William Blair

EMERGING MARKETS DEBT

Investment Management
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Navigating China's Property Market

A rebound in the Chinese property sector, spurred by the post-COVID reopening and government support, was short lived, and the prospect of a broad recovery in 2023 seems unlikely due to high leverage and excess housing stock in lower-tier cities. As a result, investing in the Chinese property bond market is challenging. But we see light at the end of the tunnel. Although the opportunity set has narrowed significantly, with more than half of developers we cover in deep distress (some facing default), we expect surviving developers to be less levered and more cautious about their future development, resulting in a healthier investment environment.

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Property a Key Issue at China's July Politburo Meeting

During China's Politburo meetings (the most recent one took place on July 24, 2023), the committee of 24 top-brass party members discusses current economic conditions in China and reveals its latest policymaking preferences.

While the Politburo has previously described the country as facing "triple pressures in economic development" (shrinking demand, disrupted supply, and weakening expectations), at its most recent meetings the committee acknowledged that weak domestic demand is now a primary concern. In July, the Politburo maintained its cautious outlook for the Chinese economy, citing slowing external demand, lagging domestic demand, and the emergence of new difficulties.

Yet the committee fell short of specifying any stimulus plans, other than dialing up its rhetoric by pledging strong countercyclical adjustments to spur demand. In the past, the Chinese government had hoped both elements of demand—retail consumption and industrial spending—would catch up. In other words, China is pinning its hopes on increasing household income and improving industrial profitability, which unfortunately hasn't happened, as evidenced by recent data.

The committee also emphasized the importance of attracting foreign direct investment (FDI) and supporting the private sector, vowing to dismantle legal and administrative obstacles to ensure room for growth and competition between private and public players.

Regarding the roadblocks to full recovery, the committee highlighted three key risks: the high level of local government debt, the high youth unemployment rate, and the ongoing Chinese property crisis. While the high local debt levels and a lack of youth job opportunities will likely drag on economic growth in the medium to long term, the downfall of the Chinese property sector, which had been contributing as much as 30% to gross domestic product (GDP) growth (directly and indirectly), has already made a significant dent in economic growth.

Interestingly, in the statement issued after its July meeting, the Politburo omitted its long-held phrase that "property is for living, not for speculation." We do not think that the omission suggests a diversion from the government's pledge to support a "new development model" for the property sector—i.e., ensuring uninterrupted delivery of completed projects to homeowners, thereby improving the livelihood of the Chinese people and reforming the sector (which has been plagued by property developers' excess borrowing and aggressive expansion). Nevertheless, the omission signals that the Politburo is more open to providing support not only to first-time homebuyers but also to those upgrading their homes or even second home purchases. Additional commitments to "adjust and optimize property policies timely" and vows to "invigorate the capital market" for financing activities are positive twists to the rather lower expectation set by the market before the July meeting.

China Property Easing: Failure to Launch in Q4 2022, Better Luck in 2023?

Recognizing that the Chinese property sector remains an important pillar to sustain Chinese growth in the long run, the government has also made several attempts to revive the presale market, although the outcome so far has been very mixed.

In November 2022, the People's Bank of China (PBOC) and China Banking and Insurance Regulatory Commission (CBIRC) joined forces in rolling out a package consisting of 16 financial measures to support the recovery of the real-estate market and encourage its healthy development. These supportive measures can be broadly categorized into four policy objectives: 1) promoting smooth refinancing for developers, mortgages, and construction loans; 2) ensuring property delivery; 3) facilitating sector reforms and protecting buyers' legal rights; and 4) providing headroom for banks to fulfill regulatory requirements if the weakness in the sector persists.

Financial markets initially responded positively to these policy announcements, but that early optimism proved to be misplaced, as the property sector met with more defaults and credit downgrades in the first quarter of 2023. There were also disappointments on the macro level as the reopening rebound peaked and political tensions hurt export outlooks, depressing purchasing managers' indices (PMIs) and industrial profits. Even the services sector, which was expected to enjoy a prolonged period of above-trend recovery, started to see its momentum fading.

Given several growing near-term risks—including a shrinking export market (due to escalating geopolitical tensions), contracting domestic demand, and disinflation due to an aging demographic trend and high youth unemployment—the stakes are now high for the government to react with some economic stimulus measures for the broader economy, including the property sector. It was reported in early June that the government is mulling a new set of property market support measures in the second half of 2023, including but not limited to reducing down payments, lowering commissions, further relaxing home-purchase restrictions, and extending measures under the 16-point plan mentioned earlier.

In our opinion, the focus of a second round of significant measures should be on how the government can help induce a faster pickup of home sales in lower-tier cities, rebuild buyer confidence in privately owned developers, and, most importantly, ensure that these measures are effective in lifting demand.

"The stakes are now high for the government to react with some economic stimulus measures for the broader economy, including the property sector."

Zina Mytilinaiou, CFA

A Step Back: How Did We Get Here?

Credit-driven growth and speculative behavior in the property market led to tightening measures from Chinese policymakers. Specifically, in August 2020 the government implemented what it called the "Three Red Lines." This policy imposed specific limits and requirements on property developers' borrowing capacity in an effort to contain leverage growth in the sector. Concurrently, the PBOC and the CBIRC established an upper limit to the ratio of mortgage and property loans in relation to the total outstanding loans for banks. Other tightening measures included limitations on bond quotas and access to escrow accounts, adding to the pressure on the sector.

The developer business model also contributed to the downturn in the industry. Property developers relied heavily on presale financing, using buyer deposits for future projects (including new land acquisitions, which were then used as collateral for further borrowing). Developers also used creative forms of credit, including securitized loans and borrowing from trust and other shadow banking financial institutions, as exhibit 1 illustrates. Notably, property developers also focused on new starts relative to completions, as shown in exhibit 2. This lack of progress in project deliveries—aggravated by tighter financing conditions—would later spark the mortgage-payment boycotts that took place in 2022.

