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S&P Global

China Ratings

In Crisis Lies Opportunity

Credit Outlook for the Real Estate Development Industry in 2022

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Key Takeaways

- An about-turn in real estate policy in 2022, in our view, very unlikely. However, the recent spate of credit events in the sector may lead to a slight ease in policy.
- Efforts to stabilize the sector shouldn't shrink the market. However, after decades of breakneck growth, we expect industry scale to peak and drop off slightly. Residential property sales (by volume) are set to drop around 7% in 2022, sales by floorspace may fall by 5% and prices are set to dip by about 2%. Demand in first-, second- and core third-tier cities should remain strong, but other regions may see a drop in sales volume and price.
- In 2022, we expect investment in the sector to maintain growth between 0% and 5%. Construction costs would be the main pillar of support amid a sharp fall in land acquisition. At the same time, developers' margins may shrink further. In 2022, the median EBITDA margin may fall 2 percentage points to about 16% YoY.
- 2022 may see the emergence of both risks and opportunities for players. Developers with smooth refinancing channels, high-quality inventories and stable operations can cope with industry pressure and, thanks to their resilient models, find growth opportunities.

2021: What's Happened

2021 saw real estate come under wider, more comprehensive supervision. With the gradual implementation of the "three red lines" policy and measures targeting loan concentration, land expenditure and use of pre-sale funds, access to funding in the industry has continued to tighten.

Amid increasing caution towards land acquisition, developers' main focus has been on reducing leverage. From January to September 2021, "other" expenses on developers' balance sheets increased by only 3.5% YoY, with growth falling month on month. Total spending on land was basically unchanged from 2020.

At the same time, falling margins are dragging on developers. Data for more than 90 developers show the median EBITDA margin fell from about 24% in 2017 to about 19% in 2020. Median gross margin dropped from 30% in 2017 to about 23% in the first half of 2021. The sector faces a painful transition period, with developers that once grew at breakneck pace now under significant liquidity pressure, with default a looming possibility.

Key Assumptions

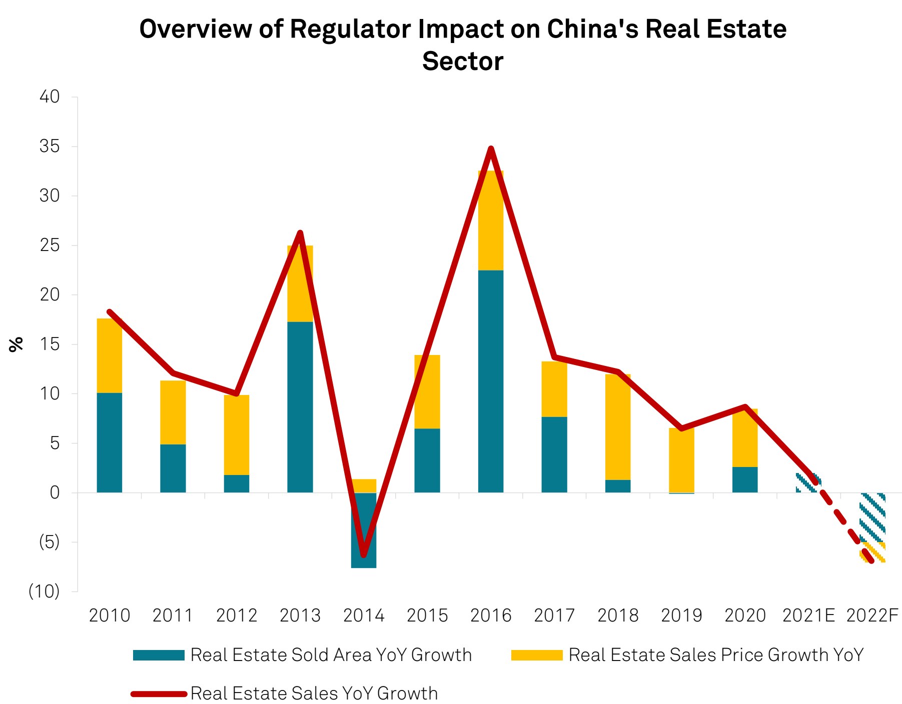
In our view, a volte-face in real estate policy is highly unlikely. However, the recent spate of credit events among developers may see policies ease slightly. The regulator may look to avoid implementing "one size fits all" policies for development loans and mortgage loans while gradually optimizing its stance on use of pre-sale funds.

Amid efforts to stabilize expectations, land prices and property prices, we don't expect a significant contraction in the real estate market nationwide. The sector will remain an important component of China's economic system. However, after decades of rapid development, the industry's scale may peak and drop off slightly.

