Issue 1 | First Quarter 2015

# THE PRESIMA GLOBETROTTER

## *Opportunities always look bigger going than coming.*

***– Chinese proverb***

During our recent trip to Southeast Asia and China, one of our first meetings was with a private banker in Hong Kong. Walter, an old friend of ours, serves wealthy Chinese clients. He has always been generous of his time and blessed with seemingly boundless energy. We have always found him to be a fantastic source of information and market sentiment. He has always been one of the most optimistic of our network of colleagues, through good and bad times.

As we waited in the sitting room of his office, the scene was familiar. Dark wood and an assortment of red Chinese decorations surrounded us. A beautiful Chinese jade ornament with a dragon and phoenix design, and a portrait of the Yuan dynasty Emperor Kubilai Khan were displayed prominently.

Our host walked in and the all-too-familiar scene changed. "What are you guys doing here?" Walter asked with a big smile and a slight wink. "No one comes to see me anymore." He guided us into his office, where we chit-chatted and were served a cup of oolong tea. Then we got down to business.

Walter started by explaining the pervading negative mood amongst his wealthy Chinese clients. "Of the 12 clients that I have, 11 have foreign passports and no longer want to hold a Chinese one." He said that his clients are most concerned that the wealth that they have accumulated may not be theirs to keep. "For them, your money is not truly yours while it's still in China." He said that they have been investing outside of China for years, but they often lack good investment opportunities. Real estate has been a very popular destination for their capital. "The number of flats they have accumulated in China is staggering, it's almost impossible to count." When they have invested abroad, Walter's clients have stuck with the familiar. "They like to invest in things that they know best, so residential property is often on top of the list. They usually think of Singapore, New York, London and

Chinese officials are leaving the banquet halls empty and reducing their consumption of "baijiu" (liquor) these days for fear of crackdown-related repercussions.

PRESIMA

**Author**
Vincent Felteau, CFA

**Editor**
Peter Zabierek, CFA

**Contact**
Robin Marcoux
rmarcoux@presima.com
514-673-1303

Vancouver first; Hong Kong is now probably too close to home."

We must admit that we were surprised by our ordinarily sanguine friend seeing Southeast Asia's glass as half-empty. Is it so bad? Is every investor a loser, or are there some winners, too? Should we discount this one data point given the unique make-up of his client base (i.e. wealthy Chinese)?

Our research trip continued for the next few weeks and we had plenty of chances to explore the issues that Walter identified, plus a few more. In short, there were five takeaways from the trip:

## Five Takeaways:

*1. China slowdown has drawn a housing policy response, but is it enough?*

*2. "Anti-extravagance" measures are having a significant impact on Chinese real estate,*

*3. Risks are rising in the shadow of Hong Kong's "Occupy Central,"*

*4. Hong Kong residential market defies gravity, and*

*5. Best investment themes are those aligned with government reforms.*

## Takeaway #1

*China slowdown has drawn a policy response, but is it enough?*

In late 2014, the People's Bank of China (PBOC)[1] announced a set of new measures to support the housing market that include:

- Removal of home purchase restriction policies across China,
- Reduced mortgage loan rate for first home buyers,
- Second home purchase treated as first mortgage (if mortgage on first loan is fully repaid), and
- Encouragement of banks to issue mortgage backed securities to support quality developers and to supply interbank bonds.

**"Of the 12 clients I have, 11 have foreign passports and no longer want to hold a Chinese one"**

During the course of our trip, we met more than 20 developers of varying sizes including site visits to more than five residential projects currently on sale in Guangzhou (a Tier 1 city representing a good gauge for the Chinese property market).

### Sales rebounding in the short term but developers remain unsure about the long term

Most local sales agents and developers noted a significant rebound after the relaxation measures in terms of sentiment, traffic and sales volume. Most developers agreed that upper Tier 1 cities such as Beijing, Shanghai, Guangzhou and Shenzhen were selling well, and the same for provincial capitals.

