29 September 2021

Research China

No 'Lehman moment' but financial stress is not over

- **Chinese developers are in a perfect storm as all funding channels are severely squeezed currently. While we don't expect a 'Lehman moment', we also warn against too much complacency. More developers could soon be in the headlines facing liquidity problems.**
- **In our view, the Chinese government needs to ringfence Evergrande, ease regulation on developers, support home sales and beef up bank lending to developers. For a government keen on cleaning up a highly leveraged sector, we see a real risk they hesitate for too long and things get worse before it gets better.**
- *In a coming paper we will look more into the downside risks to Chinese growth from the development in the property sector and other recent headwinds.*

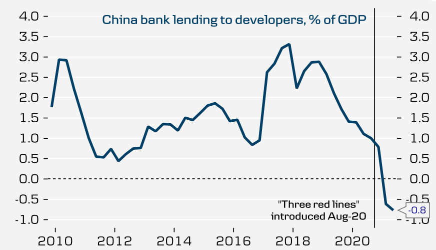
China's developers in a perfect storm

Financial markets have calmed down over the past week with Evergrande moving to the background again. Confidence has grown that the Chinese government will step in and avoid a 'Lehman moment'. A default of Evergrande is more or less a done deal, in our view, but Beijing will work to ringfence it and support other developers if dominos start to roll. The property sector is under severe stress, though, and more financial stress will be difficult to avoid.

There are already signs that some other big developers are coming under significant pressure. On Monday, the fifth largest developer measured on assets, Sunac China Holdings, supposedly asked the city of Shaoxing for help saying the market had almost frozen adding that the face "huge pressure". Sunac later said the letter had not actually been submitted to the city government. But it does reveal the challenges facing most developers right now as all sources of funding and liquidity is under pressure:

1. **Bank loans:** Lending to developers from banks have fallen substantially after new regulation this year put limits on how much real estate exposure banks are allowed to have, see top chart and box on page 3.
2. **Bond financing:** The Evergrande woes have been a wake-up call for investors in real estate bonds. Evergrande is in a league of its' own when it comes to leverage and creative financing. But it is far from the only developer that has run a business model with very high leverage (see table at the end of the paper). When China introduced the 'three red lines' on debt and liquidity in August 2020, around 1/3 of the 30 biggest developers breached all three lines. Fears of other possible defaults risk freezing investor demand for developer bonds. This has to some extent already happened and China's high yield rates have increased to 15%, levels that are not sustainable for developers.
3. **Home sales:** With a squeeze on financing after the 'three red linies' were introduced many developers started to sell out of their inventory of apartments to

Bank lending to developers dropped sharply after tightening of regulation



Source: Macrobond Financial, PBoC, Danske Bank

Financing costs for developers has risen sharply

Source: Macrobond Financial, Danske Bank

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provide finance of their business. Incomes from this channel was boosted last year when home sales shot higher during the pandemic. But in recent months a decline in home sales has cut into this source of raising money. Early indicators suggest home sales in September continued lower. A dangerous scenario would be if people become reluctant to buy housing from developers that are seen as vulnerable. In a market with many both private and state owned players, home buyers could decide they would rather buy from state-owned developers as they are deemed more secure. This would be detrimental for private developers.

4. **Shadow finance:** Another source of finance for some developers has been Wealth Management Products (WMP) typically sold through trust funds**.** The funds come from savings of Chinese households looking for an extra return while mostly expecting the funds to be secure. If people start redeeming money in these products realizing it is not a secure investment, another financing channel dries up for developers. Evergrande is said to have USD6 bn outstanding in WMP's already and has *begun to offer repayment* through physical assets such as discounted apartments, office, retail space or car parks.

5. **Accounts payable:** When developers were hit by the 'three red lines' another strategy to raise finance was to lengthen credit maturities with suppliers and thus increase accounts payable. This source is also likely to dry up with suppliers not being eager to offer long credit to developers under financial pressure.

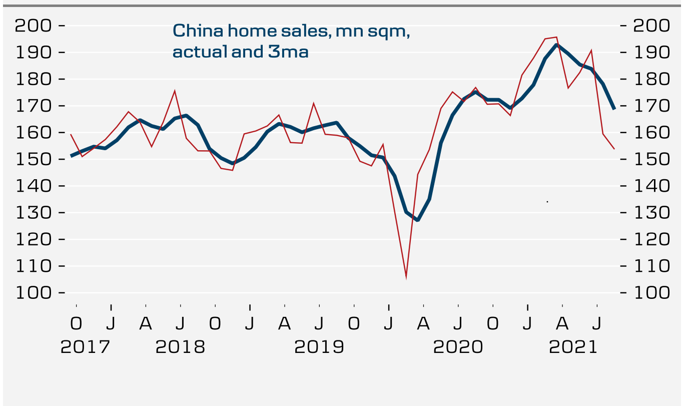
Another risk for developers is a decline in the price of their assets (land and inventory of housing) as this would push up leverage through a decline in the denominator of their debt-to-asset ratio. Fire sales of land or property to raise money is thus not a viable solution for the sector as a whole.

In sum, developers are currently hit by a perfect storm with home sales falling and external financing sources being significantly squeezed.

