JCAP

China Primary Insight

October 1, 2018

Commentary

To survive

Real Estate Wealth: A Winter of Discontent

- **Not optimistic** Housing transactions continue to rise, albeit slowly, but developers, despite high profitability in 2018, are pessimistic about market prospects.
- **Property continues to be a purely speculative market** In spite of regulatory restrictions in many cities that limit families to two commercial housing units, a survey indicates that a quarter of buyers in 2018 already own two or more apartments. Nationally, only 31% of homebuyers do not currently own an apartment. A decade ago, that proportion was 70%.
- **How dependent is the average household on property speculation?** A recent survey showed a sharp downturn in household wealth for less wealthy families in the first quarter of this year, a possible warning sign for the abrupt reversal that could come with a property decline.

Anne Stevenson-Yang

Banner at Vanke September meeting. Photo from Fang.com

When, at a southern region meeting, the property developer Vanke hung a banner that said "Survival!" the Chinese public decided that the property markets had reached a turning point. Vanke has a lot of credibility with Chinese consumers for telling the truth about the market.

The whole Chinese economy surfs atop property speculation, and values of residential real estate, although in vast oversupply, have lofted higher year after year, often in double digits. The rare exceptions when property prices flatline are always linked to slowed growth in the money supply, not to bedrock measures like employment and household wealth (interest rates have been consistently low for homebuyers). What sustains high residential property prices, at current exchange rates exceeding most of the toniest cities in the world, is not an excess of demand over supply. It is rather a unique combination of Chinese features, including the state ownership of land and the local government allocation of it, local government dependence on rising land values, local government involvement in building materials and construction, and local controls over postable land values and sale prices. Taken together, these interventions have jacked up property prices to levels far,

Anne Stevenson-Yang anne@jcapitalresearch.com +1 860 391 6094

far beyond what any natural market would support. If real market transactions ever took control of property prices, there would be a devastating reset.

Seemingly, everyone understands that when property prices crater, that is when debt throughout the economy becomes unsupportable. Inflated property prices are the core asset base of a vast chunk of bank assets. The task for China's government is to freeze up the markets transactions in order to trap current artificial values in property, thus making sure that consumers feel rich on paper without actually being able to pull cash out of the market. That will enable banks to maintain the high book value of property that collateralizes their loan books.

So far, it seems that the freeze-and-pretend strategy is working, in fact working so well that not only are prices holding but some modest levels of new investment continue to flow into the property markets at the current prices. But what else does it mean for the Chinese economy?

Will property markets crash?

Property statistics are among the least reliable, which is saying a lot. Overall, they indicate:

- Developers are aggressively pre-selling unfinished buildings, as pre-sales have become a much more important source of financing. For buyers, they offer a much larger theoretical gain but a lot of risk. Completions can be very delayed.
- Local governments are cash-strapped and are putting more land on the market at lower prices.
- Property markets are slowing down significantly, but there is still sales growth, in the low single digits.
- Pricing data, always unreliable, have completely disappeared from national statistics. Anecdotally, prices remain very high but seem not to be rising.
- Real estate developers are attracting a rising share of capital, but the listed companies that have sufficient brand reputation to sell housing two or three years before it's built are much better positioned. Government statistics indicate that bank loans to developers have dropped by nearly 7% in 2018, and foreign funding has fallen through the floor, but funding from pre-sales and share issuance is up by 15%. Real estate development is taking up a bigger portion of fixed-asset investment.
- Mortgage issuance was still rising by 19% in the second quarter even though sales of housing were reported up by only 3%. This suggests banks are called on increasingly to provide some liquidity through transaction support.

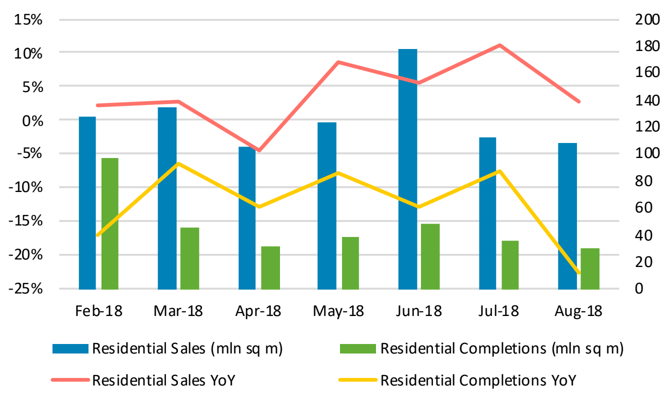
Probably the best property indicators are transaction volumes and land sales. Those numbers are messy, but they generally indicate lower transaction volumes for all types of real estate for the year through August and more land on the market at lower prices.

