

Could the arrival of the year of the dragon rescue the country's beleaguered property developers? As Chinese new year approaches later this month, tens of thousands of couples are preparing to marry under what is considered an auspicious sign. To win over a bride in a country undersupplied with women, it helps a lot if the aspiring groom first proves his worth by buying a home.

China's developers need all the help they can get. Keen to cool overheating residential-property markets, the central government has restricted purchases of multiple homes, demanded larger down-payments and curtailed opportunities for speculators to "flip", or quickly sell on, properties. It has curbed developers' access to bank lending and cut off credit from new trust companies. It is also encouraging the use of property taxes like those introduced in Shanghai and Chongqing last year. The government remains committed to policies of this ilk.

Taken together, these measures have splashed cold water on the market. Price growth has been slowing since early 2010. Analysis by Soufun Holdings, the country's largest property website, suggests that prices fell during December 2011 in 60 of the 100 cities it monitors. Land prices are falling fast, too. A recent survey of leading developers by Standard Chartered indicates that land prices are a third off their peaks of late 2010. There are also reports of land auctions run by local governments—a prime source of assets for developers and of funding for local exchequers—failing across the country. All of which presages an overdue consolidation of the industry.

One harbinger of the bloodshed to come is a row that erupted in Shanghai just after Christmas. SOHO China, a big developer, announced that it would buy a 50% stake in prime property near the city's Bund promenade. It agreed to pay roughly 1 billion yuan (\$158m) to Greentown China Holdings and nearly 3 billion yuan to Shanghai Zendai Property, two smaller developers. This outraged Fosun International, a conglomerate that owns the other half of the property, which claimed it had the right of first refusal and is now threatening legal action.

The row is revealing for several reasons, and not only because such public brawls are unusual in China. It serves as a good example of past excess: the property in dispute became the city's most expensive when, in 2010, Shanghai Zendai paid 9.2 billion yuan for it in an auction. That the two smaller firms agreed to sell their crown jewel hints at the liquidity squeeze now facing weaker developers. And the squabble between the bigger players shows that there are cash-rich developers primed to take advantage of the tumult.

The scope for consolidation is huge. There are over 30,000 property developers in China. Many of these are small local firms that cannot command the access to credit, economies of scale or geographic diversification that big firms can. Analysts at Citibank estimate that the biggest 100 or so firms control only a quarter of the sector, with the next 500 firms commanding perhaps 10% to 15% more. But consolidation is gathering pace.

The obvious losers from this process will be firms that are heavily leveraged. HSBC estimates that the average gearing for leading listed developers rose from 47% in 2010 to 56% last year (before tightening measures hit home). That average masks wide variations, however: China Overseas Land & Investment (COLI), a state-run goliath, has a leverage ratio of only 36%, whereas Shimao, a smaller rival, has one of 77%. Analysts from Standard & Poor's, a ratings agency, have run stress tests on the balance-sheets of leading developers and conclude that a 30% drop in contract sales from 2011 levels could push many weaker firms to the brink.

What about the winners? Conventional wisdom maintains that the big listed developers will best the unlisted developers, which are seen as having murky accounts and weak access to capital markets. Not necessarily, argues Andrew Lawrence of Barclays Capital. He sees an analogy with Britain's frothy property market in the 1960s, when it was the flashy listed firms that overloaded their balance-sheets with debt, whereas the unlisted firms stayed trim and came out on top. He thinks much the same may happen in China.

Another bit of conventional wisdom holds that property developers focused on booming provincial cities will do much better than those with eyes on the biggest "Tier-1" markets like Beijing and Shanghai. One reason to think so is that the edicts issued by the federal government to curb market fervour are enforced with vigour only in the largest cities.

But it is just possible that the downturn could lead to a reversal of fortunes. Markets outside the big cities are often very thin, with few secondary buyers and little investment from other parts of the country. A sharp drop in prices and confidence could lead to a frightening freefall. Privately built housing in peripheral markets is also more vulnerable to cannibalisation by the vast amount of subsidised "social housing" being built by the government.

Pointing to Beijing's speedy rebound from an earlier property downturn in 2008, analysts at Citibank argue that the leading markets may have a natural floor for prices even in the worst environment. If so, firms like China Resources, Longfor and COLI, which are well positioned in the big cities, may weather the storm better. This is especially true if there is a flight to quality. As the number of defaults and failed projects increases, buyers (who typically pay for homes before they are built) may well favour bigger developers with strong brands and stronger balance-sheets.

In any contraction, big and diversified firms that have little debt and access to cheap capital will come out on top. On that basis, the biggest winners of the coming shake-out are likely to be firms that are state-owned or that have strong links to the government. The likes of COLI and Poly Real Estate Group enjoy official patronage and access to subsidised credit. Of the 20 biggest developers, as measured by yuan sales, ten are wholly or partially controlled by state entities. That share will rise.