We expect sales of residential housing to decline by about 7% in 2022. Demand should remain strong in first-, second- and core third-tier cities thanks to their better population and economic situations. Such cities should maintain modest growth in sales (by floorspace), and a significant dip in prices is unlikely.

However, we are pessimistic about demand in lower tier cities. In 2022, both sales volume and property prices could drop in tandem. Looking at the sector as a whole, 2022 may see sales of residential housing (by floorspace) decline by about 5%, with average sales prices falling slightly by around 2%. If current trends continue until the end of the year, annual sales (by floorspace) and sales volume for 2021 will be basically unchanged from 2020.

Chart 1



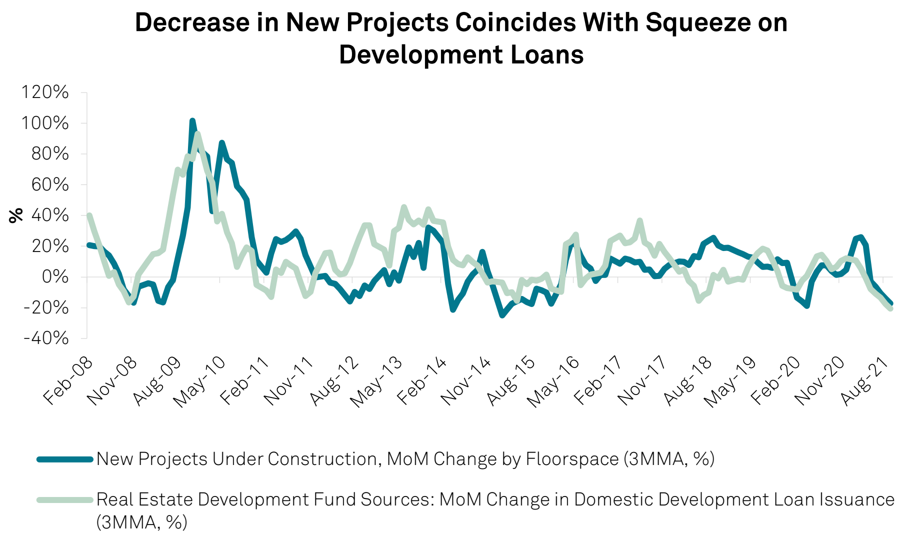
Note: E -- Estimate, F -- Forecast.
Source: National Bureau of Statistics, public information, adjusted by S&P Global (Ratings).

For 2022, investment growth in the industry would largely come from construction and installation expenditure. We expect land acquisition to decline significantly, with total completed investments in real estate maintaining single-digit growth of about 0% to 5%.

We anticipate relatively stable growth (of less than 10%) in spending on construction and installation in 2022. Faced with a funding shortage, developers would need to prioritize expenditure on construction and installation. This is not only to ensure delivery of pre-sale properties, but also to enable access to pre-sale funds as soon as possible.

Work on new construction projects (by floorspace) that got underway in the second half of 2021 has remained muted or even turned negative. We believe one of the main reasons for this downturn is delayed delivery of development loans. For 2022, we expect policy to continue easing slightly, leading to a return to growth for development loans, which will in turn support the recovery of new construction projects.

Chart 2



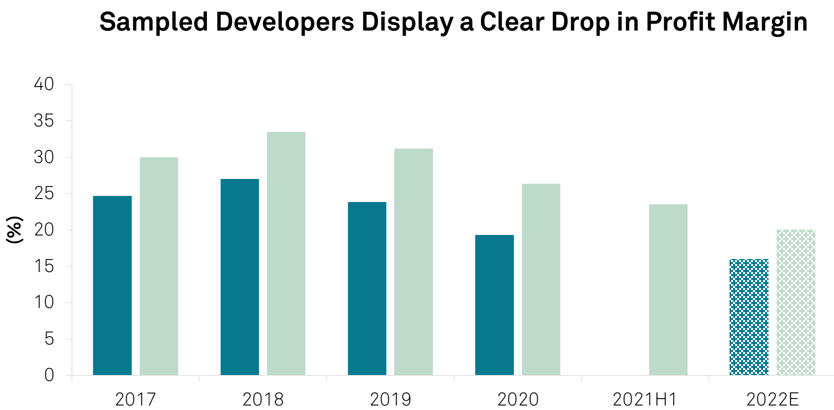
Source: National Bureau of Statistics, Wind, adjusted by S&P Global (China) Ratings.

