

Real Estate Outlook

China – Edition 2020



Slowly but surely



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Much at stake over the medium term.



Given the real challenges facing the economy, we will be watching China's commitment to its medium-term objectives. And even as China's rise on the global stage attracts its fair share of geopolitical skirmishes, affirmative policy goals will continue to support the development of key investment themes in real estate.

China



Signposts

- 2020 target of doubling household income
- 14th Five Year Plan (2021-2025)
- 20th Congress of the CCP in 2022



Threats

- Simmering trade tensions
- Slowing residential market has wide impact
- The unwilling Chinese consumer



Opportunities

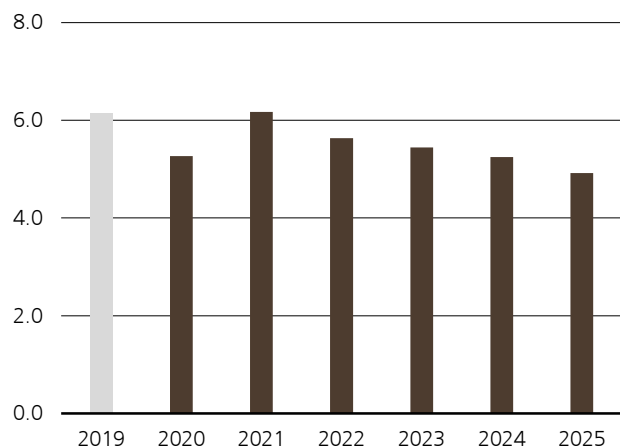
- Made in China 2025 a boon for Industrial
- Cold chain logistics is niche but growing
- South China real estate markets on the rise

Much at stake, but China will not break

Every year in March, we look towards the annual National People's Congress (NPC) in China and attempt to make sense of the signals that could guide our macro views. At the point of this writing, China has postponed the 2020 NPC sessions due to the COVID-19 pandemic. There are reports that more than one-third of the NPC delegates are local officials and it is not the best of times to be distracted from the ongoing fight against the virus. In terms of growth targets for 2019, China put forth a range of 6.0% to 6.5% - And indeed China grew at 6.1% in 2019. Assuming that virus outbreak is contained before mid-year, we expect economic activity to ramp up immediately, and full year growth to come in at 5.0% to 5.5%.

Figure 1: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
Note: Data for the period 2020-2025 are forecasts.

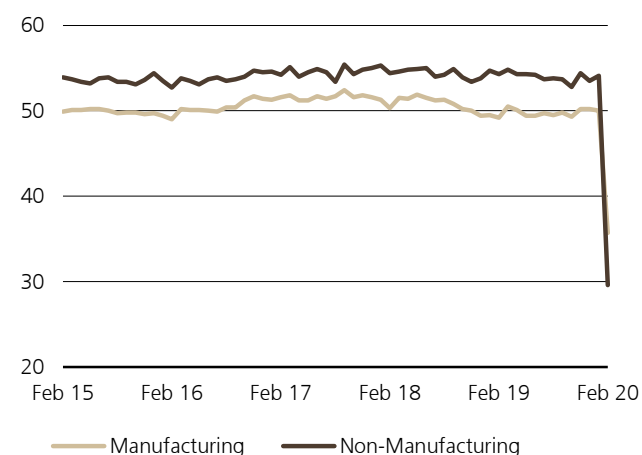
The latest Purchasing Manager Index (PMI) reading in February 2020 saw the Manufacturing PMI plunge to 35.7, a sharp drop from the 50.0 in January 2020, and possibly the lowest on record. Services related sentiments also retreated, as Non-Manufacturing PMI posted the deepest contraction on record, dropping from an expansionary 54.1 in the first month of 2020 to 29.6 as at February 2020. Services now account for almost 60% of China's GDP and this pillar of support is particularly critical to China as trade tensions continue to simmer against the backdrop of the COVID-19 fallout.

