Orient Capital Research

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# Funding Crisis in China's Property Market

**Widespread Credit Crunch Expected Later This Year**

## Summary

Based on our interviews, **we believe the property sector will face a liquidity crisis when the peak of debts come due in the second half of 2017 and beginning of 2018.** According to the Centaline Group, China's property developers raised Rmb1.14trn in 2016 through privately raised company bonds, corporate bonds, medium term notes and related sources. This was a 26% increase YoY, for the first time breaking Rmb1trn. However, both domestic and foreign financing channels have been blocked since last October due to tightening regulations on capital raising, along with a strong U.S. dollar As a result, property developers are confronting a significant increase in the cost of financing that could cause them to reach crisis levels in the near future. ***We estimate Rmb544 billion in corporate bonds alone will come due in 2H 2017 and early in 2018.***

There are several possible outcomes to the expected capital crisis in the property market:

1) **PBOC Intervention.**

2) **Shadow Loans.**

3) **Defaults.**

We discuss the property industry's capital constraints and potential outcomes from a potential shortage.

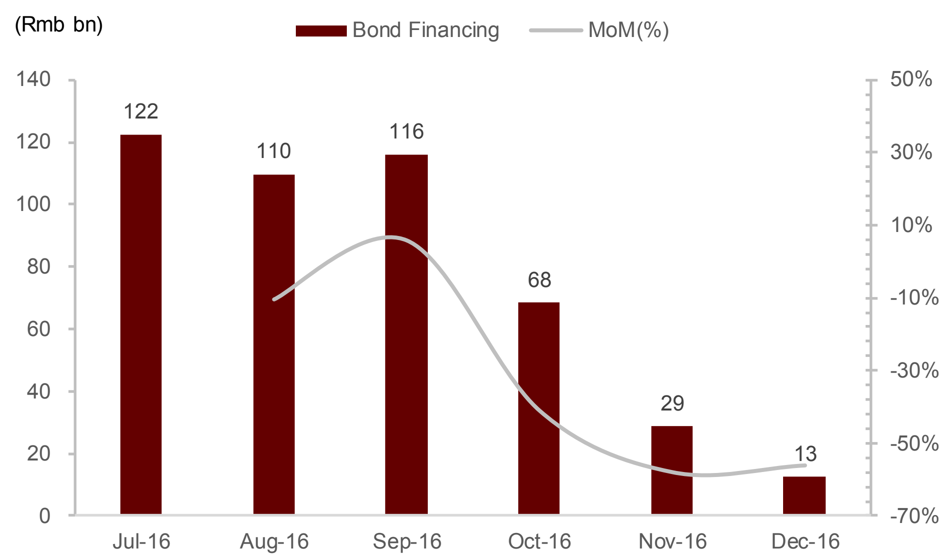
## Decline in Bond Financing at the end of 2016

In October, the Shanghai Stock Exchange suspended bond-raising applications from developers under new rules that disqualifies them from issuing corporate debt. Some smaller real estate companies failed to receive final approval for bond sales on the Shanghai exchange even after going through the required paperwork.

Due to these new regulations, bond sales by property developers fell 68.4% in the fourth quarter, to Rmb110 billion, far less than the Rmb348 billion raised in the third quarter of 2016.

In addition, total financing raised in December hit a year-low, accounting for just 1.11% of the sector's capital for 2016. In December, Chinese property developers raised only ~Rmb12.67bn through bond issuance, down 56%, 81.5%, 89.1%, 88.4% and 89.6% from November (Rmb28.8bn), October (Rmb68.5bn), September (Rmb116bn), August (Rmb109.7bn) and July (Rmb122.4bn).

