# China's residential woes

*Despite stimulus measures, oversupply problems are creating a sluggish recovery for China's residential sector*

by Mard Naman

What is going on with China's housing market? Sales volumes, prices and new development all declined in 2014, despite the lifting or relaxation of home purchase restrictions almost everywhere except the first-tier cities of Beijing, Shanghai, Guangzhou and Shenzhen. In addition, an interest rate cut this past November was designed to help stimulate sales.

In December 2014 and January of this year, sales volumes started to increase, but prices generally did not. The main culprit appears to be excess supply in almost all markets. The underlying growth in demand has not kept up with the pace of new construction the past few years, and the market now is feeling those effects.

A year ago the word on most people's lips was "bubble", but no national residential real estate bubble emerged. However, some cities do have oversupply issues, according to Joseph Huang, executive director and China country head for Forum Partners. "The structural oversupply issue is unlikely to be easily resolved in some tier 3 and 4 cities, even with the expected loosening of policy controls and/or credit easing," says Huang. According to UBS, the oversupply issue will persist throughout 2015, with a noticeable improvement in the demand/supply balance expected in 2016.

The excess inventory reached an average durational high of 19 months in 2014, according to Thomas Delatour Jr, co-founder and CEO of Century Bridge Capital in Beijing. As a result of this large inventory overhang, land sales in the second half of 2014 dropped 50 percent, and construction starts for the year dropped 15 percent.

But before all this sets off too many alarms in investors' minds, it is best to step back a bit and look at this in the context of a longer timeframe. According to Delatour, sales volumes were down 10 percent in 2014 from 2013, but 2014 volumes were 10 percent higher than in 2012, which had set a previous annual sales record. So it is not as though sales volumes suddenly dropped off a cliff.

In the meantime, the relaxation of restrictions on home purchases and looser credit have begun to help clear the inventory overhang. According to Delatour, the demand/supply imbalance is starting to work itself out, and over the next six months the pent-up demand for housing will drop the excess inventory from 19 months to 18 or 17 months. It is important to note, however, the amount of oversupply varies widely among cities; according to Huang, first-tier cities now have 12.7 months of inventory, while third-tier cities still have a whopping 33.6 months. Second-tier cities now have about 20.1 months, down only slightly from a historical high of 21.2 months in July 2014.

Recovery and progress? Yes, but very slow and not yet steady. "The easing measures are gradually making an impact," says Robert Ciemniak, founder and CEO of Real Estate Foresight, an independent research and analytics firm based in Hong Kong. "Some cities show clear improvement in sales volumes, albeit at lower prices."

## The price is not right

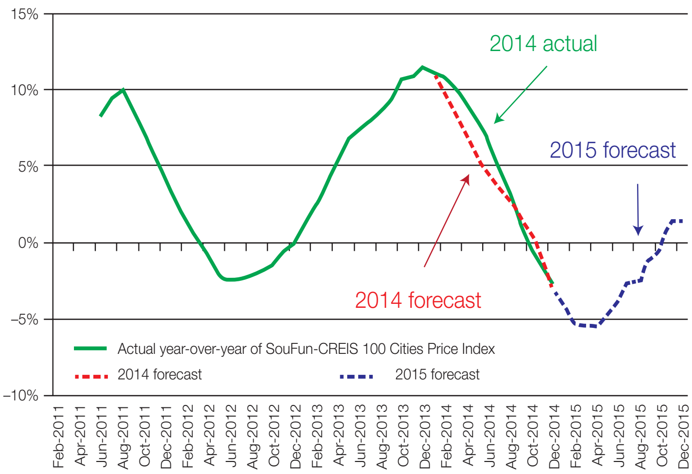
How far have prices dropped, and when will they start moving back up? National average selling prices declined about 9 percent in 2014, which includes –3 percent in first-tier cities, –7 percent in second-tier cities, and –12 percent in third- and fourth-tier cities, according to Huang.

Prices may not be at the bottom yet, but with expected steady sales volumes, and the ongoing inventory-reducing effect of fewer construction starts and fewer land sales, Delatour says the supply of residential units will continue to diminish. As a result, he expects prices generally will begin to recover by mid-2015. But as with supply, the pace of price recovery will vary widely in different tiered markets.

Huang projects average selling prices will decline another 3 percent nationally in 2015 in total, but that first-tier cities will be up 4 percent, second-tier cities will be flat, and third- and fourth-tier cities will be down 8 percent. Using a different metric, the SouFun-CREIS 100 Cities Price Index, Ciemniak expects the average house-price growth for the 100 cities to bottom out at about –6 percent year-on-year for the first quarter of 2015 and finish 2015 up about 1 percent year-on-year.

