## Weak Development

# Looking for a Heartbeat

- Property transaction growth remains very strong and yet construction activity is not following. We believe it will not pick up.
- Individual buyers are back in some property markets in the expectation of asset appreciation. Given the 22% decline in the Shanghai Composite since June 12, some people may put money back into property. But we expect price speculation in the areas of highest transaction growth without new construction to follow. The sales appear to be a monetary phenomenon.
- Even though sales have sped up, we do not see developers deleveraging. Price declines and hidden debt obligations have helped make operating cash flows negative for many. This year has an added burden: maturation of RMB 30.8 bln in perpetual bonds.

**Qin Shengxian**

Local housing bureaus in 70 cities reported by the NBS reported phenomenal transaction growth in June. Total area sold from June 1-28 grew 42% YoY and 5% MoM. Tier 1 cities jumped by 48% YoY in terms of transaction area, and Tier 2 cities reported 58% YoY growth. Among Tier 1 cities, Shenzhen was the highest, with 246% YoY growth, followed by Shanghai, up 46% YoY.

That these two cities contain the stock exchanges is unlikely to be a coincidence. Shanghai and Shenzhen now are cash-rich, and the new cash flows have meant an abundance of financing and speculative investment pouring into property markets there. In particular, corporations and financial institutions in those two cities are buying to hold for price appreciation and sometimes booking collateralized refinancing as sales. Those transactions, however, are not driving developers to build more; developers want to capture whatever cash flows they can and are not interested in investing more.

Despite the apparent growth in buyer interest, developers are offering more credit to buyers and lower down payment requirements. Mortgages are getting cheaper as well: the current interest rate for mortgage loans is about 5.4%, with further discounts of 5-15% available, compared with 6.5% in 2014. According to Fang.com, buyers using Soufun's financing services pay only 15% down, while developers themselves offer much lower down payments. Evergrande is requiring a flat RMB 25,000 for many properties.

Discounts are rising. Based on contracted sales reported in company filings provided by Bloomberg, YTD contracted sales value in May 2015 increased 39.6% YoY, while ASP dropped 5.8% YoY. Average ASP for listed companies was RMB 9,922/sqm, the lowest in two years.