*Figure 1: Monthly property financing through bond issuance*



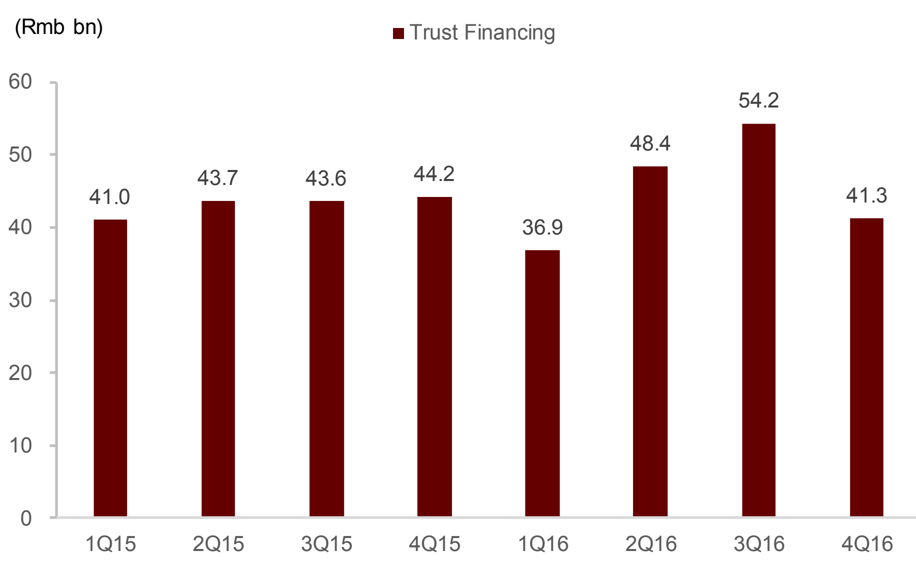

*Source: Centaline Group, OCR*

According to a senior manager of a Chinese commercial bank responsible for financial customers, "Bond issuance is the property developers' favorite way to raise capital given that it has the lowest interest costs. Most observers agree that the boom in the property market of 2016 was partially driven by robust bond issuance in the first three quarters. However, bond financing was seriously restricted after a series of tight regulations issued since September. For example, we received clear orders to review the details of bond issuance, including total size, use of funds and the disclosure arrangements of bonds issued by property developers. We further require property developers to submit proof that raised funds will not be invested in land purchases or real estate development." However, loans are permitted for day-to-day working capital.

## Shadow Banking Loans Dry Up

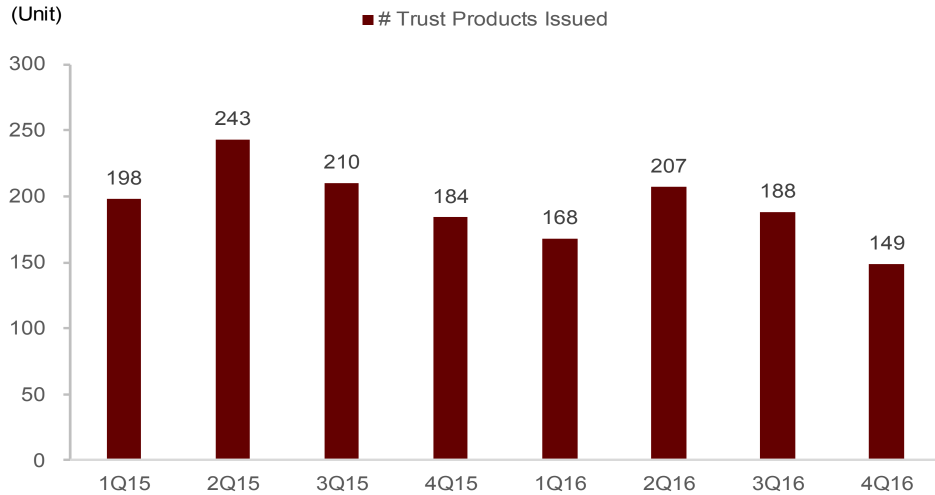
In the past, Chinese Trusts – essentially investment banks in disguise – were a significant source of capital for property developers. However, they are losing market share in the property sector. According to www.usetrust.com, 149 trust products were issued in 4Q16 with a total amount of Rmb41.3bn raised and invested in property markets, representing a decline of -6.6% YoY and -24% QoQ. In December 2016, 52 trust products were issued, three more than that of November. However, the capital raised was only Rmb12.6bn for the property sector, significantly down 47.1% YoY and 21.4% MoM, the lowest amount raised since April 2016.