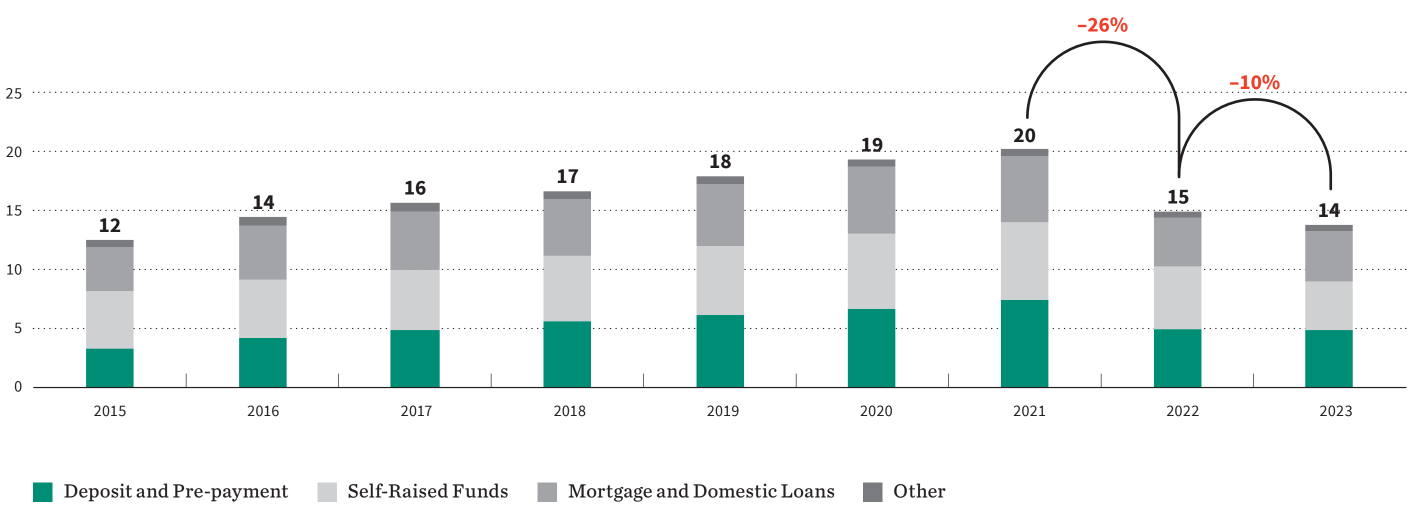
Meanwhile, heightened restrictions in mortgage lending and buyers' disinterest in real estate during the zero-COVID period resulted in a decline in demand. This decline, coupled with funding constraints, triggered a profound liquidity squeeze, ultimately leading to a record number of debt defaults. As of June 2023, of the 45 developers we monitor, more than 20 have defaulted on their offshore bonds, representing 38% of the 2021 sales market share of developers in our coverage.

The surge in defaults, the underwhelming recovery prospects for the sector, and the lack of visibility in policy support have eroded market confidence. Even three years after the downfall of the sector, last-12-month sales through June 2023 were 16% lower and real-estate investments were 14% lower year-over-year.

The sector's leverage has also shown little improvement. While property loans as a percentage of total bank loans have decreased to 24% after reaching a peak of 29% in 2019, as exhibit 3 illustrates, the sector's leverage has shown little improvement. The estimated debt of the developers we track remained at RMB 5.1 trillion as of fiscal year 2022, only marginally lower than the peak. As exhibit 4 shows, these developers' ratio of liabilities to assets stands at 83%, higher than two years ago.

EXHIBIT 1

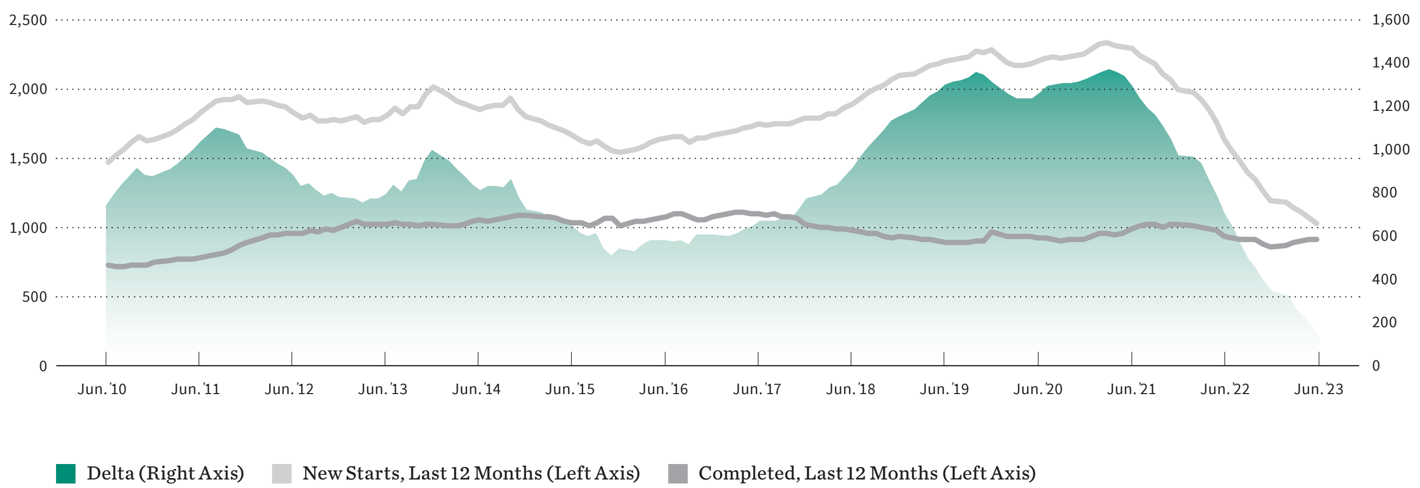
Developers' Funding Sources (in Trillion RMB)



Sources: NBS and William Blair, as of 2023 (for which data is six-month annualized).

