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China's "Three Red Lines" policy initiative drives credit improvement across Chinese HY property bonds

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For much of 2020, one of the dominant themes for the Asian HY market was the government's introduction of the Three Red Lines (or TRL) policy for Chinese property companies. After many years of robust growth in the sector, the government realized that the systemic importance of real estate companies for both the domestic economy and the health of the financial system meant ensuring stability for the sector was a key priority for policy makers. As we previously reported here, the idea behind the TRL initiative was to persuade the sector to improve its balance sheet health and debt coverage capabilities. Three key performance tests were introduced and for property developers to continue to enjoy free access to debt funding markets they would need to bring their financials in line with these metrics. The policy was first announced in August 2020 and therefore the 2H20 earnings reports have given us the first glimpse to how this policy may have actually impacted financial performance and management discipline. Hence this year's reporting season has given the market significant insight into the trajectory of the sector for the medium term.

We have closely scrutinized the financial performance of key China HY property holdings in our JKC Asia Bond 2023 portfolio which represent some of the largest and most systemically important property companies in the country. Our conclusion is not only that there has been a clear observable improvement in credit health in 2H20 but that we believe this can be directly linked to the TRL introduction.

The main idea of the TRL policy was to reduce leverage, improve debt coverage and increase liquidity. The study of our portfolio holdings' 2H20 results shows some interesting trends. Firstly, there was a strong acceleration in contract sales which is arguably the first leading indicator of operating cash flows. Admittedly contract sales in the sector has been on a growth path for several years, however the rate of growth in 2020 was particularly strong and impressive considering the 1H saw significant disruption from COVID shutdowns.

A second observation is across the sector we saw a material decline in gross margin. Of course, margin compression is not normally positive as it generally indicates land prices have risen faster than average selling prices and certainly the depressed performance of property companies' equity prices in recent months reflects this. However, while historically lower margins would usually cause managements to slow down their contract sales (to protect their profitability), in 2020 this does not appear to be the case. A combination of strong contract sales and lower margin trends together indicates a broad-based acceleration of the liquidation of land banks and prioritization of cash flow over earnings. For credit investors and particularly those holding short duration paper this is positive as it significantly improves near term debt service liquidity. Furthermore, we also saw many developers slow down their new land capex in 2020 again to the benefit of free cash flows.

So what has been the impact of these trends on the sector's overall balance sheet gearing and, more importantly, performance against the TRL policy test? As the tables below show, the execution of credit improvement has been broad-based, in our view. For the first TRL test (Adjusted liabilities / assets) 90% of the companies saw an improvement between June 2020 and December 2020. For the second test (net debt/equity) 81% saw and improvement and for the third test (unrestricted cash/ST debt) 86% saw improvement. In terms of the TRLs themselves - which are measured from green (passing all three tests) to yellow (passing two), to orange (passing one) and red (passing none) – 10 of the 21 companies under our study saw an improvement in ranking by at least one notch and 4 companies (namely Sunac, Powerlong, Ronshine and Hopson) improved by two notches. It is perhaps unsurprising therefore that March was the first month, since the COVID crisis that rating upgrades in the China property sector exceeded downgrades.

Admittedly there has been some underperformers, (Yuzhou and China Aoyuan some notable examples) and we have seen some volatility in those bonds as a result. However, over the long term we continue to believe these trends should prove to be credit-positive as they demonstrate the developers' willingness to follow government policy to reduce leverage in the sector even if it means some short term impact on earnings growth. We also welcome the fact that some of the most highly geared developers in the sector, such as Evergrande, Kaisa, Sunac and Guangzhou R&F have been some of the most aggressive in reducing debt.

Our positive view has been shared by S&P, who in their recent report “S&P Global Ratings: Chinese Developers’ Discipline is Policy Induced” drew the similar connection between improving debt growth levels and liquidity position to the “Three Red Lines” policy. According to the report, it is projected that more than 90% of developers will be able to fulfil two of the three requirements by the end of 2021, with at least half fulfilling all three of the red lines.

China property, given its scale and volatility, will always be a highly sensitive sector for Asian HY investors however as the sector has traded cheaply in recent weeks, we continue to see this as an opportunity for the market as fundamentals continue to improve.

Table 1: Change in “TRL” credit metrics for key property developers in our portfolio (between June 2020 and Dec 2020)

Portfolio Company	Change in Adjusted liabilities/assets	Change in Net debt/Equity	Change in Unrestricted cash/ST debt
Evergrande Group	-1.9%	-46.0%	0.11
China SCE Group Holdings	-7.7%	-10.0%	0.33
China Aoyuan Group	-2.0%	3.0%	-0.12
Shimao Group Holdings	-2.3%	-5.0%	0.1
Future Land Development	-2.0%	-4.0%	0.56
Guangzhou R&F Properties Co.	-1.5%	-47.0%	0.16
Sunac China Holdings	-3.5%	-53.0%	0.47
KWG Group Holdings	-2.2%	3.0%	0.16
Yuzhou Group	-1.9%	18.0%	-0.15
Ronshine Group	-3.9%	-22.0%	0.23
Kaisa Group Holdings	-4.3%	-34.0%	0.54
Central China Real Estate	-0.8%	-21.0%	0.16
Times China Holdings	1.0%	-7.0%	0.53
Logan Group Company	-6.2%	-6.0%	0.4
Powerlong Real Estate Holdings	-3.3%	-6.0%	0.24
Agile Group	1.1%	-12.0%	0.14
Fantasia Holdings Group	-3.0%	-4.0%	-0.14
Hopson Development Holdings	-0.8%	-12.0%	0.4
Modern Land (China) Co.	-1.4%	-11.0%	0.09
Redco Properties Group	-0.5%	12.0%	0.41
Zhenro Properties Group	-0.6%	-7.0%	0.03

Source: Citi Research

Table 2: Change in "TRL" rating for key property developers in our portfolio (between June 2020 and Dec 2020)

Portfolio Company	June 2020	Dec 2020
Evergrande Group	Red	Red
China SCE Group Holdings	Yellow	Green
China Aoyuan Group	Yellow	Yellow
Shimao Group Holdings	Yellow	Green
Future Land Development	Yellow	Yellow
Guangzhou R&F Properties Co.	Red	Red
Sunac China Holdings	Red	Yellow
KWG Group Holdings	Yellow	Yellow
Yuzhou Group	Yellow	Yellow
Ronshine Group	Orange	Green
Kaisa Group Holdings	Orange	Yellow
Central China Real Estate	Yellow	Yellow
Times China Holdings	Yellow	Yellow
Logan Group Company	Yellow	Green
Powerlong Real Estate Holdings	Orange	Green
Agile Group	Orange	Yellow
Fantasia Holdings Group	Yellow	Yellow
Hopson Development Holdings	Orange	Green
Modern Land (China) Co.	Orange	Yellow
Redco Properties Group	Yellow	Yellow
Zhenro Properties Group	Yellow	Yellow

Source: Citi Research

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