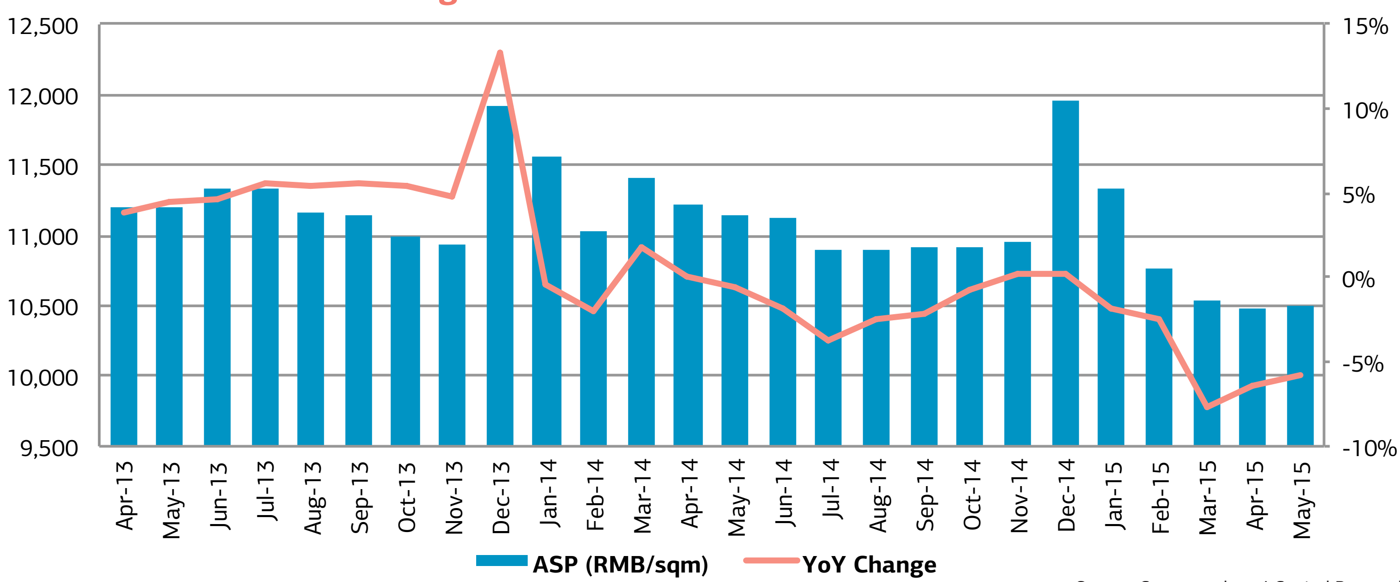
July 2, 2015

## Table 1. Transaction Data from June 1-28, 2015 (in sqm)

| Transaction | Month | Tier 1 | Tier 2 | Tier 3 | Tier 4 | Total |
|---|---|---|---|---|---|---|
| Monthly Transaction Area (sqm) | **Jun-14** | 3,731,896 | 12,071,658 | 5,532,212 | 2,136,662 | 23,472,427 |
| | **May-15** | 4,922,986 | 18,017,153 | 6,145,874 | 2,939,989 | 32,026,003 |
| | **Jun-15** | 5,527,021 | 19,012,145 | 6,244,099 | 2,953,023 | 33,736,288 |
| | **YoY** | 48.10% | 57.50% | 12.90% | 38.20% | 41.90% |
| | **MoM** | 12.30% | 5.50% | 1.60% | 0.40% | 5.30% |

Source: Local housing bureaus, J Capital Research

## Chart 1. ASP and YoY Change




Source: Company data, J Capital Research

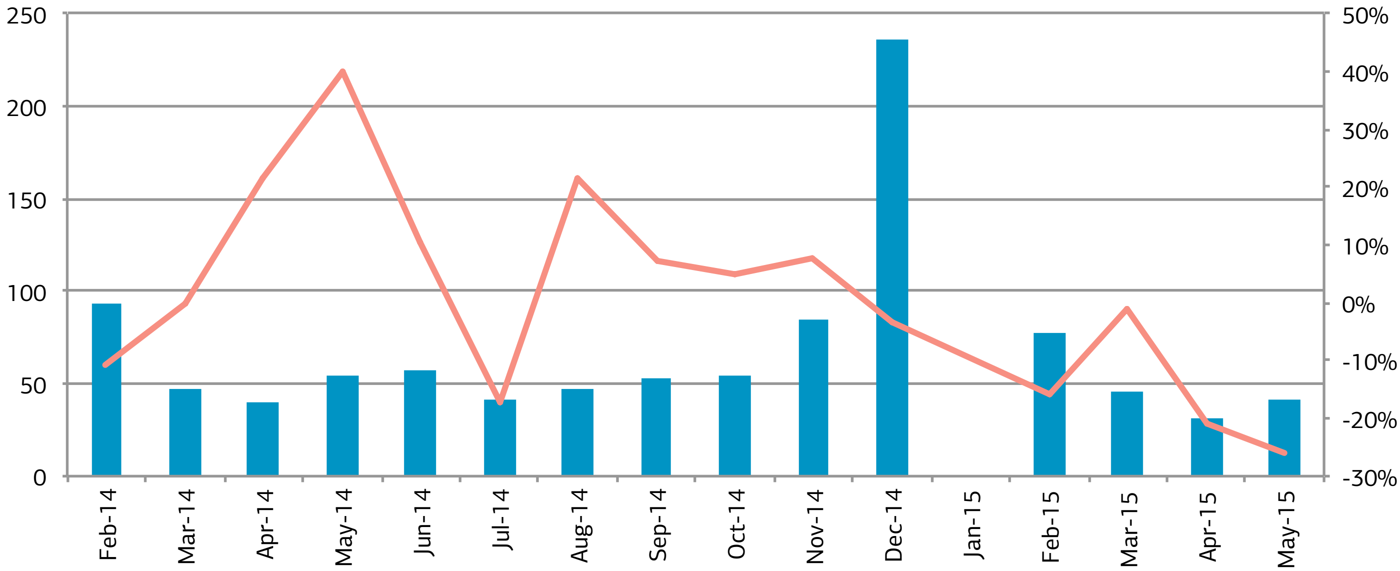
## Where Is The Construction?

In spite of all this purchasing, developers do not want to buy land or build out the projects already approved. Despite a sequential bump in new property starts, there is no detectable new demand for materials. May saw a 30% sequential increase over March in residential new starts—high even on the low 2014 base.

But this year, new starts and construction activity have diverged. In the past, approved floor space would most likely have been commenced at once, but now developers are starting construction on only 20-30% of the approved floor space, according to our checks. One reason for this may be that delivering committed capital is the key hurdle for receiving "new start" approval, and localities may be providing incentives to developers to inject capital.

