China: Special Update

Collapse of a Chinese property developer raises fears. We urge caution.

Early this month saw China's first onshore corporate default, when a Shanghai based solar company defaulted on its bond repayments of RMB 89.8 million (around US$14.7 million).

This has been followed this week with a collapse of an unlisted private property development company, with the scale of the debt far more significant. The Zhejiang Xingrun Real Estate Company is reportedly unable to repay its debts – which total RMB 3.5 billion (around US$569 million) – of which RMB 2.4 billion consists of bank loans (from 15 different banks), RMB 0.7 billion in illegal borrowings and RMB 0.4 billion in owed wages and accounts payable (according to reports in Chinese language media sources).

The company's assets are reportedly between RMB 2.7-3 billion, having declined by around RMB 1.4 billion over the past four years – due to falling land prices in the city of Fenghua.

The size of illegal borrowings highlights the growing role of shadow banking in China's property sector. Credit controls intended to slow the real estate sector instead pushed developers to seek alternative sources of finance – with one report suggesting that interest rates on Xingrun's illegal deposits were between 18% and 36%. Many developers used land as collateral, banking on rising real estate prices to service their debts.

Defaults in the property sector are relatively unusual – with firms typically selling projects or arranging equity partnerships rather than entering bankruptcy – however there have been examples in recent times, such as Hangzhou Glory Real Estate (also in Zhejiang province) and Guangdeye Property Development (based in Guangdong province) in 2012.

Implications for China's economy

The real estate sector is an important part of the Chinese economy. Nomura notes that in 2013 it represented 16% of GDP, 33% of fixed asset investment, 20% of outstanding loans, 26% of new loans and provided 39% of government revenue.

Reports in the financial press indicate that corporate bonds and shares for Chinese property development firms have been sold off in response to Xingrun's collapse. The broader concern would be financial contagion and a credit crunch – which could trigger bankruptcies outside the property sector.

At this stage, it appears too early to tell what the potential impacts will be. Various commentators and analysts have expressed concerns around the broader Chinese property sector, however it is difficult to connect a systematic risk to this failure – instead it may simply be a case of poor business practices.

A statement on the Fenghua government website noted that "In recent years, Zhejiang Xingrun's management has been chaotic, its funding chain has broken."

The Wall Street Journal reports that in 2010 Xingrun purchased the largest piece of land that the local government had auctioned for two years at around RMB 4700 a square metre. In late 2013, the local government sold three adjoining lots for RMB 3500 a square metre – under cutting the land's value as collateral.

Xingrun is based in Fenghua, a relatively small city in Zhejiang province (at around half a million people) – just outside the metropolitan area of Ningbo (with a population of around 3.5 million within its metropolitan area). Conditions in a comparatively small market are not necessarily indicative of wider trends within China. That said, according to the Wall Street Journal, developers in neighbouring cities such as Hangzhou, Changzhou, Chengu and Ningbo have started to cut prices in recent weeks in an effort to boost sales.

There are reportedly around 60 000 property development firms in China. Consolidation of this highly fragmented sector would be a longer term positive for the economy.

The response of China's governments and the finance sector to this bankruptcy will be crucial to the short term impact. Attempts to curtail the shadow banking sector could see further bankruptcies this year (particularly among smaller scale developers).

Allowing private firms to default provides a signal that there is no implicit government guarantee on such investments and reduces concerns around moral hazard – which encourage firms to take greater risks. While allowing individual defaults to occur, the Central Government will be keen to avoid a credit crunch that would pose significant risks to the shadow banking sector – and by extension, a significant impact on the economy.

As with the earlier solar collapse, this bankruptcy could result in an improved focus on asset risk and funding allocation – away from less efficient but well connected borrowers – which would contribute to a stronger financial sector in the future. Broadening access to corporate debt and equity funding sources would also reduce the reliance on the poorly regulated and overseen shadow banking and provide a more stable platform for sustainable long term economic growth.

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