According to the recent *China Forecast* from Real Estate Foresight, after hitting bottom the first quarter, the residential market will start a cyclical rebound in the second quarter of 2015 (see graph, below). "We may not yet be at the bottom of the cycle, but there are more and more signs of upcoming cyclical pickup in volumes and prices," says Ciemniak. Even though China's average home prices extended their year-on-year declines through January 2015, for example, Ciemniak's latest research shows on a sequential month-on-month basis, prices recorded their first increase after eight consecutive months of decline. A Knight Frank news summary from February confirms prices of new homes in 100 mainland cities rose slightly (0.21 percent) in January 2015 from December

### China house price growth forecast




*Source: Analysis by Real Estate Foresight based on data from SouFun-CREIS*


Shenzhen, China

2014, with Beijing recording the biggest growth of 1.15 percent, followed by Shanghai and Chongqing. Whether this is an aberration or a trend remains to be seen, but it appears the bottom may be near.

But the recovery still may require another push from the People's Bank of China. "We believe one rate cut alone from November does not quite cut it," says Ciemniak. "'Mr Property Market' would likely say, 'Give that to me one more time'." And indeed, he expects further easing and further declines in mortgage costs. Whenever the cyclical rebound officially starts, third- and fourth-tier cities almost surely will lag behind. "The general view is that home prices in first- and second-tier cities will stabilise, while prices in third- and fourth-tier cities will continue to fall in 2015," concludes Forum Partners' Huang.

### Sentiment heading slightly south

Late last year, Vincent Felteau, portfolio manager for Presima, travelled to China to see firsthand the impact of the relaxation of home-purchase restrictions. He and his group met with more than 20 developers of varying sizes. Most developers noted a significant spike in sentiment and sales volumes since the relaxation measures this past September and the interest rate cut in November. But they also agreed that while first-tier and provincial capital second-tier cities were selling well at reduced prices, third- and fourth-tier cities still were going through a very difficult time because of oversupply.

What was surprising to Felteau, however, was that most developers were unsure about the sustainability of the recovery. In previous cycles, developers usually have turned very positive when the PBoC steps in. Not this time, says Felteau. He believes another sign of ongoing weakness for the residential sector is that most developers he met, apart from state-owned enterprises, said they would slow down their land-replenishment strategy in 2015. "Some developers even mentioned they would completely stop construction process on some of their projects, especially those in tier 3 and tier 4 cities," notes Felteau.

Ciemniak also sees sentiment going a bit south. At his company's Third Annual China Property Outlook seminar in January 2015, Ciemniak reports the sentiment among more than 50 fund managers, investors, lenders and researchers was slightly more negative and divided compared with the previous year's seminar, with about 30 percent being negative compared with about 20 percent in 2014.

At the end of the seminar, Ciemniak held a debate between the "bulls" and the "bears" on China's residential sector. The bears focused on the oversupply issue, deteriorating demographic fundamentals, and concerns about buildup of credit and debt. The bulls, on the other hand, focused on government-driven cyclicality and the Chinese government's ability to stimulate the market, as well as the ongoing urbanisation drive and upgrade demand.

### Moderate government intervention viewed positively

Despite this slight increase in negative sentiment, most analysts believe the Chinese government knows what it is doing. The government's approach reflects its view that market conditions are not as severe or dangerous as many perceive. "Their approach of applying moderate regulation in systematic small increments recognises the maturity of the residential market and its ability to adjust to temporary supply and demand imbalances without significant government intervention," says Delatour.

Like Ciemniak, Forum Partners' Huang expects the government to cut the interest rate further in 2015 to lower financing costs, which will help. But Huang says it is important for local governments in third- and fourth-tier cities to reduce the land supply in the next few years to help reduce the current inventory. He also sees a need for looser restrictions on home loans and lower taxes on the trading of properties, both of which would assist the residential market recovery.

Presima's Felteau says the central government did the right thing during this downturn by staying on the sidelines for as long as possible, and it is much better for the market to function naturally without artificial forces. "At this point, we believe it makes sense for the market to go through a consolidation phase," he says. For investors, careful developer selection becomes more important than ever. As it becomes increasingly difficult to generate profits, Felteau notes the largest players will be best positioned to gain market share because of their lower cost of capital and better access to land.

To protect their investments, Huang says investors need to consider some key factors in a down market. Of course, project location is crucial, and projects with easy access to public transportation, schools and hospitals usually are more resilient during downturns. Also, developers with proven track records and robust financials (such as leverage level, liquidity and access to cheaper financing) are more protected in a down market.