EXHIBIT 2

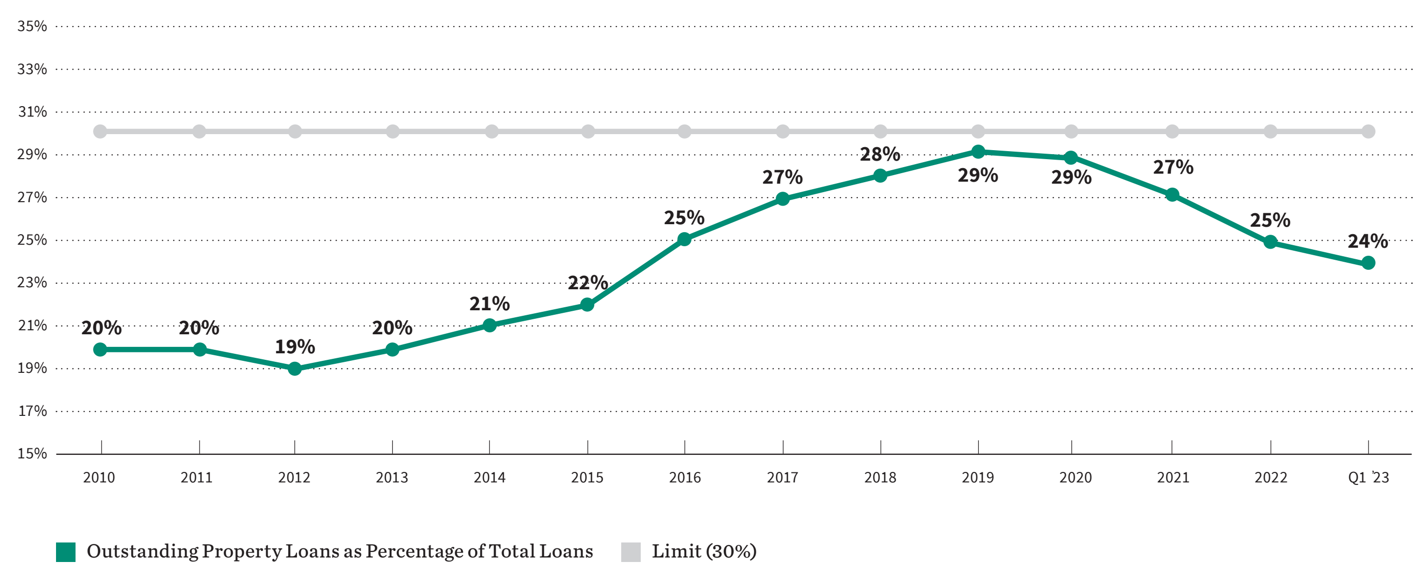
New Starts vs. Completions (in Million Square Meters)



Sources: NBS and William Blair, as of June 2023.

EXHIBIT 3

Outstanding Property Loans as Percentage of Total Loans

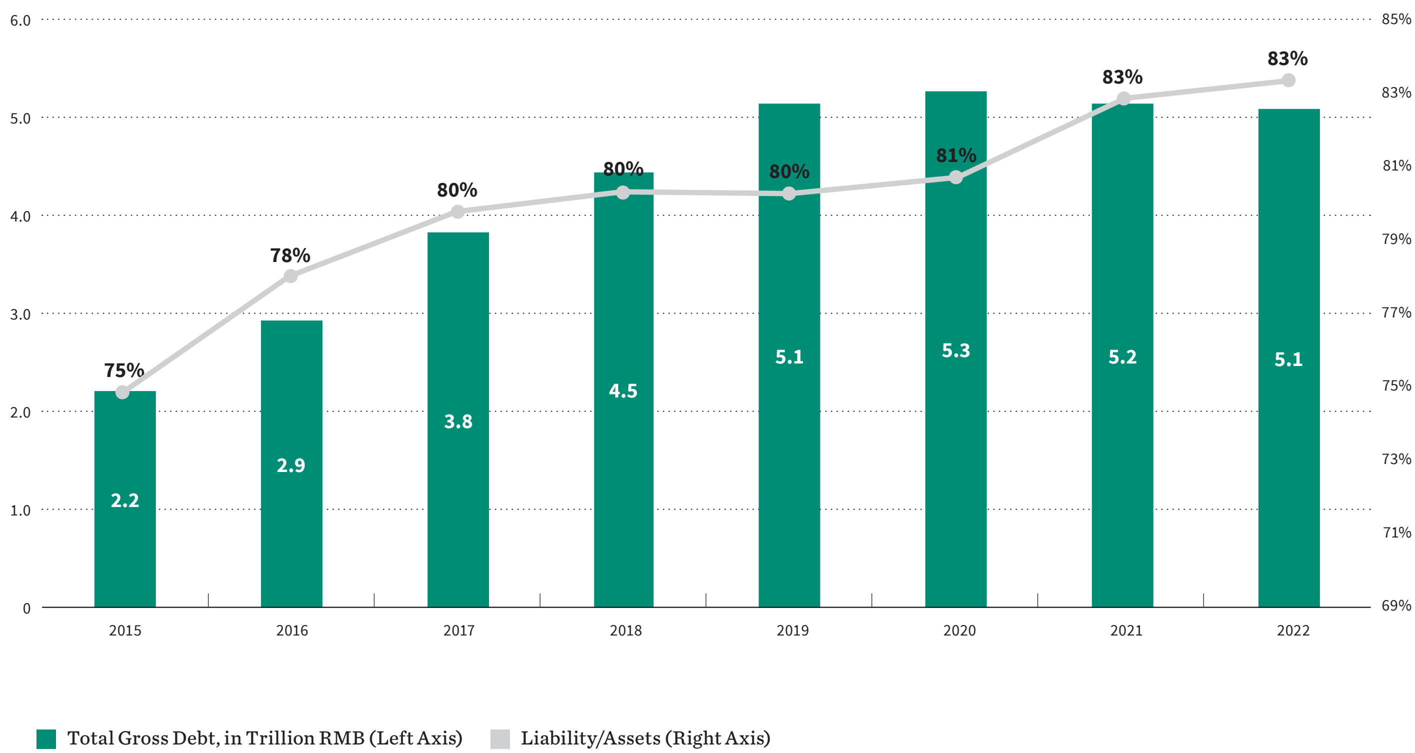


Sources: NBS, Citi, and William Blair, as of Q1 2023.

