



## Gloomy outlook for Chinese developers despite recent cheers

by [Justin Hsiao](#)

The Chinese real estate industry is a prominent part of China's economy as this industry accounts for over [20%](#) of the country's GDP and has important linkage with many other industries. The housing prices and transactions fell in many of the cities in China last year, giving a lot of pain to the home builders across the nation. However, in the first five months of this year, the weak market seems to have had a turnaround due to favorable monetary and regulatory policies. Yet, the real estate market is still facing some strong headwinds amid a slowdown in the economy, oversupply in the non-major cities, high debt burdens and risky survival strategies.

The real estate industry can be taken as the economic engine of a country, as it has a rippling effect on a variety of other industries. The good sales of properties usually help to pick up the labor market, raw material demand, banks, brokerages, etc. The growth of housing sales in major cities, gauged by floor space, increased by [37.4%](#) in May compared to a year earlier. In addition, Moody's on Tuesday last week also [upgraded](#) its outlook on the Chinese property market to stable from negative as it anticipated a pickup in nationwide property sales revenue of up to 5% in the next 12 months. The market attributes these positive signals to the supportive monetary and regulatory policies of the government.

The Chinese authorities have unwound the second home restriction, which aimed to prevent the overheating in the market earlier, and the central bank has cut interest rates three times while the down payment requirements were lowered to boost home purchases. As shown in the left panel of Figure 1, the China 1-year benchmark lending rate has been lowered three times since November last year, and the YoY growth of overall national property sales started to recover from the beginning of this year. The RMI Aggregate 1-year Probability of Default (PD) of 200 listed Chinese developers, in the right panel of Figure 1, has decreased from around 45bps at the beginning of this year to below 30bps right now in tandem with the improved sales.



Figure 1: YoY growth of overall national property sales, China 1-year benchmark lending rate, and RMI aggregate 1-year PD for 200 listed Chinese developers excluding REITs. Source: Risk Management Institute, Bloomberg

Despite the improvements so far this year, the property sector is facing some problems. First, the Chinese government lowered its forecast of GDP growth next year from 7.1% to 7%. More importantly, the growth of imports has been slowing down, which indicates a withering domestic demand (see left panel of Figure 2). This indicator is especially meaningful to the developers, since raw materials, which are crucial for the property industry, take up a significant portion of China's imports. Second, the home builders have a bulk of inventory at hand, especially for those outside of Tier 1 and 2 cities. According to the IMF, China's Tier 3 and 4 cities have

nearly [three years'](#) worth of sales in unsold homes in the market. Last but not least, the debt level of Chinese home builders is piling up. As shown in the right panel of Figure 2, the current and the long term liabilities of 200 listed developers have kept increasing even in a slowing economy. Data compiled by Bloomberg show that the current liabilities of China's 200 listed developers are greater than CNY 3tn. Besides, according to a JPMorgan report, the Chinese issuance in the USD-denominated bond market this year stood at [USD 42bn](#) to the end of May, the highest on record. And [7 of the top 10](#) Asian borrowers in the USD high-yield market with bonds outstanding are Chinese developers. Interestingly, despite the growing debts, the cumulative YoY growth rate of investment in real estate development is decelerating, as shown in the left panel of Figure 2, suggesting that China's builders are spending more slowly in the real estate market.

