How Much Progress Have Real Estate Developers Made on Deleveraging?

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Key Takeaways

Our research of 100 property developers has found that most of them have improved net gearing, while asset-liability ratios (after deducting advances) haven’t improved much, with cash/short-term debt ratios worsening on average.

In our view, not many developers have deleveraged through operating efficiency improvement. To meet the regulator’s “three red lines” leverage thresholds, developers are tending to manage their finances through measures such as increasing non-controlling interests and moving development projects off their balance sheets.

In our view, developers with improved operating efficiency will have better long-term development prospects while others significantly using off-balance sheet measures may lead to higher potential risks.

We have noticed an overall decline in the average cash to short-term debt ratio, indicating worsening liquidity. Liquidity risk may become a more pronounced trigger for credit events among developers.

We have analyzed a sample of 100 issuers or listed entities in the domestic real estate development industry finding limited declines in leverage levels despite the introduction of the regulator’s “three red lines” regulatory requirements. The three thresholds require developers to reduce their on-balance sheet financial leverage. However, we have found that most players have looked to reduce leverage through means such as increasing non-controlling interests or moving development projects off their balance sheets.

In our view, reducing leverage by enhancing operating efficiency leads to better development potential. Developers taking this path may be able to gradually improve their credit qualities, amid the industry’s current tight external environment. Those players massaging their leverage data through financial management are, in our view, kicking the can down the road, and can expect to face credit pressure in the long term from hidden debts.

Additionally, the sector’s tight financing environment throws the spotlight on developers with deteriorating liquidity indicators and those that are already under high liquidity pressure. Such players tend to have lower operating efficiency, higher financial leverage and are more likely to see credit risk events.

To gauge improvements in operating efficiency, we looked at developers’ inventory turnover from a cash flow perspective (cash inflow from provision of products or services after being adjusted by gross margin/average inventory for that year) and compared our findings to 2019 and 2020. If the
inventory turnover ratio was higher in 2020 than in 2019, we would consider that operating efficiency had improved, and vice versa.

In our analysis of developers’ non-controlling interests and off-balance sheet items, we look at the growth of non-controlling interests, long-term investments and other receivables for that year. If growth of these items exceeded that of total assets for the current year, we would hold the view that expansion of non-controlling interests and off-balance sheet items was excessive when compared to the company's overall development level, and that the company had shown clear signs of using financial management measures to reduce leverage.

‘Three Red Lines’ See Limited Improvements¹

We find little cause for optimism when looking at overall leverage in the real estate industry from the perspective of the “three red lines.” For 62 players in our sample of 100, net gearing has decreased. Asset-liability ratios (after deducting advances) decreased for 53 players, and cash/short-term debt ratios increased for only 49 developers. In our opinion, developers’ net gearing data can be manipulated by increased sales proceeds, selling project equity and making changes to non-controlling interests, etc, while a developer’s asset-liability ratio (after deducting advances) is highly dependent on its sales ability and market situation. Meanwhile, cash/short-term debt reflects the capital structure of the enterprise and can be affected by many factors, making it difficult to adjust directly.

Chart 1

The above findings are also confirmed by stepping back and looking at changes across the wider industry. By the end of 2020, our sample saw a clear YoY decrease in average net gearing, falling from 103.6% to 95.8%. However, the asset-liability ratio (after deducting advances) fell by only 0.8 percentage points YoY to 69.5%. There was even a drop in the average cash/short-term debt ratio, falling from 2.51 times in 2019 to 1.83 times, suggesting an increase in liquidity pressure across

¹The “Three Red Lines” Leverage Indicators are calculated as follows:
Net Gearing = (interest-bearing debt – cash and cash equivalents) / total equity*100%
Cash/Short-term Debt Ratio = cash and cash equivalents / (short term loans + notes payable + financial liabilities held for trading + current portion of non-current liabilities)
Asset-Liability Ratio (After Deducting Advances) = (total debt – contract liabilities and advances) / (total assets – contract liabilities and advances) *100%
the whole industry. This decrease may be connected to the tightening finance environment for developers in the second half of 2020.

