Asia Credit Research

OCBC Bank

China Property: Sector Update

Tuesday, 04 October 2016

The middle way

- The government has oscillated between tightening and stimulatory measures in managing the residential real estate market since the private housing market began taking off in the early-2000s. Over the past two weeks, at least 10 cities introduced new cooling measures (Beijing, Tianjin and a range of 2 cities). These measures share broad similarities (i) increase minimum down payment (ii) restrict purchases by non-locals (iii) restrict purchases in "hot" districts within cities (iv) target land supply-demand and (v) attempts to reign in errant actions by property developers and brokerages. Given the divergence of property markets within China, the exact details remains differentiated. In the immediate/near term, the recent spate of policy actions is likely to push money flow into a wider range of cities given the lack of alternative investment channels. Our Greater China Research colleagues view such coordinated measures as a sign that the top leadership may have reached a consensus that concerns about overheating in the property sector have overshadowed concerns about the economic slowdown.[1] We think that these signs point towards a slowing of the property sector come 2017.

- 64 of 70 cities experienced stronger month-on-month price growth in August 2016. However, absorption rates (tracks volume of properties sold against existing stock) in 11 important cities have fallen, a signal that transaction volumes have slowed in these cities. Household debt has accelerated in recent months but is still manageable in our view, and we expect housing mortgage defaults to grow, but starting from a low base.

- Some destocking has happened and we do not see signs of over-building in this property cycle. We think inventories have leveled off after rising in 2H2012 through to 2013.

- Sector-wide sentiment among property developers remain muted despite headline grabbing land acquisitions and eye-popping home prices. Debt levels across property developers with at least one international rating have risen in the last 3 years, with those highly geared vulnerable to pull-back in the housing market.

- Property developers under our coverage are embarking on strategies to generate recurring income eg: management contracts (CENCHI) and, expansion into income generating properties (VANKE and FSG). We see this as a defensive strategy by developers against a residential housing market that is entering into a stabilized growth environment (at least until such time that structural reforms change the ball game).

- **Recommendation:** Among the companies we cover, we see YLLG to be most impacted by the property measures, we think the bond's price has run its course and will not be looking to add at these levels. We continue to like the CENCHI 6.5 '17s given its manageable short term debt. VANKE continues to be subjected to idiosyncratic risks, with the quest of control capping bond upside. For FSG, sales at Chengdu are likely to slow down and we expect cities in the Guangdong Province (including Dongguan) to be targeted next. Though at a YTW of 660 bps, the bond (albeit illiquid) is attractive given less than 2 years to maturity. We opine that FSG is unlikely to call the bond in June 2017. We hold all four issuers at Neutral.

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[1] *OCBC Greater China Research "Greater China Week in Reivew" - 3rd October, 2016*

Issuer	Issue	Maturity	Outstanding Amount (SGDm)	Ask Price	Ask YTW	I-Spread	Rating
VANKE	VANKE 3.275 '17	06/11/2017	140	100.85	2.49	122	BBB+/Baa1/BBB+ (Issuer)
YLLG	YLLGSP 6.2 '17	08/05/2017	400	102.80	1.41	30	BB-/Ba3/NR (Issuer)
CENCHI	CENCHI 6.5 '17	26/05/2017	200	101.70	3.81	268	B+/Ba3/NR (Issuer)
FSG	FSGSP 4.0 '18	04/06/2018	50	96.00	6.58	521	NR/NR/NR

Note: Indicative prices as at 3rd October 2016
VANKE: China Vanke Co Ltd *YLLG: Yanlord Land Group Ltd*
CENCHI: Central China Real Estate Ltd *FSG: First Sponsor Group Ltd*

A) China Residential Property Update

64 cities out of 70 key cities monitored by the National Bureau of Statistics ("NBS") have reported month-on-month (m/m) price increase in August 2016. OCBC Credit Research also tracks pricing data of 100 key cities as provided by Fang.com and the pace of price change in such cities since September 2015[2]. As of August 2016, we find that there were only 38 cities where pace of growth remains persistently flat and/or negative since September 2015. In our mid-year credit outlook, there were 46 cities which were in negative/flat territory. We also find that the median price growth has trended upwards. Such signs indicate that the housing price increase has spread to more lower-tier cities beyond the usual investment destinations. OCBC Greater China research views that the housing price increase is largely driven by the lack of investment channels rather than a marked shift in the fundamental outlook of the economy.

