds in the later stages of development. Policies and regulations have restricted developers' ability to obtain external financing which in turn have caused liquidity issues for those who are too highly leveraged. These liquidity issues have led construction contractors to be more cautious, be slow to accept delayed payments and to be more ready to stop work and supply until amounts due to them have been paid. As a result, it has become common for projects to be delayed or for works to be suspended – something that has become apparent across the country in recent times.

Unsurprisingly, delays and suspensions of projects cause concern among home-buyers, who are reluctant to buy from distressed developers, especially in the pre-sale stage of a development. Policies and regulations have also tightened banks' lending on personal housing loans. In addition, governments and regulators have implemented measures to monitor and control the use of pre-sale proceeds, to make sure that such proceeds are only used to complete the associated projects and not applied towards other purposes.

What will happen next?

As with any industry or sector that is suffering or is subject to a destabilising event, the stock and bond markets are losing confidence in China's real estate developers and, as a result, the government and banks are loosening their lending policies to encourage loans to support financially-sound and reputable real estate developers to merge with, or acquire, those in distress.

Developers are realising their higher quality assets and refinancing loans and bonds. For less attractive third or fourth grade assets, it is not easy to find buyers and refinancing liabilities amidst current market conditions is difficult. It will take time for the market to absorb these assets and for the associated debts to be reduced. Developers, creditors and regulators are all well aware of this and, in large part, are working collaboratively to find appropriate solutions.

While some commentators disagree, China's government encourages the use of market solutions to deal with corporate distress, including rationalising a particular corporate's business and liquidating assets, to improve its cash flow and reduce its debt. This present opportunities – for asset management companies, real estate-focused funds, financially-healthy and sizeable developers, and international investors – to acquire quality assets when valuations and prices remain at reasonable levels.

Whether a distressed real estate developer can successfully mount a turnaround will generally depend on, amongst other things, the cause of the developer's distress – in particular, whether the challenges faced arise from a short-term liquidity issue or a more deep-rooted and longer-term insolvency with associated underlying difficulties. Lenders and investors should probably expect a mix of both with certain of the larger developers.

Co-operation and co-ordination amongst stakeholders – including management, shareholders, bondholders, lenders, contractors and suppliers and their advisers – is also important and, to date, has remained strong in this sector. As matters stand, it appears likely to continue to do so in future.

The speed of recovery of China's real estate market will also depend on market confidence and the government's policies and regulations going forward. The world – and not least the creditors, shareholders, bondholders and investors grappling with the issues at the heart of the debt crisis – will be watching China's real estate market and developers as 2022 progresses.