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S&P Global
China Ratings

Property Developers Face the Effects of COVID-19

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Key Takeaways

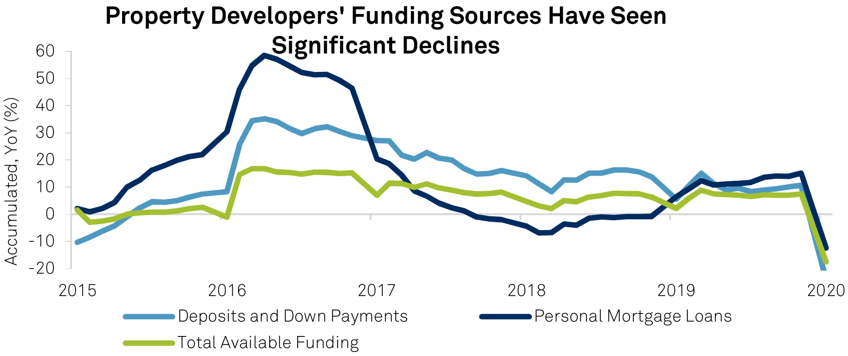
- We believe that the COVID-19 outbreak has had a significant impact on the cash flow of some property developers, increasing their liquidity risk.
- In our view, certain developers with inadequate inventories will need to accelerate land acquisitions once the outbreak comes to an end. This will likely lead to greater financing requirements over the next few months.
- Financing costs in the offshore bond market for property developers are rising due to COVID-19, and financing conditions for developers in the onshore market remain tight. Certain developers which struggle to bear higher financing costs may find it more challenging to get financing.

We believe that in the short term, the COVID-19 outbreak may mainly impact the cash flows of the real estate development sector. In the medium term, it may affect developers' sales momentum and financing environment. For certain property developers, short-term pressure on liquidity, inadequate inventories and increasing offshore financing costs are the main risk factors.

Sharp drop in sales proceeds increases certain developers' short-term liquidity risk

We believe that the COVID-19 outbreak has put unprecedented pressure on cash flows among property developers. Since emerging earlier this year, the COVID-19 outbreak has seen domestic property sales effectively grind to a halt. There has been a significant reduction in proceeds from property sales (in the form of deposits, down payments and mortgage loans), all of which are key sources of funding for the sector. In the first two months of the year, developers' sources of capital fell by 17.5% year-over-year, as deposits and down payments fell 23.9% and personal mortgage loans went down by 12.4%. According to the China Index Academy, sales of residential property by floor area across 50 representative cities fell by more than 35% year-over-year in March.

Chart 1

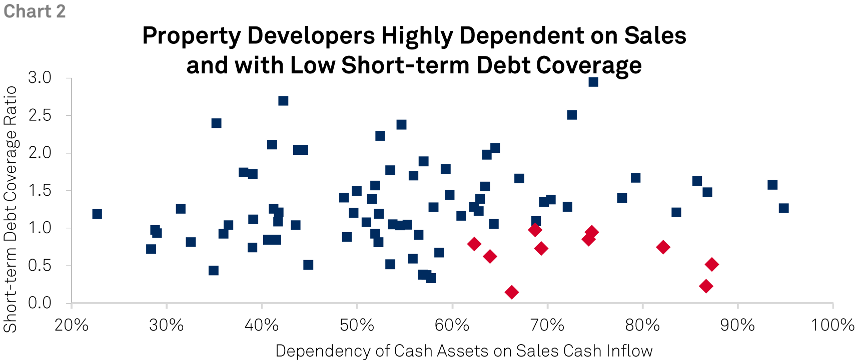


Source: National Bureau of Statistics.

Among the domestic property issuers, we found a relatively large portion have relied on sales proceeds for more than 60% of their overall funding over the past three years. The COVID-19 outbreak has affected these cash inflows for developers, testing their ability to manage their cash flow.

Some of these developers may not have enough cash and cash equivalent to cover short-term debt. Using data from 30 June 2019, we carried out stress tests on the liquidity levels of 99 property developer issuers. Based on the scenario where we assume sales proceeds have fallen 20% year-over-year in the first quarter of 2020, certain developers may not have enough cash to cover their short-term debt. We believe these developers may face high liquidity risk.

