Time Needed for Real Estate Recovery, 2023 Sales Potentially Down 5%

January 12, 2023

Key Takeaways

- The gradual post-COVID recovery and ongoing policy support should, in our view, lead to a marginal recovery for the real estate market in 2023. However, depending on how long it may take for the economy and prospective homebuyers’ incomes to recover, residential property sales may decline by about 5% in 2023.

- Policies focusing on guaranteeing delivery of unfinished housing projects should see the decline in real estate construction and installation investment in 2023 narrow compared to 2022. Land acquisition activity is likely to remain level with 2022, without significant improvement.

- The credit landscape of the real estate industry faces structural changes, with the sector set to be dominated by SOEs in the future. Downward pressure on sales may see developers’ leverage ratios and financial risks may continue to rise.

The Long View: No change to regulator stance of "houses are for living in" as sales of new residential houses undergo "L-shaped" growth trend

Real estate remains an important part of China’s economic system. Recent policies issued in 2022 Q4 continued to reflect the central government’s firm adherence to promoting the steady development of the industry and maintaining market stability, with little change in the overall tone of "housing is not for speculation" and "stabilizing land prices, housing prices and expectations" has not changed. The latest policies are, in our view, not intended as stimulus measures, but instead focus on ensuring delivery of unfinished housing projects and giving high-quality developers more time and space to get their houses in order.

We believe that policy still encourages demand for higher-quality housing for residential purposes, with no support for speculative real estate investment. Long-term demand for residential housing depends on regional population growth, economic development and per capita income. Considering China’s current declining population growth trends and the shift in policy focus from rapid growth to high-quality development, we expect an “L-shape” trend in the long run for residential housing sales. The market is unlikely to return to previous highs where it was worth some 17-18 trillion RMB.
2023: More time needed for demand recovery

In our view, 2022 saw a trough in speculative property investment demand as the market bottomed out. Full year sales reflected actual demand for property, either for residential or upgrade purposes. For this reason, we don’t expect any significant further decline in the sales volume of new housing in 2023. As COVID restrictions ease and policies remain supportive of high-quality enterprises, the prospects for the industry should continue to improve in 2023. However, a post-COVID recovery in income levels won’t be achieved overnight, and time is needed for there to be a substantial recovery in industrywide demand. In 2023, any real estate recovery is likely to be fairly weak, with sales remaining sluggish.

We therefore expect some slight downward pressure to remain in place in 2023, with nationwide housing sales potentially falling by about 5%. As the economy gradually recovers from the impact of COVID and industrial and social activity slowly return to normal, recovery on the demand side should drive an uptick in housing sales. However, the timing of the recovery may be dependent on regional economic development, the degree to which incomes are restored and changes in prospective homebuyers’ expectations.

Nationwide, we expect sales to maintain the sluggish trend seen in 2022 Q4 before market demand picks up. Our baseline assumption of COVID’s impact dissipating by April 2023 would see demand gradually recover from July onwards. 2023 sales of new-build properties would basically the same as 2022. If market demand does not recover until November 2023, sales would likely decline by 5%.

Table 1

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Expected Time of Market Recovery</th>
<th>Degree of Recovery</th>
<th>YoY Cumulative Residential Property Sales in 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basecase</td>
<td>July</td>
<td>Recovery based on 2022 sales</td>
<td>0%</td>
</tr>
<tr>
<td>Downside</td>
<td>November</td>
<td>Recovery based on 2022 sales</td>
<td>Down 5%</td>
</tr>
</tbody>
</table>

Chart 1

Some Pressure Expected to Remain on Residential Property Sales in 2023

Note: A- actual, E - estimate, F - forecast.
Source: S&P Global (China) Ratings.
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In 2022, investment in real estate-related construction and installation contracted. While the contraction should continue in 2023, we expect it to be by a narrower margin. The drop in new real estate projects would weigh on construction and installation demand, but the push to deliver uncompleted projects should provide some support for construction.
There has been a significant decline in new projects in the past 12-18 months in terms of floorspace constructed and sold, putting 2023 construction and installation investment under pressure. Intensity of construction has also been impacted on by the industry downturn, again hampering growth in construction and installation investment.

However, in our view, recent financing policies should help resolve existing problems around ongoing projects. The six mega banks and a number of property developers have agreed on credit facilities of about 2 trillion RMB. This should help the industry complete and move on with delayed and ongoing construction projects.

Industry data indicates developers lacked capital in 2022, leading to a high number of delayed or halted housing projects nationwide. Resolving this issue should be a positive for construction and installation investment and help slow the decline over 2023.

Table 2

<table>
<thead>
<tr>
<th>Bank</th>
<th>Developer</th>
<th>Details of Partnership</th>
<th>Amount involved (RMB, billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and Commercial Bank of China</td>
<td>Country Garden</td>
<td>Bank to meet real estate companies’ reasonable financing needs in terms of real estate loans, residential mortgage loans, real estate project M&amp;A financing, rental housing financing, letters of guarantee to replace pre-sale funds in escrow accounts, bond underwriting and investment. Agreement covers planned financing of 655 billion RMB in total.</td>
<td>655</td>
</tr>
<tr>
<td></td>
<td>Gemdale</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Radiance</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Greentown</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Longfor Group</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Midea Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Vanke</td>
<td>and etc. with 12 in total</td>
<td></td>
</tr>
<tr>
<td>China Construction Bank</td>
<td>China Communications Construction</td>
<td>Agreements signed with eight real estate companies cover real estate finance, housing</td>
<td>Undisclosed</td>
</tr>
</tbody>
</table>
Beijing Capital Development leasing, comprehensive financial services, joint risk prevention and mitigation measures.
Yuexiu Group
Dahua
Hopson
Longfor Group
Midea Real Estate
Vanke

