Anybody home?

In late August, Chinese real-estate giant Country Garden reported a record $7 billion loss, prompted by $15 billion worth of debt due by June 2024, for the first half of 2023 and missed a dollar-denominated bond payment on October 19th.

This has come as a concerning surprise to those who believed that the developer was one of the few survivors of the liquidity crisis in the country's property sector two years ago that hit many of its rivals. After all, Country Garden is China's largest real-estate developer, taking the crown last year for most home sales in the country and, as of a few months ago, had over 3,000 developments nation-wide. For the year 2023, it reported $64 billion in revenue and over $200 billion in total assets. With numbers like those, it seemed like it wasn't going to turn into another Evergrande.

But the reality is that Country Garden is in crisis. It is burdened with $194 billion in total liabilities, of which $15 Billion is due within 12 months, only $13.9 billion in cash, restrictions on borrowing, and panicked bondholders seeking to speak with leadership immediately after recently missing payments on dollar-denominated bonds. How did we get here?

Over the past few decades since economic liberalization, China's economy has become a manufacturing superpower, reflected in its nickname "the workshop of the world", making the sector its greatest growth engine. In order to feed this machine, the demand for migrant factory labor in cities has been immense.

Spurred on by the promising path to middle-class prosperity that little else but a manufacturing job could provide, seemingly endless hordes of poor rural Chinese from the hinterlands, most of whom had been living on subsistence wages for centuries, moved into China's urban areas every year.

Called the greatest internal migration in human history, China's rate of urbanization has been, to say the least, quite rapid. In the 1990's, ⅓ of Chinese lived in cities. In the 2020's, the number of urban dwellers, close to 950 million or 64% of Chinese, is nearly double the rural population.

After urbanization, this new economic class looked for ways to invest their new house-hold wealth. The answer they found was property. The reason for this is that real estate is one of the only investments permitted by the CCP, and provides by far the reliable and generous return. And thus, China's population has channeled most of its private household wealth, about 70%, into the speculative side of the property market. In fact, so much in available assets needed to be invested were these properties that, as allowed by Chinese law, many buyers bought units sight-unseen and paid mortgage dues oftentimes before a stake was put in the ground.

At the heart of this story are China's property developers, who have provided the supply of residences for rural migrants clawing their way to move in and urbanites foaming at the mouth for investment opportunities. Always finding themselves unable to keep up with the sheer demand from both, developers have been rather happy with the resulting tremendous upward pressure on residential property prices.

In fact, so great have these pressures been on residential housing prices that China's property market has turned into one of the most inflated residential property markets in the world. With a nation-wide price-to-income ratio of 32.3x in mid-year 2023, over 3 times that of NYC, David Woo, a former IMF economist, called it the "most overvalued property market in the world". Beyond this is also the speed with which it has inflated. In 2009, China's ratio was a more reasonable-looking 15x.

However, looking below the surface of this incredible economic phenomenon, the property developed by real estate companies over the course of this massive urbanization period has been largely financed through debt, and quite a lot of it.

With these loans, property developers very quickly built these residential property developments in large numbers. Many developments were built in China's premier and well-established cities like Shanghai and Guangzhou. In many other cases though, properties were developed in China's tier-3 cities. Developers have invested in tier-3 cities since they are significantly less populated and have significantly cheaper land prices. With the allure of sky-high prices, and the assumption that China's urbanization trend would continue and spread to more cities, it appeared to be a good idea to get in early while land was cheap and abundant to maximize profitability when prices rose from new migrants moving in and increased investment activity.

Yet now, the same developers are struggling to pay those loans. One of the reasons for this is revenue shortfalls. China's decline to 3% economic growth, the second-lowest level since the start of economic liberalization in the 1970's, has created a serious spike in factory closures and pay cuts for factory workers and white-collar workers across China. Unfortunately for developers, this means there is less money able to be invested by Chinese in property, and fewer people looking to move into cities.

Additionally, there is also an increasing realization among Chinese that these companies, perhaps banking on customers not knowing and/or caring, or perhaps unbeknownst to management in the first place, have been cutting corners in the construction of these developments. Particularly for tier-3 cities, developments were built quickly and cheaply, resulting in poor quality projects made with brittle concrete and/or located on land unfit for development. This has evidently turned off many would-be investors or homebuyers who see it as an excessive risk.

The most important reason, however, is the sheer amount of housing stock built by these companies in China. So much has been built that it is likely that the entire population of China couldn't fill all the units. Analyst He Keng, a former deputy head of China's statistics bureau, confirms this, saying "How many vacant homes are there now? Each expert gives a very different number, with the most extreme believing the current number of vacant homes is enough for 3 billion people. That estimate might be a bit much, but 1.4 billion people probably can't fill them." Combining primary residences, homes purchased by speculators that remain vacant, or residential projects that have already been sold but not yet completed due to cash-flow problems, it is estimated that there are at least around 65 million units in total, over 20% of China's total housing stock, that are unused in China. This much of the housing stock being either unused, unwanted, or both implies that developers have been building for no one.

For all these reasons, China's developers now find themselves saddled with massive portions of their assets unable to generate any revenue or cash flow, another significant portion generating lower revenues and cash flow than they did before, and significant amounts of their liabilities due in a relatively short time frame.

Country Garden is one of the developers in this situation. However, given its exposure to tier-3 cities, which make up 61% of all of its developments, these problems are only further amplified. Prices in tier 3 cities have already decreased, particularly compared to properties in the 1st and second tiers, but demand is further predicted to fall 30% by 2035. With so much money of its assets tied up in these cities, and uncertainty over just how much of these assets can actually generate cash flow, this can only mean trouble.

Country Garden is far from the only Chinese developer on the brink. Companies accounting for 40% of Chinese home sales have already defaulted on one of their obligations, and the catastrophe that Evergrande turned out to be is certainly still fresh in our minds. Yet, being the largest of them all, the crisis that Country Garden finds itself in suggests that the Chinese property sector as a whole has finished the progressive climb to the top of the roller coaster, and the only way forward now is down.

In the end, the lesson here is that the speed with which China has grown has, for one, come at the cost of massive market bubbles that cause everyone to lose track of the market, and secondly, led to a self-defeating and dangerous idea shared by many in and outside of China that growth is not a privilege but an expectation. Hopefully, China will heed this lesson before it's too late, if it isn't too late already.