According to a report on global property bubbles recently published by a top investment bank, in the wake of the 2008 financial crisis, the five most overheated markets have produced a spike of 20-80% in housing prices. However, China is not on the list despite seeing a multi-fold increase during the same period. Housing prices in China have been soaring since 2012, with sales records being repeatedly broken by a succession of top bidders.

Bubbles in China's property market have never stopped being a controversial subject. Still, it requires deeper investigation to see whether the scale of growth we have witnessed equals sustainability, and to explore ways to maintain reasonable profitability and liquidity.

Striving for Sustainable Growth in Adversity

BY / Richard Ho and Vivienne Huang

It is generally accepted that the government's regulation has had limited effect so far. In 2012, the government kept a steady but tight rein on the property market unlike its earlier approach in 2010 when it repeatedly tightened the screws. In 2013, after the market had had time to assimilate the government's five high-profile measures to stem rising housing prices, we saw a full recovery of the investment environment and the familiar trends – rises in sales and prices.

To get a better picture of the outlook for the property market, Deloitte took a sample of 168 property companies in 2011, and 174 in 2012. These were companies variously listed in Shanghai, Shenzhen, and Hong Kong, largely operating in the Chinese Mainland market, and with more than half of their revenues and asset incomes being generated from property development or investment.

I. Financial Performance Analysis – 2012

Despite tightened regulations in 2012 and slower economic growth, the sample companies achieved average revenues totaling HKD 7,912 million, a year-on-year increase of 24.6%. The aggregate increase of 16.5% was fuelled in particular by a 30% rise in the market capitalization of Hong Kong-listed companies. However, on net profit margin, companies sampled reported a slight rise of 0.5% in average net profit margin over 2011, and a decline of 2.65% over 2010. Return on equity also declined from 11.5% in 2010 to 9.98% in 2012. The sample companies were challenged by further weakening liquidity, with the current ratio and quick ratio dropping by 4.5% and 7.4% respectively compared to 2011.

Table 1 Key Average Financial Ratios/Market Capitalization in 2010, 2011 and 2012

	2010	2011	2012
Revenue (in million HKD)	5246	6348	7912
Market Capitalization (in million HKD)	10010	10382	12091
Net Profit Margin*	20.9%	17.75%	18.25%
Return on Equity*	11.5%	10.72%	9.98%
Current Ratio*	2.40	1.82	1.74
Quick Ratio*	1.09	0.58	0.54
Debt/Equity Ratio*	0.94	0.93	0.92

* Adopting a new set of accounting principles, financial data collected in 2011 from some samples were reprocessed, and a few deviation cases were left out.

Source: Deloitte Analysis

According to the total revenues during the reporting period, we categorized the sample companies as MEGA, BIG, MEDIUM, and SMALL.[1] They were also analyzed by the above seven indicators of size, profitability, and liquidity.

i. Growing in Corporate Size

In fiscal year 2012, property companies listed in Shanghai, Shenzhen and Hong Kong had been steadily growing in revenue by 22%, 39.5% and 18% respectively, and the number of sample companies reporting from HKD 5 billion to HKD 10 billion increased to 29 from 22 in 2011. Hong Kong continued to have a significant concentration of MEGA companies, with 72.4% of the HKD 10 billion samples. In 2011, 64.9% out of the 168 samples achieved total revenue growth, with a greater proportion of the larger companies achieving revenue growth. 81.8% of companies with more than HKD 10 billion in total revenue reported revenue growth compared to 54.5% of those reporting less than HKD 1 billion in total revenues. A similar pattern was found in terms of market performance. Bigger players fared better in the face of the government's harsher regulations and the sluggish economy – achieving a rise in sales through pre-emptive marketing strategy redesign and product portfolio restructuring, targeting clients with inelastic demand or those for the housing upgrading.