Figure 1: Cities with strong price growth

Source: Fang.com, OCBC Credit Research
Red denotes the 17 cities (of 100 cities) where pace of price growth since September 2015 has been the fastest. These include: Hefei, Beijing, Xiamen, Foshan, Huizhou, Shenzhen, Zhongshan, Zhuhai, Langfang, Wuhan, Kunshan, Nanjing, Suzhou, Shanghai, Tianjin, Hangzhou, Wenzhou. Yellow denotes the next 8 cities where pace of growth has picked up. These include Dongguan, Guangzhou, Baoding, Changshu, Wuxi, Nanchang, Jinan and Jiaxing

[2] *The People's Bank of China ("PBOC") and the China Banking Regulatory Commission cut the minimum down payment level from 30% to 25% for first-time buyers in many cities. Down payment on second properties was lowered to 30% in February 2016 (after being reduced to 40% from 60% in March 2015). Both these measures apply to most cities in China except a handful of key cities with restrictions in place*

Figure 2: Cities where policies are likely to continue to be supportive

Source: Fang.com, OCBC Credit Research
Green denotes the 38 cities (of 100 cities) where pace of price growth has been flat and/or negative since September 2016

B) Local Policy Responses Target Land Kings and Non-local Buyers

In September 2016, cities which have seen heightened risk from soaring land prices have introduced tailored policies targeting "land kings"[3]. While price caps on land have been introduced earlier (eg: Suzhou and Nanjing in May 2016), authorities have come up with more demand-based approaches to reduce land premiums. These include measures that increases the opportunity cost of entering into a land bid, reduce attractiveness of underlying housing projects and negatively impact cash cycle of developers. This marks an expansion of the set of policy tools used by city-level authorities, in addition to housing demand-based approaches where rules were set on down payment rates and number of houses per households.

Certain higher-tiered cities have also attracted spill over demand from non-local resident buyers (eg: Hangzhou, Nanjing, Suzhou). According to a Caixin media report, Hangzhou saw non-local buyers making up 39.3% of total property purchases a week after the G20 meetings. Of this pool of buyers, a quarter bought two and/or more houses. In September 2016, the local city government also introduced policies to restrict buying from non-locals[4] in particular districts of the cities. Earlier in March 2016, both Shanghai and Shenzhen increased the requirements in which non-local buyers need to meet in an attempt to reduce housing prices. Hangzhou and Nanjing followed with similar moves in September 2016.

C) Soaring Land Prices But Not in Volume

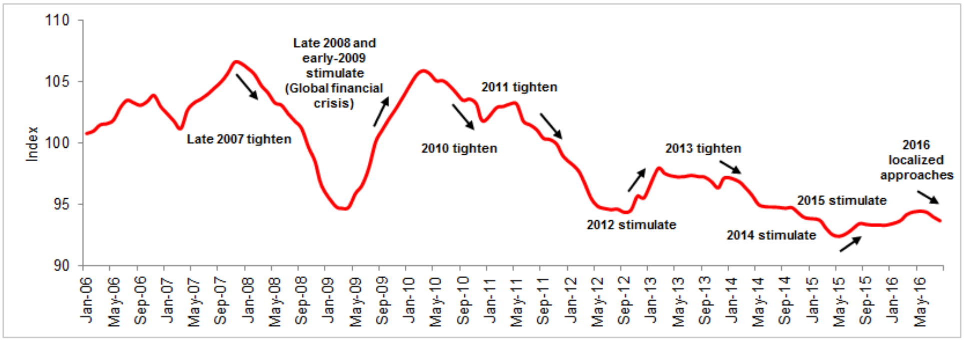
Land prices have increased markedly though land transactions were lower. According to NBS data, by area, 12.9 million sqm of land was purchased YTD August 2016, 8.5% lower than YTD August 2015. On average, each month saw buyers buying about 1.6 million sqm of land in 2016. In contrast, the monthly average in 2015 was 1.9 million sqm while the monthly average for 2014 was 2.8 million[5]. To keep margins constant, property developers would need to sell houses at ever-higher prices on the new land acquired. Given new policies are likely to rein in prices of fast-growing cities, signs point towards sector-wide gross margin compression. The soaring land prices are in large part driven by the involvement of state-backed companies (including those whose core businesses are not within real estate).