But not all is lost. The People's Bank of China announced a 50 bps cut in the required reserve ratio (RRR) for banks on the first day of January 2020, which is estimated to release RMB 800 billion of liquidity into the economy. 2019 had already seen at least three such similar cuts in the RRR, on top of a lowering of the seven-day repurchase rate, the first such easing since 2015. The PBoC revamped China's loan prime rate system in August 2019, seeking to narrow the gap between bank lending rates and money market rates.

The one-year loan prime rate has already been cut three times in 2019. In late February 2020, the PBoC trimmed the one-year and five-year loan prime rates in a further bid to support the economy and corporates. We are not expecting a huge stimulus in the form of helicopter money or a non-targeted liquidity slush, as China would have learned its lessons from the credit-fueled stimulus of 2008, of which it now continues to struggle with the consequential ramifications.

Figure 2: PMI Index

(Reading above 50 denotes expansion)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

China's situation is always being compared to that of Japan's experience since the 1970s, but the difference is as uncanny as the similarities are. Japan dealt with the challenges of rebalancing from investment to consumption in the 1970s, wrestled with a credit and asset bubble in the 1980s, and has grappled with a rapidly aging population since the 1990s. China, meanwhile, has the undistinguished burden of contending with all three issues at the same time. No doubt it is always easy to extrapolate and assume that economic history may provide textbook answers as to how China should and would manage its problems, but more often than not, we neglect to see China's current conundrum in its entirety.

Signposts we are watching out for

In the 13th Five-Year Plan (2016-2020) issued in late 2015, the Chinese government reaffirmed its goal of doubling household disposable income from 2010 levels by the year 2020. This was a target set way back in 2012 and the political resonance remains high, as the achievement of such will be considered a key highlight of the 100th anniversary of the Chinese Communist Party in 2021. If Beijing were to achieve this objective, the 2020 GDP growth rate has to come in at an estimated 5.6%, at least.

We are watching the significance of meeting the target vis-à-vis the real challenges facing the economy in the long term. For one, the external environment has become difficult to navigate, not helped by the fact that China's rise on the global stage has attracted its fair share of geopolitical skirmishes. Should there be a repeat of the 2008 GFC stimulus, will that be a sign that Chinese leaders are willing to kick the can down the road in exchange for immediate economic and political wins?

We are also keeping an eye on the 20th Congress of the Chinese Communist Party, which will convene in 2022. The continuity of China's reform progress and over arching progress goals is highly dependent on the line-up of the members of the Politburo Standing Committee. There is no need to delve deep into politics here, but suffice to say, investing into China's real estate sector calls for a strong grasp of the political situation and recognizing the key figures and policies that could influence the dynamics of the property and capital markets.

The 14th Five-Year Plan (2021-2025) for China was deliberated and further refined towards the end of 2019, and it is scheduled to be approved by the top legislature in 2021. This Five Year Plan will be a blueprint of China's developmental goals for the next half decade and guides the policy actions of Beijing. For real estate investors, the plan is critical, as there will be indications as to where new growth areas will be, and how investors should position their strategies and allocate their capital accordingly in the medium term.

Among others, the 13th Five-Year Plan had a large focus on economic restructuring, property destocking and initiating reforms on deleveraging, which culminated in a period in which we saw limited land supply for real estate activities, as well as greater control over access to property financing and controls over outbound capital flows. We believe the development plan for the next five years will not be a significant deviation from the previous period, but with an added emphasis on the delicate balancing between growth and mounting fiscal risks. Market reforms will continue and the focus on people will be paramount, to ensure that the mandate of the party remains endorsed through social and economic progress.