A difference was also noticeable in the 2012 performance of the sample companies over 2011, depending on whether they were listed in Shanghai, Shenzhen or Hong Kong. Hong Kong-listed samples saw a 29.9% increase of average market capitalisation to HKD 15,107 million from HKD 11,613 million while there was minimal change in market capitalization for the samples from the other two stock markets. Share prices were stable for mainland companies listed in Hong Kong and the Hong Kong stock market outperformed its mainland peers, benefitting from the ample liquidity and a recovering global economy assisted by the quantitative easing policies worldwide. On the other hand, the performance of the Shanghai and Shenzhen stock exchanges were taking a beating from a slowing national economy. Investors were concerned by expanding financing, flawed trading rules, and lifted bans on non-tradable shares. Nevertheless, due to their growing sales revenues and higher-than-average profitability, share prices for real estate companies still outperformed those for other sectors.

ii. Declining Profit Margin

Whereas average gross profit margins of all samples remained at a high level ranging from 35% to 47%, nearly 60% of the 168 sample companies posted a reduced net profit margin in 2012, and the trend was fairly similar across all four categories of corporate size. It's obvious that the property market as a whole was experiencing a downward spiral in profit margin despite the fact that industry profit margin was much higher than those of most other sectors.

Sample companies listed in Shanghai and Shenzhen experienced a double digit decline in net profits. Their Hong Kong peers outperformed them in average net profit margin by 96.4% and 133.5% respectively, reporting a 27.8% growth in profit margin over fiscal year 2011. Property investment may have been a differentiating factor as it accounted for 67.5% of the fixed assets of Hong Kong listed sample companies, compared to only 40% for Shanghai-listed samples. Taking into account different taxation policies between Hong Kong and the mainland, property investment contributed to Hong Kong-listed samples with an added tax burden rate of up to 18.5%. Only 49% of Hong Kong listed samples reported a net profit margin below 20% compared to 76% of those listed in Shanghai, and 73% of those listed reported in Shenzhen. In fiscal year 2012, all of the Shanghai-listed samples reported a falling average net profit margin, with the MEGA ones reporting the sharpest declines at 24.63%. In Shenzhen, SMALL samples reported the sharpest declines of 35.68%. Hong Kong-listed samples, except for SMALL companies, also reported declines. In sharp contrast to all this, Hong Kong-listed SMALL companies reported significant growth in average profit margin, fuelled by the rise in market valuation of their property holdings, or their asset sell-off to survive.

An analysis of companies' gross profit margin and net profits found that listed property companies showed more initiative in reinforcing internal management and improving operational efficiency. According to data analysis, gross profit margin was not directly proportional to the corporate size of a sample company in a marked way – SMALL samples listed in Shenzhen and Hong Kong reported the highest gross profit margins. However, profit margin is related to the location of property projects. According to their annual financial statements, companies sampled in first-tier cities like Beijing, Shanghai, and Shenzhen, or in economically developed regions like major cities in the north, south and east, posted a profit margin two to three times higher than those in third- and fourth-tier cities. In addition, some sample companies successful in selling exclusive residences, apartments, and villas, reported substantial profits. For the most part, the ratio of selling and management expenses to sales revenues is inverse to the corporate size. Hong Kong-listed companies had invested the most in management, which was necessarily required by their operations both on the mainland and in Hong Kong.

However, a different pattern was observed for average return on equity. In 2012, sample companies listed in Shanghai suffered a slump of 25.1%, those listed in Hong Kong a slight drop of 11.11%, but those listed in Shenzhen gained an increase of 13.3%. As with the case of net profit margin, the returns on equity of over 80% of mainland-listed samples fell below 20%, with only a few exceptions going beyond 20%. A closer look at the returns on equity of samples of all sizes found that a bigger corporate size equals more profits for shareholders. 34.5% of MEGA companies achieved a return on equity in the region of 20% compared to only 1.7% of SMALL players. Bigger companies were better at securing a real increase in profits and attracting more diversified sources of funding besides equities to support their operations and development.

iii. Slight reduction in liquidity

Affected by overall market trends, property companies in 2012 became more meticulous and conservative regarding investment and construction of new projects. More of them were willing to get rid of what was left on their inventories. At the same time, the current ratio of the companies sampled as a whole declined by only 4.48% compared to that in 2011, indicating that liquidity remained a concern. The three sample markets performed differently in terms of current ratio, with Shanghai reporting a slight average improvement, and Shenzhen and Hong Kong suffering respective setbacks of 5% and 9.3%. Except for MEGA companies, current ratio deteriorated for all sample companies listed in Shanghai and Shenzhen, mainly caused by BIG companies.