A Step Back: How Did We Get Here? (continued)

EXHIBIT 4

Developers' Gross Debt and Liabilities/Assets



Sources: Bloomberg and William Blair, as of 2022.

How Has the Chinese Property Market Changed Since 2020?

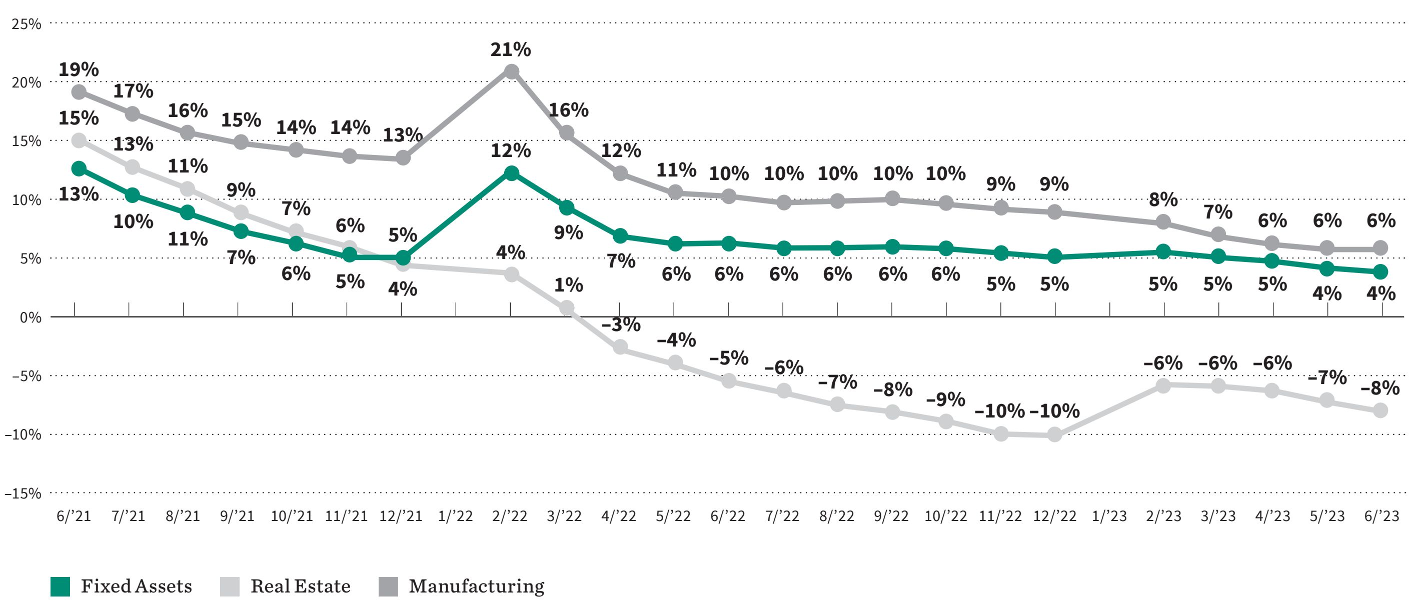
The varying responses and changing behaviors from Chinese regulators, property developers, home buyers, and financial market investors over the past few years have combined to reshape the Chinese property market in several ways.

First, there has been a fundamental shift in the government's approach to stimulus. During previous broad economic downturns in 2009, 2012, and 2015-16, the Chinese government used the usual tactics of credit expansion and investment spending to stimulate the economy. However, the Xi Jinping era of Chinese growth, which emphasizes common prosperity and reconsolidation of power, led to several changes. These include 1) a regulatory clampdown on excesses, such as overpowering tech sectors and imbalanced educational opportunities from private institutions; 2) a demotion of the real-estate sector to a secondary growth engine; 3) a moderation of infrastructure spending due to over-construction; and 4) the transformation of the Chinese growth model (which is now led primarily by the consumption, services, and manufacturing sectors, and new economies such as digital, technology, and renewables), as shown in exhibit 5. When it comes to Chinese property, policies are aimed at stabilizing the sector by ensuring completion of ongoing projects rather than enabling unrestrained levered growth.

> "Policies are aimed at stabilizing the sector by ensuring completion of ongoing projects."
>
> **Clifford Chi-wai Lau, CFA**

EXHIBIT 5

Investments in Fixed Assets, Real Estate, and Manufacturing (Year to Date, Year-Over-Year Change)



Sources: Bloomberg and William Blair, as of June 2023.

