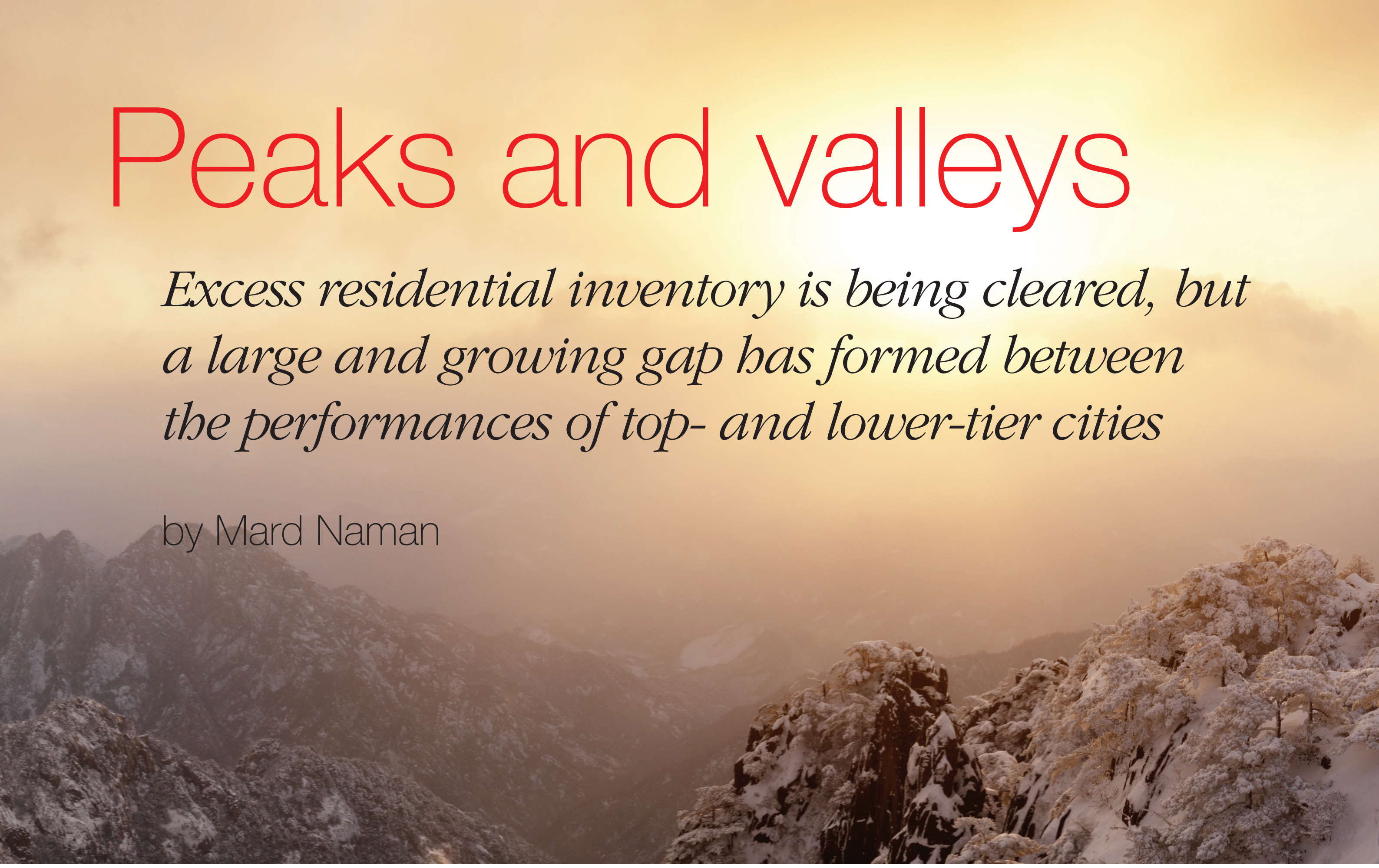

Peaks and valleys

Excess residential inventory is being cleared, but a large and growing gap has formed between the performances of top- and lower-tier cities

by Mard Naman

While China's stock market volatility and slowing growth have received the lion's share of media attention so far this year, the country's housing sector slowly but steadily has been shedding the excess supply that has dragged it down the past couple of years. At the same time, buyer and fund-manager sentiment seems to be on the upswing.