To our surprise, however, most developers told us that they were unsure about the sustainability of the recovery. In previous cycles, developers had turned very positive when PBOC stepped in with supportive measures such as those recently announced. This time was different.

In addition, most developers we met apart from state-owned enterprises (SOEs) mentioned that they would slow down their land replenishment strategy heading into 2015. Some developers even mentioned that they would completely stop construction on some of their projects, especially those in Tier 3 cities and Tier 4 cities, mainly due to a significant inventory overhang.

### Central bank "encouraging" banks to support the sector

Residential developers were pleased to see that most banks were offering discounts to first home buyer (FHB) in the range of 5-10% below PBOC rate (versus at least 10% premium in the past). They also shared that mortgage approvals were speeding up, taking a couple of months in the past to now about only one month.

Cranes at a residential site in Beijing

1 People's Bank of China, www.pbc.gov.cn, September 29, 2014.


Pedestrians walk past a branch of Bank of China in Yichang city, Hubei province. BOC is one of two of China's state-run lenders are looking to boost mortgage lending.

Many developers also expected quotas from banks to increase for FHB on the back of more forceful demand from the Central bank.

We also noted that access to cheaper financing for developers had become even more important as they are trying to find ways to maintain their 20%+ gross margins. Many developers now are seeking investment grade ratings from rating agencies. With an investment grade rating, companies can qualify for Hong Kong syndicated bank loans (4-6% interest), which is a much cheaper alternative compared to traditional local bank debt and construction loans (6-9%), offshore bonds (10-13%), or trust loans (11-16%).

## Labor cost rising faster than average selling prices

On the pricing side, almost all developers confirmed a downward trend in profitability and gross margin, especially for small and medium-sized developers. In an environment where China's economy is slowing, and that inventory levels are relatively high in many cities, the average selling prices (ASPs) are not keeping up with this fast pace of growth on the labor cost side.

Many developers talked about shifting their focus toward smaller units as larger units, were not selling well (affordability issue). Most developers stated that discounting strategies were not feasible. Reducing prices creates significant tension in the market, sometimes even causing social unrest as owners who bought in earlier phases at higher prices would vilify the discounts.

## The industry is consolidating; expect some winners to emerge

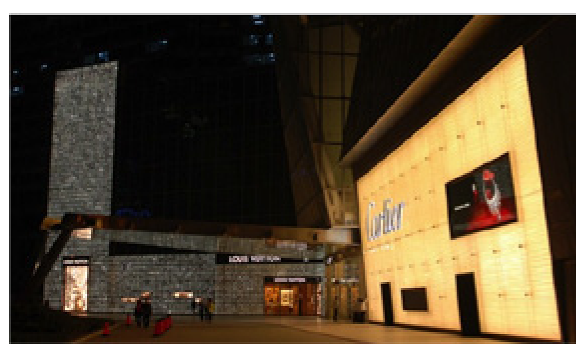

Models of new residential developments for sale at a real estate fair in Qingdao in eastern China's Shandong province last month.

Our overall impression is that the industry is entering a consolidation phase where it will become more and more challenging to generate profits for all. Considering that some cities sell better, that size of units matters more, and that lower cost of capital becomes increasingly important, we feel differentiation and selection amongst the group will be key. In that context, we believe that in general, the larger players will continue to gain market share and outperform the rest of the market. Despite that sweeping generalization, we do see opportunities for local sharpshooters despite the long odds against them. Lastly, because the residential market is such an important driver of the economy as a whole, we expect more policy relaxation in the short- to medium-term.

# Takeaway #2

***"Anti-extravagance" measures having significant impact on real estate.***

Retailers and retail landlords are adjusting to a new reality after the Chinese government implemented these new measures. Bloomberg recently reported gold demand in China shrank for a third quarter as slumping prices failed to boost purchases by the world's biggest user. Gold buying by Asia's largest economy tumbled 37 percent in the three months to September from the same period in 2013, and jewelry consumption fell 39 percent[2]. Since the luxury segment is slowing down very rapidly, tenant mix is getting



High-end retailers have seen demand drop precipitously at many China malls.