Chart 2



Note: Red dots represent developers that rely on sales cash inflow for more than 60% of cash assets, with a short-term debt coverage ratio of less than 1.0. Short-term debt coverage ratio=stressed cash assets/short-term debt based on mid-year 2019.

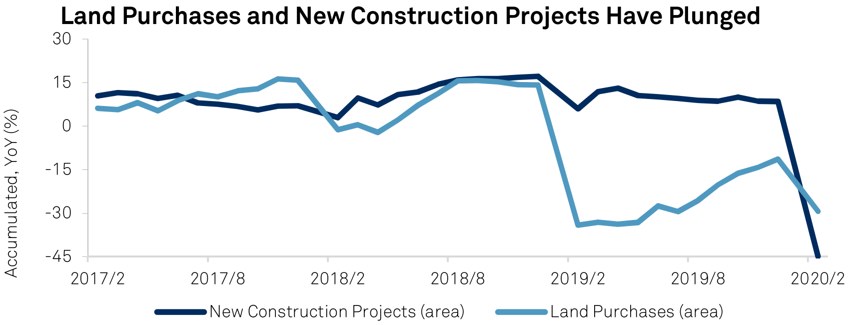
Source: S&P Global (China) Ratings.

COVID-19 impact on new projects and land purchases may affect sales plans for the year ahead

The outbreak has also had a significant impact on property developers' land purchases and resumption of construction work. In the first two months of the year, the floor area of new development projects fell 44.9% year-over-year, and land purchases fell 29.3% year-over-year. We expect that land acquisition and the resumption of development work may have both accelerated in March, but overall there may still be a year-over-year decline for the first quarter.

While we believe the first three months of the year are typically not a peak period for real estate construction and land acquisition, the impact of COVID-19 on both has been significant, and that impact may reverberate for the whole of 2020, slowing down sales and marketing momentum for property developers, and in turn affecting their ability to complete their full year sales targets.

Chart 3

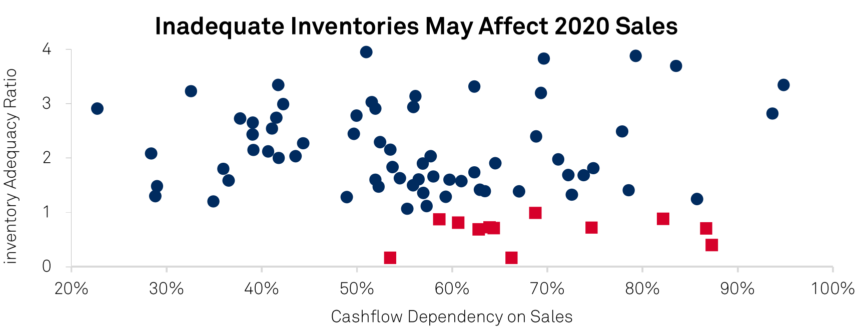


Source: National Bureau of Statistics.

In our view developers with inadequate inventories may face greater financing risk. While struggling to acquire land and resume construction work in the first quarter, such enterprises may face the increasing likelihood of a decline in annual sales. After analyzing data by comparing adjusted inventories to sales proceeds for 30 June 2019, we estimate that some developers with sales proceeds accounting for more than 50% of their funding sources may not have enough inventories to sustain their sales over the next year. In our view such developers may need to accelerate land acquisition once the epidemic comes to an end, which may lead to greater financing needs in the coming months.

We have observed that certain property developers are faced with three different risks at the same time: a high reliance on sales proceeds as a source of funding, high liquidity risk and inadequate inventories. COVID-19 may have already led to a deterioration in the credit quality of such developers. We believe close attention should be paid to how these firms balance their cashflow, financial leverage and sales plan execution.

Chart 4

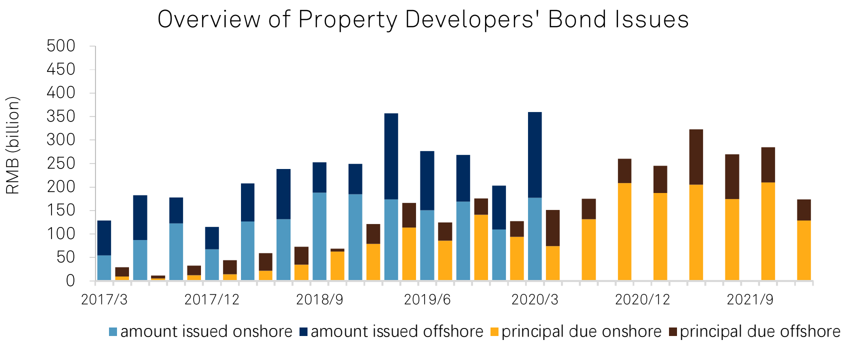


Note: Red dots represent developers with an inventory adequacy ratio of less than 1.0 which rely on sales cash inflow for more than 50% of their cash assets. Inventory adequacy ratio=adjusted unsold inventory/estimated sales per year.
Source: S&P Global (China) Ratings.

