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S&P Global
China Ratings

China's Developers Need Inventories To Fuel Cash Generation

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Key Takeaways

- We believe China's developers are keen to stay on a fast cash generation path through high presales, given pressures on their funding.
- This strategy has reduced inventories to a historical low.
- Speeding up inventory replenishment raises credit risks, as debt and delivery obligations come due.

PRIMARY CREDIT ANALYST

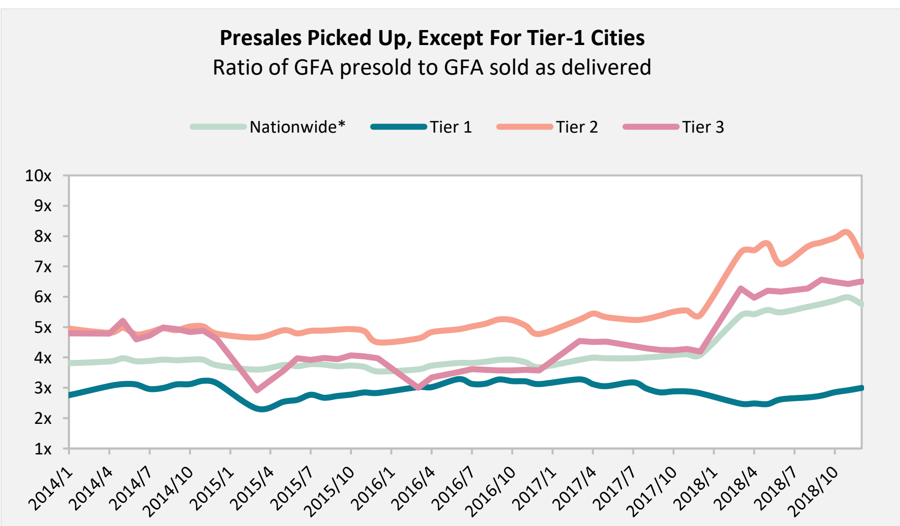
Xiaoliang Liu
Beijing
+8610 6516 6040
xiaoliang.liu
@spgchinaratings.cn

SECONDARY CREDIT ANALYSTS

May Zhong
Beijing
+8610 6516 6051
may.zhong
@spgchinaratings.cn

Even as financing conditions in China have improved, S&P Global China Ratings believes developers are still under pressure to maintain a fast cash generation model. They do this by selling a high proportion of apartments one or two years before construction is completed (see Chart 1), providing needed cash flows to stay relevant in China's highly competitive property market. That contrasts with an era when developers hoarded projects in anticipation of even higher prices.

Chart 1



Note: *Nationwide figures are calculated with contract sales. Subdued Tier 1 ratio growth was due to heavier restrictions. GFA – Gross floor area. Source: National Bureau of Statistics of China.

Developers also need large sales figures to qualify for land parcels and bank loans in China. And returning to the old strategy of hoarding is not an option, as financing costs would eclipse any gains from higher prices.

By increasing the proportion of presales, developers have lowered their unsold inventories, freeing up cash to support their operations and expansion. As of April 2019, developers needed 47 months to sell their inventories as per their selling speed over the prior 12 months. This was a record low compared to more than 80 months in early 2015 when they had not yet turned on the fast mode. We attribute the declining ratio to relatively lower inventories.

However, we believe such inventories are unsustainable. The fast-cash strategy is running out of resources. Expectation of a generally cooler market also drove developers to reduce land acquisitions sharply since the start of 2019, after a spree in 2016-2018. This raises questions with the sustainability of their land bank over the longer run.

