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China Tightens Curbs on Property Firms to Improve Capital Structure

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Recently, Chinese regulators tighten financing rules for real estate developers to ensure healthy and stable development of China's housing market. In order to control the scale of developers' interest-bearing debts, the China Banking and Insurance Regulatory Commission (CBIRC) has issued "three red lines" for real estate developers and subtle changes have taken place in the approval of developers' debt issuance. Against the backdrop of rising house prices and land prices, the new policy could curb real estate developers' financing spree and help channel the funds to the real economy instead.

Chart #1: New regulatory rules of "three red lines"

Details of "three red lines" policy			
Three red lines	**Four brackets**	**Scenario**	**Interest-bearing debts growth**
Liability-to-asset ratio (excluding presales) >70% Net debt ratio >100% Cash ratio <1	Red	Touch 3 lines	<= 0%
	Orange	Touch 2 lines	<= 5%
	Yellow	Touch 1 line	<= 10%
	Green	Touch 0 line	<= 15%

Source: PBOC, NCB Economic Research

Note: Cash ratio refers to developers' cash on hand to pay off short-term debt

Real estate supervision shifts from demand side to supply side

Since the phase "houses are for living in, not for speculation" was first mentioned in the 2016 Central Economic Work Conference, Chinese policymakers have emphasized the healthy development of housing market and

have strengthened supervision of real estate market. China has rolled out a series of demand-side policies including the introduction of purchase restrictions, lending restrictions, sales restrictions, and price restrictions for cities with hot property market since the end of 2017. At the beginning of this year, loose monetary environment ignited investment demand, with housing prices in some large and medium-sized cities rising rapidly. Therefore, local governments have tightened restrictions on purchases since July to curb excessive demand.

The "three red lines" policy, which extends the stance of tight supervision on housing market, mainly focus on the supply side, and aims at controlling the scale of real estate businesses' interest-bearing debts by setting specific thresholds. Since the policy started from the supply side and mainly targeted developers with high debt ratio, the regulation is more flexible than ever.

Developers could reverse leverage-driven business model

Since 2008, developers' explosive growth was built on the "high leverage, high turnover, and low cost" model, which increased their debt burden significantly.

According to the brackets set in the "three red lines" policy, nearly half of the 224 listed real estate companies have touched two red lines and above, which implicates that the growth of interest-bearing liabilities of these real estate companies must be controlled within 10% or even 5%. However, average interest-bearing debt growth of the 224 listed real estate companies is 12.3%. It is worth noting that financial status of leading real estate companies is worse. Average growth rate of interest-bearing debt of leading real estate companies was 16.3%, with the growth rates for most real estate companies exceeding 20%.

Chart #2: Classification of China's developers according to the new policy

Classification of China's developers				
Brackets	**224 listed developers**		**Top 30 developers**	
	Number	**Share**	**Number**	**Share**
Red	51	23%	9	30%
Orange	45	20%	5	17%
Yellow	60	27%	11	36%
Green	68	30%	5	17%

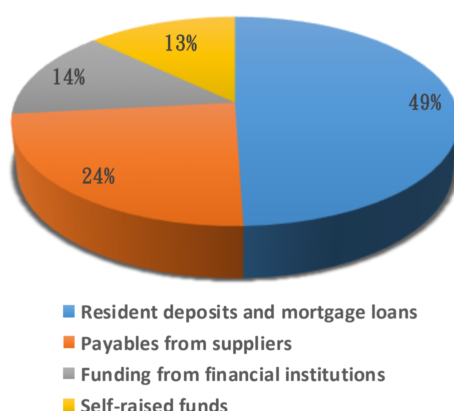
Source: Public information, NCB Economic Research

In this context, the new policy will impose greater deleverage pressure on real estate developers, who may have to adjust the "high leverage, high turnover, and low cost" business model.

At present, funding sources for real estate companies mainly include resident deposits and mortgage loans, payables from suppliers, funding from financial institutions, and self-raised funds. In order to meet regulatory requirement, real estate companies must increase sales and accelerate inventory turnover in the future, to replace financing cash flows with operating cash flows. As a result, the proportion of funding from household sector is expected to rise.

In fact, in the wake of introduction of the new policy, some leading real estate companies began to cut prices and promote sales, to increase sales collection and reduce liabilities. As developers replace financing cash flows with operating cash flows, their financial status could improve.

Chart #3: Funding sources of real estate companies



Source: NBS, NCB Economic Research

Property price growth could slow down, easing crowding-out effect on consumption

Besides direct constraints on developers, impacts of the new policy on property prices also attract market attention.

