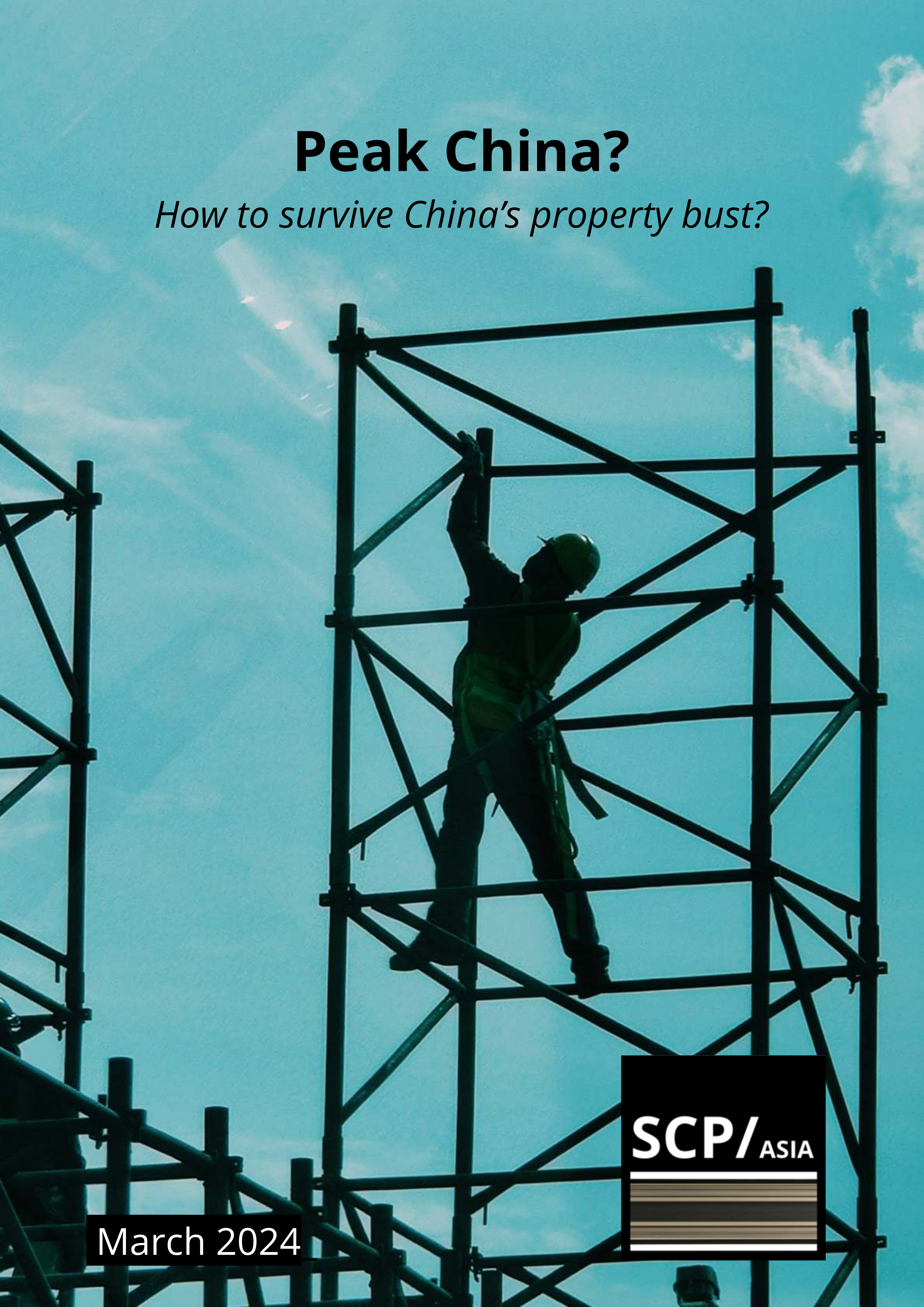
Peak China?

How to survive China's property bust?



