

Bottom-Forming and New Balance: Property Development Outlook 2024

November 24, 2023

Key Takeaways

- From a long-term perspective, we expect the real estate sector to strike a new balance between supply and demand that adapts to the current market scale, given the top-level policy guidance and actual market demand. The likelihood of new residential house sales resuming 18 trillion RMB is very low.
- In our view, 2024 should see the forming of property sales bottom and a decline of about 5% in residential house sales from 2023. The sales slippage is caused by the fact that the impact of sluggish demand in low-tier cities could not be counterbalanced by stabilized sales in high-tier cities, and that dented confidence and the population trend also put some pressure on housing sales.
- We expect construction and installation investment to continue the downward trend due to weak new starts. Land acquisitions would remain muted with increasing divergence across cities. Land demand in high-tier cities may stabilize first while land markets in low-tier cities continuously come under the strain.
- Developers with solid asset quality and land reserves concentrated in high-tier cities should enjoy greater market space and resilient creditworthiness.

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Long-term Prospects: Supply and Demand to Reach a New Balance, with Affordable and Commercial Residential Houses Playing Separate Roles

In our view, China's real estate market has transitioned from a phase where supply falls short of demand to a new stage featuring more balanced supply and demand dynamics. Despite its prominent position in China's economy, the real estate sector is set to see the end of a booming period and enter into a new era highlighting high-quality and healthy growth, as the market landscape has undergone some fundamental changes. In the medium and long run, we expect to see a new balancing point between real estate sector's supply and demand that fits the current market scale. The national new residential house sales are unlikely to hit 18 trillion RMB again.

In our view, the new balancing point will be driven by two factors: 1) the central government's top-level policy guidance addressing housing issues; and 2) the actual home-buying demand.

In terms of central government's policies, we think regulators would encourage the subsectors of affordable house and commercial residential property to fulfill their respective roles, where part of the demand for commercial residential houses will be met through purchasing affordable houses.

In the Guiding Opinion on Planning and Construction of Affordable Houses (“No. 14 document”) approved by the executive meeting of the State Council, policymakers call for efforts to enhance the supply of affordable houses in large cities to meet housing demand from wage earners and high-end talents. Furthermore, top leaders pledge to propel the transformation in real estate sector and facilitate a more market-oriented mechanism for residential house transactions, which is aimed at meeting the needs of homeowners looking to upgrade.

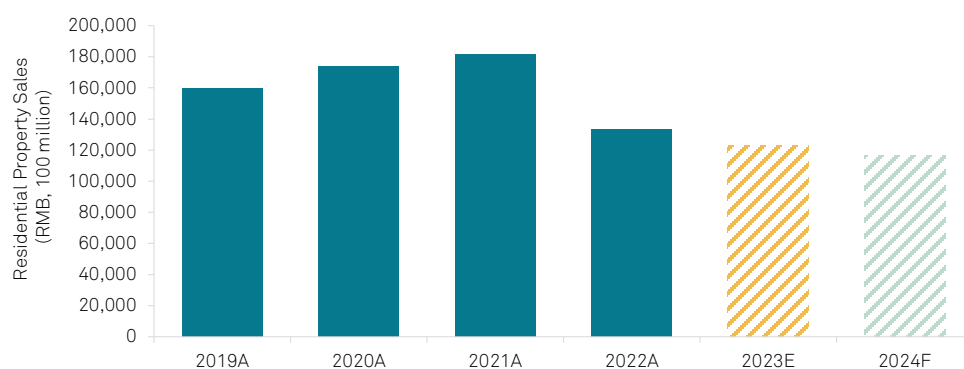
The reality on the demand side also urges the property sector to seek a new balancing point given the long-term prospects. The demand for commercial residential houses, in the long run, depends on the population trend, economic growth and income per capita, with differentiation among cities likely to intensify. Benefitting from continued population inflow and well-established industrial base, high-tier cities still see further demand from first-time homebuyers and move-up buyers; urban village renovation programs in extra large cities also bolster the demand to some extent. To the contrary, low-tier cities, troubled by population outflow, high residential property inventory and demand migration towards high-tier cities, have become insensitive to policy stimulus and thus face a dim outlook ahead, with the likelihood of suffering sustained sluggishness. Affected by supply and demand dynamics in the property market, investment demand would be restrained in the face of increased affordable house supply and steady house prices.