[3] Nickname for buyers (including both state-backed, privately-owned property developers and non-property developer buyers) who pay hefty premiums on land
[4] For the purpose of this sector update, non-locals refer to buyers who reside primarily outside a particular city
[5] Information derived by OCBC Credit Research from data provided by the NBS, January numbers are not provided by NBS

D) Muted Sentiment Among Property Developers

China's property development sector is highly fragmented, with VANKE being the largest listed company (market cap: ~SGD57bn) only commanding ~2.5% of market share by residential area sold. Despite headlines of record-setting land prices and euphoria over housing prices in key cities, the China Real Estate Climate Index ("CREC")[6] as produced by the National Bureau of Statistics has shown a downtick in August to 93.7, after climbing since end-2015. We think this signals that property developers are in a cautious mode (index includes those operating outside of hot markets and smaller developers squeezed out by larger companies for land and capital).

Figure 3: China Real Estate Climate Index



Source: National Bureau of Statistics (and complied by Bloomberg), Reserve Bank of Australia

Growth in total real estate investment (including land acquisition, construction, and equipment) has improved to 5.4% y/y for YTD August 2016 (YTD August 2015 y/y growth of 3.5%). Such growth rate is still significantly lower than the 2012-2014 cycle, following government stimulus measures in 2Q2012.

E) Some Destocking Happening

There is no official data with regards to vacancy rates in China. We use floor space of residential buildings available for sale[7] as a proxy for inventory levels. As at 30 August 2016, this number was reported at 425.4 million sqm, declining for the 6th consecutive month since March 2016 and representing a 0.7% decline from 30 August 2015. Despite the small decrease, destocking of inventory is finally happening after ballooning in 2H2012 through to 2013. As inferred by the still negative and/or flat price trend across 38 cities in China[8], such destocking is not happening in congruence. Until structural issues (eg: emergence of new growth impetuses, flat-declining population growth arrested) are addressed, inventory that remains unsold in such locales are likely to remain so.

Accumulated area where construction has newly begun (proxy for housing start) was 736 million sqm in YTD August 2016, 12% higher than YTD August 2015. However, we do not see significant risk in new supply indigestion given housing starts is somewhat lower than monthly area sold (proxy for quantity demanded). In China, 75-80% of property is sold on a forward basis (ie: before completion of property).

Based on average of all tier 1 and selected tier 2 cities[9], it took 10.1 months for inventory to be absorbed in August 2016, longer than that exhibited in July 2016 (8.7 months). Of the 13 cities, Shenzhen and Suzhou were the only two cities where month-on-month absorption was faster. This signals that transaction volumes have slowed in the rest of the cities. Average tier 1 data is skewed towards Shenzhen which saw much quicker absorption of 5.7 months (July 2016: 17.5 months). The other tier 1 cities all saw absorption slowing.