In 2015, in the wake of the government's supportive measures, housing sales increased as oversupply dropped from the previous year's historic highs, and prices started to recover in many cities. That being said, oversupply is still a problem. "Destocking started in 2015, and we expect this trend to continue in 2016," says Catherine Chen, head of research and strategy, Greater China, and national director at LaSalle Investment Management. Chen says inventory is lowest in first-tier cities, and the government is aware of that, and thus, recent policy relaxation is focused on the lower-tier cities.

"I still expect oversupply to be a big problem in 2016, particularly for lower-tier cities," says Vincent Felteau, portfolio manager with Presima. But because Beijing is fully aware of the problem, Felteau believes it will not be such a big issue by year's end.

Stabilising the property market and decreasing inventory levels are two of the government's primary missions for 2016. This was explicitly stated at the government's annual Central Economic Work Conference in December 2015, according to Gregory Wells, managing director and head of Asia for Forum Partners. In February 2016, the government announced it was lowering the down payment required for first-time buyers (from 25 percent to 20 percent) in most cities. "We expect more loosening policies — for example, further reduction in interest rates and the reserve requirement ratios — to come in the near term to ensure the overall recovery of the property market," says Wells.

Felteau points out the oversupply problem is concentrated primarily in third- and fourth-tier cities, and says a number of different sources on the ground believe it should now take about 20 months to clear inventory in those lower-tier cities, well above the historical average. But it should only take about 12 months for second-tier cities, which is on par with the historical average, and less than 10 months for first-tier cities, which is much less than the historical average.

Therefore, while lower-tier cities have ongoing oversupply problems, first-tier and major second-tier cities generally do not. "On the contrary, Tier 1 cities seem to be lacking supply of new land in core areas, a leading factor in driving up land prices at a very rapid pace in certain cities, particularly Shenzhen and Shanghai," says Felteau.

This structural imbalance between supply and demand for higher-tier versus lower-tier cities is not going to change anytime soon, according to Robert Ciemniak, founder and CEO of Real Estate Foresight, an independent research

and analytics firm based in Hong Kong. But there are a few twists to the usual oversupply story. First, it is not equally distributed, even among lower-tier cities. There will be winners and losers. Second, Ciemniak thinks investors should look at pricing relative to oversupply. If oversupply is significant, but the prices reflect that (and in some cities, prices are at five-year lows and land remains cheap), then the market has a certain balance, like a stock with poor fundamentals that is also cheap.

Finally, Ciemniak says some of the oversupply comes from unfinished, empty or failed projects. But as the market becomes increasingly driven by upgrade demand and more-discerning buyers, these failed or unfinished projects are not as relevant competitively for the types of products buyers desire. "We need to distinguish between aggregate-level scary figures versus what product-level opportunities there are for developers who bring the right product for the right clients at the right price," notes Ciemniak.

Widely divergent prices

Ciemniak predicts we will see a cyclical rebound in overall prices until mid-2016, reaching 7 percent growth before slowing down to 3 percent to 6 percent by the end of the year. But, like supply, pricing in China is a story of widely-divergent results. By the end of November 2015, housing prices in Shanghai and Beijing grew 14 percent and 12 percent per year, respectively, ranking them seventh and eighth among the world's top 10 cities for price growth, according to a Knight Frank report. Shenzhen prices are up even more, making it the fastest-growing major property market in China. But at the same time, the average housing price in the rest of China fell 3 percent year-on-year.

Looking at new-home sales only, Real Estate Foresight's research shows average sales prices increased 4.4 percent year-over-year in January 2016, the sixth month of positive year-over-year growth. But the overall positive numbers should not obscure the fact they are comprised of some extremely high prices and extremely low prices in different markets.

"In this cycle, we are seeing a more divergent performance of cities compared to the past," says Ciemniak. This greater divergence can be seen in Real Estate Foresight's "Five-year house price dynamics" chart (see page 17), which tracks 100 cities over 60 months. The data shows the year-on-year growth was led by Shenzhen, Shanghai, Wuhan, Beijing and Hefei. "The 2015 house-price pickup cycle was the most divergent in the past five years," notes Ciemniak. Some cities, such as Beijing and Shenzhen, were at five-year highs, while others, such as Sanya and Xi'an, were at five-year lows.

This gap between the haves and the have-nots likely will only widen. Wells says the booming property market might continue in first-tier and some major second-tier cities because better job opportunities and more comprehensive public welfare will continue to attract new residents and support the property markets. Also, higher land costs in those cities will further drive up prices. "In contrast, in lower-tier cities, the lack of drivers for price growth will likely further widen the gap with Tier 1 and major Tier 2 cities," says Wells.