2 Lenys Sim, Bloomberg, November 13, 2014.

more important than ever for retail landlords. They see lifestyle and entertainment components as well as food and beverage (F&B) as increasingly important in driving traffic to the malls. They also think the first mover advantage is getting more important because international retailers have much less appetite for space in a given city or area. Consequently, they believe faster development pace and flawless execution is needed in order to succeed in that tougher market environment.

Moreover, track record of landlords is also increasingly important in signing the best tenants as well as getting access to prime locations not yet developed in key cities.

## Not only retail; residential also feeling the hit

Prior to doing this trip, we already knew that the "anti-extravagance" or "anti-corruption" measures were having a significant impact on the market but we were surprised to hear how much serious of an impact it had on many other sectors aside from luxury retail. As we briefly discussed in the previous section, the residential sector is also very much impacted by the various measures for three reasons:

1. Developers are seeing much less demand for larger units,
2. Prospective owners are less willing to buy more than one unit at a time, and
3. Many wealthy buyers are shifting their purchases to overseas markets.

## A unique discounting strategy: "Buy one, rent one free"

***Even if outright discounting strategies were not significant according to many developers that we met, nearly all acknowledged the fact that they were using creative marketing strategies in order to stimulate sales. At one project in Guangzhou, we had a conversation with a high-energy sales agent who told us about a very out-of-the-box strategy.***

**He explained to us that there are millions of vacant units in China and most of them are sold "bare shell" (i.e. no appliances or other fit-out). The company had an ongoing promotion whereby it would offer prospective "Phase 2" buyers an option to live in one of the vacant units from "Phase 1" for a period of 1-2 years without paying any rent while they would wait for their own unit to be delivered.**

**The strategy depends on some footwork on the part of the sales agent. He offers owners of vacant units in Phase 1 to fully furnish the owner's apartment in exchange of "renting" the unit for free for a period of 1-2 years to an undisclosed client.**

**The strategy seemed to be working. Oftentimes, buyers do not have the necessary capital needed to pay for their full purchase, which would include capital outlay necessary for fit-out. As such, receiving a full fit-out of their unit while giving up 1-2 years of free-rent allows these owners to make the numbers work.**

**From the sales agent's standpoint, the benefits are clear:**

- **Selling units in a project full of people is much easier than selling units in a project that appears empty.**
- **Projects that are fully sold are often very poorly managed. Cleaning and maintenance quality goes down significantly as soon as developer is done selling and leaves.**
- **The developer does not have to offer discounts which could seriously disrupt the market "equilibrium."**

**Last but not least, now that government is stepping up its anti-corruption campaign, many affluent residential owners, sometimes government officials, appear to be more and more nervous about the state of the residential market. In fact, they seem increasingly afraid of being identified as having too many residential units. As such, many of them are trying to offload units in the very limited secondary market. As such, many of them apparently prefer to have someone living in their empty units because their unit becomes "owner-occupied" and less prone to scrutiny.**

## Takeaway #3

*Risk rising in shadow of "Occupy Central"*

The Occupy Central movement shed light on the mistrust amongst general population of the "elite." On August 31, 2014, Beijing announced it would vet candidates for Hong Kong's 2017 elections. On September 26, 2014, an estimated 80,000 students flooded the streets of Hong Kong's business districts to protest the Chinese government decision. The protest continued for nearly three months.

Occupy Central started in Admiralty on September 28 and the last site, in Causeway Bay, was cleared on December 15, 2014.

### Not what we had expected…

Occupy Central was no longer making as much noise in the media when we arrived in Hong Kong in late 2014. But while we were walking through this spectacular urban campground in the middle of Central, we were amazed by the sheer size and scale of the gatherings.