Imminent threats

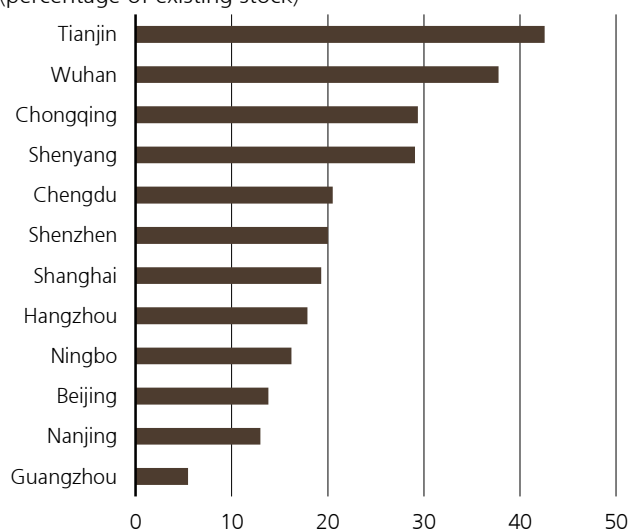
After a staring contest that lasted almost an entire year, the stand-down in trade tensions offered some late but welcomed relief to Asia markets, and of course to China. The fundamental issue here is not who emerged victorious – the US or China – but whether the next few years will see the same circumstances being repeated. The impact of the trade tensions were fully felt throughout China, with anecdotal evidence suggesting that smaller industrialists bore the brunt of the slowdown in export demand.

The Chinese industrial sector suffered in particular, but the collateral impact was definitely felt in the office sectors across China, as corporate sentiments took a hit, resulting in pullback in office absorption. In markets such as Tianjin, Wuhan and Chongqing, where office vacancies were already trending high, the situation is even more dire.

The upcoming US presidential election may be a factor in how the trade rhetoric between the US and China could evolve in the next few years. Then again, the race for dominance in the global hegemony is never straightforward, and this threat of another trade dispute remains very real.

Figure 3: Office vacancy rates as at 2019

(percentage of existing stock)



Source: CBRE (as at 4Q19), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020

How can China pull off the Houdini act of rebalancing the economy while juggling multiple reform goals without triggering a hard landing? The truth is, the economy is still grappling with possible defaults and local government debt exposure, while the general property sector remains bedridden. These are chronic ailments that will take time to heal, and there is no silver bullet. The impact of a slowdown in real estate extends beyond that transmitted through headline growth figures. On the financial end, many developers were and are still highly leveraged, and the sustained slowdown in property sales meant a disruption in their traditional model of churning and selling, which is affecting ability to meet loan and interest repayments (particularly so for pure-play residential builders).

Coupled with a growing reliance on shadow banking, especially for builders with limited access to bank lending, this is a ticking time bomb waiting to explode. Given the high gearing ratios of most developers, compounded by a weaker RMB, onshore and offshore debt servicing remains a big challenge. Any high profile default would definitely ignite a domino series of liquidity pullbacks, possibly crippling the economy. And this is why a slowdown in the real estate sector extends its tentacles deeper than what we can perceive from the outside.

As much as household consumption has multiplied on an absolute basis over the last two decades, making China one of the largest consumer markets in the world, its share of China's GDP has been very low. In the whole industrialization cycle of China since the early 1990s, its share of consumption to GDP has always been generally lower than that encountered by other major Asian economies, which already had been through this same stage. Consumption growth has also lagged behind that of investment. The key culprit in the case of the unwilling Chinese consumer, as most will easily point to, is the extraordinarily high level of savings in China. The concept is straightforward: if you don't save, you spend.

As former US Federal Reserve Chairman Ben Bernanke noted recently in March 2016, China's fiscal policy going forward should aim to support emerging social safety nets, covering the costs of health care, education, and retirement. Indeed, increasing income security in China would promote consumer confidence and consumer spending. If reforms to the healthcare, hukou system and the social security do not make significant strides in the next few years, the drag on consumption could weigh down on the already bloated retail sector, which is struggling with a meaningless decentralized retail space glut as well as direct competition from e-commerce.