2024: Bottom to be shaped with mild decline in sales

We expect new commercial residential house sales to drop mildly in 2024, owing to the following three reasons. 1) First, growing sales in high-tier cities are not able to fully offset the sales decline in low-tier cities - the major contributor to overall commercial residential property sales across the nation but faced with weak demand. High-tier cities play a critical role in ensuring the stability of the real estate market. Yet, we see that even some high-tier cities fail to generate adequate demand. 2) Second, consumers’ confidence will take some time to be restored. Households’ ability and willingness to buy residential properties remain weak at present, evidenced by elevated household leverage, increasing savings scale and strong motivation to repay debt in advance. A series of homebuilders’ defaults also materially hurt home buyers’ interests in buying pre-sale properties. Temporary bearish sentiment and industrial down cycle come together to put a drag on sales. 3) Third, the new supply and demand landscape should see a gradual decline in demand in the medium and long term, as the generation born after 1992, which constitutes the leading force of home buyers, has seen a significant decline in population. Therefore, we anticipate a year-on-year drop of about 5% in total commercial residential house sales in 2024, leading to a smaller sales scale of 11.5 trillion RMB. High-tier cities are the primary targets stimulated by policies, and increased average selling prices could partially offset the impact of decreased GFA sold nationwide.

Chart 1

We Expect Residential Property Sales to Slip by about 5% in 2024



Note: A- actual, E - estimate, F - forecast.

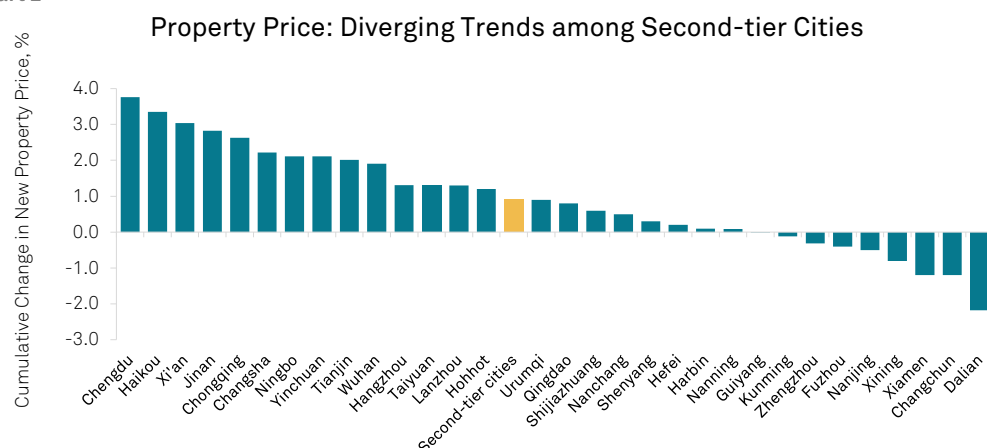
Source: S&P Global (China) Ratings.

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By city tier, we expect that:

- First-tier cities see resilient demand, providing support to prices, and total sales remain stable or record mild growth in 2024.
- Market trends in second-tier cities differentiate. Certain second-tier cities lack robust demand, resulting in their poor performance in terms of property sales and prices. We estimate overall sales across second-tier cities to pick up by 0-5%, but such improvement is not sufficient to compensate the sales shrinkage in third- or lower-tier cities.
- Third- or lower-tier cities are facing considerable sell-through pressure and continuously declining prices due to discouraging demographic and industrial conditions and sluggish reaction to policy stimulus, hinting at bleak prospects for demand. We project that these cities contribute around 50% of national residential house sales, bringing significant downside risk to the overall market. In the meantime, property developers' attempts to reduce inventory through cutting prices accelerate the sales slide. We expect total sales to fall by 5%-10% in 2024.