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Peak China?

How to survive China's property bust?

By Michel Brekelmans

China has been a key player in the global economy, experiencing significant growth over the past few decades. Its rapid industrialization, export-oriented policies, and massive infrastructure projects have propelled it to become the world's second-largest economy. However, in the last few years China his witnessed significant headwinds with a collapsing property sector, declining working population, sagging consumer confidence and significant constraints around technology trade. Reports of 'Peak China' have become frequent in the international media.

Based on recent project experience we're diving into a number of industry sectors to explore whether China truly has become 'uninvestible', as some commentators believe, or whether China remains 'open for business', a narrative currently pushed hard by China's government. In this second article we look at China's property sector which has been hit hard over the past 2 years. Specifically, we look at the implications for suppliers into the property sector, from building materials to appliance manufacturers, and what options they have available to survive the deluge.

China's property collapse

China's real estate industry has been in a prolonged downturn, as evidenced by an ongoing decline in both investment in and sales of property since February 2022. The downturn in the property market has been driven by cyclical factors such as slowing income growth during the pandemic, and structural factors including shrinkage of the working-age population in China, diminishing returns on investments and slower growth in total factor productivity. The global interest rate hiking cycle of 2022-23 triggered several defaults in China, especially on US$ denominated debt, including by major property developers.

The slump has hit household and business confidence, holding back domestic growth and increasing the risk of a liquidity trap. The spillover effects to the economy have been mainly through a fall investment and consumption, estimated to affect around 24% of the real estate-related value chains that make up China's GDP.

Figure 1: Newly Started Residential Buildings (2004-2023)

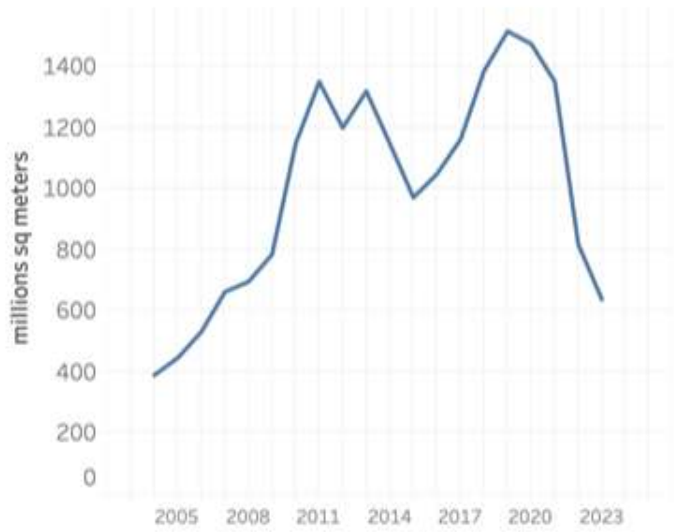
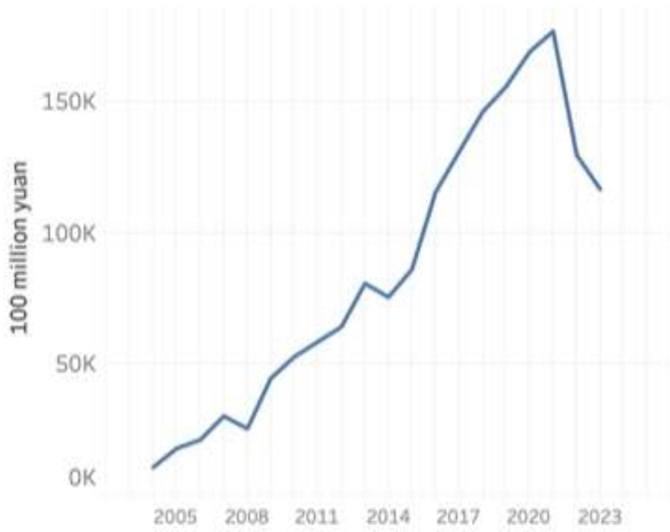