Unlike price growth, sales-volume growth has been more widespread. Many cities show high volume growth but at declining prices, which is in line with the "inventory clearing" theme pushed forward by the government, according to Ciemniak.

Smart investor approaches

What does this mean for institutional investors, and how they should approach the market going forward? "What it all means is a need for much greater selectivity and a discerning approach to city selection," explains Ciemniak. But he says it also depends on one's investment strategy — bets on price momentum in supply-constrained locations with higher land prices are different from volume bets in many lower-tier cities with cheaper prices but also cheaper land costs.

Forum Partners' Wells says institutional investors should focus on first-tier and major second-tier cities, given the urbanisation trend, more medical and educational resources, and the loosening of hukou (the Chinese household registration system), whereby migrants to cities can more easily attain official resident status. This will help support ongoing demand. The excess inventory in lower-tier cities also supports the view investors should focus on first-tier and major second-tier cities. "In higher-tier cities, underlying demand is strong and supply is limited," adds LaSalle's Chen. "These markets are more institutionalised and have more downside protection."

Richard Yue, CEO, CIO and portfolio manager for Arch Capital Management in Hong Kong, says higher-tier cities along the eastern coast are generally in good shape, and this is the area where commerce traditionally has been focused. Heading west, you start finding problem areas. "As you go into third- and fourth-tier cities, they built well ahead of demand," he says. Some of these excess supplies were built during the boom days and are tied to commodities such as oil.

Yue believes smart investors should follow some simple rules. First, stick to cities that have their own economies — private enterprises, not state-owned. "Private enterprises means there are real people there with real wealth," he says. Populations in decent numbers with good demographics are a must, as is good infrastructure, particularly good connectivity to other cities, especially major first-tier cities. "If you check all those boxes, you generally are in a pretty safe place," says Yue. "Those cities will continue to be magnets for people moving in."

Even within these "safe" cities, however, investors must be careful because oversupply can still be an issue. You need to know which district to go to even within a city with strong fundamentals. Take the so-called "new towns". Generally, these spring up because it is difficult to redevelop the older parts of cities, partly because in China, it is very hard to move people out of their homes. So when high-speed trains and brand new highways are built, they tend to run through the newer parts of major cities. These are the new towns that spring up right outside the old parts of town.

To help pay for the new infrastructure, the local government master plans and sells to developers major parts of the land surrounding the new town train stations. "Even within major second-tier cities, you get these pockets where suddenly 10 developers are building at the same time," observes Yue. Despite healthy demand, these new projects hit the market about the same time, which means

Currency risk on the rise

In November 2015, the IMF approved the Chinese renminbi as a main world currency, joining an exclusive club that includes the dollar, euro, pound and yen. While this will lead to its wider use in trade and finance, it also means China has to give up some of its tight control over the currency, which will lead to greater volatility.

What will this mean for investors? The renminbi has been depreciating, which is healthy and planned, according to Richard Yue, CEO, CIO and portfolio manager for Arch Capital Management in Hong Kong. As for volatility, he says there are not a lot of ways to hedge your position against the renminbi. "If you want to invest in China, you have to put up with that kind of risk," he says.

Gregory Wells, managing director and head of Asia for Forum Partners, agrees in the short term foreign investors likely will face increased currency risk because of the greater volatility of the renminbi, and this could negatively affect the amount of inbound investment into the property sector. But in the long run, this move is likely to help the renminbi become a more stable currency. "With the internationalisation and increased transparency of the renminbi and the destocking process, the Chinese property market might be more attractive to global investors again," says Wells.

Yue says although currency risk has not traditionally been of much concern to investors, it is now on their radar screens. "Going forward, people need to focus on this," he says. But Yue still thinks the risk is comparatively low. He says other world currencies — the Australian dollar, Canadian dollar, euro — have much higher volatilities, and investors have a much tougher time managing their positions in those countries. "So the magnitude of the problem is probably not huge," concludes Yue.

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product is not absorbed as quickly. So some new towns have oversupply issues, and sales are slow. "Eventually everything will get absorbed, but if you have an expensive clock on your money, then you'll suffer," says Yue.

And it is not only the new towns. Every city has large price gaps among different districts, in terms of both average selling price and price growth, according to Forum Partners' Wells. Zhabei and Jing'an in Shanghai saw growth in average selling price during 2015, for example, while districts in suburban Shanghai witnessed relatively-stable prices. "It's crucial for institutional investors to focus on submarkets instead of citywide markets," says Wells.

