DANIEL'S TOUR OF CHINA

September 2018

HAWKSMOOR
FUND MANAGERS

2. THE PROPERTY MARKET IN CHINA

The property sector represents 25% of China's gross domestic product (GDP) - covering property developers, construction companies and the suppliers to the industry such as the steel and glass manufacturers.

It is also a large constituent of the bond market, both onshore (local currency) and offshore (mostly US dollars), which is why so many commentators voice their concerns about the build-up of debt in the sector. The Chinese authorities recognise the importance of the property sector and use tools to manage it alongside usual monetary or fiscal policies.

Some key facts about the housing sector

- First time buyers have to pay a 30% deposit, meaning Loan To Value ratios (LTVs) are no more than 70% - way lower than in almost any other developed country. A second home requires a 60% deposit and you can no longer get a mortgage on a third or more homes. So where do people get their deposits from? The bank of Mum and Dad and Grandma and Grandpa – a positive legacy of the one-child policy.

- Individuals must have a 5 year history of paying income tax, i.e. been in a job for 5 years before they can apply for a mortgage. Mortgages are typically 30-year floating rate and the average rate for a first home mortgage is currently 5.69% and 6.05% for a second home, compared to 6.9% and 7.5% back in 2014.

- Banks won't lend unless an individual's debt service ratio to income is less than 50%.

- Demand for mortgages is high, as **renting is deemed inferior in terms of social status** which is evidenced by the fact that living in a rental home does not qualify for entry to the local school. It can also be prohibitive as 10 years' rent can be demanded up front.

- New residential developments are pre-paid in full, not just the deposits, shortly after the foundations are laid - meaning the next phase of the construction is fully funded thereby reducing the risk of half-built developments.

- Off-plan flipping is no longer allowed and high taxes are paid if a property is sold within 12 months (50% of value) and if less than 2 years (25%).

- Mortgage defaults and non-performing loans (NPLs) are low but starting to rise. However, even in a default, single home owners cannot be ejected.

- Local government and property developers cannot displace villagers – they need to be compensated and relocated within the same city boundaries. The photo below was taken in Shanghai from the offices of Shui On, who is developing a luxury apartment block in the centre of this photo where the

AGENDA

24th September - Hong Kong

- Head of Moody's China
- Moody's Asia Property
- Kaisa Group Holdings (Property Developer)
- BNP Paribas top ranked China strategist
- Agile Group (Property Developer)
- Gleneagles Hospital (Private Hospital)
- Head of Moody's South East Asia
- Deutsche Chief Economist
- Deutsche Asia Chief Economist

25th September - Shenzen

- Shenzhen Investment Holdings (State Owned Property Developer)
- Shenzen Investment Holdings' new science park
- Huawei headquarters and innovation centre (technology company)
- SF Holdings distribution centre (logistics company)

26th September - Shanghai

- Fosun International (conglomerate)
- Greenland Holding Group (State Owned Property company)
- Shui On Properties (Property Developer)
- Xintiandi – new mixed use retail/ dining centre developed by Shui On
- Yingde Gas (industrial gas producer, owned by private equity)

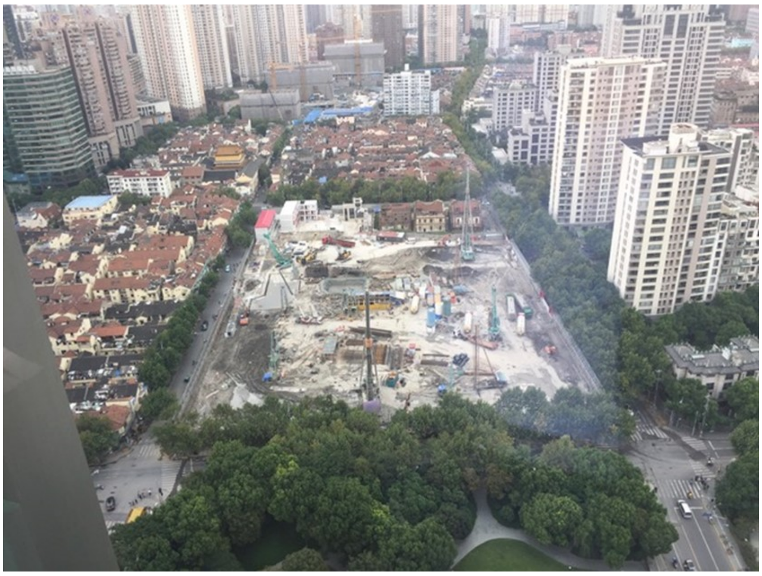
27th September - Beijing

- Metallurgical Group (State Owned Steel producer)
- Aluminium Corporation of China (State Owned Aluminium producer)
- Orient Advisers (State Owned Asset Management Co.)

