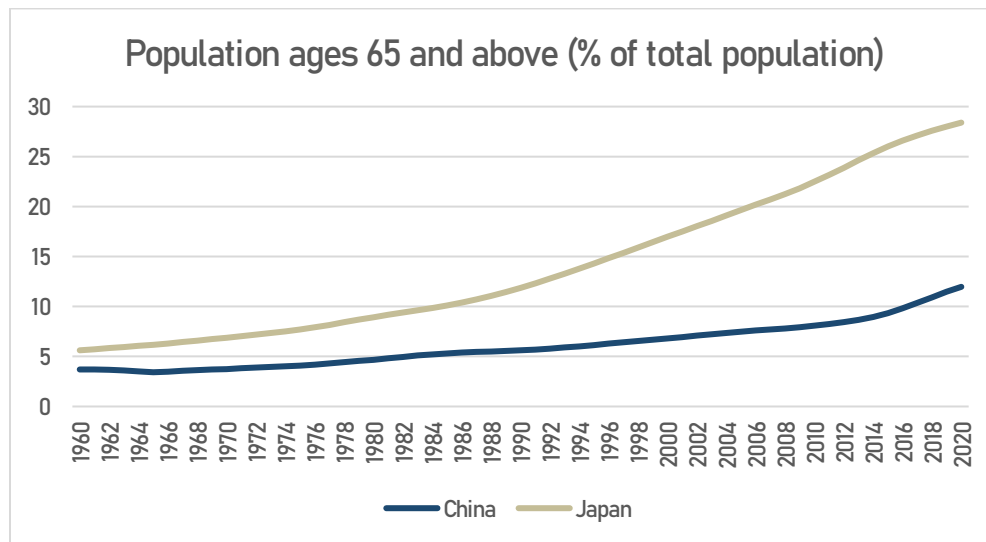


Chinese Property Sector: A boom that comes to an end?

The Chinese property market has been growing at an annual rate of 8% between 1999 and 2021¹. Evergrande Research estimates that real estate, excluding housing construction and some residential consumption accounted for 7% of China's 2019 GDP. While, if you were to include other industries that intersected with real estate, it accounted for 17.2% of 2019 GDP². At the same time, homeownership is as high as 90% in China³. Leverage in the mortgage market is a lot lower than in the UK or the US, with most lenders requiring 30% equity⁴. This makes investing in Chinese real estate sound very attractive and is probably the reason why property prices are often at 17 times the median Chinese annual income, in places like Shenzhen this figure is as high as 30, while in Hong Kong, one of the most expensive property markets in the world, it is 20.9⁵. However, China's demographics has been shifting after the 1-child policy was introduced in 1980 with its population aged 65 and above now reaching 12% - a level Japan has reached in 1990, when their asset bubble had burst.



Source: Worldbank

¹ <https://www.ceicdata.com/en/indicator/china/house-prices-growth>

² <https://www.scmp.com/economy/china-economy/article/3117401/how-will-chinas-gdp-be-hit-beijings-new-caps-real-estate>

³

<https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7546956/#:~:text=Today%20China%20is%20a%20country,et%20al.%2C%202020>

⁴ <https://www.hsbc.com.cn/en-cn/mortgages/products/home/>

⁵ <https://asiatimes.com/2019/09/shenzhen-property-costs-more-than-hk-report/>

Now, the likelihood of Evergrande, one of the largest property developers in China, defaulting on its obligations is probably around 100%, in one way or another. Below, I have consolidated the balance sheets of some of China's largest property developers by only looking at current assets and current liabilities to spot any potential default scenarios. The balance sheets are simplified here, but what strikes out is that all developers seem to show positive equity as well as a positive current ratio (current assets – current liabilities).

Company (all numbers in mio RMB)	Current Assets	Current liabilities	Current Receivables	Current Payables	Cash	Property for sale	Properties under development	Contract liabilities	Short-term debt	Report
Evergrande	1,952,593	1,572,759	175,946	951,133	86,772	144,514	1,278,965	215,790	240,049	2021 Interim
Country Garden	1,766,568	1,469,637	391,410	619,047	167,921	60,762	1,055,306	724,271	86,780	2021 Interim
Vanke	1,632,307	1,380,852	366,091	537,671	186,986	76,445	985,471	694,228	85,567	2021 Interim
Sunac Holdings	910,258	754,961	70,734	248,282	101,099	71,328	560,457	319,733	90,962	2021 Interim
China Overseas Land	661,905	312,079	12,906	79,480	117,427	451,205		126,789	45,227	2021 Interim
China Resources Land	602,684	456,600	72,216	124,240	94,851	384,053		241,400	41,801	2021 Interim
Longfor Properties	576,776	399,508	30,740	113,216	77,006	38,691	336,449	182,389	18,338	2020 Annual
R&F China	302,731	229,279	45,254	99,200	12,764	53,579	167,980	54,998	51,904	2021 Interim
Kaisa	244,571	134,152	45,234	43,373	38,364	16,226	83,474	51,545	25,017	2021 Interim
Poly Property (in HKD mio)	178,431	105,581	11,328	26,107	42,964	18,513	93,813	38,688	28,107	2020 Annual
Fantasia	76,224	50,985	14,177	7,926	24,923	18,940	13,770	17,265	18,180	2020 Annual