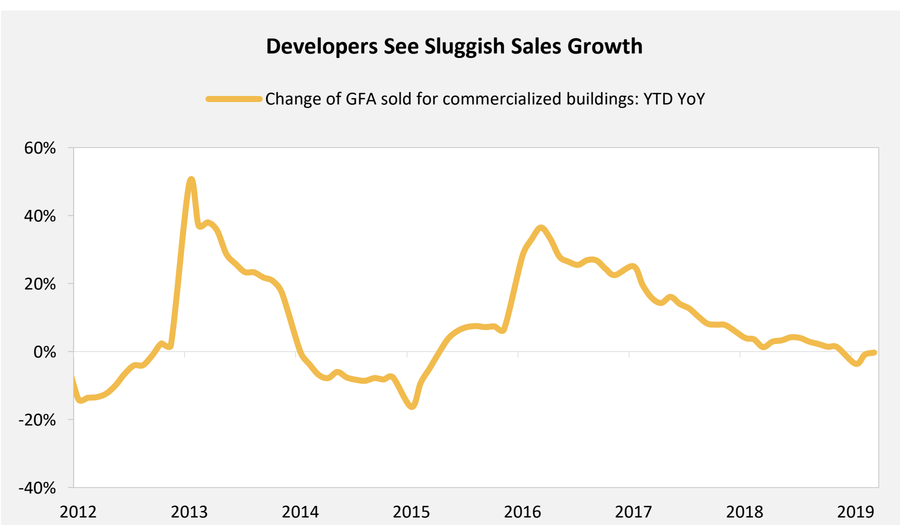
Replenishing saleable projects and land bank to keep fast cash generation in the future would stress developers now. They have ongoing obligations to deliver completed homes and repay maturing debt, Watch out for those with small sizes or high leverages, yet a growing appetite to rumble.

Charts and data cited in this analysis are based on financials of about 170 companies, including many listed developers in mainland China or Hong Kong, as well as non-listed players who have bonds outstanding in the onshore market.

The Fast-Cash Strategy Is Running Out Of Ammunition

Despite stronger property sales in some parts of China this year, a full-swing revival in end demand is far from certain, due to continued administrative restrictions to prevent overheating in China's housing markets (see Chart 2). Another potential dampener is the narrowing pipeline for state-supported affordable housing niches. The central government targets to start construction on "shantytown redevelopment" projects holding 2.85 million units in total in 2019, less than half of the 6.26 million units started in 2018. The decline in this affordable-housing segment will greatly reduce the demand for new houses in third- and fourth-tier cities.

Chart 2



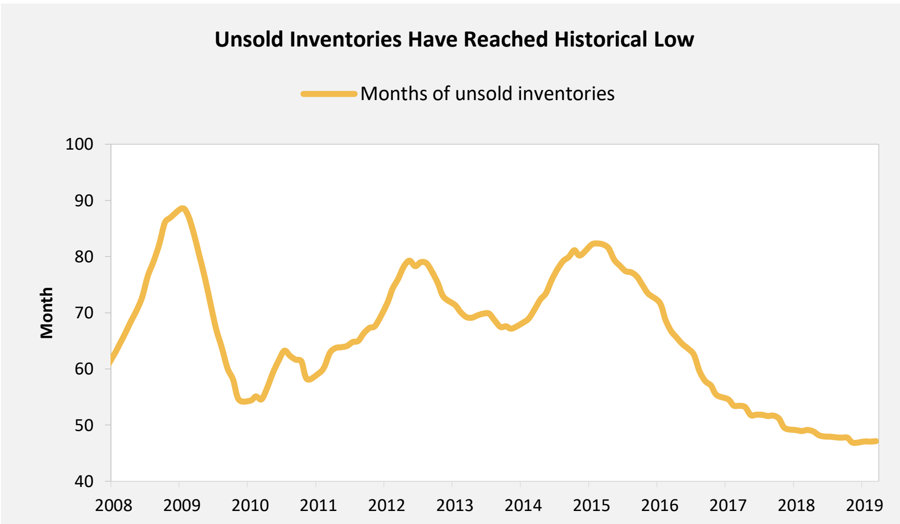
Note: GFA -- gross floor area. YTD -- year to date. YoY -- year on year. Commercialized buildings are those built and sold by developers, including residential and commercial properties. Source: National Bureau of Statistics of China.