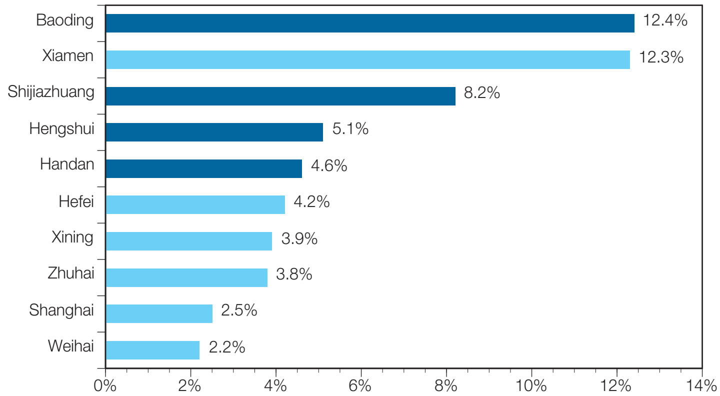
The recent problems of developer Kaisa Group Holdings certainly heightened investor doubts about Chinese property developers. Shenzhen-based Kaisa missed an interest-rate payment to international bondholders in January 2015, and the cash-strapped developer finally made the payment almost a month later after being bailed out by rival developer Sunac China Holdings. Sunac, which is headquartered in Tianjin, acquired a 49.3 percent stake in Kaisa. This may calm the market, but probably will only partially alleviate investor concern about property developers.

### Getting a handle on scandal

President Xi Jinping has been conducting a national anti-corruption campaign that has netted more results than most first expected. The campaign nabbed 66 central and local government officials in 2014, and it is now expanding its scope to the private sector to indict business officials involved in graft, bribery and other forms of corruption.

Given this lengthy and expanding anti-corruption campaign, investors need to conduct more thorough due diligence on the political background of developers. In general, says Huang, developers who acquire land mainly through formal channels, such as public auction, are less likely to be embroiled in political scandals. And institutional investors should insist on a strong deal structure to prevent or reduce loss under a worst-case scenario. Huang says generally a debt/mezzanine structure with a certain level of equity subordination protects the investor better than an equity structure.

### Top 10 in terms of house price growth in 2014 — year-over-year price growth




*Note: Cities highllighted in dark blue are in China's Hebei province*
*Source: Analysis by Real Estate Foresight based on data from SouFun-CREIS*

While most people have focused concern on excess supply and lower selling prices, Huang does not think the chief concerns for 2015 are average selling prices or a sales-volume collapse. Rather, he first foresees problems because of margin pressure, given the continued price cuts and the slower decline in land prices than in property prices. And second, he sees political risks because of the ongoing anti-corruption campaigns initiated by the central government.

Felteau applauds the central government's recent focus on eliminating corruption as much as possible. He believes better governance practices need to be implemented by the different property players to bring more trust back to the sector. "Right now, the significant discounts to net asset value are a clear sign that global property investors are still very reluctant to give full credit to residential developers," says Felteau.

For investors, Felteau sees a silver lining behind the anti-corruption campaign. Because of the amount of turmoil in the market, such as Kaisa's missed debt payment and corruption allegations against high-level executives at other developers, Felteau thinks more developers now might finally focus on what institutional investors want for the sector: profits over volumes, conservative leverage, higher payout ratios (or not aggressively reinvesting proceeds into expensive land plots), and the adoption of better governance and disclosure practices.

### Size matters

Interestingly, Felteau believes in 2015 the size of units will matter a lot more than in the past. He says the anti-corruption campaign is likely to affect larger and luxury units more than smaller ones. Because larger flats are obviously more expensive and require higher down payments, "people buying larger units are much more likely to be investigated versus people buying smaller ones," reasons Felteau.

Further impacting larger and luxury residential property is the slower overall economic environment in China. Some wealthy people are diversifying their holdings in residential property by moving money outside of China, a process that has accelerated over the past couple of years.

### Best opportunities for investors today

Given the serious oversupply issue in many third- and fourth-tier cities, Huang believes the best opportunities for residential investment are in first- and second-tier cities, which also benefit more from the urbanisation process because of their superior infrastructures and access to medical and educational facilities.

In terms of the underlying market economics, Real Estate Foresight's Ciemniak believes good investor opportunities lie within some second-tier cities with reasonable price and supply levels, and within select lower-tier cities that benefit from a genuine urbanisation drive and the spill-over effects from major cities nearby. In fact, the top five cities with the strongest price growth in 2014 were Xiamen in Fujian province and four cities in Hebei province — Shijiazhuang, Handan, Hengshui and Baoding — the latter three all being lower-tier cities benefiting from being near major cities (see graph, page 21).

Delatour of Century Bridge believes the best residential investment opportunities today are in middle-class high-rise developments in second- and third-tier cities. He likes infill locations with pre-existing infrastructure, transportation and amenities including educational, retail and healthcare facilities. Delatour believes second- and third-tier cities will continue to experience job growth and create additional housing demand. He notes the critical relationship between household income and housing prices will further improve as per capita income continues to grow faster than housing prices in second- and third-tier cities.

Furthermore, Delatour says a good strategy is to target middle-class buyers, who are seldom affected by the home-purchase restrictions because they do not generally buy multiple homes, and they often either pay all cash or make substantial down payments.

With careful selection of city, developer and type of development, good opportunities for investors indeed exist. But given the overabundance of supply, the financial strains many developers are experiencing and the ongoing anti-corruption campaign, investors would be wise to proceed with an abundance of caution. ❖

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