Pre-sales rose in August in most of the 18 cities that report, probably because of news that the central government was considering restricting presales in several provinces. Shenyang pre-sales, for example, quadrupled: Liaoning Province is on the restriction list. So is Sichuan, and Chengdu pre-sales rose by 169%. This could also be a money effect, though; the property market in August and September generally ticked up, as the PBOC poured cash into the economy. Presales provide an additional gearing of bank risk If supported with mortgages on the presold asset, as the asset is prospective, does not exist, and may never exist.

Residential sales are up 4% through August, a significant slowdown from the 10% through August

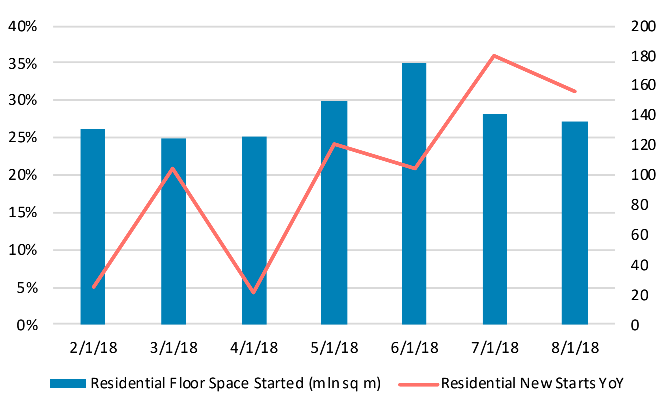
2017. Completions are sharply down. New construction starts are up, but that appears to be a statistical anomaly. Like so many things in 2018, in real estate, there is more reporting by bigger, state-owned companies, which have gained market share, as private and city-owned companies have gone out of business.

Chart 1. Real Estate Construction Completions and Sales



Source: NBS

Chart 2. New Residential Starts (mln sq m and YoY)



Source: NBS

As smaller companies go out of business, larger, listed developers are reporting higher profitability.

Property and wealth

Property prices, of course, are intimately wound up with household wealth and therefore with spending power.

A recent report from China's Southwestern University ("The Survey and Research Center for China Household Finance"), which conducts a celebrated biennial survey on household wealth, provides some interesting data points. The report concludes that household wealth for the poorer segments of Chinese society, who derive less than half of their wealth from assets, has declined in 2018, while wealth has grown modestly (about 2%) for the asset-rich percentiles. The report concerns itself with the Survey Center's interview sample, not with society at large, and seems to skew toward wealthier households. The poorest class of asset-owning families in the survey saw their household wealth decline by 7.5% in Q1 2018 compared with a year earlier. The main reason for the decline is a falling stock market and losses from other financial products. Family losses have been substantial in many categories of shadow investment, with fraud and defaults for the last 18 months at least.

The report looks at home buying by residents of small cities and towns. It indicates that the percentage of home buyers buying a primary residence has dropped sharply during the expansion years, from 70% of homebuyers in 2008 who were buying their first commercial housing unit to about 31% now. At the start of 2018, 25% of homebuyers already owned at least two housing units. In the top 16 cities, a lower percentage, just over 12%, in 2017 were buying third and fourth units, but top-tier cities have restrictions on purchasing investment units that cause distortions in the statistics; many buyers buy under the names of family members or friends who have not met the purchase quota. The report estimates that 37% of buyers nationally are buying strictly for investment purposes. Historically, the surveys show that wealthy households are the biggest buyers of housing.

What's next

The Southwestern University report is telling for the sharp and rather sudden decline it describes in household wealth but also for the relatively high net assets of the households surveyed, where the median asset value was ¥360,000 or $52,000. The households surveyed were deriving a large portion of their income from assets—stocks, property, wealth management products—whose value has been subject to huge speculative swings in the last few years. In 2015, for example, the index of China's $10 trn stock market fell by about 40%. In 2016-17, property values rose by something on the order of 40% nationwide. The Research Center survey provides an indication of how rapidly fortunes change in an economy as financialized as China's has become, with investment values wildly volatile as well.

