China - real estate market snapshot

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My personal conclusion

Outrageously high prices have put normal Chinese under great pressure and have hurt consumption. Lower housing costs would also stimulate buying by freeing up more of people's incomes. Home ownership has become a mission impossible for large segments of the population.

An implosion of the real estate market is not a preferable correction in the Chinese housing market. But one way or another, prices must come down as the oversupply is obvious.

Developers and real estate companies will suffer and some will even go bankrupt. Due to different mortgage practices and down payments in China, a devastating impact in the financial sector looks unlikely, as compared to the subprime crisis in the USA; some players might still be badly hit.

The correction in price levels will be uneven, between the different tier cities but also within tier-one cities where location will dictate high demand and prices while other locations will face oversupply and serious price corrections. Even in the top-end market some segments will see price corrections. Location – and increasingly quality – are the key.

For the Chinese government it will require a balanced approach, to make housing more affordable, to let the market correct itself while avoiding a downright price implosion with the danger of social instability, or worse.

A bubble ready to burst?

A few big urban centers are thriving while hundreds of smaller towns struggle in what one China strategist called 'triumph of the megacities'. Stories about '*ghost cities*' are back. There used to be one or two, notably Ordos. Now the list is growing: Caofeidian, Manzhouli, Changzhou, Shenfu, Yujiapu, Taizhou, Chenggong, and so on, according to Mingtiandi.

Real estate agencies are laying off staff after sales slumped in early 2014 to just one-third of the levels seen in 2012. They are also holding off on opening new branches. An increasing number of Chinese property developers are facing the threat of bankruptcy as their credit dries up and weak sales have cut their cash flow to a trickle.

According to a report by *Goldman Sachs Group & Gao Hua Securities Co*, the financial situation of 110 developers listed on the A-share market deteriorated in the first quarter of 2014.

Moody's Investors Service revised its outlook for China's property market to negative from stable as it expects growth in home sales to slow notably. Moody's forecasts year-on-year home sales growth will slow to at most 5% in the next 12 months, from 27% last year.

The "Golden Era" for China's property market has passed, according to *Vanke*, the nation's biggest developer, which is shifting its focus to homes for owner occupiers rather than investors. "The period in which everybody makes money out of property is gone," President Yu Liang told reporters in May. "Vanke will take a cautiously optimistic approach to face the slowdown and target those buyers who need homes for self-use." Vanke is also interested in investing in industrial property and homes for the elderly.

In a recent poll of economic experts by *Bloomberg News* from May 15 to May 20, addressing the popular question of whether the country is suffering from real estate bubble, 12 of 18 economists say that China has some national oversupply of housing, but only seven went so far as to call it a nationwide bubble. Half see a bubble in some cities, and a majority say the loosening of restrictions on home purchases and loans will be limited to a regional level.

“I think China’s property market is like the Titanic and it will soon hit an iceberg in front of it,” *Soho* China’s chief *Pan Shiyi* said in May. “After hitting the iceberg, the risks will not only be in the real estate sector. The bigger risk will be in the financial sector. I am not optimistic about China’s property prices.”

Economist *Andy Xie*: “China’s property market has been set up as a big casino, where the average person might win big or might lose big, but the government always makes a profit.”

Economists for J*P Morgan Chase* and *ING* both warned of risks to the nation’s economy: Zhu Haibin, chief China economist with JP Morgan Chase said that although home prices are not likely to collapse in all cities, the real estate slowdown represents the biggest macro risk to China’s economy. Maarten-Jan Bakkum, Senior Emerging Market Strategist at ING Investment Management saw China’s real estate issues hurting the economy’s competitiveness internationally: “Sales and price dynamics in the real estate sector continue to be outright negative.”

Too big too fail?

Real estate is a major component of China’s GDP, with massive construction, using cement, iron and steel, aluminum, furniture etc. Real estate investment was worth 11% of GDP in Q1 2014 and directly impacts around 40 other business sectors. In 2013 sales of new homes were equal to nearly 12% of China's GDP, according to brokerage CLSA. According to China Daily, the property sector is contributing even more to the GDP: 16%, and 25% of fixed-asset investment; over 60 industries are linked to it.

The past two decades showed unstoppable price increases. In five years prices have doubled. In central Beijing prices of 40,000 to 60,000 yuan per sqm are “normal”.

Households in China held 66% of their assets in homes, in Beijing it is 84%; in the U.S. it stands at 41%.

Who bought real estate? Private buyers for their own use; as speculative investment (lack of alternatives); to hide illicit gains (corruption); companies who divert investment into the real estate sector for a quick profit. The speculative inventory became huge. Many apartments were bought as investment and are not rented out.

The government started a clamp-down to fight corruption and to cool the market by imposing punitive interest rates, high down-payments for second home mortgages (70%), prohibition to buy a third home, restrictions on buying through residency (hukou) requirements.