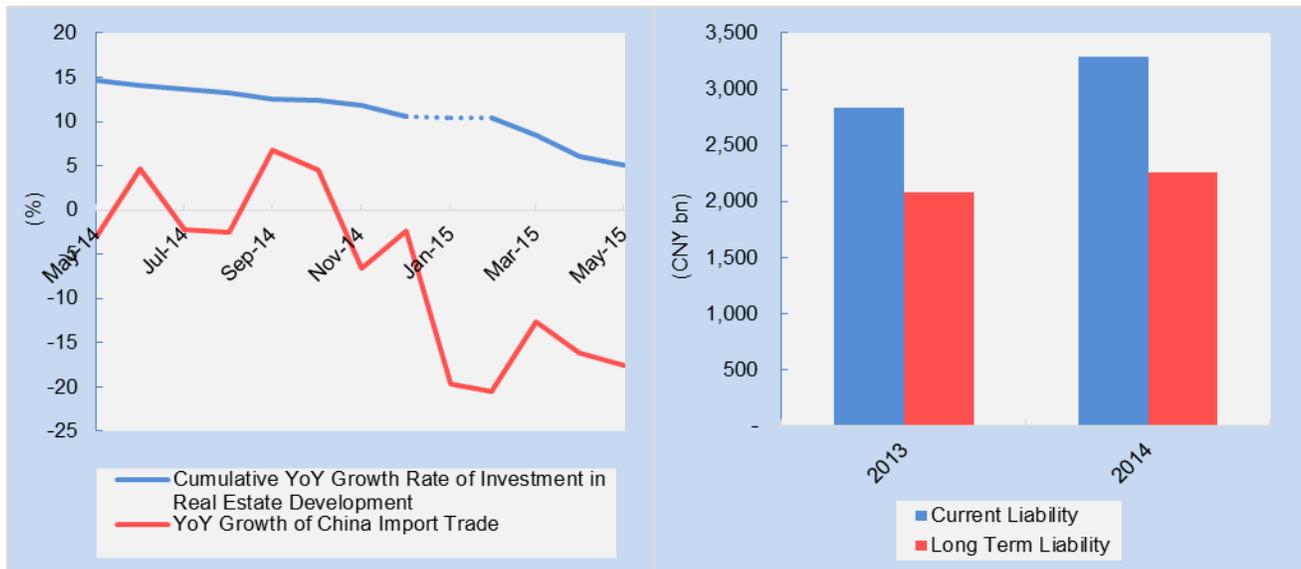


Figure 2: Cumulative YoY growth rate of investment in real estate development (taking January as the base), and current and long term liability of 200 listed Chinese developers excluding REITs. Source: National Bureau of Statistics of China, Bloomberg

Given the downturn in the housing market, the developers are reengineering their businesses to generate cash flows from new channels, indicating that many developers are [diversifying](#). Evergrande Real Estate Group Ltd (Evergrande), the fifth property developer in China by sales, is one of the classic examples. Evergrande had done billion-renminbi investments ranging from solar panels, agriculture, to consumer business last year. This heavy spending drew [criticism](#) from some credit agencies, since the company has already been heavily indebted. Figure 3 shows that Evergrande's market cap had increased by 154% to its record high on May 4 from the beginning of this year, in accordance with a decreasing RMI 1-year PD. However, the company's shares tumbled 27% on May 29, the biggest decline since it went public in 2009, after it was forced to [cut the price](#) of a share sale to achieve its target amount. Analysts said that will only make small difference to the company's indebtedness. Evergrande is the most indebted among the 20 major Chinese developers with a debt to equity ratio of 138.87% at the end of 2014.

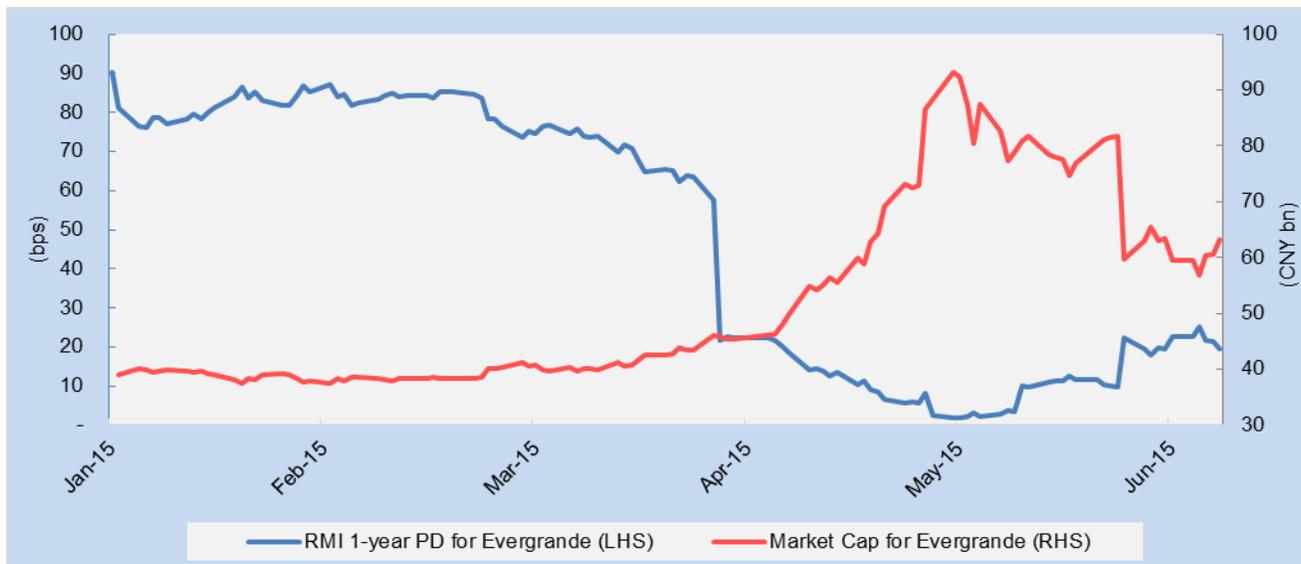


Figure 3: RMI 1-year PD and Market Cap of Evergrande. Source: Risk Management Institute, Bloomberg

In summary, the Chinese home builders' credit health has become better recently due to the stabilized prices and sales. However, the fundamentals of this industry are still in bad shape, especially for those companies in small and medium-sized cities with a serious oversupply problem. Although many companies have diversified, this business strategy might further drain companies' liquidities since most of them are still in initial investment stages. In the long run, the Chinese developers are still facing headwinds.