Figure 2: Total Sale Value of Residential & Commercial Buildings Sold (2004-2023)



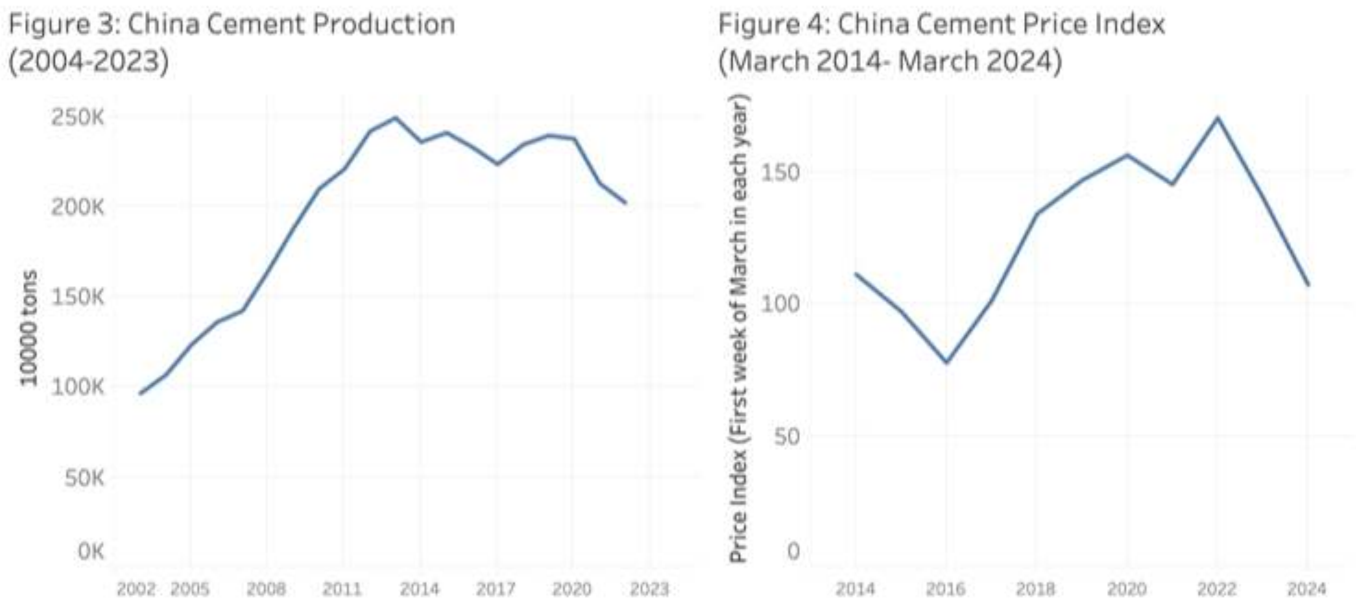
Source: National Bureau of Statistics of China, SCP/Asia Research & Analysis

Impact on Suppliers – Building Materials

Suppliers into the property sector have been hit hard by the collapse in property development. To illustrate let's take a look at the cement industry and some of China's key players.

China accounts for more than half of the world's cement production and consumption. Production declined 15% over the past 2 years to 2 billion tonnes in 2023, the lowest since 2010, government data shows.

Seeking to reduce supply, authorities have ordered production suspensions. But with supply exceeding demand and inventories remaining high, production restrictions have not had a meaningful effect and cement prices are falling. The average price per tonnes on early March 2024 stood 50% below an October 2021 peak and 30% below the average level over 2018-2022.



Source: National Bureau of Statistics of China, ccement.com, SCP/Asia Research & Analysis

The depressed real estate market in China is prompting cement manufacturers to remix their operations, with industry leader China National Building Material Group merging production units and its rivals acquiring smaller players.