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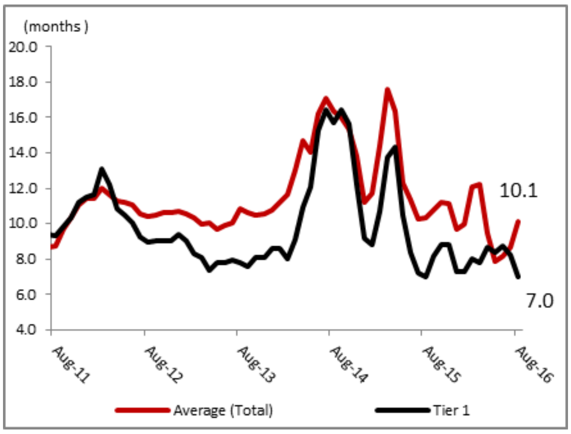
[6] *Index prepared by the NBS, adjusted for seasonality. Takes into account selected indicators such as real estate investment value, capital, area and sales. Index range of 95 to 105 indicates moderate outlook*
[7] *NBS data*
[8] *Cities outside of tier 1 and tier 2 account for ~40% of floor space sold in 2013 based on FangGuanJu data and quoted by an IMF Working Paper*
[9] *Tier 1: Beijing, Shanghai, Shenzhen, Guangzhou. Tier 2: Fuzhou, Suzhou, Dalian, Hangzhou, Nanchang, Nanjing, Qingdao, Xiamen, Changchun. Absorption data from the China Real Estate Information Corporation as compiled by Bloomberg*

Figure 4: Housing Absorption Rates (in months)

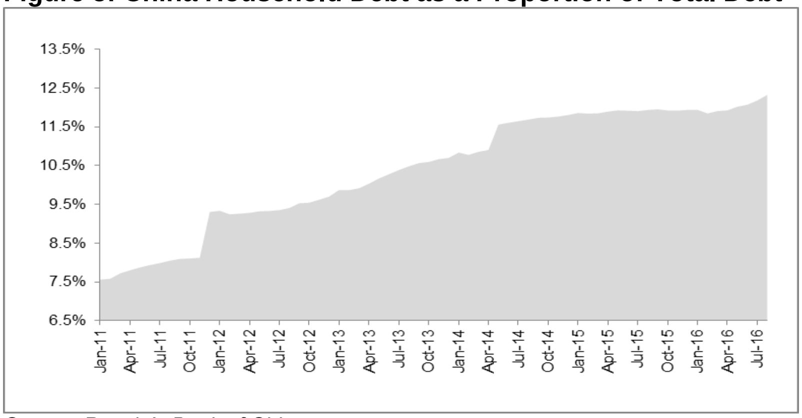


F) Household Mortgages Increasing but Still Manageable

Based on the latest available China population census for year 2010 (released in 2013), home ownership in China is some 85% (~25% higher than the USA). JLL, a property consultancy, opines that if only urban households are factored, the percentage is lower at ~75%. We think the following indicates that housing prices was spurred by households who already own at least one house, given: (i) already significant levels of home ownership in China (ii) reduction in minimum down payment for second homes from 60% to 30% (iii) policies targeted at reducing demand from non-local buyers (iv) housing is still perceived as an investment and store of value.

Formally, China has an effective down payment-to-mortgage ratio (25% minimum for first time home buyers and 30% for second-home purchases)[10]. Down payments have traditionally been funded via savings, inter-generational wealth transfers or loans from family/friends which provides a buffer to systematic shocks should there be a sharp fall in house price values. Using data released by the PBOC, we find that Chinese household debt has grown in recent month, a phenomenon we believe helped fuel house prices (y/y price growth in August 2016 of 14%). Household debt as a proportion of GDP is 46% as of August 2016, rising from 38% in August 2015. Household debt as a proportion of total debt was 12.3% in August 2016, rising from 11.9% in August 2015. Commercial banks have also ramped up efforts in growing their residential mortgage businesses, in line with market demand and as a response to existing market conditions in the corporate loan side.

