CapitaLand Investment

China's Deleveraging Platform: Opportunities Ripe for Select Picking

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The market presents a defined window to potentially access investment opportunities driven by special situations and market dislocation, brought on by the current predicaments faced by the developers.

Get Comfortable With Volatility

China adopted a new development model in 2020 to pivot towards a consumer-driven economy by focusing on high-quality and balanced growth. This is a departure from the previous investment-led model which has resulted in the debt levels we see today. The Chinese authorities identified the rising debt position as a potential threat to the government's overarching aim to achieve economic stability in the long run, and in recent years tried to reduce the country's reliance on debt; one of the most prominent campaigns being the "three-red lines" policy[1] which was aimed at improving the longer-term stability of the real estate sector; which has since evolved into a credit crunch for developers.

While the ongoing troubles of the Chinese developers' debt issues have not resulted in any meaningful upward spikes in short-term interest rates (i.e., repo rate & SHIBOR) so far, the financial market is still expected to stay volatile as long as the debt issues remain unresolved. However, the People's Bank of China (PBOC) has the essential policy levers to ensure sufficient liquidity to maintain market stability, as necessitated.

1. The "three-red lines" policy (implemented in August 2020): (1) net debt to equity ratio of ≤100%; (2) liability to asset ratio (excluding presales) of ≤ 70%; and (3) cash holdings to short-term debt ratio ≥ 100%.

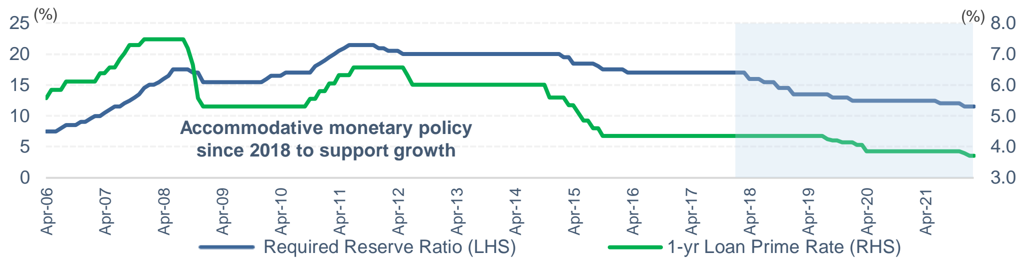
Three Key Trends To Observe

01 Policy easing is underway, but the ride will be bumpy

A careful balance of growth and debt management will remain the top agenda for the central government in the next year or so. As such, we expect the PBOC to adopt a relatively accommodative monetary policy through 2022/23. The mild inflationary environment should allow for more front-loaded monetary easing to shore up growth. Further cuts to the reserve requirement ratio (RRR) and loan prime rates (1yr & 5yr) are anticipated in the near term.

Most recently, Vice Premier Liu He indicated[2] that the regulators would pivot from their tightening policy stance to incrementally ease their sweeping crackdown on the various sectors, including the property market. As such, more policy easing is underway to support the downside and not to stimulate growth. Even so, this may not be sufficient or timely enough to bail out the troubled developers as it will take time for the policy easing to feed through to the physical market.

Banks' Required Reserve Ratio & Prime Lending Rate



Source: Bloomberg, PBOC, CLI Research, March 2022.

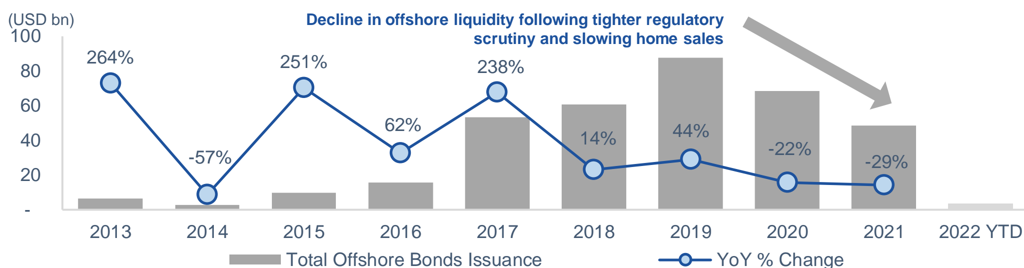
02 Debt capital markets for developers to remain curtailed

The challenging refinancing environment in the offshore bond market is likely to persist due to the elevated yields and subdued investor risk appetite. Hence the offshore bond market should see more bond defaults or extensions to maturities through 2022/23. Most restrictions under the "three-red lines" are likely to stay, despite some ongoing calibrated easing.