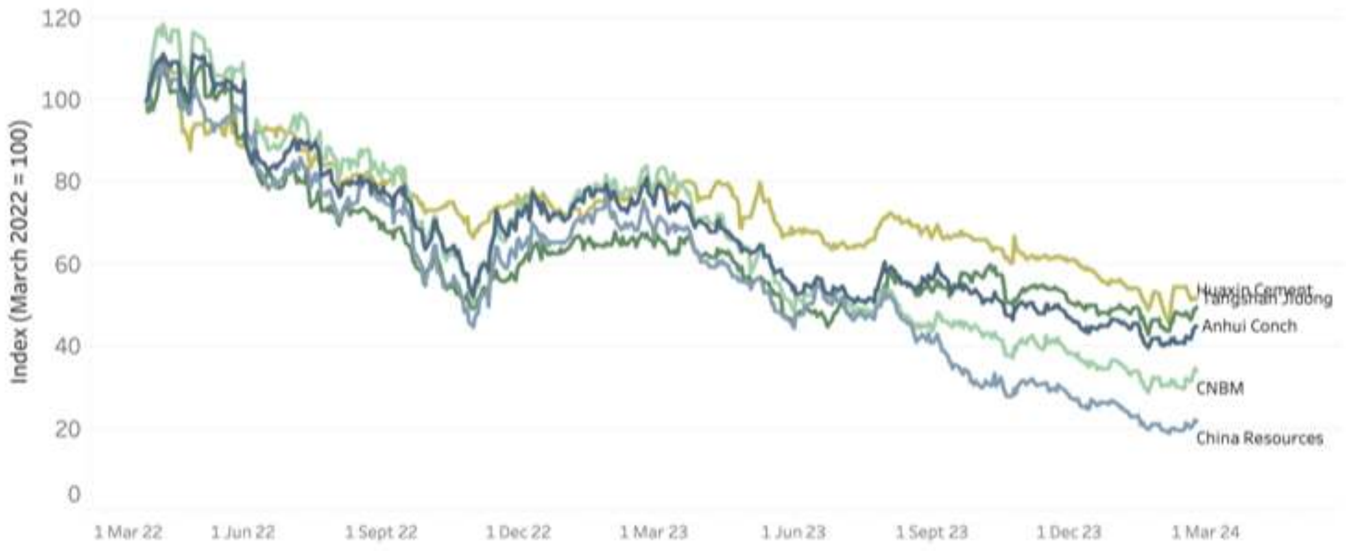
Industry consolidation on the way but results have continued to deteriorate

Concerned about a capacity glut, the Chinese government has been urging the industry to reorganize. Responding to that call, No. 2 player Anhui Conch Cement went on a shopping spree in 2022, buying a dozen companies and continuing with acquisitions in 2023. BBMG, the third-ranked producer, also purchased several companies in recent years.

The supply glut and price drop is eroding earnings. CNBM's sales fell 9% to 380.1 billion yuan for 2022, while net profit dropped 23% to 22.1 billion yuan. Conch's sales tumbled 21% while profit plummeted 53% in 2022. Industrywide profits from the major players in 2022 and 2023 declined over 80% compared to 2019 levels.

Some players have continued expanding overseas despite the downturn in their core markets in China, resulting in higher leverage and negative free cash flow. Not surprisingly, share prices of China's top-5 cement suppliers have collapsed over the past 2 years.

Figure 5: Top-5 China Cement Producers - Share Price Index (March 2022- Feb 2022)



Source: HKEX, Shenzhen Stock Exchange, SCP/Asia Research & Analysis

Impact on Suppliers – Furniture & Fittings

Looking further upstream along the value chain, we can see that the impact of China's property slump is not isolated to the construction industry and building materials sectors. Suppliers of furniture, home furnishings as well as kitchen and bathroom fittings are seeing their business severely impacted by the slowdown in demand.

Early March, China's cabinet approved a plan aimed at promoting large-scale equipment upgrades and sales of consumer goods. The plan is one of a series of steps China is taking to boost the economy which has been recovering weakly since the Covid-19 pandemic.