Inevitably, compared with direct supervision on the demand side, supply-side regulation will affect property prices more implicitly. However, considering current high-leverage business model of most real estate companies, the new rule could, to certain extent, help curb property price growth.

As mentioned above, with financing capacity limited, developers have to increase sales collection to maintain continuing operations. To meet requirements of the “three red line” policy, especially the cash ratio, developers are more likely to increase sales collection by reducing prices.

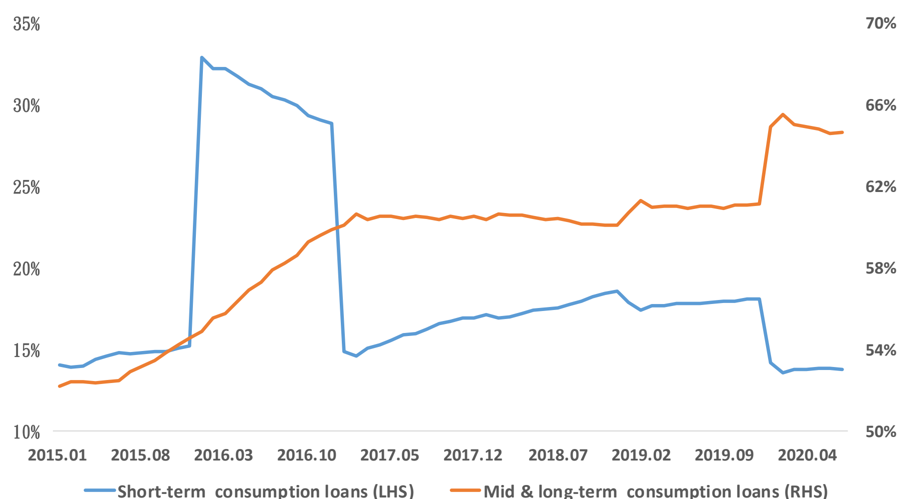
In terms of financial indicators, growth in property prices could decelerate. Based on high-leverage business model, as long as the increase in housing prices

can cover the cost of capital, real estate companies could make profit. In other words, in an intact property market, financing cost of real estate companies (especially the short-term debt interest rate) should be the psychological lower bound of new house pricing.

Under loose monetary environment in the first half of this year, weighted average financing cost of real estate bonds dropped to record low of 3.87%, while some leading real estate companies can borrow with interest rates as low as 2%. During the same period, new home prices in first-tier cities rose by 3.3% year-on-year, and the prices in second-tier and third-tier cities rose by 5.3% and 4.6% year-on-year respectively, which were significantly higher than the financing cost of real estate companies. Therefore, theoretically, there is still room for property prices to adjust. If property prices growth slows down in the future, crowding-out effect of high property prices on household consumption will be alleviated, thereby releasing China's huge consumption potential. In the past, high housing prices have increased household debt burden, which not only resulted in higher than average household leverage, but also crowded out household consumption. This could hinder the development of dual-cycle pattern dominated by domestic demand.

According to the Bank for International Settlements, China's household leverage ratio registered 55.2% in 2019, exceeding global level of 53% and significantly higher than the average level of 38.5% in emerging markets. In the household sector, mid & long-term consumption loans account for nearly 65% of total household loans, while short-term consumption loans, which represent consumer spending, account for less than 14%. In addition, between 2016 and 2017, investors leveraged short-term consumption loans to enter the property market.

Chart #4: Structure of China’s household loans



Source: PBOC, NCB Economic Research

Therefore, curbing developers' financing spree and adjusting high housing prices from the supply side could lead to rational new home pricing, optimize household debt structure, and finally help unleash China's consumption potential.

New policy channels funds to emerging industry, underpinning dual-cycle development pattern

Recently, Chinese leaders repeated the need to "gradually form a new development pattern with the domestic cycle as the main body and the domestic and international cycles mutually promoting each other". Within the domestic cycle which is driven by consumption and technology, new infrastructure and high-tech industry play important roles.

However, real estate investment has outpaced manufacturing investment in recent years, with commercial property sales stronger than social retail sales at the same time, which reflected the crowding-out effect of real estate on consumption, as well as its excessive occupation of financial resources. Amid China's urgent need of economic transformation and upgrading, rapid expansion of the real estate industry seems outdated, and real estate investment should return to rational track.

At present, China's economy is getting back on its feet from the pandemic, but manufacturing investment and household consumption remain weak. Slower-than-expected pace of the recovery makes it necessary to maintain loose monetary environment. Therefore, tighter regulation of the real estate industry can redirect financial resources from real estate to high-tech industries such as new infrastructure, which could help with China's economic upgrading and underpin the new dual-cycle development pattern.