Chart 2

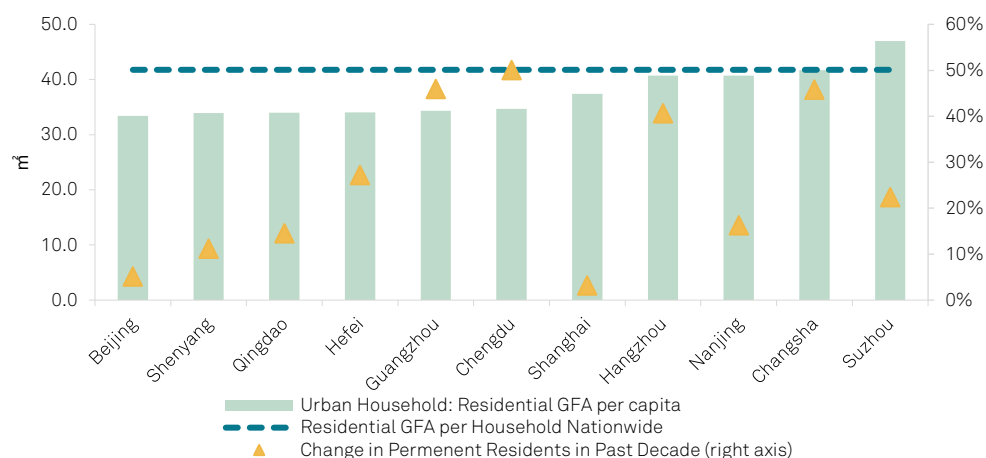


Note: Data from January to September 2023. We calculate cumulative change in new residential property sales based on month-on-month changes, setting sales in January 2023 as the baseline. Cumulative change in new property sales for "Second-tier Cities" in the chart is calculated based on "New Residential Property Price Index in 70 Medium and Large Cities: Second-tier Cities: MoM". Source: National Bureau of Statistics, Wind, S&P Global (China) Ratings. Copyright © 2023 by S&P Ratings (China) Co., Ltd. All rights reserved.

While not expecting a sales rebound, we think the real estate market is unlikely to suffer a sharp decline again, because of: 1) solid policy support. Chinese leaders point out the major changes in the supply and demand dynamics in the property market and vow to adjust and optimize real estate policies in a timely manner. Such a tone-setting statement leaves space for further adjustment to real estate policies in face of market changes; 2) incremental demand in certain high-tier cities. Thanks to continued population inflow, industrial concentration and strong purchasing power of home buyers, there's still growth potential for GFA per capital in core first- and second-tier cities, demonstrating authentic demand for buying first homes and upgrading; 3) steady progress in urban village renovation in extra large cities, which may help unleash demand for trading up and shore up sales in the short term.

Chart 3

First- and Second-tier Cities See Authentic Demand for Upgrading

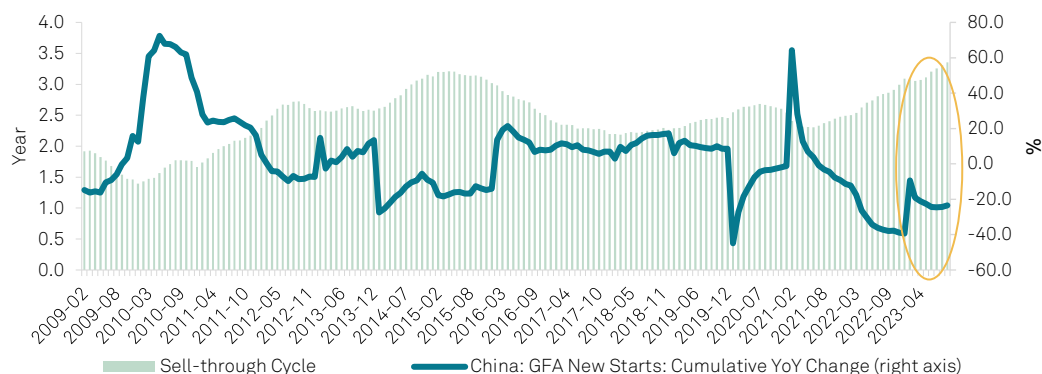


Note: Residential GFA per household nationwide is based on the seventh national population census. Urban residential GFA per capita is the latest local data disclosed in 2021 or 2022.
Source: National Bureau of Statistics, local statistics bureaus, Wind, S&P Global (China) Ratings.
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We anticipate a further drop in construction and installation investment in 2024 with decline in new starts narrowing. Efforts to ensure delivery of presold properties will provide driving force. As “strong completion, weak new starts” prevails throughout 2023, GFA new starts fall short of GFA completed by a large margin, resulting in a rapid contraction in GFA on-construction. Without fundamental improvement in leading indicators such as housing sales and land acquisition, the likelihood of GFA new start seeing a remarkable turnaround is low. In addition, inventory sell-through cycle appears to reach a peak amid de-stocking progress. The gradually improved sell-through cycle may narrow the decline in GFA new starts. We expect the decrease in GFA new starts to marginally improve to 5% to 10% in 2024. With the work of ensuring real estate project delivery advancing, GFA completed registered robust growth in 2023. Net GFA stalled slipped, but to an extent that is milder than what we expected at the beginning of the year. A slew of incidents surrounding large homebuilders within the year may stall the progress of delivery of presold houses. In 2024, the efforts to ensure delivery of on-construction properties may still act as a core driver while net GFA stalled would fall further, at a pace similar to that in 2023. This could underpin GFA on construction to a certain degree. However, the double-digit growth in GFA completed is unlikely to be sustained, as a result of sharp decline in GFA new starts in two straight years.