Meanwhile, suppliers of household furniture and fittings, which includes many MNC players, have seen a severe deterioration of the performance of their operations in China. Japan's Lixil is one of the leading players in China with a range of kitchen and bathroom brands, including Toto and Grohe. It's sales have been hampered by the slowdown in property sales and home renovations.

Figure 6: Lixil China - Quarterly Revenues (Q2 2022 - Q4 2023)

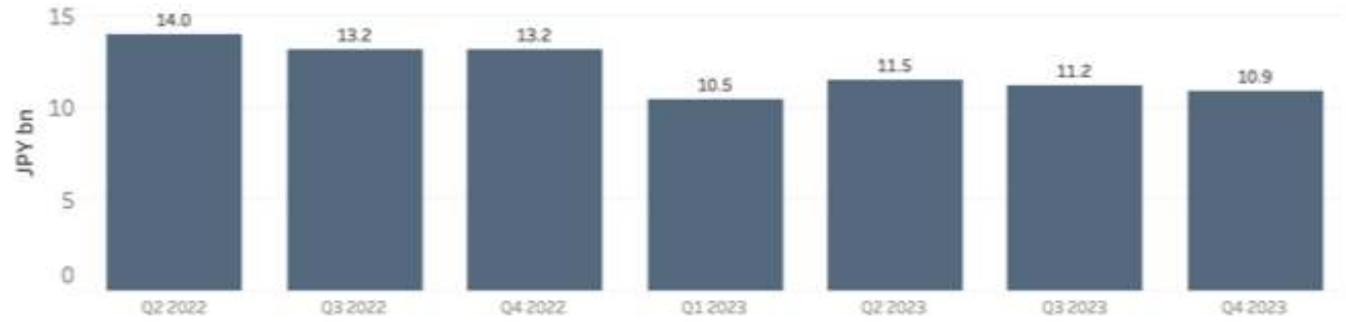
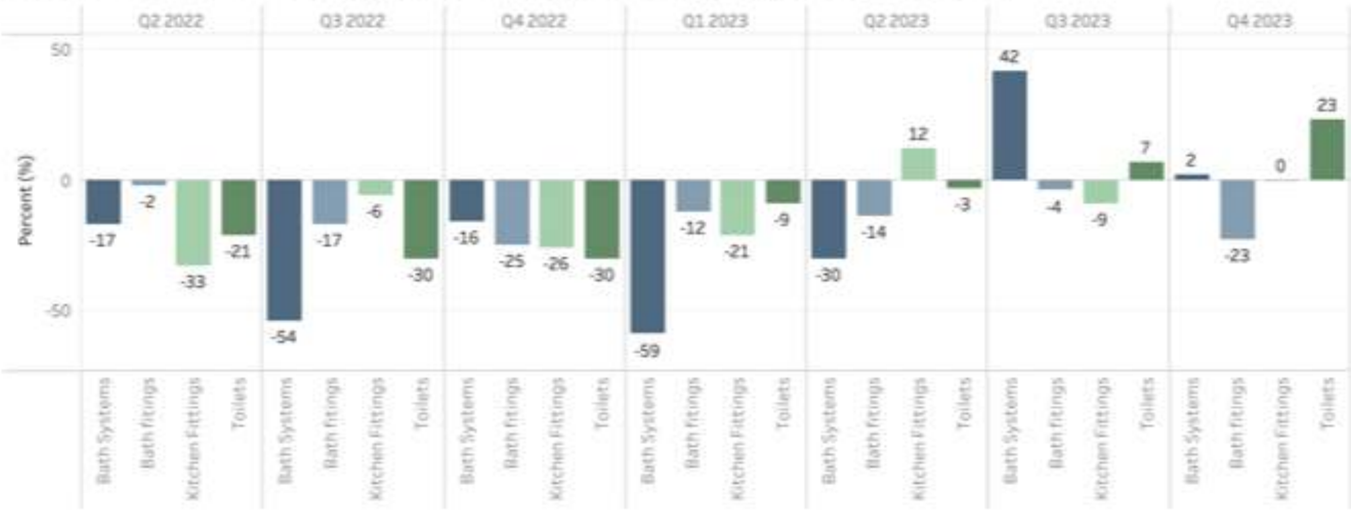


Figure 7: Lixil China - Quarterly Growth Rates by Segment (Q2 2022 - Q4 2023)



Source: Lixil, SCP/Asia Research & Analysis

What are the options?