*Figure 2: Quarterly property financing from the trust market*



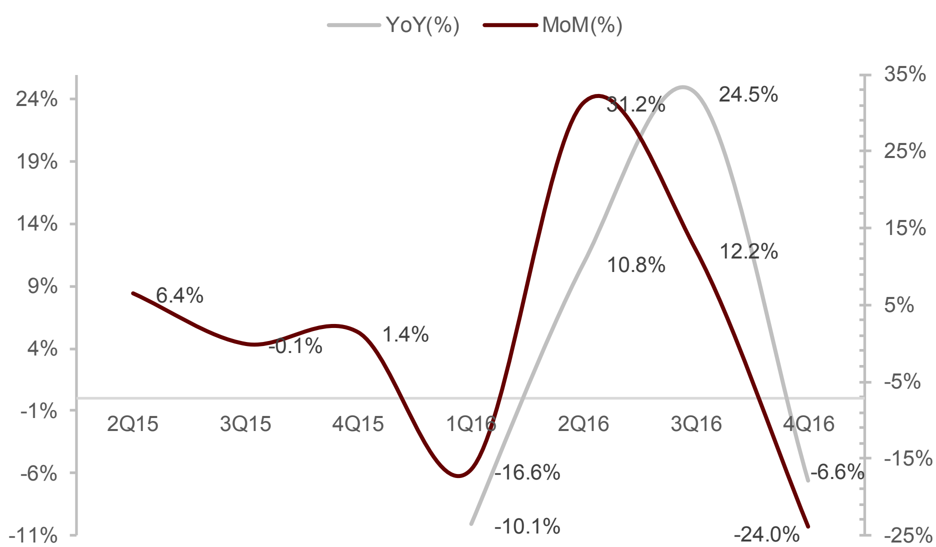

*Source: www.usetrust.com, OCR*

*Figure 3: Quarterly number of trust products issued for property financing*



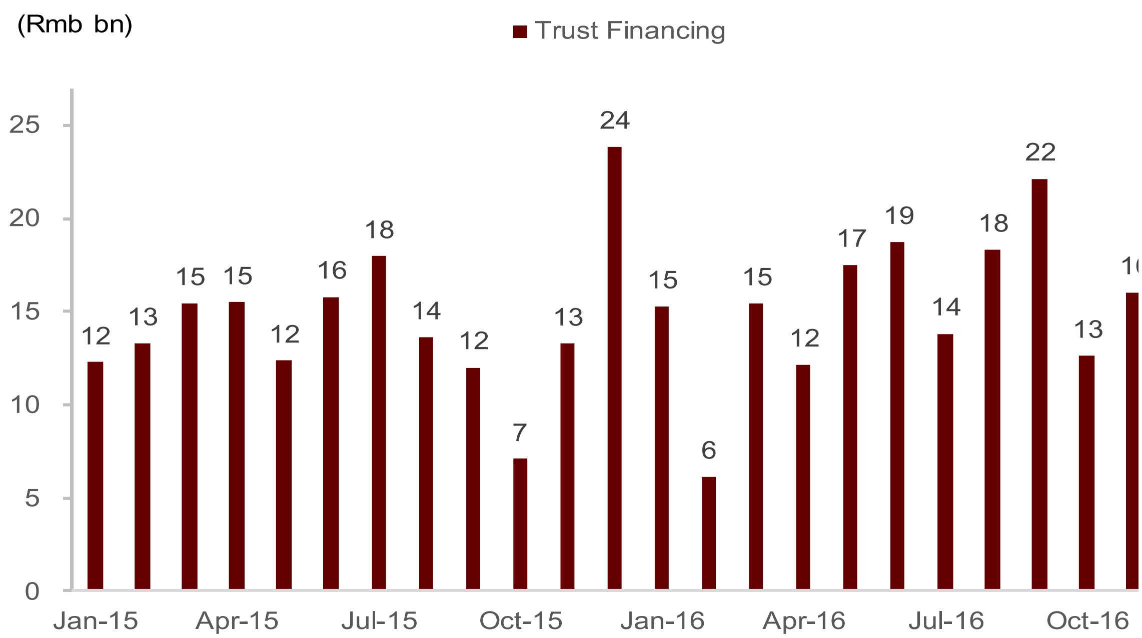

*Source: www.usetrust.com, OCR*

*Figure 4: YoY and MoM changes of quarterly financing through trusts*



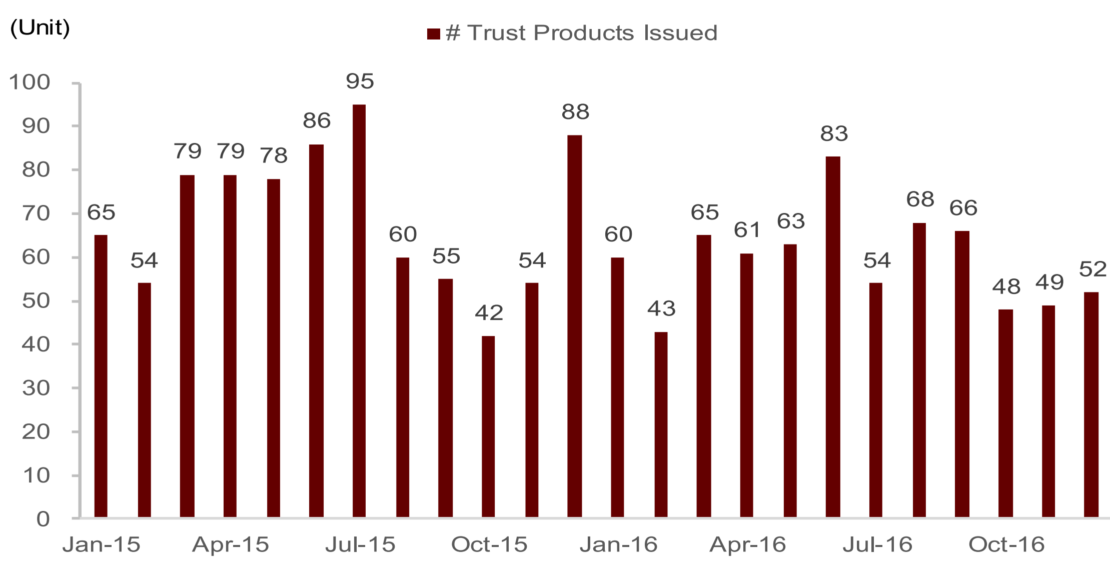

*Source: www.usetrust.com, OCR*

*Figure 5: Monthly property financing from the trust market*



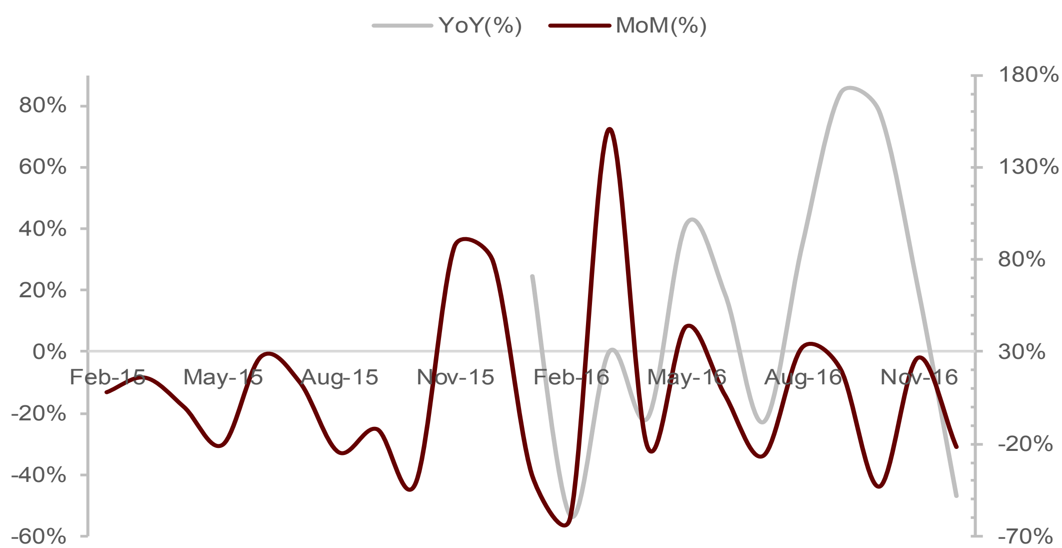

*Source: www.usetrust.com, OCR*

*Figure 6: Monthly number of trust products issued for property financing*




*Source: www.usetrust.com, OCR*

*Figure 7: YoY and MoM changes of monthly financing through trusts*




*Source: www.usetrust.com, OCR*

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### Corporate Defaults?

Bankers said capital constraints will likely cause **defaults** in 2H 2017. According to a loan specialist at one of the Big Four banks in China, "We expect policies to remain tight for the next six to nine months and thus exert huge financial pressure on Chinese property developers to raise new capital from the market. In addition, the whole sector is facing large debts from bank loans, short-term bills, bonds and mid and long-term loans accumulated over the past two years. ***We estimate that Rmb544bn will start to come due in 2H17 and the beginning of 2018.*** Without raising new funds from the market, we think most property developers will have trouble of paying the debts given the expectation of declining sales in the following months." There are early indications of softening prices in Tier 3 and 4 areas of the country.