Sentiment slowly growing more positive

In 2014 and the first part of 2015, people were apprehensive about buying, explains Yue, and this was reflected in the falling sales volumes and prices. Then the government incrementally lifted some of the restrictive buying policies and lowered mortgage rates. In the meantime, incomes still continued to grow, so affordability improved. Now, people are coming back into the market.

Yue is seeing sentiment change from wait-and-see to positive. "Our showrooms are busy again; people are buying again," he says. He is not talking about investors or speculators, but families or people who are upgrading. "And we don't need to reduce prices to induce them in," he adds. "We're actually increasing pricing, ever so slowly, but it's going in the right direction."

Half of Arch Capital Management's business is in greater China, mostly in middle-market housing. "Our perspective is on the ground," says Yue. "We do feel the pulse on a daily basis." He thinks the lifting of policies and lowering of rates help in a directional way — it is not so much the absolute number the government lowers interest rates by, but the direction they are moving. When the government was adding restrictive policies, it discouraged people from entering the market; everyone hunkered down and waited, thinking it was going to get worse before it got better.

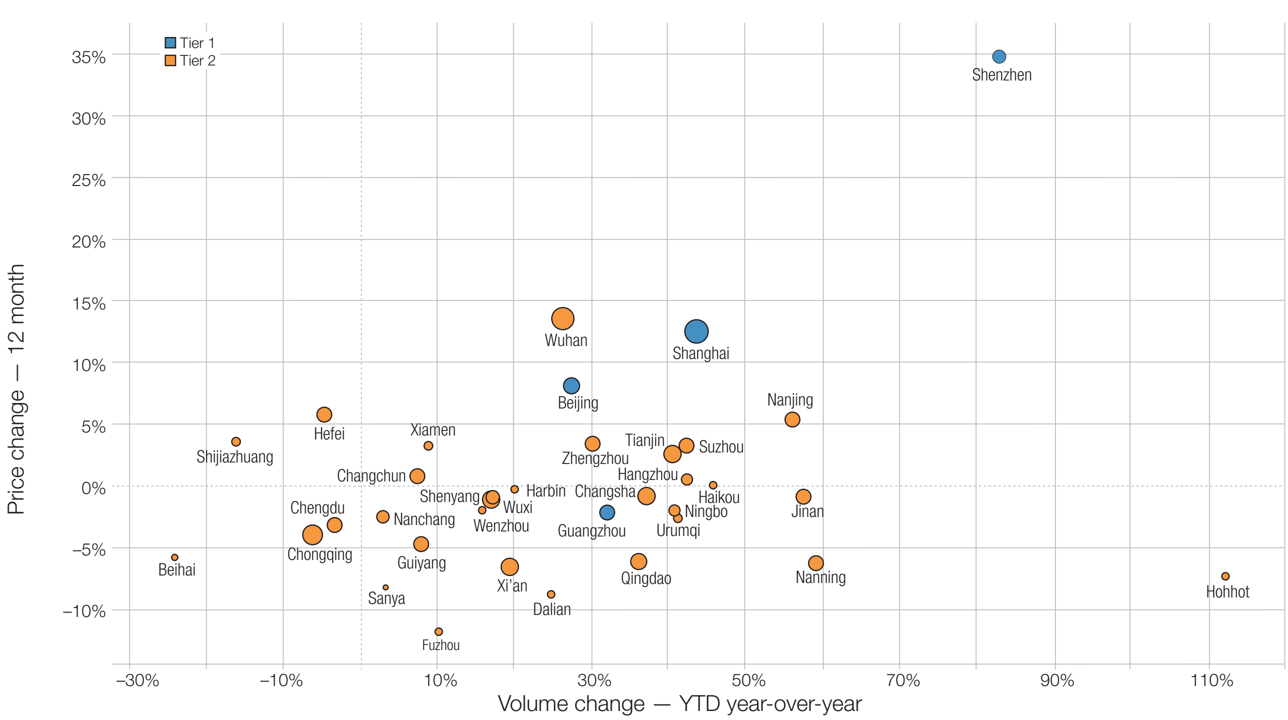
Investor sentiment also appears on the upswing. At Real Estate Foresight's 4th annual China Property Outlook Seminar in January 2016, more than 30 fund managers, investors and researchers expressed a more optimistic sentiment about the residential sector than they had the previous two years; 50 percent expressed an optimistic outlook compared with less than 30 percent last year and less than 20 percent in 2014.