This means that highly leveraged developers will continue to be challenged to refinance or obtain further funding, which will push them to seek for alternatives either through asset disposals, private equity or debt.

On the flipside, healthy developers are in a strategic position to increase their market share but will need to explore alternate capital sources to grow and hence should become more receptive towards partnering with capital providers.

Total Offshore Bond Sales by Developers



Note: As of 15 March 2022, based on data from Bloomberg.
Source: Bloomberg, NBS, CLI Research, March 2022.

2. In a specially convened meeting of the central government's Financial Stability and Development Committee on 16 March 2022.

03 Persistent residential sales slump to further exacerbate the cash crunch nationwide

The residential sales market slowdown points to several potential headwinds in the next 12-18 months that can further strain the going concern of developers, and they include: modest sales rate; limited price increase as further policy easing is not aimed at stimulating growth; and margin squeeze due to elevated land price. There are also increasing concerns on local government financing vehicles[3] (LGFVs) taking on more debt to fund operations and land parcel acquisitions, in part due to the subdued land sales activity[4].

This has led to a handful of provincial authorities taking steps to limit new borrowings and push local governments to address excess indebtedness through cost-cutting and asset sales. Moreover, banks are still very likely to stay prudent and highly selective when financing projects to mitigate the credit risk of their loan portfolios.

Market Opportunity Set

Varied Options Across the Capital Stack

	Key Considerations	Risk Level
Asset-Backed Project Financing	• Relationships to gain access • Active asset management capabilities	Low
Development Joint Venture	• Requires hands-on approach and deep local market knowledge • Relations to gain access	
Preferred Equity & Mezzanine Financing	• One of the riskier forms of investments – ranks below senior debt • Lower risk profile in preferred equity and secured debt	
Non-Performing Loans ("NPLs")	• High barriers to entry with specialist knowledge needed • Relationships with asset management companies ("AMCs")*	
Investment Grade & High Yield Bonds	• RMB fluctuations • Pricing volatility of publicly listed bonds	High

* The five major AMCs are China Huarong AMC, China Great Wall AMC, China Orient AMC, China Cinda AMC and China Galaxy AMC.
Source: CBRE, Preqin, Moody's Analytics, CNBC, CLI Research March 2022.

Deep Experience Is Essential In Opportunity Selection

Most developers are still expected to pursue asset sales and seek alternate capital sources due to narrower funding channels. Besides, existing resources are largely prioritized to complete pre-sold homes and to pare down debt, rather than invest in new projects.

This should present a window of increased access to varied opportunities for institutional investors across the capital stack, including asset-backed project financing and preferred equity & mezzanine financing, and/or to collaborate with the more reputable developers.

We hold the view that the credit stress should remain acute for the next 12 to 24 months.

ABOUT CAPITALAND INVESTMENT

Headquartered and listed in Singapore, CapitaLand Investment Limited (CLI) is a leading global real estate investment manager with a strong Asia foothold. As at 31 March 2022, CLI had about US$90.1 bn (S$124 bn) of real estate assets under management, and about US$63.5 m (S$86 bn) of real estate funds under management held via six listed real estate investment trusts and business trusts, and 29 private funds across Asia-Pacific, Europe and USA. Its diversified real estate asset classes cover integrated developments, retail, office, lodging, business parks, industrial, logistics and data centres.

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3. LGFV is a local government funding mechanism in China, and usually takes the form of an investment company, fully owned and operated by the local government, which sells bonds (i.e., "municipal investment bonds" or "municipal corporate bonds") and takes on bank loans tofund projects that are fiscal in nature.
4. Real estate is one of the key pillars of the economy and an important source of revenue for local governments in the form ofland sales proceeds and accompanying taxes. Land sales consistently contribute approximately 20-30% of the total annual revenue and account for 40-50% of local revenue (i.e., fiscal revenue and land sales).

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