Besides sales uncertainty, three other factors are weighing on the fast-cash model:

Insufficient inventory. Given a heated sales pace since 2017, apartments available for sale have dropped to historically low levels. The industry-wide inventory level, as measured by months needed to sell through, has been declining since 2015 and is now at its lowest since more than a decade ago when data was first available (see Chart 3).

A comparison between sold and started areas also reflects this deterioration. In recent years, the ratio of GFW sold to GFW started has risen steadily to 0.8. A ratio higher than 1 would mean the sector is depleting its saleable and unsaleable projects, instead of adding them.

Chart 3

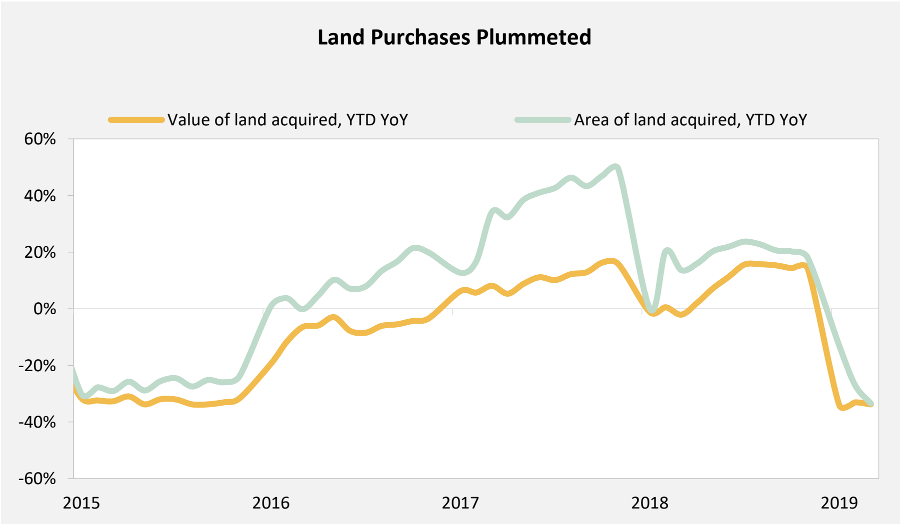


Note: months of unsold inventories is calculated as inventories divided by GFA sold per month. Source: National Bureau of Statistics of China, S&P Global China Ratings.

A slowing pace of land purchases may result in insufficient land reserves that can be converted into marketable inventory for some time to come. From January to April 2019, land acquisitions in China fell by 33.5% year on year (see Chart 4). Part of this is a high-base effect from record acquisitions in prior years. But it also represents developer caution amid uncertainty on demand and tough funding conditions.

At the same time, developers are consuming more land than they're buying. Since the second half of 2017, land development accelerated while land purchases cooled down, breaking a strong correlation between their change rates.