The road ahead

Despite slowing growth and continuing stock-market volatility, China's economy is unlikely to have a hard landing, according to the World Economic Forum's *Global Competitiveness Report 2015–2016.* Moody's Investors Service declared its outlook for China property was "stable" through 2016 but expects nationwide sales growth to slow.

Wells generally agrees with this view and is positive but cautious with respect to the property market in 2016. He says mass-market demand continues to stay strong. The nationwide sales growth rate might slow in 2016 after a strong rebound in 2015, but Wells expects further sales growth, even

Five-year house price dynamics, November 2015



Source: Real Estate Foresight

at a slower pace. And as Felteau notes, growth in sales volumes in some second- and third-tier cities should be due to aggressive price-cutting by developers, so average selling prices could come down in these areas as a result.

Predictions of an inevitable burst of the property bubble continue to show up in the press, but none of the experts interviewed for this article buy into that view. Yue believes, while the boom days are over, the Chinese residential market still is fundamentally healthy. "I don't expect it to bounce back to where it used to be," he says. "The market is going to be stable. We don't see a major collapse or hard landing." Like Wells, Yue is taking a cautiously-positive outlook.

LaSalle's Chen says the firm's base case is China's economic growth will trend lower in a soft landing. And she says the government has many policy options at its disposal to support growth if it sees macro-risks growing.

Longer term, Ciemniak believes the end of China's one-child policy last year also will drive more demand. Chen expects increasing demand for upgrades because of growing family size and stronger demand for larger units. "Institutional investors may look for development opportunities targeting middle-class families in the higher-tier cities," she says.

In the short to medium term, however, Presima's Felteau does not expect the end of the one-child policy to have a huge impact on the market. First and foremost, a lot of families in China cannot afford to have more than one child, and the slowing economy is not helping. That being said, Felteau believes the upgrade demand from smaller to larger units should be strong in 2016, particularly in first- and second-tier cities. Mid-sized units of about 90 to 144 square metres should be the best-performing segment in 2016, especially those apartments having more than one bedroom.

Ciemniak notes the residential market will continue to move in cycles, and policy moves are the main thing to watch for because, in the past, turning points in the cycle have been preceded by some sort of tightening, restrictions, rising costs or crisis. "We would assume stimulus measures supporting the property sector will continue near-term, but there will be another down cycle coming after that," he predicts.

Ciemniak says the market remains vast in size, however, and presents opportunities at all points of the cycle. He points out 10 million to 12 million marriages occur every year in China, urbanisation continues, and housing remains a major indicator of quality of life and wealth perception in the country. The upgrade demand also will always be there. "The question now is more whether you can come up with the right product," concludes Ciemniak.

The bottom line

China continues to work off its excess housing supply and, in the short term, the government will continue to support the residential sector through policy moves. But a large gap exists between the fundamental strength of first-tier and major second-tier cities, and the fundamental weakness in many third- and fourth-tier cities. This gap is likely to widen further in the future. Good investment opportunities exist but, more than ever, investors need to have great discernment in the selection of cities, submarkets and product types. ❖

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Stock-market volatility attracts investment in housing

Chinese stocks plunged about 10 percent during the first full week of January, and China suspended trading twice that week to prevent more widespread selloffs. The previous summer had seen a similar seismic blow to the market. The renminbi also continued its depreciation, hitting a five-year low in January.

Richard Yue, CEO, CIO and portfolio manager for Arch Capital Management in Hong Kong, views the stock market volatility as a good wake-up call for the property market. When the stock market crisis hit China in the summer of 2015, Yue monitored the bond prices of public developers, usually held by local institutional investors. The bond prices of real estate developers barely moved, while their stock prices were about half. This told him retail investors were running for the door — everybody was selling, so they were selling, too. "But smart investors are hanging on to the bonds because they know this has nothing to do with the underlying real estate market," says Yue.

In addition to the government's continuing supportive policies, the volatility in the stock market and the depreciation of the renminbi actually have attracted investment in housing, according to Gregory Wells, managing director and head of Asia for Forum Partners. "We believe this trend will continue in 2016," says Wells. As Yue explains, in China financial instruments are limited to the stock market or the real estate market. With increasing stock-market volatility, people are now putting their money back into something safer, such as brick-and-mortar houses. "Worse comes to worst, the apartment is still there, and I can still rent it or live in it, instead of just having a piece of paper," says Yue.

While investors are spooked by China's slowing growth and stock market volatility, and the Chinese government is not managing this process very smoothly, it is important to remember China is still projected to grow its GDP by 6.2 percent to 6.5 percent this year.

— Mard Naman