In regard to quick ratio, Hong Kong-listed samples also took a heavier blow than the other two groups on the mainland – down by 15.4% from 0.67 in 2011 to 0.57 in 2012, indicating a worsening short-term liquidity. This was consistent with Hong Kong-listed companies in other industries. 87% of them ended below 1 in 2012 compared to 75% of them ending above 1 in 2011. In Shanghai and Shenzhen, BIG samples suffered noticeable drops of 28.25% and 35.84% respectively. In Hong Kong, those operating with more than HKD 10 billion saw nearly a 30% drop. BIG companies experiencing deterioration in short term liquidity due to their extended investment in land and new projects. Better current ratios reported by SMALL samples may have come as a result of their worsening short-term financing capabilities.

Operational data indicated that samples listed in Shanghai and Shenzhen were more aggressive in clearing their inventories than their Hong Kong listed counterparts, with their respective inventory turnovers rising by 10.3% and 13.9%, while the latter dropped by 21.2%. However, when it comes to the other indicators, Hong Kong-listed samples outperformed the other two groups, reporting respective increases of 16.7% in current ratio and 23.5% in quick ratio.

With regard to debt/equity ratio, the three sample capital markets altogether reported inconspicuous changes. Shanghai-listed companies declined by 4.35% in leverage ratio, Shenzhen-listed ones were basically unchanged, and Hong Kong-listed ones were slightly up by 3.75% to 0.83%. These changing indicators did not markedly correspond to the corporate size and seem to be more closely related to different choices of financing sources made by individual companies in 2012.

Generally speaking, the absolute value of a leverage ratio is inversely proportional to the corporate size. The reported leverage ratio of 60% of the SMALL companies stayed below 0.5, an indicator of weak borrowing power. On the contrary, an increasing number of BIG companies reported a high leverage ratio. Taking a look at different arrangements in long-term borrowing by Shanghai-listed samples, the corporate size is connected to loan accessibility and costs: the smaller the size, the more mortgages and collateralized loans; the bigger the company, the more credit-line and guaranteed loans. It is worth noting that big companies, competent in financing, need to pay close attention to market trends to ensure in-time cash inflow and an unhindered capital chain.

II. Prospects and implications of the property market

Since 2012, China's property market has been recovering – with increasing sales, rising prices, more frenzied land trading, and gathering momentum in investment and construction. To some extent, the sampled public companies have confirmed these trends in their financial indicators. However, China is undergoing a crucial period of economic restructuring, and progressing with reforms of long-acting mechanisms. Where the property market goes inevitably provokes controversy within the industry. An analysis of the market data points to the following likely trends in China's property market.

- **More stable pace of growth.** China's economy rapid growth in the past 30 years mainly driven by investment has started to slow down, the government, meanwhile, is trying to deepen the transformation of economic pattern restructuring. Property industry also needs to change the extensive and high-speed growth model practised in the past, and is likely to grow at a more stable pace instead.

- **Routinized and long-acting supervision.** Property market regulation will be established as a routine practice. The monetary policy is set to remain prudent, leading the aggregation of currency loans and social financing into a steady, proper upward trend. The specific regulating practices will emphasize prudence, and carry forward long-acting mechanisms like pilot property tax projects, New Urbanization, and agrarian reforms.
- **Declining profit margin.** This has been convincingly demonstrated in the analysis of financial data of 2011 and 2012 from the sample companies. Costs resulting from land, financing, marketing, and labor have taken their toll on the industry's profit margin. Consequently, the industry faces a downward spiral of profit margin. However, companies may have greater potential to achieve a high rate of return by adopting a different competitive and operational pattern, and advanced management mechanism.
- **Increasing industrial consolidation.** The China Real Estate Industry Association predicts that over the next 3 years at least 30% of the property companies on the mainland will be crowded out. A look at the financial data and market information does seem to indicate divergent corporate performance among our samples, and the continuous consolidation of the property industry is highly likely with the stronger growing stronger and the weaker being crowded out.
- **Spreading resource- and energy-efficient products.** Determined either by the government's regulation preferences or by market demands, properties driven by inelastic demands guarantee the industry's steady growth. Accordingly, resource-efficient housing estates or those of small or medium size will become a major product for most of the property companies. At the same time, green, low-carbon, energy-efficient, and environment-friendly notions will be included in the processes of design, construction, and management.
- **New Urbanization-driven industrial transformation and upgrade.** China's housing industry, over its course of 20 years, has been under pressure to seek transformation and upgrade. The New Urbanization opens a window for the industry as a whole to undergo a game-changing transformation. The advance in New Urbanization is expected to bring along the housing industry, though beneficial effects will vary with cities, regions, and property categories. In future the strategic transformation of property companies should take into account integrated urban management and rural industrial development.