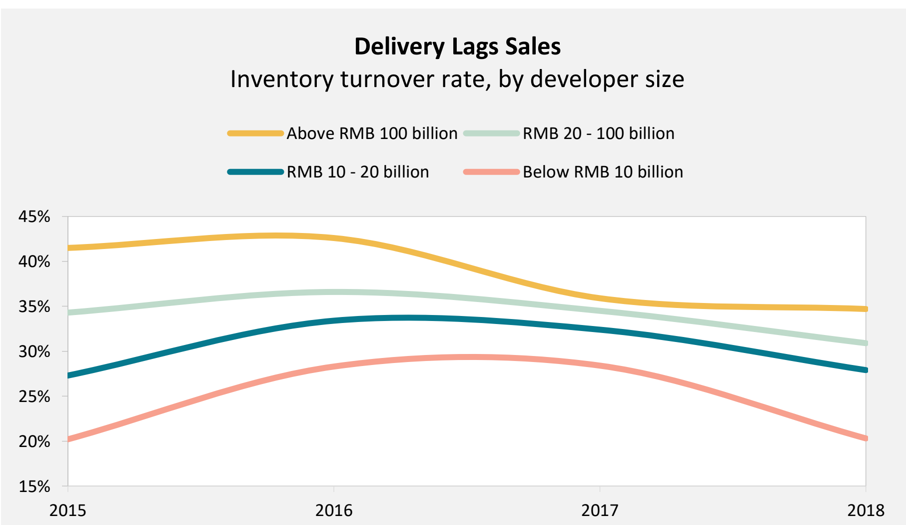
Chart 4



Note: Value of land acquired -- total contract prices of land purchased by developers. Source: National Bureau of Statistics of China, S&P Global China Ratings.

Delivery obligations. Strong presales in recent years has left a growing pipeline. Delivery lagged sales as reflected by declining inventory turnover ratios reported, which are essentially COGS recognized upon delivery divided by average inventories. This is regardless of the size of developers we examined (see Chart 5).

Chart 5



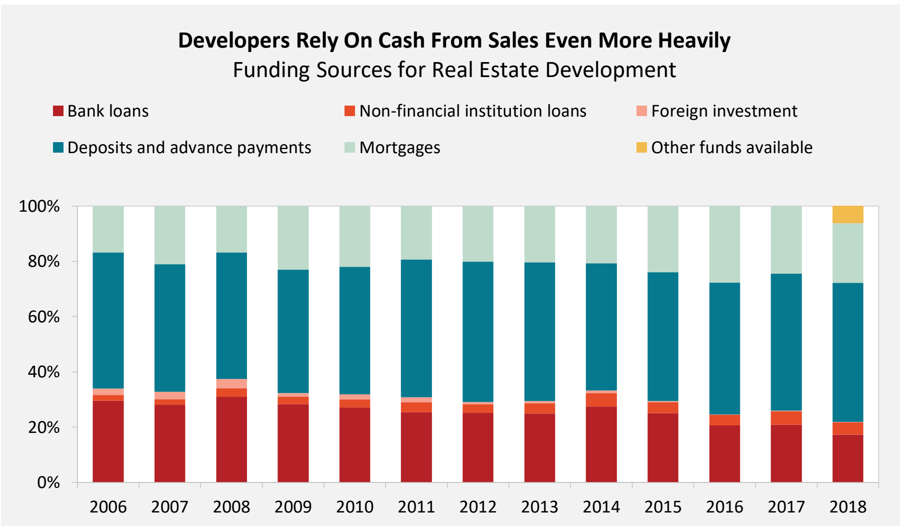
Note: Inventory turnover ratio = COGS / Average inventory. Developer sizes are measured by revenue. Chart lines are smoothed. Source: Company reports, S&P Global China Ratings.

Why We Believe Developers Still Want Fast Sales

In our view, several factors underpinning this model remain unchanged. For example, financing is still tight, forcing developers to rely heavily on proceeds from sales, which mainly consist of down payments and mortgages. Since 2016, China's central government has strictly regulated the provision of loans to property development by banks and nonbank financial institutions. As a result, the share of sales proceeds in the funds developers raise for development activities has increased to 53.0% over the first four months in 2019, from 44.5% for the full year of 2015 (see Chart 6).

By promoting presales to collect cash early, developers did broaden their capital sources. Cash flow from operating activities for developers we examined for this research totaled RMB 2.9 billion in 2018, compared to just RMB 235 million in 2017. We attribute a large part of this to presale efforts.

Chart 6



Note: Deposits and advance payments are effectively down payments in presales. Source: National Bureau of Statistics of China, S&P Global China Ratings.

At the same time, the bigger, the better. Larger developers benefit from better execution, lower cost per unit and higher gross margins, so they were consolidators over the last few years as sector consolidation accelerated. Besides, some local governments require bidders for land parcels to meet sales thresholds. Banks hesitate to grant loans to small players in this highly leveraged sector. In such conditions, the top line sometimes takes priority over the bottom one.