According to *CLSA* empty apartments are estimated to number at least over 10 million, a vacancy rate of 15%; others estimate it at 20 to 30%. Adding construction already underway, CLSA says the vacancy rate will hit 20% and could go even higher unless developers immediately curb new starts. Vacancy is heavier in small cities, already nudging 20%. The ghost cities are altogether worse.

The British bank *Barclays* said in a report: “Tightening monetary financing conditions, combined with overbuilding and increased developer leverage in 2013, have worsened the housing market's supply-demand picture.” It said that Beijing won't allow China's property bubble to suddenly burst, as a 5% decline in property investment growth would shave 50 basis points off of China's GDP growth. Instead, the bubble will gradually deflate this year and next.

A new agency is being set up under the Ministry of Land Resources to track real estate assets nationwide (including land and forests). The goal is a *National Registry*; target dates are 2016 (property registry) and 2018 (information management). Next step: *property holding tax*. The national database is a necessary tool for enforcing a property holding tax, and could also be used to track the assets of individual officials, many of whom have previously been exposed as having accumulated real estate holdings far beyond what could be acquired through their salaries. The setup of the agency is facing a lot of foot-dragging as people do not want to show their illicit wealth. As a result, a flood of luxury properties is seen on the second-hand market to save the wealth of their owners, affecting some segments of the high-end residential market, including for some villas, affecting sales and price levels.

Residential market

After increasing at double-digit rates for most of the year, home prices started cooling in late 2013 as a sustained campaign to clamp down on speculative investment and easy credit started showing results, and the economy slowed down. Annual growth in average new home prices slowed to an 11-month low in April. Existing home prices dropped from a month earlier in 22 of 70 cities in April, compared with 14 in March. According to another report, 45 out of 100 big cities saw prices decline in April 2014. Property sales dropped 6.9% in the January-April period from a year earlier in terms of floor space, and fell 7.8% in terms of value. Sales in April and May 2014 showed a heavy drop in the sales of pre-owned houses, the barometer of the market.

Hangzhou led the price slide with a 0.7% drop, followed by Huizhou in Guangdong, Jinhua in Zhejiang, Ganzhou in Jiangxi, Wuxi in Jiangsu, Anqing in Anhui, and Ningbo and Wenzhou in Zhejiang. Fewer cities were able to achieve increases in housing prices last month with only 44 out of 70 reporting monthly price growth, compared to 56 during March.

New housing starts were down 25% in April 2014, year-on-year. According to *Standard Chartered* official figures show there was a 17 months of stock of apartments in China’s major cities, including Beijing and Shanghai.

In some locations, the oversupply is dramatic and will take years to find buyers.

In the first quarter of 2012, property investment in Heilongjiang province jumped 157% year-on-year. Developers seemed to expect people from the surrounding provinces to flood Heilongjiang to fill the mass of apartments under construction. But at the same time, the neighboring provinces were building just as fast, adding huge numbers of units. Investment in real estate in Jilin province hit 304% year-on-year in the first quarter of 2012. Every developer thought it could attract people from other areas.

Tangshan is one example where years of frenzied construction have crowded the city's skyline and, as demand slows, prices for apartments are falling rapidly. In 2013 the price of new housing in some developments has fallen from around 10,000 yuan per sqm to about 6,000 yuan. Tangshan has a vast housing stock and it would take more than a decade to exhaust the current supply.

Selective easing of some restrictions in selected areas is expected but restrictions on property introduced over the past five years are to largely remain in place, particularly in major cities, with some local authorities relaxing the measures to support the local real estate market. The central government is allowing cities other than Beijing, Shanghai, Guangzhou and Shenzhen to open up their residential real estate markets. The economist Andy Xie believes that the removal of policies restricting housing sales could actually bring prices down further, by flooding the market with properties.

First-tier Beijing, Shanghai, Guangzhou, Shenzhen: average price is 30,000 yuan/sqm and prices were up 20% year-on-year. Overall the growth rate of prices is slowing down. The smaller cities are hardest hit due to oversupply; heavy discounts try to lure buyers, angering former buyers. In second-tier cities prices were up 7.7% year-on-year. In third-tier cities prices were up 3.9% year-on-year with an average price of 7,330 yuan/sqm.

A wait and see attitude for both pre-owned and new housing is becoming more general.

In Beijing, luxury apartments and villas in some locations are still in high demand. Prices are still increasing and 100,000 RMB/sqm is “normal”. All really depends on location.