Wanted: Easing up on regulation and more bank lending

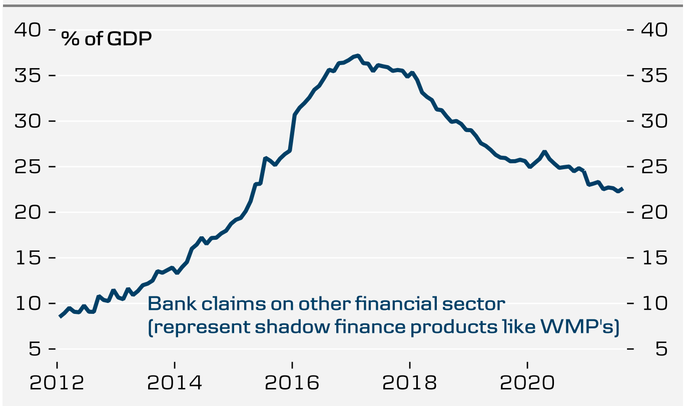
So what is the way out of this crisis? **It is hard to see the problem solved without an easing of regulation that reduces the deleveraging pressure for developers in the short term** and thus the need for liquidation of assets. An orderly restructuring of Evergrande with government participation will also be needed and this may already be taking place

Falling home sales push down cash flows for developers



Source: Macrobond Financial, NBS, Danske Bank

Shadow finance much more limited today after the crackdown in 2016-17



Source: Macrobond Financial, PBoC, Danske Bank behind the scenes. Taking the foot off the break on the housing market is probably also needed in the short term in order to secure that home sales don't fall further and deprive developers of a key source of income to pay interest payments and their bills to suppliers and workers.

It will also be necessary to fill the financing need through an increase in bank lending via state owned banks. And provide state banks with liquidity to buy bonds from developers for refinancing purposes. A cut in the reserve requirement ratio could free up this liquidity. Private investors will be hesitant to buy bonds from developers until the crisis is deemed under control and retail investors in Wealth Management Products are not keen on buying these for a while.

Finally, the government needs to monitor closely people's behaviour when it comes to confidence in buying a home. This is also why it is critical that the construction of around 1.5 million Evergrande apartments is continued soon with help from state owned developers. Apart from the social unrest it could cause from the buyers if they do not get their apartment, it would risk leading to a freeze in home sales – at least from private developers seen as less secure than state-owned developers.

Box: China's tightening of regulation for developers

In August 2020 China introduced a range of measures aimed at reducing financial risks from China's highly leveraged developer sector. Two sets of regulations have led to a significant deleveraging pressure and highlighted the most vulnerable names in the sector.

The first set of regulation was the so-called "three red lines" which puts limits on leverage and minimum requirement on liquidity. The three lines for developers are:

1. Debt-to-asset ratio below 70%
2. Net-debt to equity below 100%
3. Cash to short-term-debt ratio higher 100%

Crossing one red line would restrict developers to only increasing their debt levels by 10%. Crossing two red lines halves that limit to 5%, while developers breaching all three lines would not be allowed to increase debt above June 2019 levels.

The second set of regulation was the '*concentration management system'* (CMS) for banks coming into force in on 1 January 2021. The system puts limits on the share of bank lending to the property sector for banks dividing banks into five tiers. Well capitalised banks can lend more than smaller underfunded banks. On top of limiting financial vulnerability it also aims at getting banks to lend more to 'productive sectors' such as manufacturing and tech sectors.

Source: Misc. media reports

We believe, the government understands these risks and will act accordingly. But there is also not much room for mistakes. What complicates things further is that the government is not inclined to bail out a sector that it has been trying to discipline with the tighter regulation.

To sum up, while we don't expect a big financial crisis, we also warn against complacency. We still see a risk that the worst is still ahead of us in the Chinese property sector and financial stress will get worse before it gets better as the government is hesitant to do more than necessary.

The challenges will also put a drag on Chinese growth in a period already characterized by challenges from more frequent COVID outbreaks and recently power reductions to meet emission targets, which hurt production. We will look more at this in a coming paper.

Financial ratios among biggest developers (sorted by revenue)

	Revenue	Assets	Total debt	Rating (Moody's)	Net debt/equity	Interest coverage	Quick ratio
Evergrande Group	73,592	352,549	110,578	Ca	160	0.80	0.13
Country Garden	67,151	308,832	50,119	-	60	2.32	0.14
Greenland Holdings	61,982	164,712	44,280	Ba2	162	5.82	0.22
Vanke	60,805	286,367	43,722	Baa1	28	4.26	0.14
Poly Real estate	35,285	191,717	47,762	Baa3	62	8.40	0.20
Sunac China Holdings Limited	33,454	169,813	46,589	Ba3	115	1.55	0.15
Longfor Properties	26,774	117,226	27,742	Baa2	54	5.81	0.20
China Resources Land Limited	26,055	133,142	26,111	Baa1	30	7.15	0.22
Seazen Group	21,199	83,418	16,149	Ba1	55	1.91	0.16
Shimao Property	19,637	90,353	22,248	Ba1	55	3.22	0.21
China Merchants ...	18,805	112,936	24,521	-	28	1.96	0.25

Note: Red color of rating indicates high yield. Quick ratio is a liquidity measure.

Source: Bloomberg

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Report completed: 29 September 2021, 15:18 CET
Report first disseminated: 29 September 2021, 16.15 CET