We expect developers' demand for land to remain sluggish for an extended period, with spending on land to fall by about 10% in 2022. Should funding conditions remain tight, developers would likely push land acquisition towards the bottom of their priority lists, below construction and installation expenditure and interest payment and principal turnover.

Meanwhile, we expect demand for land to change on a regional basis. With resources limited and destocking becoming harder, developers may look to higher-tier cities for land acquisition, given their better population and economic situations. In lower-tier cities, the primary land market should come under even more pressure.

We expect the overall industry's profit margin to further decline in 2022, amid higher land costs and slowing turnover of capital. In 2022, the industry's EBITDA margin may decline to about 16%, with gross margin falling to about 20%.

Chart 3



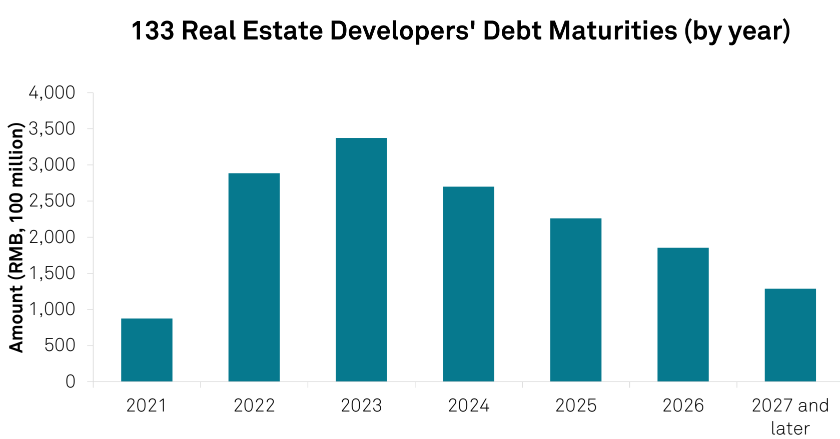
Note: Dark blue bars -- EBITDA margin, green bars -- gross margin. Data are median values from our analysis of 99 developers' EBITDA margin and gross margin. Data unavailable for 2021 H1 EBITDA margins.
Source: Public information, Wind.

Credit Outlook: Both Danger and Opportunity

It is often said that the Chinese word for crisis contains the characters for both danger and opportunity. Based on the above assumptions, we expect 2022 to see the emergence of both in the real estate sector. Potential dangers may lie in further declines in sales and profit margins. This would further hit developers' cash inflows, while ongoing capital tightness would further exacerbate refinancing risks. Under such circumstances, we would still expect some defaults in the sector in 2022, further undermining creditor confidence and squeezing developers' access to refinancing.

At the same time, we note that the period from 2021 year-end to 2022 is a peak period for real estate debt maturities, amid ongoing intense refinancing pressure.

Chart 4



Note: Data include debts maturing for 133 sampled real estate developers, calculated by bonds maturing that year. Existing bonds data as of October 13, 2021. For embedded option bonds, maturity date is based on the option date.
Source: Public information, Wind.

Beyond refinancing risk, industry transparency may weaken further, potentially aggravating market volatility. As developers look to quickly lower their debt ratios, we may see further increases in off-balance sheet liabilities.

That being said, we still expect 2022 to present opportunities to players. Despite the plateauing scale of the industry and declining profit margins, we believe many developers are resilient enough to face down risks and even take advantage of the current environment to grow their business. Such players would likely be:

- Companies with unobstructed refinancing channels, largely regional or central state-owned real estate companies;
- Private developers with good-quality inventories, historically stable development and large refinancing space.

However, certain players may fall by the wayside during the sector’s painful transition period. In our opinion, developers that may see a deterioration in credit quality may have the following characteristics:

- High dependence on high leverage, high turnover business models; liquidity risks may be particularly apparent for players that once saw rapid nationwide sales scale growth in a short period of time;
- Low inventories or land banks mainly distributed in lower-tier cities. As refinancing space contracts, such players would struggle to destock and replenish with high-quality inventory, leading to concerns over their long-term development;
- Insufficient liquidity at the parent level. Amid heightened supervision of pre-sale funds, financial risk at the parent level may increase significantly.

Long term, we expect industry regulation to continue putting players under pressure. However, the industry may start to pick up when:

- The process for dealing with defaulted developers gradually matures, with practices in place to properly handle areas such as delivery of pre-sale properties, creditor's rights and asset disposal, etc. As that process matures, the impact of defaults on the market would be largely controllable;
- The leverage ratio of the whole industry drops to a relatively safe range;
- Financial institutions ease their cautious approach towards the industry, restoring issuance of development loans and mortgage loans to more normal levels.

This report does not constitute a rating action.