Another surprise for us was the fact that it was not just the group of rebellious students that the press had spotlighted since the very beginning of the conflict. We saw people of many different age groups. We saw an emergency unit with a doctor, a temporary school and a teacher, and an old man teaching children how to use a drill and a screwdriver. Many artists expressed themselves in many different forms about the positive outcome of a pro-democracy society.

Generally speaking, walking through the site gave us a much more positive impression versus what we had anticipated. We felt that people were genuinely proud of doing what they were doing. In our view, it was peaceful, positive and collaborative at the same time.

### The underlying issue of the conflict, the "rule of law"

At one point, we met a young professional man who shared with us his view of the conflict. He argued for strict enforcement of the "rule of law" -- that the rules in society should be applicable to all citizens in the same way. He suggested that Hong Kong had one set of rules for the "elite" and another set of rules for the general or mass population. In the case of Hong Kong and China, "elite" are often referred to as the "princelings," either from a very wealthy family or from one that is directly or indirectly linked to the government.

According to him, since the Chinese government decided to "tweak" the law in order to vet a candidate to power in Hong Kong, the general population felt betrayed, that the law was not applicable to everyone in the same way anymore. He was afraid that Hong Kong was going back to its old ways.

### Feels strangely familiar…

Investors in the Chinese and Hong Kong real estate stocks generally assign a significant discount factor to the Net Asset Values (or NAVs) of the companies. Minority shareholders have historically not had significant influence in how the large Hong Kong conglomerates were being run or managed. While walking through the gatherings and protesters on that day, we had a strange feeling that these people were protesting for the same kind of concepts and underlying principles.

### Direct impact on real estate

Occupy Central has had a clear impact on Honk Kong's central business district. On October 6, 2014, shortly after the protests began, the Hong Kong Retail Management Association released performance on Hong Kong's retail sales for the Mainland's National Day Golden Week Holidays: retail sales had dropped from 15% to 50% in the luxury segments of the market. Small and medium-size enterprises saw a drop in sales as high as 80%[3].

The management teams of property companies that we met, including Wharf, Henderson, and Sino Land, all confirmed that retail would be more impacted than office properties. These management teams appeared to be particularly concerned about street retail where the protests were taking place, namely in Central, Mong Kok and Tsim Sha Tsui.

In the medium- to long-term, they argued that Hong Kong would remain a shopping destination of choice for international travellers, especially mainland Chinese, and that they expected the issue to be temporary

3 Hog Kong Retail Management Association, 2014.

and resume to a normal level when things would settle. But we expect that the combined lasting effects of Occupy Central, layered over the anti-extravagance measures already in effect, will lead to a "new normal" in Central Hong Kong, with fewer clear demand drivers and a heightened risk profile going forward.

# Takeaway #4

***Hong Kong residential market defies gravity***

We were impressed by the continued strength of the Hong Kong residential market. On October 8, 2014 the Hong Kong government announced it would expedite the process of obtaining pre-sales consent applications to increase supply in the residential market. On October 12, 2014, Centaline announced that Hong Kong secondary property price index is at a record high[4], exceeding the previous high of March 2013 by 5.0%, with year-to-date price growth of 9.1%.

After meeting almost all of the major property developers in Hong Kong, visiting six different residential sites for sale, and meeting a leading property brokerage firm, we continue to believe that the supply and demand imbalance in the residential market will continue to put upward pressure on residential prices in Hong Kong. It is estimated by the Hong Kong's Chief Executive that private housing supply will on average produce 13,600 units each year for the next five years[5]. At the same time, the average number of agreements for sale and purchase of private residential units in the primary markets registered per annum from 1997-2013 has been about 19,000 per year[6], so realistically there is a gap of about 5,000 to 6,000 units per year.

## More supply the only possible solution to slowdown price appreciation

Considering this significant supply and demand gap, we believe announcing further round of austerity measures would be totally ineffective, and we also believe the amount of speculative demand to have significantly slowed down in Hong Kong since the introduction of the latest rounds of austerity measures.