28th September - Beijing

- Bank of China (State Owned Bank)
- Lenovo campus and technology centre

penthouse will cost £1.3m. The developer has to consult with the local government and the community whose homes will be demolished – a process that can take years. We were told that the compensation is very generous as it includes a new home within Shanghai and cash that can often mean the previous occupants no longer have to work. The neighbours of this new development are patiently waiting for their turn.



An old Shanghai neighbourhood being swallowed up by new high rise development

Urbanisation

The demand for property in China is not going away. There is a structural need for residential and commercial properties simply due to the growth and urbanisation in the population. The urbanisation rate for China last year was 58.5% and the government has set a target of 60% by 2020 and 70% by 2030 – the average urbanisation rate for developed countries is 80%.

To reach those targets will require 20 million people moving from rural areas to cities (or turning existing rural areas into cities) each year. **The end of the one-child policy is forecast to have 18 million newborns every year, and at the same time the life expectancy of the Chinese now broadly matches the US at 76 years (79 years in the US) compared to 1963 when life expectancy was just 45 years (70 years in the US)**. Therefore affordable housing for the long term is a big focus for the property developers.

Slowing the pace of growth

Recognising the current hot market, the government has introduced numerous measures this year including some of the aforementioned rules on LTVs, deposits and additional mortgages, to deliberately slow down the pace of growth. Since 1990, there have only been 3 years when house prices have fallen – 2008, 2011 and 2014.

A major factor in this unstoppable price appreciation is the high savings culture of the Chinese combined with a lack of trust in the stock market, no access to corporate bonds and poor returns on offer from the bank deposit rate. This has meant that property has been seen as a sure-fire investment, but one that is unlikely to continue if the title of the government's latest report on the sector (called "Housing is for Living not for Speculation") is anything to go by.

"Whether the authorities can deliberately slow the market in a calm way was the cause of much concern across many of my meetings."

Numerous strict guidelines have also been imposed for property companies and banks. For example, the current rules prevent developers from buying land using debt. While sensible in slowing down the rapid pace of land price appreciation, possible implications of this policy are the potential loss of revenue for the local government (who rely on property sales and taxes for the majority of their income) and the likelihood that smaller and weaker companies will struggle to buy land using cash, leading to much needed consolidation in a fragmented sector.

There are thousands of property companies in China, with the largest having just 3% market share. Banks have to show that their exposure to property debt is falling and are actively encouraged to report higher NPLs. Banks also have a much higher capital ratio for mortgages, with a requirement to hold 100% capital against them, versus 20% against local government bonds and 0% against central government bonds.

Property propaganda

Property companies are much more discerning about the projects they take on. There was no denying that some ghost towns exist (huge developments with no inhabitants) but there are not as many as Western press might suggest.

People we spoke to thought that the photos we have seen in the West were taken on public holidays when the towns are quiet anyway.

"There is some propaganda here but I'm not sure who the biggest culprit is."

The companies I met were properly managed, required decent margins and would only consider developments in cities with populations greater than 10 million, or at least those that have plans to grow to that size in short order, and so won't be repeating worthless projects for fear of going bust or being acquired.

Construction of huge office and apartment blocks was evident in every city I visited, leading to the obvious concern that they will not be fully occupied. I was reassured that in prime locations occupancy rates were approximately 95% hence further development taking place in central Shanghai. But on the outskirts of the cities, or for less prime buildings, the rate is closer to 80%.

Grand plans for the expansion of the technology centre in Shenzhen/Nanshan district by Shenzhen Investment Holdings

Property companies that have a retail focus are not facing the same challenges as those in the UK. Rents are paid as a percentage of turnover rather than fixed upward only with limited flexibility. After a long bull market in the property sector, consolidation, allowing the weakest to fail, encouraging mergers and acquisitions, and allowing market forces to play a role, were recurring themes throughout the trip so it is natural to expect defaults and negative headlines. But it should be recognised that this is a deliberate policy to cleanse the market and therefore ultimately viewed as a positive development.