## What are the Implications for the Economy?

Outright default of a large number of property developer bonds would clearly cause problems for the banks, property developers, and local governments that rely on land sales and ancillary property taxes for 20% - 40% of their revenue. For the banks, there would be direct and indirect effects. Directly, banks have two links to property bonds. First, there are bank investments in the bonds themselves. Second, there are the Wealth Management Products (WMPs) arranged by the banks to invest in property bonds. These are not on-balance sheet but investors would likely attempt to hold the banks accountable.

The indirect effects concern bank loans to the property sector. According to the China Banking Regulatory Commission, as of November 2016 banks had Rmb1.6 trillion in outstanding loans to property developers. A widespread default in property bonds likely would occur simultaneously with a default in property loans.

These are all worst-case scenarios. We expect the leadership to arrange "financial patches" to avoid the most harmful outcomes. However…

## Beijing Has Few Choices

There are a couple of likely outcomes to the capital shortages among developers:

1) **PBOC Intervention.** The capital constraints on the property market are in part a function of policies from the central government on loans or other fund raising by property developers. The PBOC and the China Banking Regulatory Authority (CBRC) could loosen restrictions on bond issuance and bank loans for ailing developers. Our interviews suggest the restrictive policies will continue because the PBOC is concerned about excess investment in this sector. However, the Rmb270 billion injection into the banks through a cut in the Reserve Rate Requirement a week ago suggests the PBOC may selectively allow credit to flow, much of which will evade controls and end up in the property sector.