Housing construction / sales / investment in 2013 (% of national total), per tier:

	construction	sales	investment
First-tier	5%	5%	8%
24 second-tier	28%	27%	35%
Third and Fourth tier	67%	69%	57%

The challenge of urbanization

Those who can afford to own homes already do so or even have more than one. But poorer new migrants face an impossible financial hurdle. While smaller cities are more affordable the bigger cities attract young Chinese with better jobs, so smaller cities are actually see their population contract. With 4 billion sqm of housing currently under way (about 40 million apartments) and starting more than 1 billion sqm annually, Chinese residential developers may be building too much, and mostly in the wrong places. If 20 million farmers migrate every year, they'll need 30 sqm each; that's 600 million sqm of floor space – only. CLSA thinks small cities may need to reduce construction by 60% over the next few years. These cities consume 70% of materials used in all residential construction, which accounts for half of all steel use. That would be a huge impact on steel demand.

Concern over public discontent with China’s high housing prices has been one of the primary motivators behind the central government’s determination to rein in housing prices over the past several years.

Maps of China’s housing “agony” have been circulating on the Weibo micro blogging platform. They show the years of work necessary to save for a down-payment, if 100% of the salary is used for it.

Cities were divided into red, green and blue categories for the number of years required in order to put a down payment on a house.

Nine cities are within red zones, including Beijing, where an average wage earner would need to work for 13 years just to raise the down payment for a small apartment. Eight other cities in the red category include Shanghai, Shenzhen, Hangzhou, Xiamen, Nanjing, Macau, and Hong Kong. In those home buyers would need to save all their earnings for at least nine years to cover the down payment (usually at least 30% of the sales price) for an 80 sqm home.

In the mid-range are fifteen cities (noted in green) including Tianjin, Harbin, Qingdao, Wuhan, Kunming, Haikou and Guangzhou where home buyers would need to save for from five to eight years for a down payment. All of the cities qualify as second-tier, except for Guangzhou, where buyers would only need seven years of savings.

The blue cities require no more than four years and are mostly in western China, including Urumqi, Xining, Xi’an, and Chongqing. Shenyang (one of the most overbuilt markets) and Changsha are part of the blue list.

Office market

The office and commercial real estate markets are tiny compared with the residential real estate market.

There is a wide variation among cities and second and third-tier cities face the most difficult situation.

Good location and quality are most important in cities such as Beijing and Shanghai.

Oversupply is expected with second-tier cities to be hit first, where office space is to increase by 350% in three years. Some projects are being delayed to cope with the glut.

Beijing: rents doubled in the past four years and vacancy rates in the top areas such as CBD and Finance Street are very low, with very expensive rents. Total office space to double in the next five years. Vacancy rates to increase with demand lower than supply; rents to come under pressure.

Shanghai is also facing a surge in supply, and pressure on rents is expected.

Guangzhou: rents look more stable.

Shenzhen: rents look more stable, influenced by high demand in Qinghai Area.

Commercial real estate

Wide variation among cities, and big difference between the different tier cities.

In Beijing and Shanghai, location and quality are very important, creating two different markets: high rents/low vacancy for prime locations versus low rents/high vacancy in the other non-prime locations.

Beijing will see increased supply, increasing the gap between the two market segments.

Retail sales are slowing and face increasing competition from e-sales.

The sector is plagues by overinvestment and many shopping malls are desperate to attract tenants and visitors.

Warehousing and logistics

By 2020 China's e-commerce sector will be larger than those of the USA, UK, Japan, Germany and France combined according to a recent KPMG report.

Estimate: there is a need to invest US$2.5 trillion in the next 15 years in land and warehouses (2.4 billion sqm) – attracting the like of Blackstone Group LP, Carlyle Group LP, Prologis, Global Logistic Properties Ltd and others.

China lacks automation and state-of-the-art technology and very few warehouses are "modern". Boston has more modern warehouses than complete China!

Alibaba is to lead a consortium to invest US$16 billion in the first phase of building a national logistics business.

Retirement Homes and Senior Living Communities

Senior living communities are still attracting Chinese institutional investor and property developers (Vanke, Poly, …). Several insurers announced investment plans exceeding 200 billion yuan.

At the end of 2013 China was home to 194 million people older than 60 years and the figure could exceed 300 million by 2015 (other sources quote 250 million by 2020).

Demand for elder care could grow from 1 trillion yuan in 2010 to 17 trillion by 2050.

It is estimated that China needs 10 million nursing beds but currently only has 5 million.

Foreign companies have been trying to enter the nursing home market but have faced considerable difficulties in this "grey area", due to lack of clarity on policies such as sale of land, taxation and licenses. While the government has welcomed foreign capital, implementation has been erratic.

A key issue is the cost of nursing homes that look often like hotels. Monthly costs range from US$1,311 to more than $5,000. The average monthly pension for urban Chinese retirees is said to be around $2,000 while the large group of farmers have a monthly pension of $8.33.

Sources:

www.mingtiandi.com, China Daily, South China Morning Post, China Economic Review, New York Times, The Wall Street Journal, EuroBiz and others.

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