Chart 4

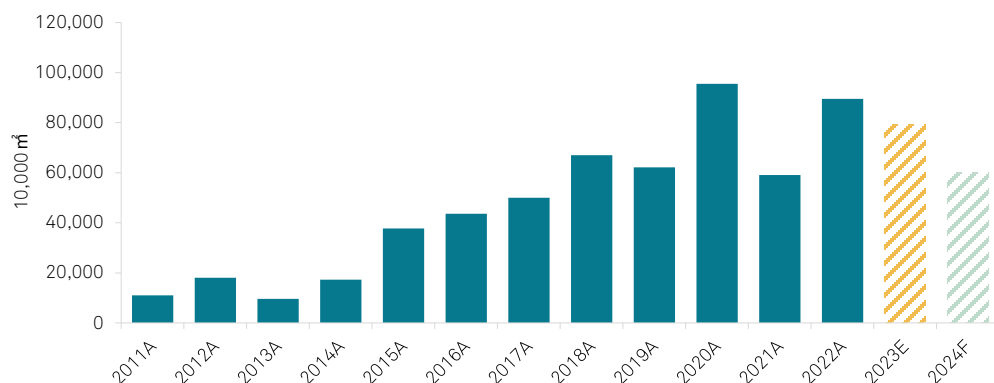
Slow Improvement in Sell-through Cycle May Narrow New Start Decline



Note: Inventory (t) = Monthly GFA of New Starts (t) * 0.9 - Monthly GFA Sold (t) + Inventory (t-1), assuming inventory in Feb 1999 is 0. Sell-through Cycle = Monthly Inventory/Total GFA Sold in the Past 12 Months.
Source: National Bureau of Statistics, Wind, S&P Global (China) Ratings.
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Chart 5

Work of Ensuring Presold House Delivery May Continue Pushing down Net GFA Stalled

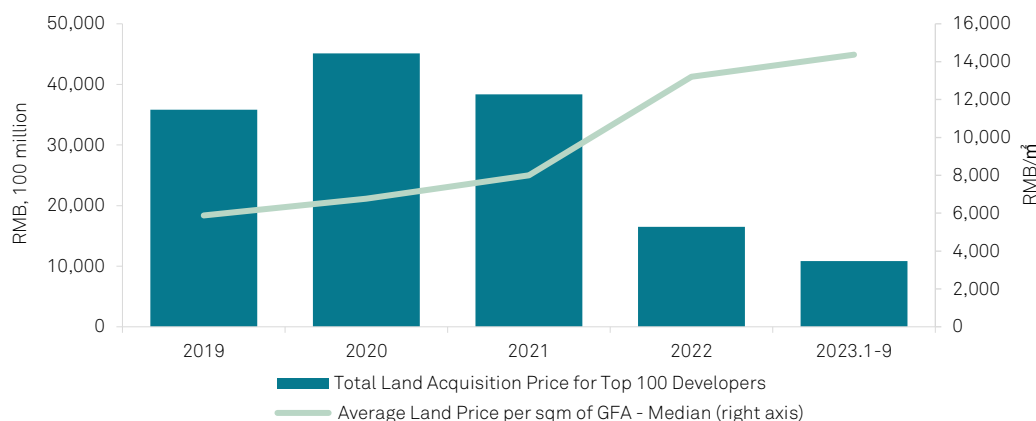


Note: Net GFA stalled is the gap between GFA stalled and GFA resuming construction in the year, which is a rough calculation based on GFA on construction, GFA completed and GFA new starts. A- actual, E - estimate, F - forecast.
Source: National Bureau of Statistics, Wind, S&P Global (China) Ratings.
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We forecast a continued downward trend in land investment in 2024, measured by overall land transactions. The core reasons for such a downward movement include lackluster sales recovery, generally unchanged amount of funds put in place by developers and low confidence level across the industry. Nonetheless, land transaction volume may see a narrower decrease, mainly due to a wave of land replenishment in core cities among mainstream homebuilders. The Ministry of Natural Resources' latest proposal of removing price caps in land auctions may further add heat to land transactions in core cities. Similar to property sales, the land market will take on diverging trends. Property developers may still focus on core first- and second-tier cities that are likely to experience a smooth de-stocking cycle and have already been on an upward trajectory since 2023. Land markets in low-tier cities remain extremely lackluster with a sustained weak trend.