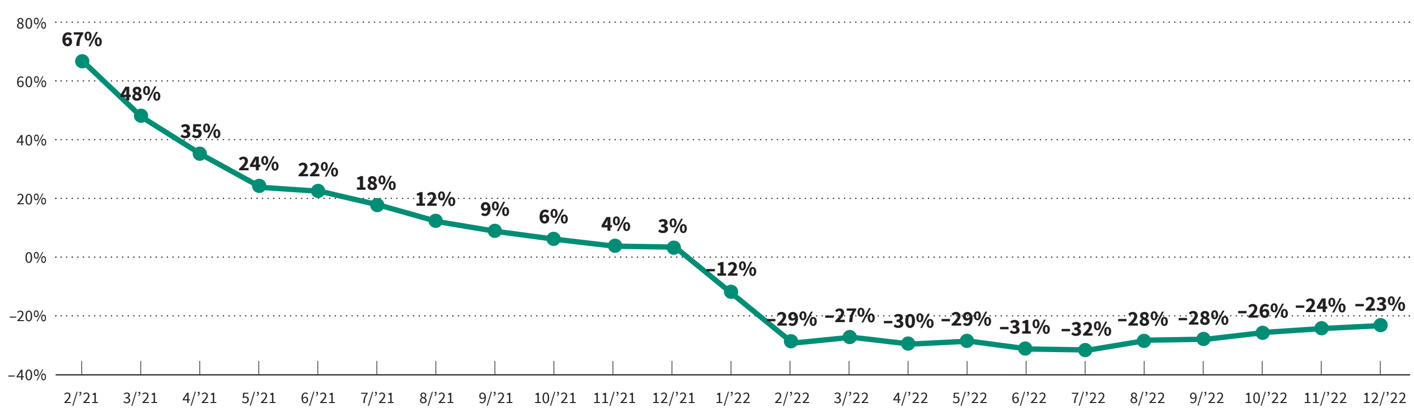
How Has the Chinese Property Market Changed Since 2020? (continued)

Second, a change in business models has affected local governments. The business model for most Chinese property companies tended to focus on growing their land bank with rapid (sometimes excessive) construction. This led to high leverage. Now, developers are ditching their land-bank-expansion business models, instead prioritizing the completion of existing projects to unlock cash previously restricted in escrow accounts. This changing strategy has exposed the extent to which local governments rely on land sales to developers for fiscal revenues. With land sales down 23% year-over-year as of fiscal year 2022 (see exhibit 6), local governments are now resorting to lower (but stable) local tax revenues and higher transfer payments from the central governments to bridge fiscal shortfalls. But fears have now emerged about the sustainability of local government financing vehicle (LGFV) debt issued over the past decade. Fiscal health is significantly impaired by the property sector downfall and changing business model of property developers—and is hitting low-income, geographically unprivileged local governments particularly hard.

Third, recoveries have differed by region. Given its vast size, China naturally has structural, demographic, and economic differences between regions. This has led to an uneven recovery in the property sector at a provincial level. For example, during the recent downturn, tier 1 cities (such as Beijing and Tianjin in the north), tier 2 cities, and the eastern provinces in general, whose local economies are dominated by the services sector, have shown strong resilience to both price pressures and volume adjustments. (Exhibits 7, 8, and 9 illustrate.) Conversely, tier 3 and tier 4 cities and landlocked provinces in central and western regions, which are mostly populated by lower-income households, fared much worse in sales and price adjustments given already high inventory levels, as shown in exhibit 10. Tier 3 and lower cities are also less economically diversified because their local economies are mainly driven by the manufacturing sector.

EXHIBIT 6

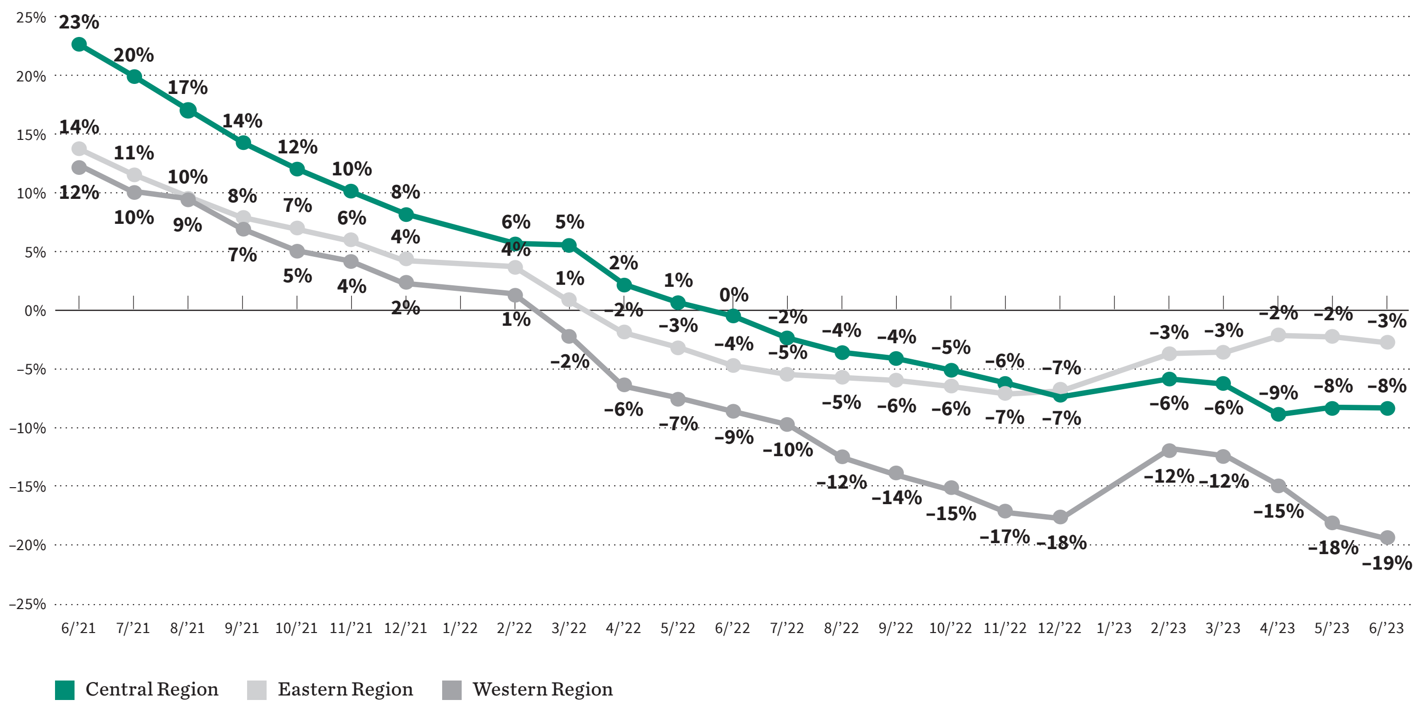
Land Sales Revenue (Year to Date, Year-Over-Year Change)



Sources: Ministry of Finance, Citi, and William Blair, as of December 2022.