2) **Shadow Loans.** Although there are tight restrictions on formal borrowing through bond issuance and loans, there remain avenues to access capital through the Shadow sector. Trusts, which are investment banks in disguise, have reduced growth in lending, but the private market is booming through the sale of Wealth Management Products (WMPs). There are Rmb27 trillion in official WMPs although the unofficial number is likely anywhere from 10% to 50% higher. Defaults, though, could cause a collapse in investor confidence in WMPs in general and property investments in particular.

3) **Outright Default.** We believe increasingly this will be a policy choice favored by Beijing – **but with limited implementation**. The People's Daily began

warning about property bubbles in the fourth quarter of 2016, a sign the State Council had become concerned. That could result in **selective defaults.** The formal banking regulator, the CBRC, is known to be weak-kneed in controlling bank credit – more concerned about profits than the macro-economy. This was evident in October 2016 when the **CBRC allowed banks to exclude mortgage loans from the limits on property loans**. The unofficial, unannounced policy led the banks to increase credit to this sector, while the CBRC simultaneously included the face-saving gesture (and contradictory policy) of imposing restrictions on second and third mortgages. That leaves the PBOC to follow through with any directives with real teeth. The PBOC, could, however, intervene on a case-by-case basis, particularly when the developer or project is sufficiently large to cause economic distress in a politically important location.

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