

The Big Read **Chinese economy**

## China economy: will hot property market threaten post-pandemic rebound?

With Beijing concerned that the sector is overheating, heavily indebted developers like Evergrande face intense scrutiny

Thomas Hale in Hong Kong and Sun Yu in Shanghai 12 HOURS AGO

The shuttle bus from central Shanghai to Venice takes almost two hours. For investors like Wang Guili, that's close enough to seek out a potential bargain.

At Evergrande Venice, named for the city which inspired it and the developer that built it, apartments in high-rise buildings that look out over the Yellow Sea can be found for as little as a fifth of the prices in her Shanghai neighbourhood.

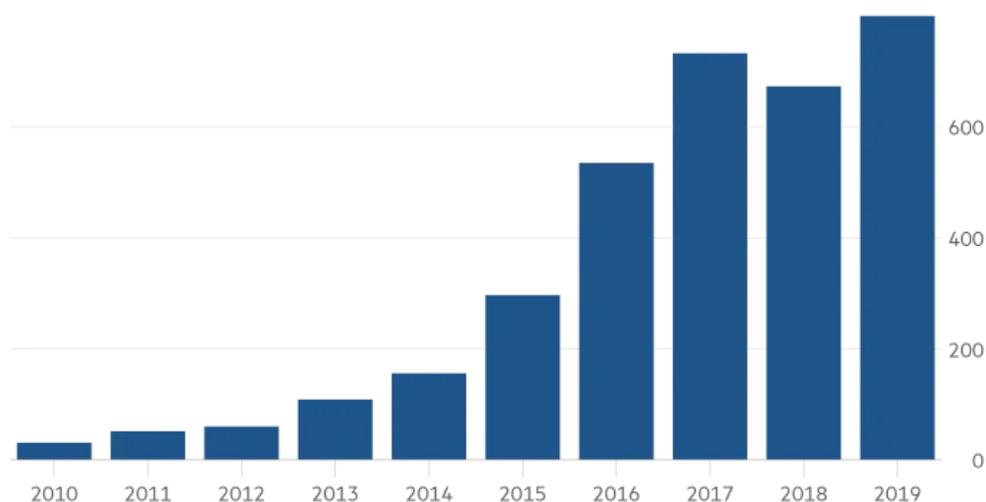
"Very few residential projects allow me to buy a home without taking a mortgage," says Ms Wang, a retired accountant. "Evergrande Venice is one of them."

The coastal project, which has been taking shape for more than decade, embodies the meteoric ambitions of [China's biggest property developer](#) — a company that has acquired the confidence to take on vast debts of over \$120bn — more than double its equity at the end of last year — and, on occasion, challenge nature itself.

The company walled off several square kilometres of the sea and adjusted the sand on its bed, creating a striking shade of blue that adorns the development's marketing materials.

### Evergrande has become the world's most indebted property developer

Total debt (Rmb bn)



Source: Bloomberg  
© FT

The viability of projects such as Evergrande Venice has long attracted the attention of sceptical analysts. But it is the [vast borrowing that funded them](#) that is now also coming under pressure from China's government as it tries to steer the country's rapid recovery from the pandemic.

China's gross domestic product is expected to grow by around 2 per cent this year — a significantly better result than any other major economy, most of which are expected to suffer sharp contractions.

One of the primary reasons for this resilience has been the relentless march of its property market. Construction activity has increased and [house prices in major cities](#) continue to rise.

However, the Chinese authorities, worried that cheap money will flood into an already highly-leveraged sector, are putting pressure on developers to reduce their borrowing. That has meant [intense scrutiny on companies like Evergrande](#).



Tianjin, where large areas of new residential districts are built on vacant land © Zhang Peng/LightRocket/Getty

The sector's approach has relied on taking on [large quantities of debt](#) to accumulate more and more land — sometimes in speculative areas outside of major cities. In Evergrande's case, it has enough land to house the entire population of Portugal and more debt than New Zealand.