Yuexiu Group
Dahua
Hopson
Longfor Group
Midea Real Estate
Vanke

CR Land
Deepen cooperation on real estate loans, residential mortgage loans, M&A loans, bond underwriting and investment. Cooperation to focus on key areas such as residential housing, affordable housing and urban renovation.
Undisclosed

CR Land
Gemdale
Longfor Group
Vanke
China Overseas

Country Garden
Binjiang Real Estate
Gemdale
Greentown
CR Land
Longfor Group
Midea Real Estate
Vanke
China Overseas
China Merchants Shekou

Country Garden
Longfor Group
Greentown
Midea Real Estate
Vanke

Postal Savings Bank of China

Bank of China

Midea Real Estate

Bank of Communications

Midea Real Estate
Vanke

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2023 land acquisitions should stay level with 2022 amid the ongoing downturn in property sales, with developers lacking appetite for new land. The gradual recovery in real estate demand should see a slow and steady recovery in the land market, but the extent of that recovery would reflect developers’ available funds and confidence levels.

Current real estate financing policy is focused on resolving problems around unfinished projects and unsold inventory. Financing should improve in the sector, but we don’t expect a sudden deluge of funding activity. Developers would continue to struggle selling off inventory housing in 2023 H1 under our assumptions. Land acquisition spending would therefore also come under pressure, considering the limited access to both internal and external sources of financing.

We gauge the market’s capital situation by looking at the difference between sources of real estate development funds and completed investment amount. This ratio usually gives a good forward-looking indication of market conditions ahead of changes in land acquisition costs. The decline seen in the first 10 months of 2022 indicates land acquisition growth is likely to remain low in 2023.

On the other hand, ongoing credit events in the industry have seen greater risk-off activity among other unaffected developers in a bid to seek stability. This is particularly so given the major changes being seen in the industry’s development patterns, with few developers willing to move against current market trends by investing in or expanding their land banks. We also note that major developers maintain decent-sized land banks, making them less willing to acquire more land during the industry downturn.

Chart 3

**Downward Trend in Real Estate Financing Sources and Uses to Remain Unchanged**

![Graph showing downward trend in real estate financing sources and uses]


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**Structural changes underway in the real estate industry**

We expect developers to see increasing leverage ratios and financial risks in 2023, as operating cash flow declines outstrip any drop in developers’ debt. Tepid demand should see downward pressure on sales continue in 2023, particularly for developers in lower-tier cities. Sales declines may exceed the industry average by a wide margin. This should see developers’ revenue and profit decline, and any reduction in debt from slowing investment activity and passive debt reduction would be negligible in the face of a sharp squeeze on profits, as leverage and financial risks show an upward trend. On the other hand, the industry accumulated high levels of debt in its initial boom phase, leading to high leverage among developers. Current cash flow pressure means developers need a longer time to reduce their leverage levels.

We expect an “L-shaped” growth trend as the industry bottoms out. This fundamental change should see the sector become more quality-oriented rather than focused on growth. Under this process, we expect structural changes to the credit characteristics of the industry.
Change No.1: SOEs to become industry leaders

We expect state-owned real estate developers to become the industry’s top players. Their refinancing advantages lend them greater resilience during downturns. While they are not impervious to declining revenue growth and growing leverage, their financing strengths and external support both help stabilize overall credit quality.

Furthermore, given SOE’s stable access to refinancing, we expect them to become the main force behind land acquisition in 2022. This would further reinforce their land banks and housing projects at hand, increasing their development potential.

At the same time, many private developers have withdrawn from the market following defaults, leading to a decline in market competition. This leaves some space for SOE developers to fill gaps in the market. From 2021 to the end of 2022, private developers that defaulted had previously had annual sales worth approximately 5 trillion RMB.

Chart 4

Change No. 2: Greater differentiation of market demand between different tiers of city, with greater pressure on low-tier regions

Given the policy focus on encouraging high-quality property for residential purposes, core driving factors behind future real estate market demand would be determined by regional economic development, per capita income and population growth trends. Under these conditions, demand between different tiered cities should see greater differentiation. We are more confident about demand in first-, second- and third-tier cities in core urban clusters. However, developers in lower-tier cities face greater pressure to sell off inventories, amid dual pressure from falling sales demand and falling prices. We found that over 2022, the differentiation in demand between different tiers of cities became more pronounced for cities that were impacted by COVID. For 10 tier-1 and tier-2 cities impacted by COVID, inventory turnover days only saw a slight increase. However, lower-tier cities saw a significant jump in inventory turnover days, increasing from an already high level.
Change No. 3: Wider differentiation in private developers’ credit quality amid sporadic credit events

Looking forward, we expect private developers to see greater differentiation in their business fundamentals and refinancing capacity. Gaps between private developers in terms of asset quality and ability to sell off inventory should widen. This differentiation is caused by the varying levels of demand across different tiers of cities. Many private developers in low-tier cities face greater pressure to sell off inventory, impacting on their long-term business performance.

From the perspective of refinancing, we believe there is a limit on the scope of recent policies. However, implementation of these policies would be delivered in a market-oriented, open and transparent way, focusing on supporting developers with sound governance structures that are well-qualified, focused on their main business and, despite occasional liquidity pressure, have overall healthy finances. Those private developers that struggle to obtain sufficient refinancing support may come under greater default pressure.

In our view, the following types of developer should be able to gain better recognition from investors in the future:

- Well-established developers with a good track record of maintaining a stable, cautious development strategy. Current cash in hand is sufficient to cover future maturities.
- Developers with good debt structures that have low short-term bond maturity pressure, with most obligations longer in term.
- Developers with low dependence on open-market financing. Such companies mainly source financing through bank loans, with better liquidity buffer in place.

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