EXHIBIT 7

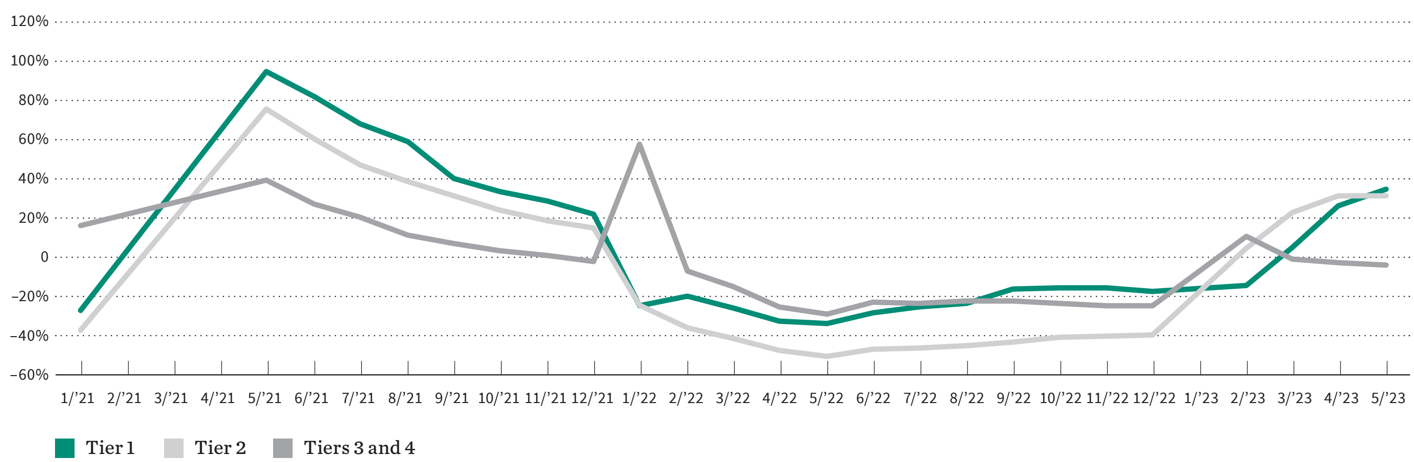
Real-Estate Investments in Central, Eastern, and Western Regions (Year to Date, Year-Over-Year Change)



Sources: Bloomberg and William Blair, as of June 2023.

EXHIBIT 8

Transaction Value (Year to Date, Year-Over-Year Change)



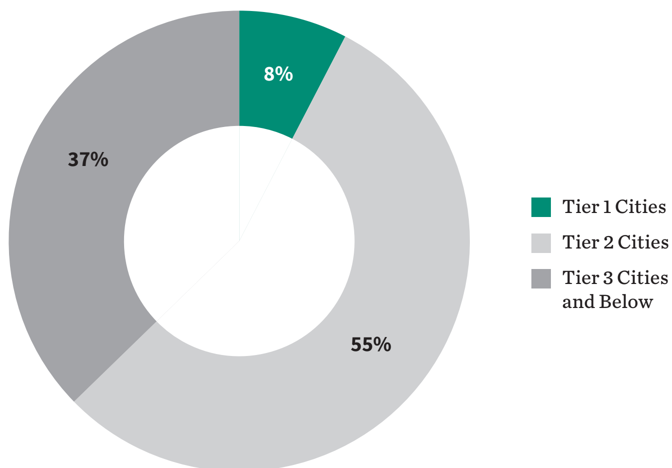
Sources: CRIC, Citi, and William Blair, as of May 2023.

Fourth, trends in urbanization have changed. Urbanization used to be the main driver of Chinese property sales growth. However, it appears that the urbanization rate is plateauing at a national average of 65%, with the 2022 urbanization rate growing less than 1% year-over-year in the last two years. This view is also supported by an International Monetary Fund (IMF) study[1] that estimates the urbanization rate in tier 1 and tier 2 cities has already reached 90% and 80%, respectively. Tier 3 cities, however, still lag, with an urbanization rate of less than 60%. The PBOC aims to lift the national average urbanization rate to 75% over the next decade to be more on par with developed markets, suggesting there could be incentives for the government to provide more support to homebuyers in lower-tier cities. This will be a daunting task for the government: Not only must a major destocking process take place in lower-tier cities first, but weakening demographics (such as the first population decline in years in 2022) and high youth unemployment are also casting a shadow over the long-term growth prospects of the sector.

1 Rogoff, Kenneth, and Yuanchen Yang. 2022. "A Tale of Tier 3 Cities." IMF Working Paper 2022/196, International Monetary Fund, Washington, D.C.