Figure 5: China Household Debt as a Proportion of Total Debt



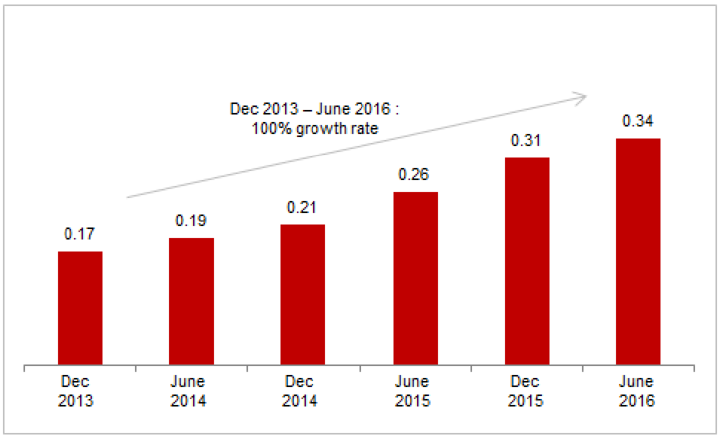
Source: People's Bank of China

Assuming household debt is only contained among urban home-owning households, we come to household debt of around RMB135,000 per household, representing 10-15% of the price of a mass-market house[11]. This increases to 10-20% in a downside scenario where home prices fall by 30%. The low mortgage rate environment in China means that middle-income borrowers have better ability to fund mortgage repayments. Net-net we

[10] *Broad nationwide policy; individual cities given certain leeway in altering minimum down payment levels*
[11] *We use price per unit of RMB1.0-1.5 million; reflective of the mass-market in a tier-2 city*

think household debt is still at manageable levels despite accelerating in recent months. Newer risks are however emerging within the non-bank sector. With the skyrocketing growth of peer-to-peer (P2P) lending[12], some would-be buyers constricted by higher home prices have used loans arranged via P2P market places to fund the down payment portion of their purchase. The PBOC has clamped down on such loans and has increased their regulatory oversight of P2P market places. Certain cities governments are also cracking down on property developers and real estate brokerages who are involved in arranging illegal funding (eg: down payment loans). In practice though, we think there is still sufficient leeway for would-be buyers to continue borrowing from the non-bank sector as "bridge funding" on the down payment portion given that actual use of funds on unsecured personal loans are hard to track. We are likely to see more housing defaults happening but this starts from a low base.

Figure 6: Non-performing loan - Residential Mortgages

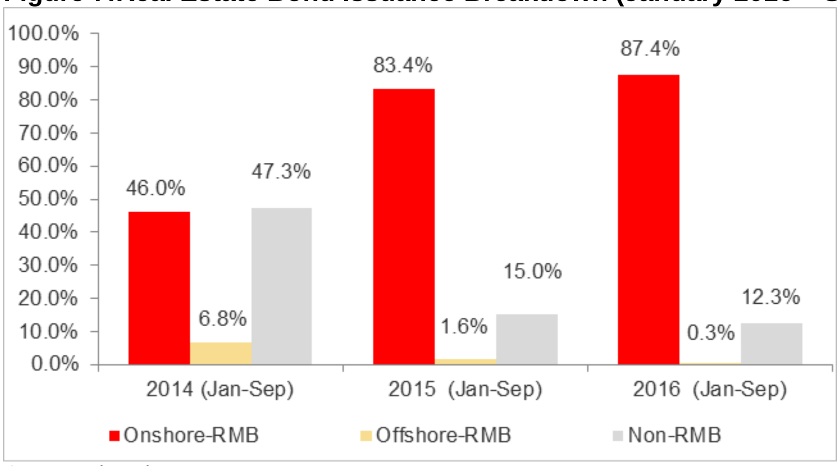


Source: China Construction Bank financials
Note: Non-performing loan for the personal consumer loans segment grew by 70% to hit 1.85% as of June 2016 (Dec 2013: 1.09%)

G) China Property Bond market Commentary

Following the lift in restriction imposed on property developers from issuing onshore bonds in late-2014, new issuances for the sector had shifted to the onshore market during the past 2 years. While the pace of increase has slowed down, absolute amount of onshore issuance remained at a significantly high level. YTD 2016 issuances (by outstanding amount issued) have already eclipsed the previous year's total issuance.