Chart 6

Land Area Sold Decreased with Higher Transaction Price and Concentration in High-tier Cities



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Property Developer Outlook

In our view, the two years of deep correction in the real estate market have brought a profound change to the existing competition landscape in the industry. In 2024, as the property sector is

embracing a new era amid industrial transition, we identify the following prominent trends in the market:

SOEs take the lead with local SOEs rapidly emerging

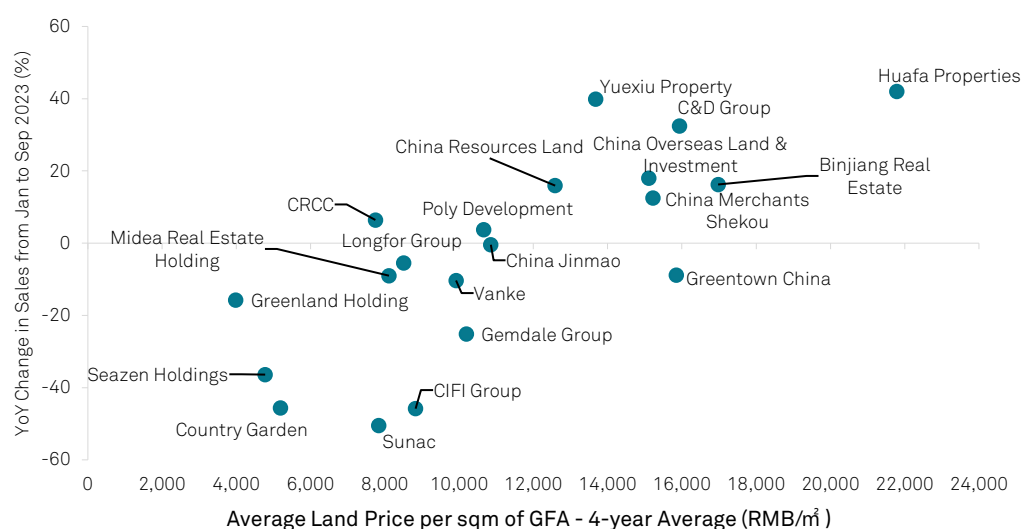
State-owned developers have become industrial leaders. Their strong refinancing capabilities allow them to maintain smooth capital turnover and ensure the frequency of land acquisition. SOE developers are now the primary bidders in land auctions and leading state-owned homebuilders may reinforce their competitive position by scaling up land reserves in core cities. From January to September 2023, land acquisition-to-sales ratio for a typical state-owned developer reached 31%, resuming to a relatively healthy level. We think some local SOEs manage to lift their competitiveness to a substantially higher level during the industrial transitional period. Leveraging their funding strengths, these local SOE developers enhance their investment in core cities and take a big leap in terms of land reserve and sales scales.

Quality of land reserve plays a decisive role, momentum is diverging among developers

Homebuilders with land reserves concentrated in high-tier cities should benefit from the current demand trend and favorable policies. How strong a rebound will be for a homebuilder hinges on the location of its land reserve. Developers with abundant land reserves in first- and second-tier cities may form an upward spiral of sales-land acquisition cycle, and are expected to see sales recovery amid relaxed policies. However, developers with land banks located primarily in low-tier cities see limited benefits from policy support. The race to acquire land parcels in core cities will intensify the competition for premium resources. In previous real estate cycles, the market size shrank sharply as many developers were ousted in a drastic way, pushing down supply and demand simultaneously. Competition continues with the arena shifting to a few core cities in the spotlight. We think the intensity of competition among existing developers will not reduce significantly despite a decreasing number of competitors. Homebuilders need to make wiser decisions in strategic positioning and capital allocation amid new demand trend. Private developers with limited access to funding may gradually fall behind their state-owned peers with similar business scales in future competition for high-quality land resources.