Anxious about the potential risks to financial stability, Beijing drafted new rules in the summer that seek to constrain the sector's leverage. Evergrande, which has already set out a plan to lower its debt and attended a government meeting on the rules in August, has seen its shares and bonds subjected to wild swings over recent months after rumours it had sought support from the Guangdong provincial government. On Monday, it cancelled a listing of a subsidiary that had been at the heart of those concerns, at a time when it is seeking to raise cash.

Despite the rebound in the economy in recent months, the new measures raise the question of whether China's developers can be quietly tamed at a time of economic uncertainty and potentially slowing property sales. If one of them [fails to repay their debts](#), that could have unpredictable consequences for the [domestic financial system](#).

## Trading in Evergrande's stock has been volatile this year as concerns mount over its debts

Share price (HKD)

— China Evergrande



Source: Refinitiv  
© FT

In the longer term, the fate of Evergrande Venice and projects like it will be a test of what happens if the country's [long-run process of urbanisation](#) eventually runs out of steam.

“I think urbanisation is still a key support driver in the sector,” says Christopher Yip, a director at S&P Global Ratings in Hong Kong. “The scale of that, it’s quite hard to even just maintain.”

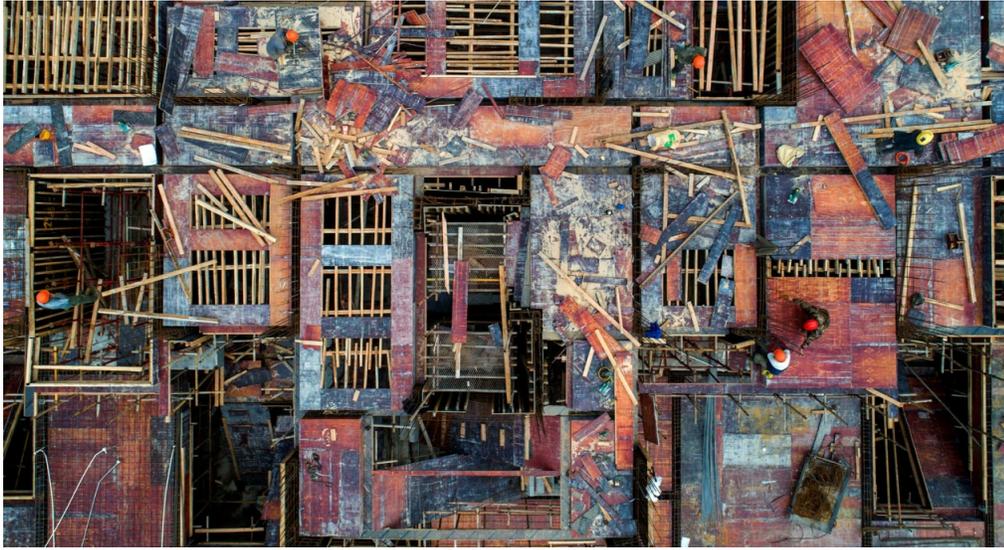
## Developer frenzy

In the late 1990s, while working for an investment bank, Michel Lowy helped to finance an unusual development in Beijing.

The deal involved lending a developer money to buy a power plant on what was then the outskirts of the city, rebuild it 100km away, decontaminate the soil and put in its place an apartment complex.

The momentum behind the sector was so strong that such investments were almost a one-way bet. “That type of transaction back then wasn’t speculative,” says Mr Lowy, who now runs his own company, SC Lowy, a banking and asset management group which specialises in high-yield and distressed debt. The site is now “smack in the middle of the city and everything has been built around [it]”.

A transformation of China’s cities — the urbanisation rate surpassed 60 per cent last year, compared with 50 per cent in 2011 — has enriched the country’s property developers, the businesses that lend them money and the citizens who have bought their apartments.



Real estate construction in Huai'an City, Jiangsu province © Costfoto/Barcroft Media/Getty

In the past decade, their growth has also coincided with an international era of cheap debt. After the global financial crisis, China ramped up investment in infrastructure and construction. Some of the funds came through China's state-owned banks but some came from new sources.