A view of Hong Kong's skyline from Victoria Peak

At this point, we strongly believe that the only possible way for the government to slow down the rapid price appreciation is to increase significantly the amount of land supply that they are putting up for sale through land auctions. Unfortunately, since building up projects in Hong Kong usually takes up to 2-3 years, we are not expecting any significant change in the direction of residential prices in the short- to medium-term.

It is worth noting that unemployment in Hong Kong still remains at a very comfortable level (3.0-3.5%)[7] and that use of leverage is actually very limited versus other regions or countries. In fact, more than 65% of Hong Kong owners are totally debt-free.

## Unlikely to get more austerity measures

A key lingering risk in the Hong Kong residential market is the possibility that government could add another round of austerity measures. Based on our on-the-ground research, we believe that this is unlikely in the near term. The main reason being that Hong Kong residential prices are now pushed to the upside by genuine buying from Hong Kong residents, or by owner-occupiers.

4 Bloomberg and Centaline Property Agency Limited, http://hk.centanet.com, October 12, 2014.
5 2014 Policy Address. www.policyaddress.gov.hk/2014/eng.pdf. January 15, 2014.
6 Centaline Property Agency Limited Market Research, http://hk.centanet.com/icrms/template.aspx?series=281&article=47117, 2014.
7 Bloomberg, Index published each month, December 31, 2014.
8 Quarterly Report on General Household Survey, Census and Statistics Department Hong Kong Special Administrative Region, 2014.

# Takeaway #5

***Best investment opportunities are those aligned with government reforms***

Shoppers queue to pay at a supermarket in Hefei, eastern China.

Given the significant influence of the government on economic activity and financial market performance, we believe the most attractive opportunities will be those that are aligned with the government reforms. In the property market, that would include:

1. **Aim high in China residential.** Seek high exposure to Tier 1 cities, high-quality developers, first home buyers, access to financing, and low leverage. Urban redevelopment capability will be a key.
2. **Aim low in China retail.** Seek retail opportunities geared toward mass consumption and daily necessities. Avoid luxury segment for the time being. Prefer suburban retail over urban locations, since the anti-corruption campaign would hurt urban retail more than suburban retail. Urban retail is disproportionately exposed to the luxury segment of the market (approximately 30% in our estimation).
3. **Value governance.** Focus on companies with better governance. The Occupy Central movement has made the market appreciate the rule of law and good governance in both Hong Kong and China.
4. **Hong Kong residential developers.** Developers should continue to do relatively well in a supply constrained market. We are not expecting US interest rates to have a significant impact on Hong Kong residential sales. Developers with low gearing and rapid execution capability best positioned.

# Conclusion

Looking back to our initial conversation with Walter, much of what he said was confirmed in our meetings and field research. In general, the mood amongst wealthy Chinese is sour. These investors are concerned that the good times they enjoyed over the last few decades are coming to an end. Thanks to the "anti-extravagance" measures, being rich and spending money has become a bad thing. The luxury goods market, once thriving, is struggling mightily. The Occupy Central movement has highlighted rule of law or "fairness" issues. For them, it is like a grand game of musical chairs where the chairs are quickly disappearing.

But as John F. Kennedy famously said, "When written in Chinese the word 'crisis' is composed of two characters. One represents danger, and the other represents opportunity." In the huge and growing Chinese economy, there is a constantly-changing set of investment opportunities for property investors. The Chinese government has shown in the past an ability to develop policy responses to market weakness, and we expect them to do so in the residential market. In Hong Kong, the forces of supply and demand will work in the market's favor, buoying prices. And finally, though growth is not as robust as it used to be in China, it is still healthy by global standards. Mass consumption is on the rise and there will be opportunities for retails landlords to take advantage of this upswing. What might to some look like danger might just be the dawn of the next set of opportunities in China.

*Research trip dates were October 30, 2014 to November 7, 2014. Follow-up research conducted in December 2014 and January 2015.*