## Credit News

### Greek default fears rise as 'eleventh-hour' talks collapse

**Jun 14.** Talks between the Greek government and bailout creditors have collapsed on Sunday as European Union officials dismissed Greece's latest proposal for further negotiations. The European Commission said that there remained a significant gap between the plans of the Greek authorities and the joint requirements of the European Commission, ECB and IMF. The creditors are asking Greece to commit to a plan to raise the budget surplus from 1% of GDP this year to 3.5% of GDP by 2018, but the Greek government countered with a different plan. The meeting was seen by observers as the last chance for Greece to secure a bailout agreement before funds run out at the end of the month. ([Financial Times](#))

### HSBC's new strategy disappoints investors who see repeat of 2011

**Jun 14.** The initial reaction by investors to HSBC Holdings' new strategy for restoring strong profit growth has been cool. The strategies include disposing loss-making operations in Turkey and Brazil and cutting 25,000 staff. Another 25,000 employees would leave the bank with the sell-off of the Turkish and Brazilian businesses. It also plans to shed USD 290bn in risk-weighted assets from the balance sheet, mainly from global banking and markets, and shift many of those assets eastwards. Some analysts have deemed the plan a back track to 2011, while others have called it a missed opportunity to take bigger actions. ([SCMP](#))

### Only in China can riskiest provincial debt get best yield

**Jun 12.** Analysis of their debt and potential to repay using taxes and land sales suggests that Jilin is the riskiest among the nation's 31 provinces, autonomous regions and municipalities. It issued three-year notes at 2.87% on Jun 11, while Tianjin also sold at a zero premium three days earlier. Low borrowing costs are a positive sign as the central government seeks to avoid a local debt crisis by allowing regional governments to issue CNY 2.77tn (USD 446bn) of municipal bonds that don't carry finance ministry guarantees. ([Bloomberg](#))

### Bank of Korea cuts interest rate to record low while MERS spreads

**Jun 11.** Warning that the spread of Middle East Respiratory Syndrome (MERS) poses an imminent threat to consumption, the Bank of Korea lowered its seven-day repurchase rate to 1.5%, the fourth reduction since August 2014 to an unprecedented low. The MERS outbreak has caused deaths and thousands have been quarantined. It threatens to damp recent improvement in consumer sentiment amidst a slump in exports. According to Chang Jae Chul, a Seoul-based economist at Citigroup Inc, the cut aims to ease the negative impact from MERS and prevent consumer sentiment and production from freezing up. ([Bloomberg](#))

### Austria is now one of Europe's most sluggish economies

**Jun 11.** Since the title "the better Germany" was applied to Austria in 2005, its annual GDP growth has slid downward, to 0.1% last year from well above 2% then. In May, Austria was handed one of the weakest European Commission forecasts of any euro nation: just 0.8% GDP growth this year, far below the currency-bloc average of 1.5% and the German outlook of 1.9%. A global export economy and resurgent domestic demand have pushed German unemployment to record lows. However, in the meantime, Austrian joblessness has been trending upwards to 5.7% in April. ([Bloomberg](#))

**Colt Defense to file for Chapter 11 bankruptcy protection** ([WSJ](#))

**Fresh fears of biotech bubble as Axovant soars on NYSE debut** ([Financial Times](#))

**Luxury goods face a global reckoning** ([Financial Times](#))

### Regulatory Updates

#### Hong Kong exchange to curb volatile stock trading

**Jun 14.** This week, the Hong Kong Exchanges and Clearing Board calls for a vote on the largest trading reform in recent years. This reform will introduce trading controls for the first time in the city's stock exchange. If implemented, it may be introduced as early as next year. This volatility control system will bring Hong Kong in line with international practice of stopping stocks from moving too fast and is similar to the system in Singapore, though not as stringent as those in the US and Europe. Some brokers disagree with the proposed reforms by justifying that market pricing is efficient and should not be controlled. Others feel that this proposed reform is beneficial to control "fat-finger" errors, which are more prone to occur, given the rise in high-frequency and electronic trading. ([SCMP](#))

#### Finra summons banks and asset managers over market fears

**Jun 14.** The Financial Industry Regulatory Authority (Finra) has called senior executives from banks and asset managers for two meetings to discuss possible solutions to the liquidity crunch in the bond market. The meetings will be held on Jun 18 and Jul 1, where the severity of liquidity downturn and possible solutions to this situation will be discussed, respectively. One of the measures being proposed to Finra is the introduction of delayed reporting requirements when trading huge blocks of debt, which may be contrary to the trend of increasing transparency in financial markets. Some notable people in the financial industry fear that this tougher environment in bond trading may trigger the next financial crisis. ([Financial Times](#))

#### Fed focuses on treasury volatility mystery as it plots rate rise

**Jun 12.** The Federal Reserve officials are studying changes in the USD 12.7tn treasury market and are concerned about the unknowns, as they are looking towards raising interest rates. Officials are concerned that raising benchmark interest rate will push bond yield higher than expected and shift market structure, which may lead to unusual volatility in the market. Understanding the source of treasury yields volatility is important to the Fed's decision making, as it affects borrowing costs in the market, which may have a significant impact on the economy. According to a Bloomberg survey of economists, the Fed is more likely to raise interest rates after September, as they are cautious about the volatility of the treasury yields, as well as the consequences of raising the interest rate. ([Bloomberg](#))

**Sweden's government monitoring 'worrying' house price jump** ([Bloomberg](#))

**SBI urges more action on loan default policy** ([Livemint](#))