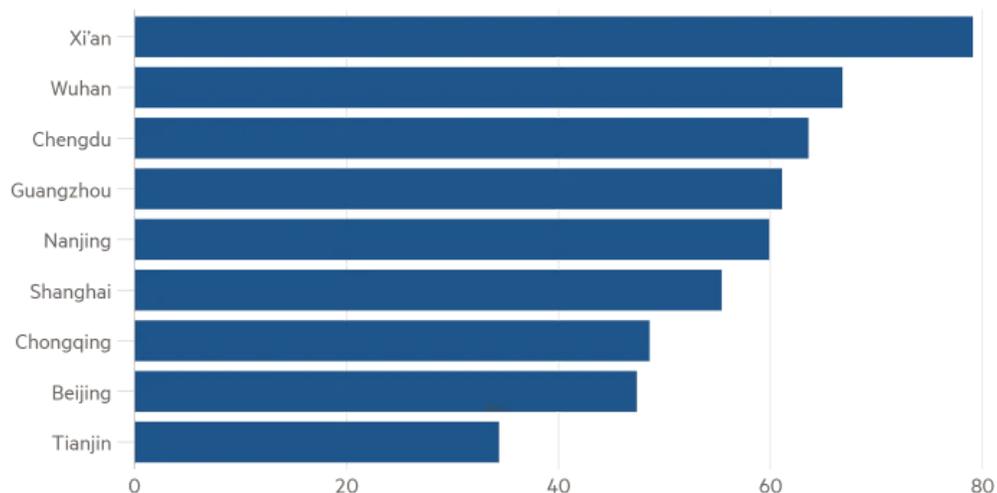
Financiers like Mr Lowy shifted from investment banks to a [bond market supported by western countries' ultra-loose monetary policy](#). Since then, billions of dollars have flowed to Chinese property developers; S&P currently rates \$181bn worth of Chinese developer bonds, meaning the sector makes up the majority of the Asia high-yield bond market.

Evergrande, with total debts of \$123bn, has over twice as much as Brookfield Property Partners, the next most indebted property company globally. In 2010, by contrast, it had just Rmb31bn (\$4.7bn) in debt. The company had \$190bn of properties under development as of the end of June.

The offshore dollar bond market has been just one part of a diverse array of financing options for developers, with even greater sums being borrowed from [banks on the Chinese mainland](#). That money in turn has funded a nonstop rush to buy and develop land owned by local governments.

## House prices have risen sharply in Chinese cities

% change in commercial and residential new builds since 2015 (selected cities)



Source: National Bureau of Statistics China  
© FT

That makes them an important part of the fiscal model in a country that “is far more decentralised in terms of fiscal relations than many, many other countries around the world”, says Weiping Wu, a professor of Urban Planning at Columbia University in New York.

“That rush for land isn’t just pushed by developers,” she says. “Municipalities also have incentives to lease out land. It’s a big source of extra-budgetary revenue.”

In the case of Evergrande Venice, the company paid the local government of Qidong in Jiangsu province Rmb100 per square metre. Its apartments ultimately sell for Rmb9,000 per sq m.



Weiping Wu: ‘Municipalities also have incentives to lease out land. It’s a big source of extra-budgetary revenue.’

For Mr Lowy, opportunities like the Beijing power plant are much less frequent today. “The tendencies in terms of urbanisation aren’t what they were 10 or 20 years ago,” he says. He adds that the sector is deeply intertwined with the Chinese government. “It’s not so much about analytical skills, credit skills, cash flow,” he says. “It’s much more about policies.”

## Borrowing squeeze

Beijing’s so-called “three red lines” response to excessive leverage in the property sector was unveiled at a meeting with top developers in the capital in August. It limits their borrowing depending on their performance on three metrics: debt to cash; net debt to equity; and debt to assets.