Opportunities in the next five years

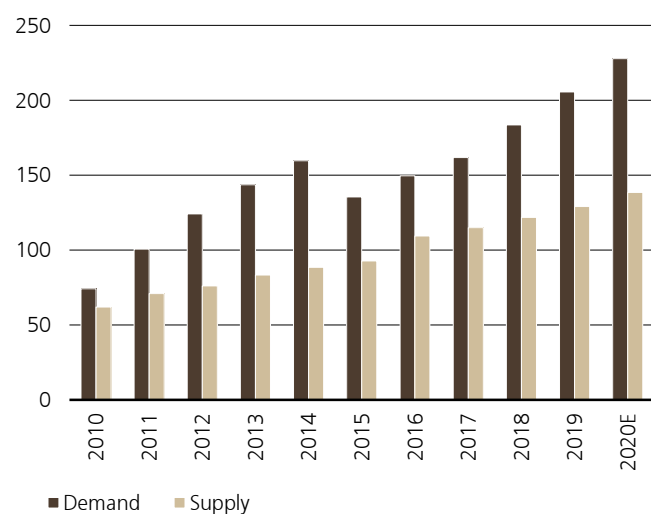
As we formulate our views on the Chinese real estate space, we constantly remind ourselves that much of the country's growth has been driven by local initiatives and developments over the years rather than by Beijing. There is an obvious heterogeneity among provinces, cities municipalities and counties, from the cultural aspects to the administrative features. In general, we are strong believers in the logistics story in China. However, aside from the widely acknowledged ecommerce and middle class drivers, there are opportunities in other specialized segments of the industrial sector.

China wants to transform from a large manufacturing country into a strong manufacturing country. That is no mean feat, as major developed economies such as Germany, the US and Japan are the incumbent dynamos in global manufacturing, particularly for high end products. As early as in 2006, China released a Medium to Long-Term National Plan for Science and Technology Development (2006-2020) that focused on the upgrading of the industrial base, and which was repeated in the 11th Five-Year Plan (2006-2010), the 12th Five-Year Plan (2011-2015) and the most recent 13th Five-Year Plan (2016-2020), all of which have consistently emphasized the need to develop strategic emerging industries and move towards medium-to-high end manufacturing.

On 19 May 2015, China's State Council published a new blueprint for the manufacturing industry termed "Made in China 2025", which set the goal of joining the league of manufacturing superpowers by 2025, moving up the rankings by 2035, and consolidating China's position as a manufacturing giant by 2049. We estimate that more than 70% of existing industrial workshop space has been developed by state-owned developers and local governments before and during the 2000s, a high proportion of which do not meet the current institutional demand in terms of build specifications. Anecdotally, we see a significant supply gap in the high end industrial workshop space, and with the government's push for industrial upgrading, we are at the early part of the cycle for this real estate segment where developers with land-banking capabilities and a strategic focus on tenants in high value added industries will be able to ride this wave.

Over the past decade, alongside the rapid growth of Asia's economy, food consumption patterns have evolved, and the demand for food-related cold chain has increased exponentially. China still lags behind Europe and the US in terms of the cold-chain infrastructure. With greater awareness of food safety, the demand for perishable goods brings with it a real need for modern cold chain facilities. The growth of B2C e-commerce in recent years, especially in the food segment, is a growing trend that looks to be unabated in the near future. Looking within the logistics sector in China, we believe a key market gap has emerged in the more specialized area of cold chain logistics. We estimate that China's cold chain capacity is underdeveloped and aging, with more than half of existing cold chain facilities above the age of thirty years. According to the China Federation of Logistics and Purchasing, more than 80% of the refrigerated warehousing in China has not been built for logistics purposes.

Figure 4: China cold storage demand and supply
(million cubic metres)



Source: ResearchInChina (China Cold Chain Logistics Industry Report 2016-2020), UBS Asset Management, Real Estate & Private Markets, February 2020

To most, the mention of China conjurs up images of the the French Concession in Shanghai or the Tiananmen in Beijing. However, South China is home to some of the largest and most economically vibrant cities in China, in particular Guangzhou and Shenzhen, as well as prefecture-level cities such as Dongguan and Foshan. The Pearl River Delta economic zone led the way in China's opening up in the 1980s, and many cities in the region rode on South China's reputation as the manufacturing base of the world. With that economic success in the pocket, the region has made a gradual and successful shift towards the services sector, and the tertiary industry now contributes a higher proportion of GDP, which is in line with China's long-term nationwide goals.

Beyond the manufacturing sector, more importantly, consumerism, proliferation of electronic commerce and solid residential population growth are driving the underlying demand for commercial real estate. The development of the Greater Bay Area is expected to further enhance the economic growth and connectivity for South China, especially Shenzhen, and we believe real estate investors will do well to increase their exposure to South China.

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