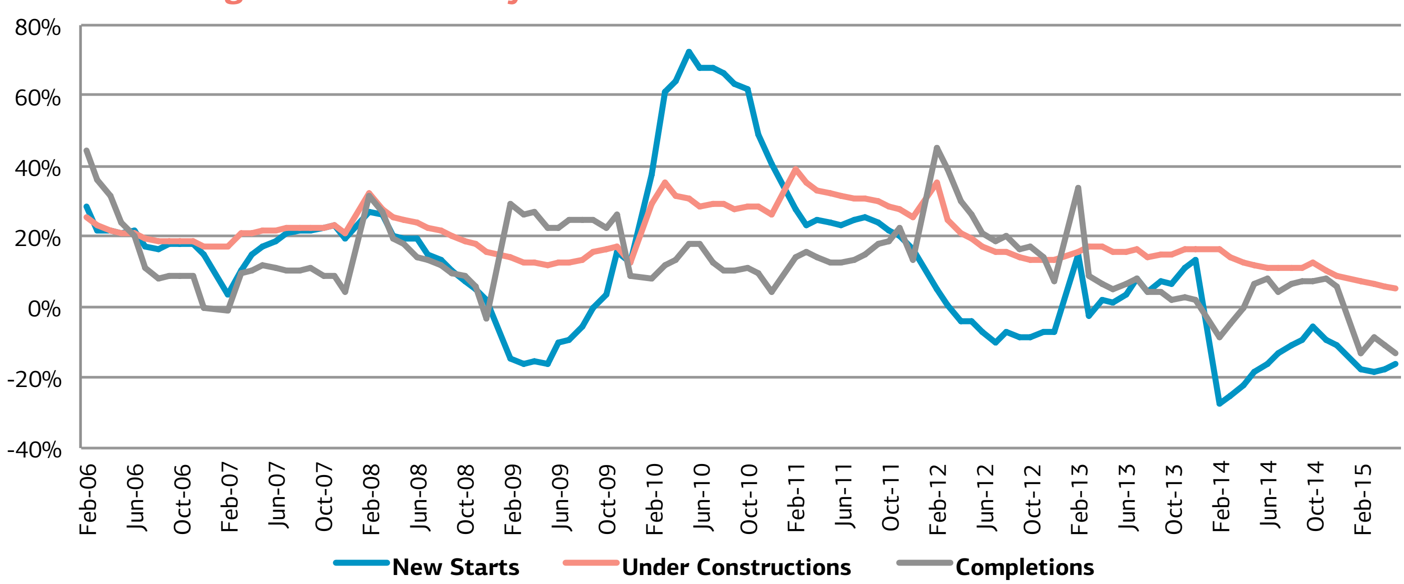
Completions overall are declining, save in Shanghai and Beijing. But those markets together are a small portion of the total. The only other market that has

## Chart 2. New Starts (in mln sqm and % YoY)




Source: NBS

## Chart 3. Change in YTD Monthly Construction Data




Source: NBS

seen growth is Shandong, by 8% year to date, and yet our steel and cement surveys in Shandong do not indicate growth.

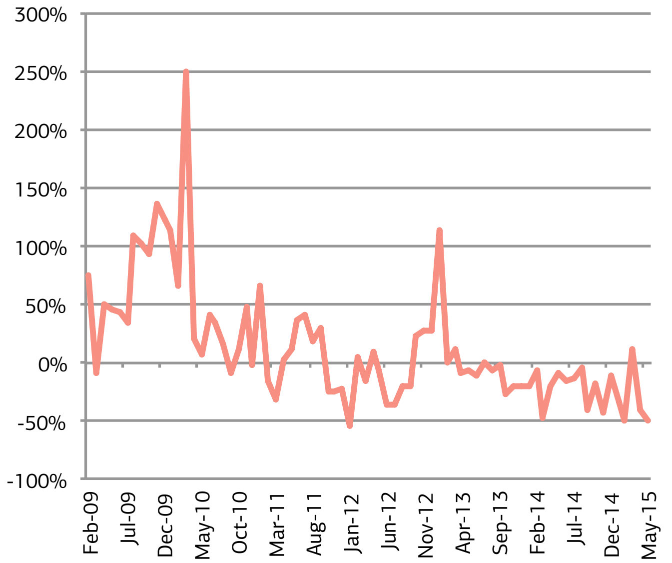
## Land Transactions

Land transactions provide another indication that companies do not want to invest in development anymore and are probably driving any extra cash into the stock market. The volume of residential land sales has fallen by nearly half this year and the value by even more, but the decline in industrial land sales is milder, as governments are pushing for the development of industrial parks.