The provisional measures came amid wider efforts to [keep house prices in China under control](#), which have included measures from individual cities to curb demand. They seem to be taking effect: in September, official Chinese data showed that prices in major cities were up 4.6 per cent compared with a year earlier, the slowest rise since 2016.

“What they worry is that real estate developers are taking advantage of this round of monetary easing and further [leveraging] up,” says Haibin Zhu, chief China economist at JPMorgan.

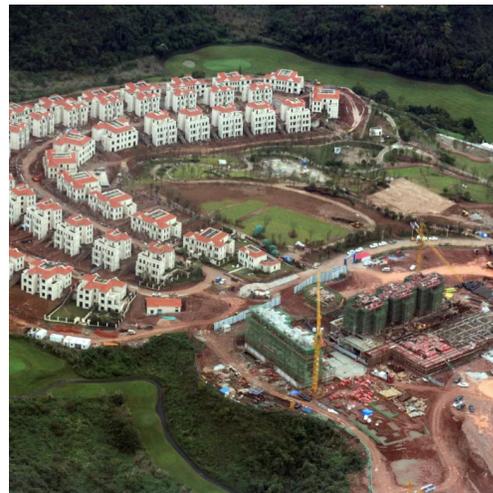
“If one of them [developers] would fail, that will have a big impact on the local employment situation, also the fiscal situation, also the credit chain,” he adds.

A government focus on balance sheets echoes longstanding scrutiny from analysts in the high-yield bond market, where the metrics of companies like Evergrande have few international comparisons.

“Over the last 10 years, Evergrande hasn’t produced a positive cash flow,” says Andrew Lawrence, at TS Lombard, who specialises in Asian property. “It’s had to fund its cash flow through borrowing.”



At Evergrande Venice, named for the city which inspired it and the developer who built it, apartments can be found for as little as a fifth of



‘River view house’ on the side of the Yangtze River in Yichang, Hubei province © Costfoto/Barcroft Media/Getty

the prices in one Shanghai neighbourhood © Sandy Li/South China Morning Post/Getty

Evergrande makes a profit but is subject to risks comparable to those faced by large banks — that its access to financing will dry up, leaving it with illiquid assets and triggering a default that could ripple through the financial system. As a result, market confidence is crucial.

Those fears were thrust into the spotlight in September, when a letter purportedly from Evergrande circulated on Chinese social media. It requested help from the Guangdong government regarding a listing of its mainland subsidiary by the end of January.

If it failed to list the entity, Evergrande was obliged to pay equity investors about \$19bn, which could have triggered a cash crunch. The frenzied market reaction that followed hinted at a potentially vicious cycle where funding was cut off.

After its share price plummeted and trading in its bonds was temporarily halted in Shanghai, Evergrande released a statement furiously denying the authenticity of the letter. It subsequently said the majority of the investors had agreed not to seek repayment if there was no listing. On Monday, it said the listing was cancelled, without providing a reason, adding that nearly all of them had either agreed to hold on to their stakes or would do so soon. Its share price rose 2 per cent but is still down 22 per cent this year.

Even before the three red lines were unveiled, developers were scaling back their leverage. S&P's Mr Yip estimates that, across the more than 60 developers he rates, debt grew at just 3 per cent through the first half of the year, compared with a rate of 16 per cent over the course of 2019. In March, Evergrande unveiled plans to reduce its debt by Rmb150bn a year until 2022.



Pan Darong, chief financial officer of China Evergrande Group (L), Hui Ka Yan, chairman (C), and Xia Haijun, president and chief executive, at a news conference in Hong Kong last year © Paul Yeung/Bloomberg



An Evergrande Metropolis community in Huai'an. The fate of such projects will be a test of what happens if China's process of urbanisation eventually runs out of steam © Zhao Qirui/VCG/Getty

Deleveraging could in itself be risky. Mr Lawrence suggests that other property developers are in a much safer position, but argues that Evergrande has “unproductive assets” on its balance sheet which could be difficult to sell, forcing it to seek out even more debt. He points to the 363,000 car parking spaces the company owned across China at the end of 2019. A source close to the company says its car parking spaces were currently on sale.