We note that Chinese developers have not always depended on a fast cash strategy. Indeed, they used to routinely acquire land then delay the launch of new projects, in hopes of capturing higher prices by waiting. However, this strategy is no longer economical, now that the era of dizzyingly rising housing prices has ended in China. The growth rates of housing prices in all city tiers have slowed to less than 10%, below the financing cost of most developers. The rates came down from a peak of around 20% in late 2016.

Finally, we believe slower appreciation in land prices since 2018 will motivate some developers to act now, rather than risk higher prices in future. This requires them to collect enough money with sales as a major source.

Credit Risks Will Rise If Developers Step Up Replenishing Inventories

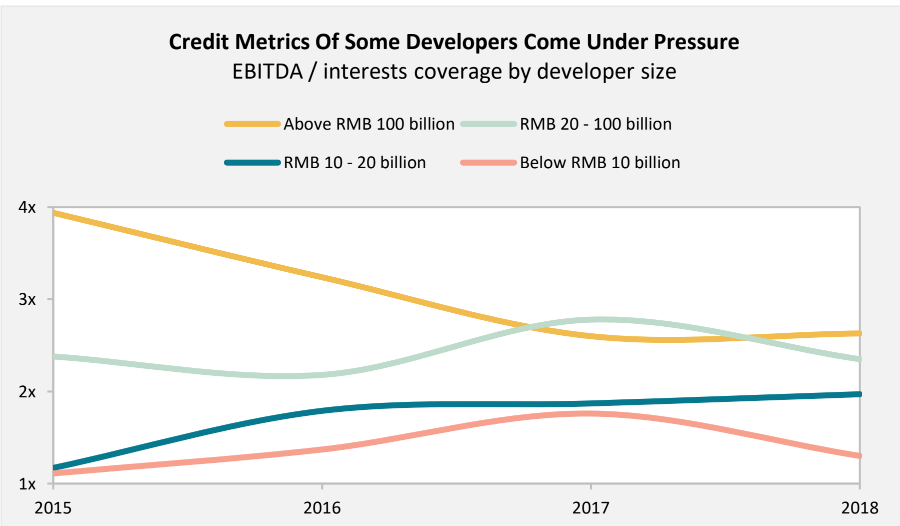
We believe developers need to replenish saleable inventories and land reserves in a timely manner in order to fuel future cash generation. However, this capital-intensive activity would come at a time when their obligations to home buyers and creditors rise, thus heightening credit risks.

The sector is facing record amounts of debt due in the next few years, with a sharp jump in maturities this year and a peak in 2020. We estimate that the amount of maturities, including bonds puttable, will reach RMB 350 to RMB 400 billion in 2020.

Past reliance on presales for fast cash has raised delivery burdens. Construction for delivery has slowed compared to presales, as reflected by a record long cycle from presale to home delivery and revenue recognition. Developers need to spend money to speed up delivery. We expect sector-wide capital expenditure, including the part on land acquisitions, will rise by 10% in 2019.

Developers with annual sales less than RMB 10 billion and insufficient land reserves would face the biggest funding gaps, if they want to keep operating in the sector. Credit metrics of such companies are at high risk levels and deteriorating. Buying land aggressively would stress their liquidity. (see Chart 7).

Chart 7



Source: Developer sizes are measured by revenue. Company reports, S&P Global China Ratings.

Besides the smallest developers, those with sales just less than the mega ones may see heightened credit risks as well. Developers with annual sales of RMB 20 billion – RMB 100 billion expanded their sizes rapidly through strong presales and high leverages. This left a high proportion of sold but unfinished projects, meaning large-scale construction expenditure soon. They also bucked the recent trend by outspending peers on new land acquisitions in 2019. We foresee substantial cash outflows to fund these acquisitions, thus weakening the developers' debt-servicing capacity.