Developers Tend to Tackle Leverage Through Financial Management Rather than Improving Operating Efficiency

In our view, the overall operating efficiency of the 100 enterprises in our sample is limited. In 2020, the median inventory turnover rate of the sample was 0.32, only slightly higher than 0.30 in 2019. However, in the same period, the median value of non-controlling interests, long-term equity investments and other receivables increased by 54.6%, 20.4% and 21.6% YoY respectively.

In contrast, the median value of our sampled developers’ total assets in 2020 increased by only 10.2% YoY. This shows that the expansion in non-controlling interests and off-balance sheet items was significant. We view this as a clear indication of companies using financial management to massage their leverage levels.

65 players in the sample display clear signs of this, with only 47 developers having improved their operating efficiency. The former group of 65 includes state-owned and private developers, as well as all kinds of large, medium and small-sized players. This suggests that reducing on-balance sheet leverage through financial management has become common practice in the industry.

Operating Efficiency the Way Forward for Effectively Reducing Financial Risk

From our perspective, although more is needed to be done to improve operating efficiency in the industry, it is the most effective pathway to reducing developers’ financial leverage in the long run. Looking at our sample in 2020, financial leverage declined thanks to a mixture of financial management measures and improved operating efficiency, with the latter playing a more significant role. 81 of the 100 developers improved on at least one of the red-line indicators. A closer look at these developers shows that the proportion of enterprises that improved their operating efficiency increases with the number of red-line improvements made, as shown in the chart below. Among the 18 enterprises that improved on just one of the red-line indicators, only 4
had improved their operating efficiency, accounting for 22% of such developers. However, among the 20 enterprises that improved on all three indicators, 75% of those had improved their operating efficiency.

Chart 3

Three Red Lines More Sensitive to Operating Efficiency

<table>
<thead>
<tr>
<th>One Ratio Improved</th>
<th>Two Ratios Improved</th>
<th>Three Ratios Improved</th>
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<tbody>
<tr>
<td>Operating Efficiency Improved</td>
<td>Operating Efficiency Worsened</td>
<td>Significant Financial Management</td>
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Note: Numbers in the bar represent numbers of companies in that category.
Source: S&P Global (China) Ratings, Wind.
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We regard developers that reduce financial leverage through enhancing operating efficiency as having better development potential and would expect them to gradually improve their credit qualities amid the tight external environment. Those players that largely resort to financial means to reduce leverage are set to continue facing credit pressure in the long run from hidden debts.

In our sample, developers which have clearly improved operating efficiency have stronger safety nets, with ample financing space and reasonable debt structures. Under the tight financing environment, we expect these players to maintain more stable operations and have more room for future development.

Taking Greentown China Holdings Limited as an example, the company has improved its operating efficiency mainly by promoting sales and increasing the scale of its sales proceeds. In 2020, the company’s operating cash inflow was 101.8 billion RMB, a significant increase of 31.9% compared with 2019. Although the company’s inventory also increased significantly in the same period, its inventory turnover ratio from a cash flow perspective still saw a slight improvement. In addition, the company has good control over other accounts receivable and the scale of its long-term investments, which are not excessive when looked at alongside its overall asset growth.
Liquidity Pressure May Emerge as a Major Risk Trigger

In our view, the overall decrease in the average cash/short-term debt ratio suggests increasing overall liquidity pressure in the industry. Should the financing environment remain tight for developers, liquidity risk may become a major trigger for credit events in the sector.

For those developers faced with high liquidity pressure, we would expect them to also come under operational and refinancing pressure. 16 of the developers in our sample saw their cash/short-term debt ratios decrease to less than 1.0 times at the end of 2020 when compared with 2019, suggesting a gradual increase in liquidity pressure, with liquidity risk at a high level.

These developers also had low inventory turnover and high net gearings, as shown below. In our view, their liquidity pressure stems from their low operating efficiency and limited access to refinancing. Their issuer credit quality is vulnerable in the current financing environment.

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