Beyond short-term liquidity risks, property developers are also exposed to a reversal of the bet they have made on land values, which depends on appetite from Chinese consumers.

“This cycle can be perpetuated as long as what you build is valued and you're making a solid profit margin out of it, that's been the case for many decades in China,” says Mr Yip. If margins disappeared, he adds, that would amount to “quite a doomsday scenario”.

## Venice for sale

In a 2016 report on Evergrande Venice, Nigel Stevenson, an analyst at GMT Research in Hong Kong, paid particular attention to its location. “It is genuinely in the middle of nowhere,” he wrote. “We struggle to see how the project will become a thriving community.”

Four years later, the verdict on the development’s success is mixed.

Prices for Venice properties have tripled since sales began in 2012, local data shows, and 80 per cent of the apartments have been sold in total, though about a third of them are unoccupied, according to residents and agents.

The project relies heavily on demand from retirees in Shanghai, like Ms Wang, who account for two-thirds of sales and tend not to live in the development all-year-round.

But this year sales have slowed. Data from the Qidong municipal housing bureau shows around 60 per cent of the apartments that went on sale have been sold. That’s lower than an 80 per cent or higher sales rate in previous years, and comes despite a 15 per cent discount on properties.

Nationwide, Evergrande discounted its apartments by as much as 30 per cent in September and October — part of what the company said was a “normal sales strategy” for a period that is usually the busiest for property transactions. It has also sought to raise cash through spinning off its stakes in other companies.

In a statement last week, the company said its sales this year to October were Rmb632.6bn, exceeding last year’s total, and that it was confident it would exceed operational targets this year.



The streets of Renmin Road, Shanghai, in July © Costfoto/Barcroft Media/Getty



Property under construction in Qingzhou City, Shandong province, last month © Costfoto/Barcroft Media/Getty

But while China’s property sales have been resilient in the wake of the Covid-19 pandemic, the long-term outlook is weaker. Moody’s last month projected that property sales will remain “modest” over the next 12-18 months and suggested that the current economic recovery is “tenuous”.

JPMorgan’s Mr Zhu says real estate’s direct contribution to GDP has remained stable at around 13 per cent over recent years but adds that the importance of the housing and real estate markets “will gradually decline”.

This year’s house price boom in China is uneven and [concentrated in the big cities](#). “Except for the Pearl River Delta, the Yangtze River Delta and Beijing-Tianjin, real estate has no hope in other areas in China because there is nothing to attract young people and new populations,” says one former executive at Evergrande who now works for a rival developer.

He adds that local governments are even more reliant this year on land sales to developers as local companies and factories struggle. “The three red lines are completely contrary to the way China’s real estate industry operates,” he says. “The approach of real estate companies is to use debt and leverage to make money. Now restricting debt means restricting our ways to earn money.”

It is not clear whether the government can completely control flows of capital into the sector, which include non-bank financing sources such as trust companies. “The three red lines won’t stop leading developers from obtaining alternative financing,” says one developer in Chengdu, capital of southwestern Sichuan province. “The key for developers to survive is still to grow big rather than reduce leverage.”

But the urbanisation that fuelled their growth in the first place cannot continue indefinitely. “The land-based urbanisation that’s been ongoing for some 20 years now is not going to last all that long,” says Prof Wu at Columbia, pointing to “a lot of vacancies in buildings [and] in small districts”.

Projects like Evergrande Venice envisage an alternative, albeit speculative, means by which development might continue if people shift out of cities rather than into them — a trend under way globally since the outbreak of the pandemic.

But if a default does eventually threaten a large Chinese developer, Beijing’s current determination to discipline the sector will face its ultimate test. “In crunch time, what are they going to do?” asks Mr Lowy. “Are they going to be comfortable with a large developer defaulting?”

*Additional reporting by Qianer Liu in Shenzhen*

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