Chart 7

Sales Momentum is Primarily Driven by Land Reserve Quality



Note: Average sales growth and land acquisition price data come from sales and land acquisition rankings published by CRIC Research.

Source: CRIC Research, S&P Global (China) Ratings.

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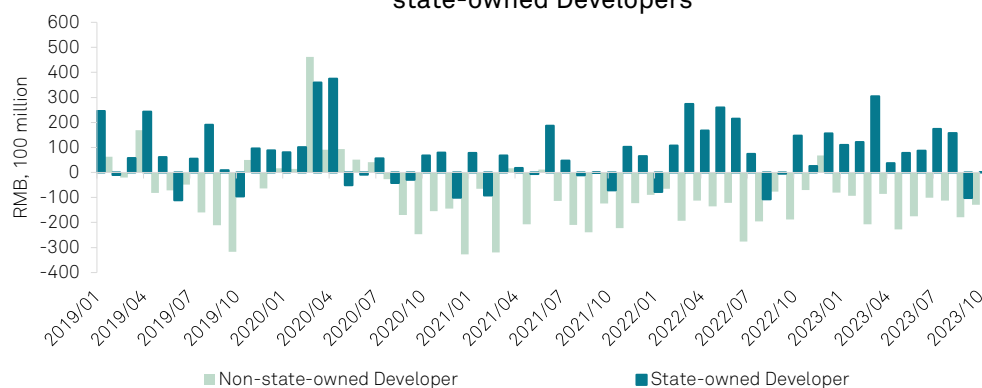
Private developers are seeking to survive in the prolonged fight

In our view, whether the market confidence in private developers will be restored depends on whether property sales can stabilize. Private developers see their competitiveness weakened by tight refunding conditions and difficulties in re-stocking amid liquidity squeeze. How long a specific developer can survive will be largely determined by its sales performance. Debt maturity distribution and diversity of funding channels (e.g., commercial property-backed loans and REITs) are also additional factors for assessing private developers' ability to tackle temporary liquidity stress. Sound debt structure could win more time for private homebuilders to regain market confidence in the backdrop of a severe refunding environment.

Notably, the consistently optimized funding policies targeting the real estate sector would relieve the refunding pressure faced by some private homebuilders on the verge of collapse. In a recent symposium with financial institutions, regulators urged each bank to maintain a property loan growth faster than or on par with the average property loan growth of the banking industry, to keep the growth of loans to non-state-owned developers at a similar or above level for its overall property loans, and to maintain the growth of mortgages relating to non-state-owned developers not lower than the overall mortgage growth of the bank. Meanwhile, there might be further revisions to regulatory measures relating to property development loans, commercial property-backed loans, and mortgages, which would provide ongoing refinancing support to non-state-owned developers. 50 state-owned and private developers on the whitelist are eligible for preferential treatment in the aspects of borrowing, bond and equity financing. We will continue to keep an eye on the implementation of such policies and the outcome in terms of their effectiveness in relieving private homebuilders' refinancing stress.

Chart 8

Net Bond Financing Differentiates between State-owned and Non-state-owned Developers



Note: Monthly net bond financing data from developers under Wind classification.
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Short-term leverage is unlikely to decrease, while long-term financial performance would become healthier

We expect “survivors” in the real estate sector to see marginally increasing leverage ratio in 2024. This is because that profit margin decreased amid tepid sales and debt scale remains stable as their balance sheets are not scaled down due to ongoing land acquisitions. The decline in profit margin may hit bottom in 2024, the logic behind which is that developers begin to recognize profit on low-cost projects considering relatively low price premium rate amid the down cycle of land price since 2022. Moreover, they have booked substantial asset impairment loss in recent two years, removing the overhang of troubled projects and releasing earnings potential.

In the long run, the financial performance of the overall sector will become stronger after experiencing this round of industrial cycle. With the sector set to grow at a slower pace, developers will discard the extensive mode where scale expansion is achieved through land acquisition and funded by massive borrowing, and are looking to make targeted investments in projects that enjoy

relatively secured collection of payments. This will help generate cash flow in a more efficient way for reducing debt. In addition, the “survivors” are primarily state-owned homebuilders, who adopt prudent approach to making investment decisions due to curbs on debt and leverage ratios and oversight of the State-owned Assets Supervision and Administration Commission. These SOEs are also restrained from using leverage. Such common features may help reshape the operating style across the industry.

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