EXHIBIT 10

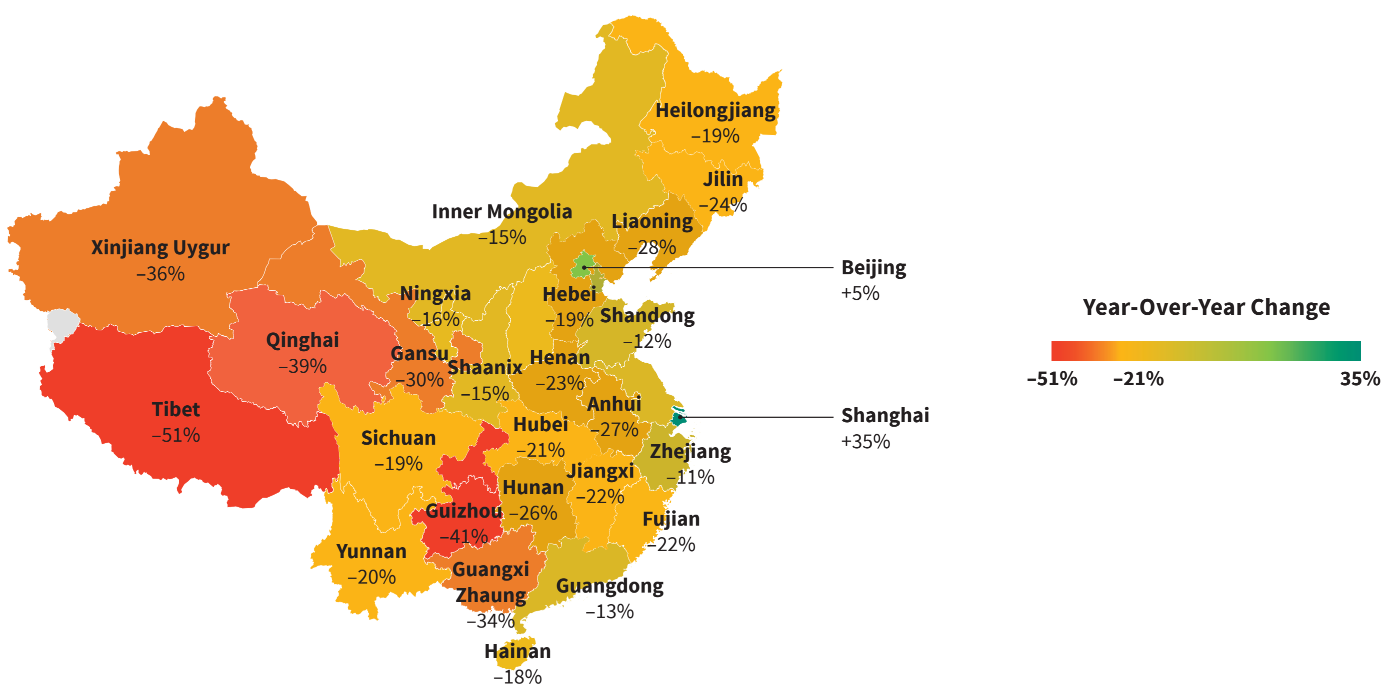
Inventory Mix for Key Cities (In Square Meters)



Sources: Citi and William Blair, as of December 2022. Inventory mix is for 80 key cities and refers to percentage of million square meters.

EXHIBIT 9

Housing Sales, Last 12 Months (Year-Over-Year Change)



Sources: NBS and William Blair, as of May 2023.

The Way Forward: Will SOEs Dominate?

State-owned enterprises (SOEs) represent only around 20% of the Chinese property offshore issuers under our coverage, but they now account for almost 70% of the presale market share through June 2023, as exhibit 11 shows. This is a notable increase from their 44% market share just two years ago.

Thus far, SOEs have emerged as clear winners from the recent turmoil in the Chinese property market. Although the fundamentals and implied support from their parent companies vary greatly for SOEs with mixed ownership, they have generally experienced a remarkable sales recovery, averaging a year-over-year increase of 18% in contracted sales through June 2023. Although monthly sales growth turned negative for SOEs in June, they are outperforming the sector year-to-date, as exhibit 12 shows.

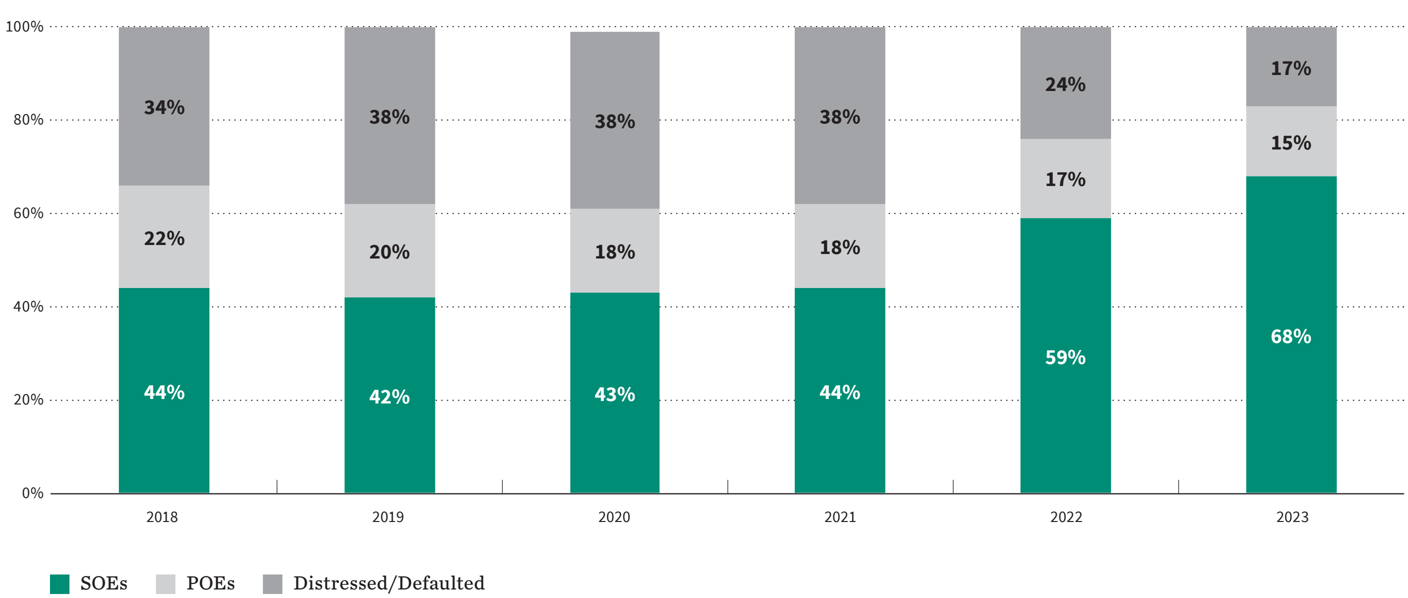
SOEs' outperformance can be mainly attributed to stronger buyer confidence in project delivery (due to implied government support), continued funding access, superior financial capabilities, and high exposure to tier-1 and tier-2 cities. This contrasts with privately owned enterprises (POEs), which have more exposure to lower-tier cities.

