China’s three red lines

Opportunities in China real estate

Three red lines will soon govern China’s real estate developers, so we sat down with Hayden Briscoe, Head of Fixed Income, Asia Pacific and Brian Huang, Senior Credit Analyst, to understand the details and gauge what opportunities the new rules create.

Three red lines and China real estate – in 60 seconds

• China’s new three red lines policies for the real estate sector will likely drive a wave of reratings for developers and open up opportunities for bond investors.
• In short, the policies amount to forced deleveraging to improve financial health for the real estate sector;
• The government is moving to address debt build-up in the sector and we have high confidence in the scope of these policies.
• Future access to financing will be predicated on developers’ adherence to strict criteria including liability to asset ratio (excl. advance receipts) of less than 70%, net gearing ratio of less than 100%, and cash to short-term debt ratios of more than 1x.

China imposed the three red lines guidance on selected developers after an August 2020 meeting in Beijing that occurred against a backdrop of growing debt levels, rising land prices, and booming sales.

As part of the scheme, twelve pilot developers must submit detailed reports of their financing situation for evaluation by regulators led by People’s Bank of China, China’s central bank, and the Ministry of Housing and Urban-Rural Development, the state construction regulator.

The regulators are to assess the developers’ finance situation against three criteria.

The three red lines

1. Liability to asset ratio (excl. advance receipts) of less than 70%
2. Net gearing ratio of less than 100%
3. Cash to short-term debt ratio of more than 1x

If the developers fail to meet one, two, or all of the ‘three red lines’, regulators would then place limits on the extent to which they can grow debt.

To simplify the implications of the policies, China’s authorities created a colour code scheme, which breaks down as follows:

<table>
<thead>
<tr>
<th>Color code</th>
<th>Number of red lines breached</th>
<th>Allowable annual growth in debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green</td>
<td>0</td>
<td>15%</td>
</tr>
<tr>
<td>Yellow</td>
<td>1</td>
<td>10%</td>
</tr>
<tr>
<td>Orange</td>
<td>2</td>
<td>5%</td>
</tr>
<tr>
<td>Red</td>
<td>3</td>
<td>0%</td>
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The policy move is, in our view, likely to grow in scope in 2021, and we expect it will expand to cover the top 30 and 50 developers in early 2021 and then progressively grow in coverage.

**Three red lines: why, and why now?**

1. **To control house prices:** China’s government is mindful of the marked rise in house prices that has occurred during the past 15-20 years, which has made property unaffordable for millions.

2. **Manage land markets:** Higher land prices feed into home price growth. Developers are partly responsible – many aggressively suck up land parcels to build their land banks and bid up land prices.

3. **To ration credit to the real estate sector:** China’s authorities are concerned about the amount of capital absorbed by the real estate industry. Reiniging in lending to the real estate sector is also part of the government’s strategy to channel lending to more productive areas of the economy.

4. **To lower cyclicity.** China’s real estate markets are highly cyclical, largely due to on-off policies like home purchase restrictions and property price caps. The government wants to stabilize markets by bringing in what they describe as a “long-term mechanism for the real estate market”.

5. **Real estate developers are systemically important.** Real estate is a significant part of China’s economy with strong linkages to numerous upstream and downstream industries. The Chinese government is thus putting stricter controls in place to ensure a more sustainable future.

**What do the three red lines mean for developers?**

In short, forced deleveraging.

According to S&P estimates, only 6.3% of their rated developers can fully comply with all of the three red lines at the time of writing.

**Percentage of rated developers with cash-to-short-term debt of less than one, November 2020**

Source: S&P Global Ratings, November 11, 2020
More specifically, we expect a tighter credit environment for developers in the short term, i.e. over the next 12 months.

We have already seen moves by the Chinese authorities to dampen the growth in credit seen amid the COVID-19 pandemic outbreak in 1H20, and we expect gradual tightening of select financing channels (e.g. trust loans) for the real estate sector over the next 12 months.

Against this backdrop, and with the imposition of the new rules, we expect that developers may respond by:

- Cutting prices to boost sales and asset turnover;
- Controlling their debt growth under monthly supervision by the central authorities;
- Seeking operational cost efficiencies;
- Disposing of assets or stakes in businesses not related to core property development.

We also expect that many smaller developers will be forced to move out of the industry, and that the sector will become increasingly dominated by larger players.
Three red lines: deleveraging pressure, rerating opportunity

Over the next three-to-five years, we expect the new policies will force deleveraging among China’s real estate developers and create a rerating opportunity for investors.

But which credit grades offer the biggest opportunity?

*B grade names have highest rerating potential*

Generally, we estimate that developers rated in the B category have the greatest potential for a ratings upgrade to BB, followed by names rated BB to upgrade to IG status.

Specifically looking at the B-grade ratings category, we estimate that up to 30% of names may eventually see an upgrade.

Many B-grade names have breached the red line on cash/short term debts and net gearing ratios, which we believe are the easiest ratios to fix.

Also, many B grade names have grown their sales in recent years to around RMB100billion per year.

Since they have already established a respectable operating scale and as their debt-funded expansion slows down, they can gradually repair the balance sheets, which is an important credit constraint at their rating levels.

*Some scope for BB to IG rerating*

We see some potential for reratings from BB to IG and estimate that roughly 10% of names in the BB ratings category may rerate upwards to IG over the next three to five years.

However, migration to IG will also need operational stability and good management quality, in addition to leverage improvement.

*Limited impact on CCC*

There are very few CCC-rated developers with outstanding US dollar bonds. These existing CCC-rated developers by and large struggle for a turnaround.

These developers usually face difficult refinancing conditions. The new three red line policies would have little impact on these distressed issuers. Also, some of these CCC category developers may default or leave the bond market after their bond matures.
Three red lines and the China credit outlook

We believe the new policy is a positive market development for bond investors in the long term.

From a valuation perspective, current levels are highly attractive in the real estate space.

With structural improvements in the pipeline as the three red lines have an impact, we believe now is an excellent opportunity for bond investors to benefit from the reratings that we detailed above. Nevertheless, the impacts will be uneven and some developers may fare better than others in a tightened credit condition next year.

China is tightening up some financing channels after opening them at the height of the COVID-19 outbreak and, coupled with the introduction of the three red lines, China’s developers will be under pressure over the next 12 months.

However, this is where active managers with a China presence and a deep, on-the-ground understanding of the real estate sector have an edge in capturing the rerating opportunity.
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