## Secondary Market

Phenomenal growth in secondary market transactions is a strong indicator that the sales revival represents speculation on price inflation. Most secondary market properties are located in core areas of the Tier 1 cities; purchases in suburban or less attractive

## Chart 4. YoY Change of Land Transaction Area of 40 Large and Medium Cities




Source: Local land bureaus, J Capital Research

areas are not picking up. In June, 19 of the 20 cities we track reported double-digit YoY growth in the secondary market. Beijing increased 121% YoY, Shenzhen 185%, Hangzhou 156%, Suzhou 267%, Xiamen 137%, and Zhangjiagang 130%.

## Hidden Debt

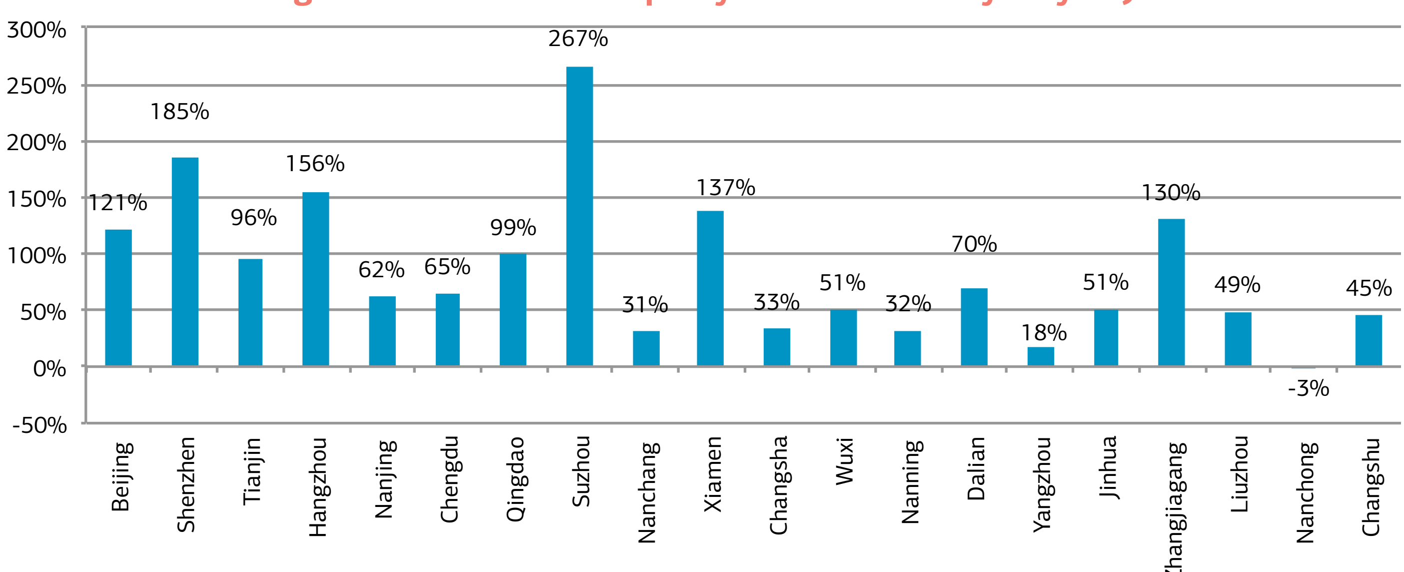
Inventories are enormous. But in addition, hidden leverage appears to be hindering new investment.

Since 2013, developers have been issuing perpetual bonds, which have the advantage of not appearing on the balance sheet as debt. This equity-like instrument generally has a duration of two years with an annual interest rate of 11-13%, and so 2015 will see many maturations. According to company reports, outstanding perpetual bonds issued by developers amounted to RMB 86.4 bln at the end of 2014, of which RMB 30.8 bln will mature in 2015.

None of the developers that issued perpetual bonds has positive operating cash flows, making us question their ability to repay the money. Of course, they can issue new debt to repay perpetual bonds, but if they fail, those developers will see their interest cost related to perpetual bond jump 50%, to 18-20% per year. That means default, with the banks left holding the bad debt.

Rumors abound about listed developers suspending projects in Northeast China due to bad sales and cash flow problems, with Greenland the most frequently cited. Our online searches also found buyers of Greenland projects in the Northeast complaining that delivery of their units was delayed.