Source: Annual reports

A deeper look into the numbers make clear that the positive current ratio is dependent on a questionable entry of “properties under development”. To demonstrate what impact this entry makes, I have separated the entries as per below. If you add properties for sale and property under development, a whopping RMB 5,910mio (US\$913bn) from 11 developers is hitting the market in under 1 year, or roughly 6% of China's GDP, which seems to be in line with Evergrande Research's 7% of GDP estimate. At the same time, those companies that have negative short term liquidity (Receivables + Cash + properties for sale with a 20% haircut – payables – short-term debt obligations), have the highest value of properties under development. What's even more curious is that these specific companies, i.e. Evergrande, Country Garden, Sunac Holdings, R&F China, often collect cash in advance of building the property from its buyers, but this cash, is often not shown as “restricted cash” on their balance sheets, hence they might even have less cash on hand than indicated. I once invested in UK listed infrastructure firm Costain, which have done the exact same thing: Touting their strong balance sheet, but the cash was set to be used for future

liabilities/construction and suddenly they needed to raise cash via equity issuance. I expect many of these Chinese developers to face similar problems... and it wouldn't surprise me that a few of them have their property under development massively overvalued, or probably valued the finished product at current market prices, without adjusting for cash they received in advance from customers and understating contract liabilities.

Company	Receivables + Cash + Property for Sale 20% haircut - Payables - Short-term debt	Under development - Contract liabilities	Non-Current Assets - Non-Current Liabilities
Evergrande	-812,853	1,063,175	31,207
Country Garden	-97,886	331,035	-19,255
Vanke	-9,005	291,243	112,266
Sunac Holdings	-110,349	240,724	53,034
China Overseas Land	366,590	-126,789	-8,579
China Resources Land	308,268	-241,400	119,966
Longfor Properties	7,145	154,060	15,457
R&F China	-50,223	112,982	-107,457
Kaisa	28,189	31,929	-28,969
Poly Property	14,888	55,125	-33,642
Fantasia	28,146	-3,495	-916

Source: Annual reports

When I studied in Japan I was always surprised how the Japanese referred to the Global Financial Crisis (GFC) in 2008 to the "Lehman Shock". Japan has had its own bubble burst in 1989/90 and since then adopted a policy of not letting companies go bankrupt to avoid a domino effect of bankruptcies. The Japanese believe that the 2008 GFC could have been a lot less bad, if Lehman Brothers was saved. The question is whether China will save Evergrande, and many China expert I spoke to, believe they won't save Evergrande. Different to the housing crisis in the US in 2007/08, China only has around \$63bn in MBS⁶, while between 1996 and 2007 the total amount of MBS issued hit \$7.3 trillion in the US⁷. The question is whether the lack of MBS in China will be a benefit for its financial system, as the risks are likely more concentrated, and different to the US in 2007 where MBS were sold to European investors, reducing the risk in the US.

As pointed out in Friday's [UK Daily](#), I believe the most likely scenario will be a default of Evergrande causing the property and construction market in China to slow down, affecting raw materials and anything else in the supply chain, which is also reflected in the market price for iron ore, dropping by 50% over the last six months. The crackdown in China against all other industries is likely related to the slowdown in China's real estate market, in my opinion. I wonder whether it is a way of "saving face" by the Chinese Communist

⁶ <https://www.bloomberg.com/news/articles/2021-05-31/china-limits-issuance-in-63-billion-mortgage-backed-debt-market>

⁷ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396

Party, promoting “Common Prosperity”, as they realise what a slowdown would mean for the average Chinese whose median income has remained well below that of Western countries and with their wealth concentrated in real estate, now facing potential further repercussions. On the other hand, a depressed stock market could enable the Chinese to shift their savings to a new asset, and with the Northbound/Southbound bond connect fully established, China can now bring in foreign investors, while at the same time keep their currency stable, as a strong currency is what brought Japan down after signing the Plaza Accord.