Changes in finance landscape will test developers' ability to raise capital and control financing costs

We believe COVID-19 could have a sustained impact on financing for property developers, leading to a potential increase in finance risk and costs. Since 2019, the onshore bond market has seen a continued decline in the bond financing rolling coverage ratio comparing bonds issued in the past four quarters to the principal due from bonds over the next four quarters. At present the ratio is less than 1.0, indicating that under the relatively strict domestic regulatory conditions on financing for the real estate sector, the onshore bond market remains tight for developers.

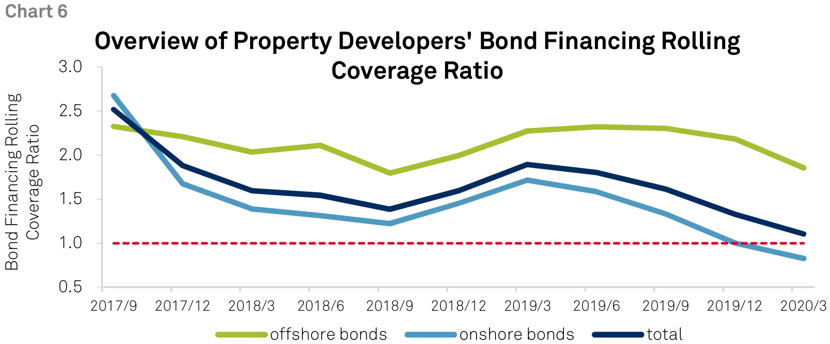
Chart 5



Source: National Bureau of Statistics. Note: Exchange rate between RMB and USD is estimated at 7:1.

The offshore financing landscape has changed dramatically. Prior to the outbreak, 2019 saw good overall conditions for real estate developers issuing bonds offshore, with the bond financing rolling coverage ratio maintaining a level of around 2.0. However, the spread of COVID-19 overseas has led to a liquidity squeeze and a risk-off sentiment among investors, leading to rapid increases in developers' offshore bond yields. We expect this situation may go on for some time, and it may lead to a significant increase in offshore financing costs for domestic developers and limit the extent of their financing.

Chart 6

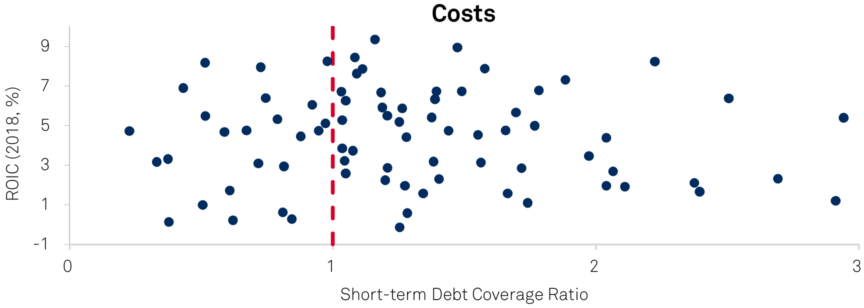


Note: Bond financing rolling coverage ratio=amount issued during past four quarters/principal due in coming four quarters.
Source: S&P Global (China) Ratings.

We believe that expanding financing channels and controlling financing costs to an acceptable level are among the key factors for developers to maintain credit stability. This is particularly true for those developers under higher pressure to repay short-term debt, which urgently need financing. If such firms take on financing costs beyond a bearable threshold, they may also put their future sustainable development at risk.

Chart 7

Some Developers May Need to Better Manage Their Financing Costs



Note: Short-term debt coverage ratio=stressed cash assets/short-term debt based on mid-year 2019.
Source: S&P Global (China) Ratings.

This report does not constitute a rating action.

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