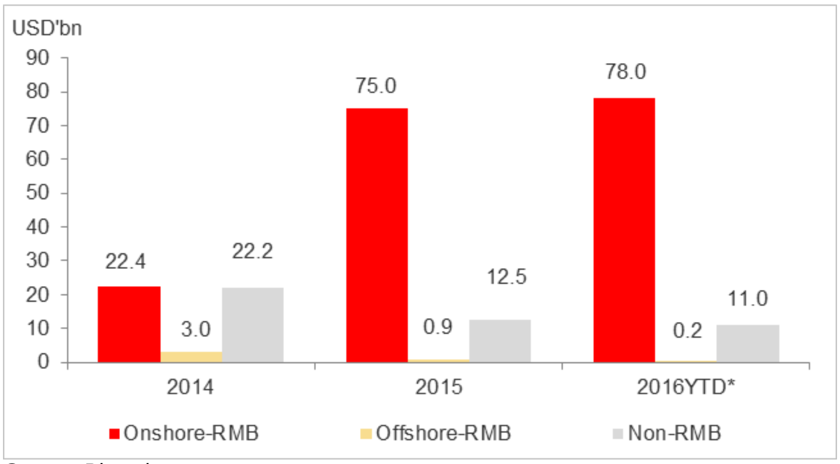
Figure 7:Real Estate Bond Issuance Breakdown (January 2016 – September 2016)



Source: Bloomberg
Note: Data reflects % of the total issuance for the period indicated

[12] *An established P2P marketplace reported that its facilitated loans grew more than 100% y/y as of 2Q2016*

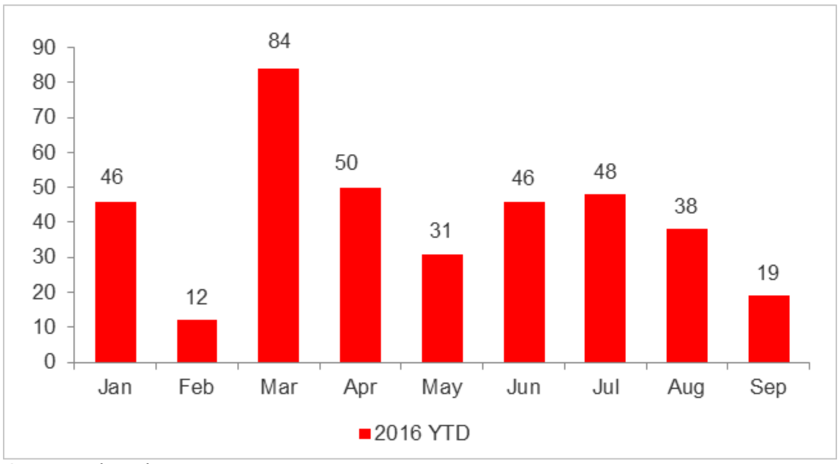
Figure 8:Real Estate Bond Issuance Breakdown (by Amount Outstanding)



Source: Bloomberg
Note: 2016 YTD refers to January 2016 to September 2016

The recent trend is reflective of the overall favourable funding environment in China as a result of the country's monetary policy efforts to stimulate the economy. This allows property developers to enjoy a lower funding cost and better terms (eg: lower coupon payments and longer maturities). Property developers have tapped the opportunity by making early redemptions of their offshore outstanding bonds and subsequently refinanced through onshore bonds. The favorable financing environment has also supported property developers to make aggressive bids on land acquisitions, of which prices was already high on the back of a pick-up in home sales and the lack of land supply in key cities. Simultaneously, we believe soaring land prices have resulted in greater financing needs which ultimately drove up this year's total issuance on the onshore market. The surge in land prices has given rise to higher default risk, if the increase in housing prices abates.

Figure 9: Number of Bond Issuances for 2016 (Real Estate)