- **Big data-fueled resource integration and operational innovation.** For the vast majority of property companies, the use of big data is still at an early stage. More players are expected to strive for platforms offering big data, to tap the hidden potential. In doing so, they will integrate resources and data sets in the face of competition, and innovate their operations, products and marketing practices, thus achieving sustainable development.
- **Expedited overseas expansion.** Over the past year, Chinese property companies have sensibly sped up their overseas expansion while diversifying their investment interests. There are various reasons for this. Markedly different strategies and patterns are employed, however a deep understanding of the target markets, cultures, and business environments is worth careful attention from all. Going global is the future of leading property companies. Enhancement of overall competitiveness takes time and hard work.

Specifically, property companies can start with the following recommendations in response to the changing market competition.

The Chinese property market has seen a new peak level of demand. To wipe away stocks of property products and accelerate their turnover, property companies need to improve and enrich their product lines for different groups of clients. A diversified product portfolio may help ease the contradictions between profits and efficiency, but it simultaneously relies heavily on solid research on and knowledge of the market, good design and introduction of products, and efficient and innovative marketing. Interior design and decoration, as well as education and healthcare facilities, and retail outlets, among others, have been playing an increasingly important role in the promotion of property sales.

Proper balance should be kept between what have been more and more confusingly defined as core and complementary operations. At present, development projects of housing estates and their revenues and profits are contributing to property companies mostly as a major source of income. However, an increasing number of players have been formulating investment plans, like estates for commercial, industrial, hotel, and logistic uses, as part of their medium- and long-term strategies. While trying to improve cost and quality control, optimising resources, and complementing existing business practices, a few property companies choose to extend the operational chain by establishing affiliates providing building materials, furniture, and interior design and decoration services. Meanwhile, some of them have diversified into other industries, like mining, biotechnology, livestock and poultry farming, education, media, and entertainment. However, it is imperative that they realize that corporate transformation and diversification must be based on their core competitiveness and resource evaluation with the support of competent management.

Aggressive marketing strategies have proved to be more important in facilitating deals and building market dominance. In addition to offering discounts as a promotional practice, property companies can also look at strengthening market research, and conducting dynamic monitoring of market demands, thus being able to immediately adjust their marketing strategies in response to any change in the market. At the same time, given the potential of China's property market as a lucrative investment, property companies are recommended to enter into strategic cooperation with wealth management departments of financial institutions to identify and serve high-net-worth clients. While the use of internet technology and online sales is helping to curb rising marketing costs and expenses, new marketing channels should be established.

Of course, financing at a reasonable cost remains a constant subject for the property industry. To that end, it's important for property companies to explore diversified financing channels in support of their growing performance and business. While China's entire capital market is going through a continuous adjustment, property companies should utilize other essential channels, besides bank credit, such as stocks, private equity funds, trust schemes, and corporate bonds, to collect more money. It is worth noting that, over the past year, the acquisition of ready-made companies incorporated in Hong Kong has become a major instrument for mainland property companies to enter overseas capital markets. The practice is expected to be seen more often as a way to establish an overseas financing source while extending markets. Considering its complicated and cumbersome nature, acquirers need to carefully screen the targets and, keeping in touch with regulators, go through follow-up procedures like asset reorganization, capital injection, and auditing. Therefore, it's recommended that property companies, at an early stage of the potential acquisition, hire a professional service agency to design the whole program to deliver the goal while minimizing unnecessary costs and risks.

Looking forward to the future, Chinese property companies should first focus more on internal operational efficiency and cost control and, where appropriate, adjust their capital structure and costs. Looking further ahead, they may achieve a better and more sustainable quality of growth by focusing on developing a refined product portfolio catering to different demands, and exploring new profit sources.

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Note

1. *MEGA: over HKD 10 billion; BIG: over HKD 5 billion, and below HKD 10 billion; MEDIUM: over HKD 1 billion, and below HDK 5 billion; SMALL: below HKD 1 billion.*