What options do suppliers along the property supply chain have to deal with the pronounced decline in demand? We asked several business leaders with major operations in China what strategies they are deploying to cope with the challenges for their businesses in China. We summarise the key lessons below along 6 key themes:

1. **Adjust to the new reality:** Gone are the days of China representing 'ever growing demand'. The revenue drop witnessed by businesses across many industries is likely representing the new reality and businesses will need to focus on reducing SG&A and scaling down their business. This means rationalising production and logistics footprints and potentially isolating the China operations into a separate entity for restructuring purposes.

2. Look to **add products to the portfolio** so that you can have more leverage over channel partners and customers: the more products in your portfolio the more relevant you are to channel partners. The goal is to increase sales (i.e. sales synergies) by offering a wider range of related products. The key is to do this is in a low-cost way (for instance through M&A instead of in-house development) but at the same time make sure you retain control (so no JV type structures).

   CNBM provides an example of this strategy. They engage in new materials, such as glass fiber, carbon fiber and materials for lithium-ion batteries. Sales in this sector grew 10% to 30% yearly between 2019 and 2021, but stayed flat in 2022, making it unclear whether these highly competitive businesses can compensate for the cement slump faced by CNBM.

3. The ongoing industry turmoil might provide a good time to **look for consolidation and M&A** opportunities to target a number of objectives:

   - add products to portfolio
   - consolidate the industry (take out a competitor or get access to new products, channels or customers)
   - achieve more scale and / or leverage over channels (for instance JD or Sunning for household goods)

- increase share and preserve production volumes (to ensure factories are running at high capacity to avoid manufacturing inefficiencies).

4. **Diversify across customer segments and channels**. For example, suppliers of kitchen and bathroom fittings could rebalance focus from project sales for new property developments to develop their business in the renovation markets by targeting new customers and channels (i.e. sell more through decoration companies, plumbing wholesalers, etc).

5. **Adjust the business model from product sales to recurring revenues and service income**. This can be achieved by offering installation, repair & maintenance services as well as earning income from spare and wear parts. Some players are even able to add recurring revenues streams by offering extended warranties, financing options and even elements of a subscription model, for instance in home security or smart utility meters.

6. The last theme sited by several industry players is to **reduce the weight of China exposure by focussing investment in other markets in Asia**. However, none of these markets are likely going to be easy replacements to fill the gap left by the collapse in China demand. Vietnam has good growth potential but is a relatively small market whilst India is big market potential but with many relatively price sensitive customers.

The domestic slump has CNBM turning to international markets. A new drywall factory was completed in Uzbekistan in 2023. Currently CNBM generates only about 10% of sales in foreign markets but the group wants to tap more opportunities, particularly in the regions open to the government's Belt and Road infrastructure initiative. But doing business in emerging economies carries a risk of instability. Loan claims for Belt and Road projects are growing increasingly sour, highlighting risks of overseas expansion.

China's property slump is having major ramifications across the supply chain from upstream building materials to fitting and furniture suppliers. A full recovery may be years away the industry may be facing structural revenue gaps that are hard to bridge. Business executives have multiple strategic options available of which 'adjusting to the new reality' is an absolute must do.

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Michel Brekelmans is Managing Director at SCP/Asia and has over 25 years of experience in strategy consulting. Before starting SCP/Asia in 2016, Michel spend 20 years at L.E.K. Consulting, initially in London and Los Angeles and from 2002 in Asia. Michel was a Senior Partner at L.E.K. Consulting, member of L.E.K.'s Asia Regional Management Committee and led L.E.K.'s offices in Singapore and Greater China. He can be reached at: m.brekelmans@scpartnersasia.com.

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