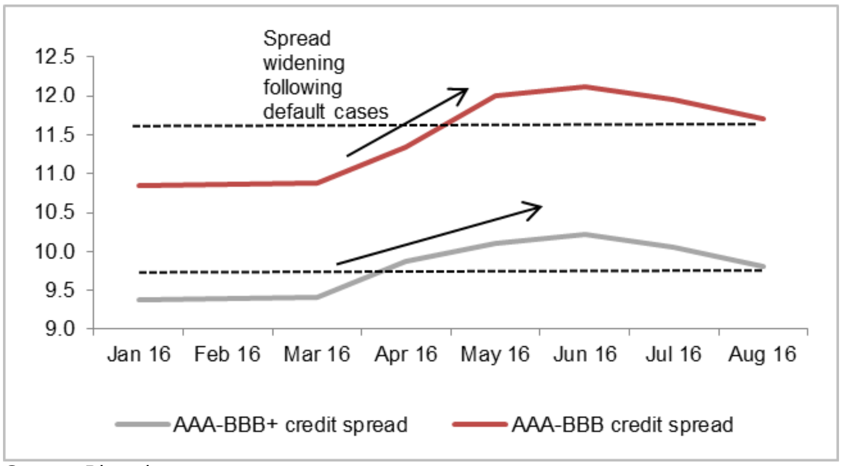


Source: Bloomberg

According to S&P, bond defaults for the first four months of 2016 in the onshore bond market has already outpaced the total number of defaults seen in 2015[13]. Although we have yet to see default cases among property developers in the onshore market, rising onshore bond defaults has been affecting investor sentiments. The total number of onshore bonds issued for the past 3 months has declined sharply, with the number of issuances down 50% as compared to August (August 2016: 38 versus September 2016: 19). Additionally, the credit spread for bond with lower ratings can be seen widening in 2Q2016. Despite the fact that spread has stabilized in 3Q2016, concerns over possible onshore bond defaults would continue to weigh upon the marketability of new onshore bond issues.

[13] *S&P: Growing defaults in China Put Market Stability At Risk (June 2016)*

Figure 10: Credit Spread for 5 Year China Corporate Bond



Source: Bloomberg

S&P, in its September 2016 China Property Watch report shared that the Chinese government has already implemented policies such as restricting developers to use proceeds raised from equities to fund land acquisitions and debt repayment. Given the likelihood that stricter criteria may be imposed on onshore bonds issuances, property developers might find it more difficult to obtain requisite approvals. The offshore market is likely to continue as a vital financing channel for Chinese property developers given the fundraising risks of solely relying on the onshore market.

H) Property Companies Under Our Coverage

	VANKE	YLLG	CENCHI	FSG
Currency/unit	**RMB 'mil**	**RMB 'mil**	**RMB' mil**	**SGD 'mil**
Short term debt	29,292	5,906	2,039	90
Long term debt	62,170	13,579	10,437	299
Cash & cash equivalent	70,907	18,955	9,362	132
Equity	138,174	29,949	7,302	923
Receipts in advanced	278,333	25,471	6,942	168
Excess cash	-207,426	-6,516	2,421	-36
Gross debt-to-equity	66%	65%	171%	42%
Excess cash / Short term debt	nm	nm	1.2	nm
EBITDA/Interest (x)	4.5	2.6	1.1	3.3
Contracted sales July 2016	27,440	NA	1,253	NA
Contracted sales August 2016	20,010	NA	2,422	NA
Credit Commentary	VANKE's shareholders & management team are in a protracted tussle for control. We see the uncertainty as capping the bond's upside potential.	YLLG's operations are likely to be negatively affected by the recent spate of property cooling measures. Given the short maturity of the SGD bond, we see no issues for current holders to hold to maturity, though we will not be adding to holding.	Despite the high gross debt-to-equity ratio, we see refinancing risk at CENCHI to be low given its current cash levels against short term debt liabilities. Company has benefitted from the recent run up of prices and demand in Zhengzhou, but this is likely to slow down going forward.	FSG is in the process of recouping its loans in arrears (from its property financing business). If successful, should improve the company's credit profile. In the interim, we think the YTW of 660 bps for a short term paper compensates for its illiquidity/small issuance.

Source: Company financials as at 30 June 2016, monthly unaudited contracted sales data for July 2016 and August 2016

Note: (1) Other debt included into short term and long term debt figure

(2) Excess cash refers to cash & cash equivalent less receipts in advanced. Receipts in advanced refers to amounts collected refers on properties sold but where properties are typically still under construction and/or yet to be transferred to customer (current liability item on balance sheet)

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