When China embarked in 1998 on creating a private housing market, housing was a basic guarantee of the government. Quarters were cramped and the quality poor, and many urban residents had to wait years for a housing unit to become available. Unmarried workers in their thirties and forties lived in dormitories, and even when families were allocated apartments, the units were on company campuses, so that workers at a particular factory shared living spaces, sent their children to the factory school, were treated for illness in the factory hospital, were given funeral rites by the factory managers. When the country began to aggressively expand housing stock, people were more than eager to acquire their apartments from their employers and eventually to upgrade to higher-quality housing.

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It has been the genius of the Chinese system that transitions like this one, from a quasi-feudal socialist economy to a cash economy, have been handled more or less seamlessly. Urban workers who had been allocated housing by their factories, for example, were provided with the opportunity to purchase the housing at prices well below market—a cash windfall for state-owned enterprises as well as a huge boost to family wealth. Farmers who occupied a plot of land in a village did not have ownership rights but nevertheless were paid for their land by local governments that wanted to develop it commercially. These transitional policies represented a massive transfer of assets from vaguely defined state ownership to private ownership, a windfall for hundreds of millions of families in China who were suddenly able to marketize or otherwise trade away assets over which they had ownership control. This provided a huge payoff for the population and softened the shock of the shift to a cash economy.

The policies also made the commercial housing market a font of cash for the great majority of people, many of whom still live in the cramped quarters they were once allocated then purchased from their employers. They often own commercial housing units that they do not occupy for speculative purposes; this is true of everyone in my large family of in-laws in Beijing. All have retired from modest jobs in the state sector and none occupy the commercial units that each own. Some units are finished and rented, but it appears a much larger percentage—called "*maopifang*," simple cement boxes without fixtures, floors or ceilings, or appliances--remain unfinished so they can in time be sold as new.

This has made swelling property values a win-win proposition for all but the new generation of young people who no longer want to live with parents and for those who find their livelihood outside of official residences where their families have legacy homes. In other words, there is a bright dividing line around 1980, when China embarked on its market reforms. Those born into "old," pre-1980s China generally benefit from heavily subsidized housing. The post-1980 generation increasingly faces the steep costs of the true commercial housing market.

Whether or not the message from Vanke is prescient and 2018 turns out to be the year when property transactions crater, that eventually will likely happen. Not just a steep downturn in perceived value could trigger such a turn, but even the end of rapid appreciation will be a serious challenge, since the cost of credit and maintenance will loom large if there is no substantial capital gain to offset it.

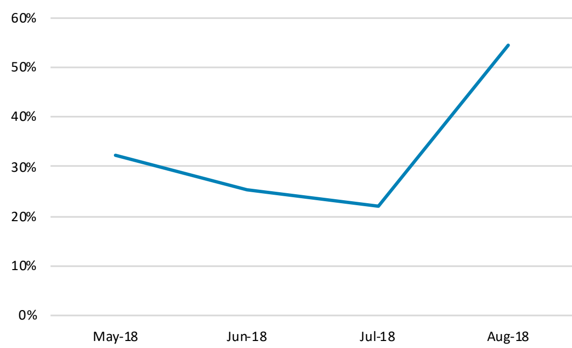
And the end of rising property values will affect the pre- and post-1980 generation differently. For older Chinese, many of whom are represented in the Southwestern University survey, property deflations will mean a sharp contraction in household wealth and, in many cases, income from rentals and housing sales. For the younger generation, appreciating housing has been a more mixed blessing. Some have managed to benefit from buying and flipping housing, but many struggle with mortgages that are feasible only as long as they are able to realize income from rentals and financial assets. Whether price deflation comes this year or next, the Chinese people, especially the younger ones, face tough winters ahead.

Data Matters

Pre-Selling

As bank loans become more scarce, property developers are relying more heavily of pre-sales income to finance development. Pre-sales rose by 54% in August in the 18 cities that report, after average increases over 20% each month since May.