Remarkably, SOEs, saw their absolute debt levels rise year over year as of fiscal year 2022, as most maintained open their funding channels, while absolute debt levels fell for POEs, which have limited access to external financing.

Due to the supportive liquidity provisions by banks and the central government, SOEs have continued to acquire land bank, build their investment capacity, and strengthen their competitive advantages over POEs. This ability to replenish their saleable property inventory should enable them to gain further market share in the medium term, particularly as private developers are squeezed out of the physical market. Given these factors, we believe SOEs should maintain their dominant position in the property market in the coming years.

EXHIBIT 11

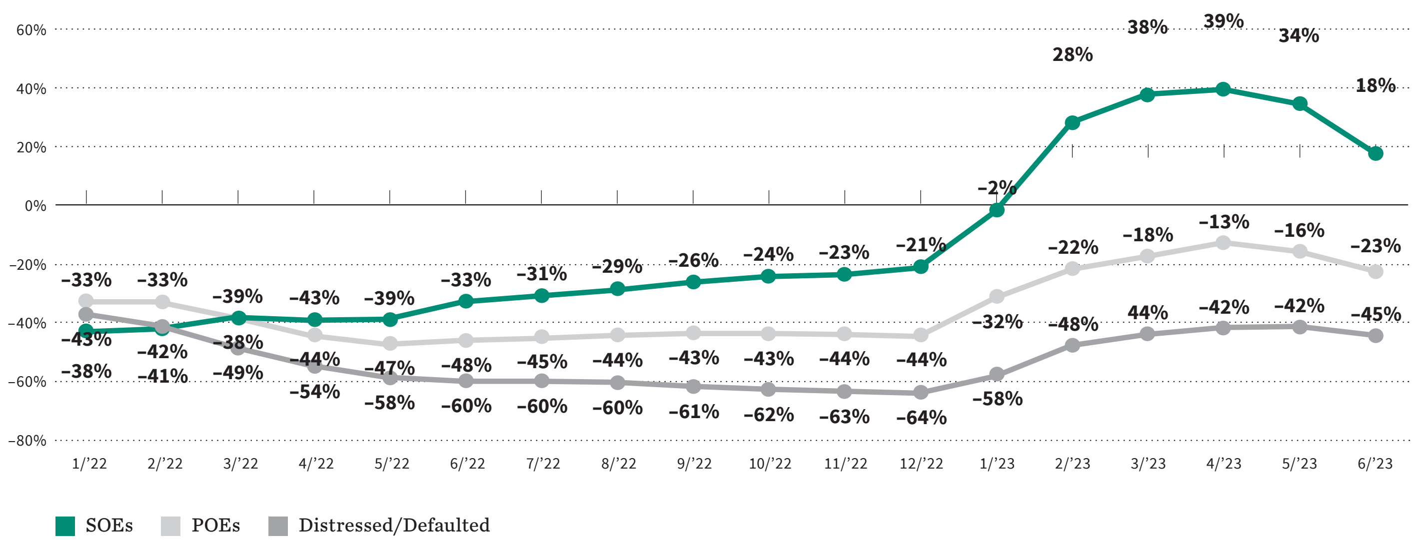
Market Share: SOEs, POEs, and Distressed/Defaulted



Sources: Bloomberg and William Blair, as of June 2023. Based on a list of 26 developers.

EXHIBIT 12

Contracted Sales Value Across SOEs, POEs, and Distressed/Defaulted (Year to Date, Year-Over-Year Change)



Sources: Bloomberg and William Blair, as of June 2023. Based on a list of 26 developers.

Conclusion and Outlook

The rebound in the Chinese property sector, spurred by the post-COVID reopening and government support, was promising but proved short lived. Housing sales ended fiscal year 2022 down 27% year-over-year, and a broad recovery in 2023 seems unlikely due to some deeply rooted structural challenges—specifically, high leverage and excess housing stock in lower-tier cities. Primary property sales numbers for the first half of 2023 show marginal growth compared to a year ago, and real-estate investments through June 2023 are down by 8% year-over-year. At the same time, secondary market sales continue to be soft, leading us to believe that absent any significant policy measures, the property sector will take time to recover.

We believe the softness of Chinese macroeconomic data since April 2023, along with the persistently weak performance of the Chinese property market, should provide incentive to the government to dial up its policy support for the economy in general and the property sector more specifically. We will closely monitor upcoming Politburo meetings for any policy signals.

“Although the opportunity set has narrowed significantly, we expect surviving developers to be better off.”

Zina Mytilinaiou, CFA

That said, there are fiscal limitations on the government underpinning the market as it has done previously—for example, much higher debt-to-GDP ratios and higher fiscal deficits than in past decades. Therefore, we believe any policy-easing package will likely be moderate and targeted, complementing existing measures, which should, over time, pass through the economy and support the sector.

Investing in the Chinese property bond market, however, remains challenging. The depressed physical market will likely continue to worsen the liquidity profile of developers. In addition, their inability to raise capital to keep their businesses afloat—along with the lack of constructive news about debt restructurings for the defaulted issuers—will likely make the already distressed pricing of offshore debts range-bound at best in the near future. A sustainable recovery in the sector would require that many top-down and bottom-up policies work together to revitalize economic activity, rebuild consumer confidence, improve income expectations, and support private investments to broaden employment opportunities.

While turmoil in the Chinese property sector has certainly taken investors on a rough ride, and uncertainty about the future of many POEs remains, we believe a more sustainable sector could emerge from the turmoil. Although the opportunity set has narrowed significantly, with more than half of the developers we cover in deep distress (some facing default), we expect surviving developers to be better off—more aligned with central government plans, less levered, and more cautious in their future development, resulting in a healthier and more conducive investment environment.

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