## Chart 5. YoY Change in Secondhand Property Transactions by City in June 2015




Source: Local land bureaus, J Capital Research

## Table 2. Perpetual Bond and Operating Cash Flows (in RMB mln)

| Ticker | Short Name | Perpetual Bond | | | | Cash From Operations | |
|---|---|---|---|---|---|---|---|
| | | 2013H1 | 2013 | 2014H1 | 2014 | 2013 | 2014 |
| **3333 HK** | EVERGRANDE | 6,014 | 25,024 | 44,484 | 52,852 | -38,751 | -45,062 |
| **2777 HK** | GUANGZHOU R&F | - | 1,000 | 15,644 | 15,648 | -11,701 | -21,847 |
| **272 HK** | SHUI ON LAND | - | - | 5,945 | 5,949 | -834 | -9,724 |
| **3383 HK** | AGILE PROPERTY | 4,481 | 4,486 | 4,483 | 4,483 | -9,819 | -2,316 |
| **3900 HK** | GREENTOWN CHINA | - | - | 3,015 | 3,015 | 89 | -1,063 |
| **1238 HK** | POWERLONG REAL | - | - | 701 | 1,302 | -2,114 | -1,151 |
| **1966 HK** | CHINA SCE PROPER | - | - | 873 | 1,173 | -1,534 | -2,112 |
| **1777 HK** | FANTASIA HOLDING | - | - | 700 | 710 | -929 | -1,665 |
| **884 HK** | CIFI HOLDINGS GR | - | - | 579 | 586 | 1,963 | -18 |
| **1862 HK** | JINGRUI HOLDINGS | - | - | - | 551 | -1,860 | -2,952 |
| **600383 CH** | GEMDALE CORP-A | - | 340 | - | 122 | -5,544 | -4,365 |
| **Total** | | 10,495 | 30,849 | 76,424 | 86,393 | -71,034 | -92,277 |

Source: Bloomberg, J Capital Research

**Large blocks of unfinished buildings in Wuxi, Jiangsu Province |** Photo by J Capital June 2015


**Ghost city in Shenyang |** Source here

## UPCOMING J CAP EVENTS

### July Trips

**China's Silk Road? Kazakhstan and Xinjiang**

**Almaty, Kazakhstan; Urumqi, Xinjiang; Xian, Shaanxi.** We aim to discover how Kazakhstan and Xinjiang are faring in the commodities downturn and see if the Silk Road project will lead them out of trouble. China is championing the Asian Infrastructure Investment Bank to develop the "Silk Road Economic Belt" to help the Chinese and neighbouring economies. China announced $23.6 billion in new cooperation projects with Kazakhstan in March. This trip will also provide insight into how the Silk Road project may help the Chinese economy to continue to grow.

Kazakhstan and Xinjiang are both land locked minerals based economies reliant on China. The heart of these economies are the mining companies and their trading relationships with China. We will focus on the key minerals of copper, nickel and coal on this trip. We aim to visit mining, mineral trading and processing companies on both side of the borders. Big dreams on one side of the boarder are often bad nightmares on the other side. We will also meet with infrastructure companies and financial institutions to understand what new transport links will be built.

- **Led by Anne Stevenson-Yang, July 18-24.**

**Luxury Autos**

**Shanghai, Hangzhou, Beijing.** We will be visiting luxury auto dealerships to assess the true growth trajectory of Chinese luxury car sales in 2015 and beyond. Given that our Q1 channel checks showed sharp declines in sales volumes, we will focus on whether negative sales will continue throughout the rest of the year.

- **Led by Kevin Yeoh, July 27-30.**

### August Trips

**E-Commerce**

We will be taking clients to take a closer look at the e-commerce ecosystem to have an update on profitability level, revenue overstatement and what the real businesses of these players actually are.

- **Led by Anne Stevenson-Yang, August 3-6.**

**Finishings: Elevators, Ceramics, and Copper**

**Xiamen, Hangzhou, Xian, Hefei.** We expect property construction completions to decline this year and sales of elevators, sanitary ceramics and copper to follow. We will visit Xiamen, Fujian, an important property market and a ceramics production base. We will then visit Hangzhou, Zhejiang, a key market for elevator sales and production. We will then visit Xian, Shaanxi, an important West China market for elevator and ceramics sales before we visit Hefei, Anhui, a key copper processing area.

For elevators and ceramics we will meet with property developers, distributors, agents and producers of equipment to understand what is happening with orders and sales in the peak construction period. For copper we will speak with traders and processors of copper to get an understanding of the end demand for copper this year.

- **Led by Tim Murray, August 5-7.**

**Methanol**

We will be testing our fundamental bearish view of the methanol market by 1) looking at the logistics of coal transportation from mines to the coast, to get a feel for the cost side of the equation, 2) visiting SOE CTM facilities to get a feeling for if there is a price level at which they would stop producing, 3) interviewing gasoline distribution blenders to get a sense of the real demand picture.

- **Led by Tim Murray, August 10-13.**

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Please email Brian Emanuelson (brian@jcapitalresearch.com) or Roberta Sanminiatelli (roberta@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips, or share with us any trip bespoke ideas you might be thinking about.

July 2, 2015

# Disclaimer