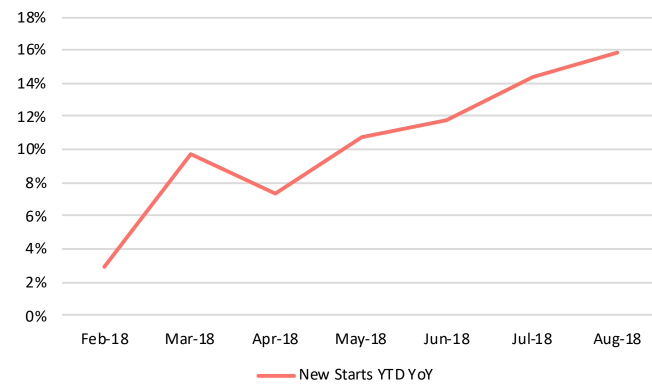
Chart 1. Pre-Sale of Housing (sq m YoY)



Source: Municipal Housing Commissions, 18 cities

Funding from pre-sales plus stock market raises has risen by 15% in 2018, according to national statistics, while bank funding has declined. Pre-sold housing is generally sold at least 18 months before construction is completed. The pre-sales period can extend to three years and, in some cases, even longer.

Chart 2. Residential New Starts



Source: China National Commercial Information Center

New housing starts have been high all year, but that may be related to the pre-sales. A pre-sale license is issued contingent on a certain amount of construction having been completed. When developers are desperate for cash and therefore to collect purchase prices from new buyers, they do the very minimum in construction in order to meet standards.

UPCOMING J CAP EVENTS

October Trips

Infrastructure and Steel: Good and Bad Provinces

Shenyang, Tianjin, Guiyang, Donggaun.

We expected central government tightening of local government spending to slow infrastructure spending in 2018. Now it looks like that tightening is only in “bad” provinces like Tianjin and Liaoning, where we plan to visit Shenyang. “Good” provinces appear to have no break on spending. We will visit Guiyang in Guizhou, which we considered a basket case, and is now being touted as one of the fastest growing provinces due to all the infrastructure that is being built. The central government believes areas like the Pearl River Delta have room for growth. So we will visit struggling Dongguan and the nearby free trade zone of Qianhai to see how these areas are growing. We will visit LGFV, banks, trusts, steel mills and steel traders on this trip.

- **Led by Tim Murray, October 15-18**

Belt and Road Initiative and Macro Economy

Beijing, Urumqi, Horgos, Lanzhou and Shanghai.

Starting in Beijing and finishing in Shanghai we will meet with policy advisors, AMC’s, banks, property and construction companies in those locations to get an overview on the macro economy. In between we will go West to see what is happening on the ground with the Belt and Road Intiative (BRI). We will visit Urumqi, capital of Xinjiang Province, to speak with the China Development Bank, visit major logistics infrastructure projects and meet with steel producers to understand the financing and build out of BRI projects. We will then travel to the remote city of Horgos on the boarder of Kazakhstan to see the economic development zone and understand how the BRI is developing trade in the region. On the return to Shanghai will stop in Lanzhou, capital of the poor province of Gansu. Here will take a look at infrastructure projects and meet with bankers and developers to understand how infrastructure is driving growth.

- **Led by Anne Stevenson-Yang, October 29-November 2**

November Trips

Banking, Insurance, & Regulation

Shanghai

We will meet with bankers, insurance executives, & policy experts to understand the current status of liquidity in the financial system and expectations for government stimulus for the beginning of 2019.

- **Led by Ada Wang, November 20-21**

Pakistan: the Biggest of the Belt and Road Initiatives

Beijing, Chengdu, Karachi

We will meet with policy banks, government authorities, Chinese companies exporting to Pakistan under the BRI initiative, and Pakistani companies receiving BRI funds to understand how important BRI is to both China and Pakistan.

- **Led by Anne Stevenson-Yang, November 26-30**

December Trips

Payments in India: Paytm, Ebix, Wirecard, Western Union, Moneygram

Mumbai, Delhi, Ahmedabad, Jaipur

We will see companies working to digitize payments in India and understand the economics of the market.

- **Led by Anne Stevenson-Yang, December 3-6**

Please email Brian Emanuelson (brian@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.

Disclaimer

Anne Stevenson-Yang anne@jcapitalresearch.com +1 860 391 6094