Research Blast

Asia Pacific Real Estate Market, November 2016

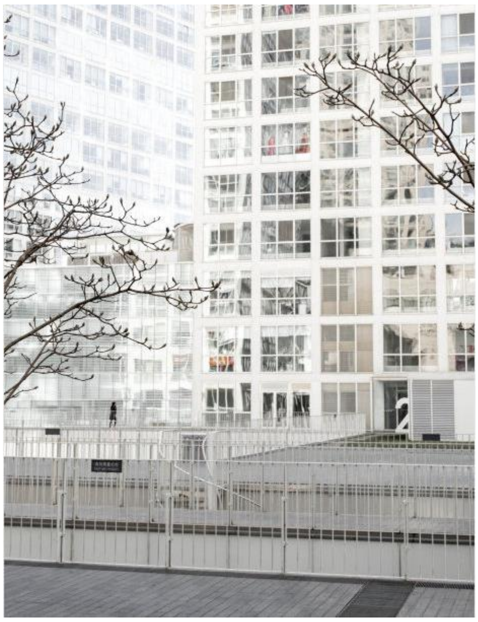
On China: Observations on the effervescent residential market

A recent headline in the Chinese local media raised eyebrows with regards to the frothy nature of China's housing market, when a prominent local developer priced its latest residential product launch in an upscale district of Shanghai at an astronomical RMB 300,000 per square meter (approximately USD 4,200 per square feet). If transacted, this will probably set a new all-time property price record (unconfirmed but estimated at RMB 240,000 per square meter) in Shanghai, providing further evidence of elevated home price gains that have defied fundamentals amid slower economic growth.

In another instance, a local developer was crowned "Land King" in August 2016 when it paid almost RMB 100,000 per square meter for a plot of land in downtown Shanghai, notwithstanding that current home prices in that area are probably trading at levels close to this land cost. In other words, in exchange for being the unprecedented record holder for the highest land price, that developer was underwriting a substantial escalation in home prices in the next two years.

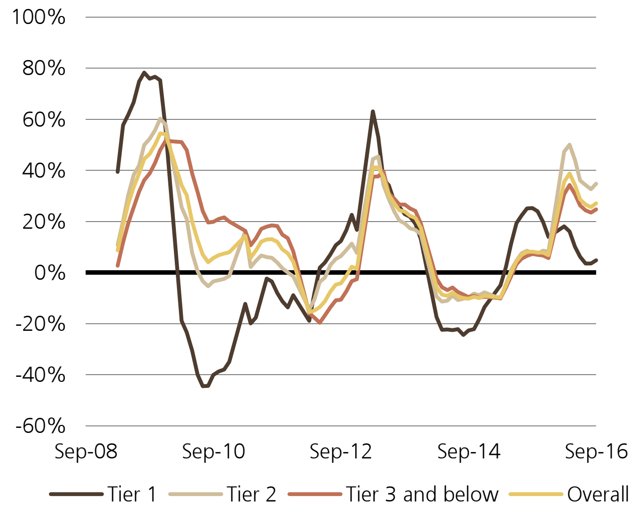
Granted, these examples are not representative of the whole of Shanghai; in the same way that Shanghai does not make for a best proxy for China's disparate residential markets. But this serves as a judicious reminder that things are stirring in the residential sector in China.

Some are quick to point out that the bustling sales and pricing activity represent a timely turning point in China's residential market recovery, while others will flag the increasing risks of sudden reversal of pricing and the broader implications for the wider economy given values are running well ahead of income growth.

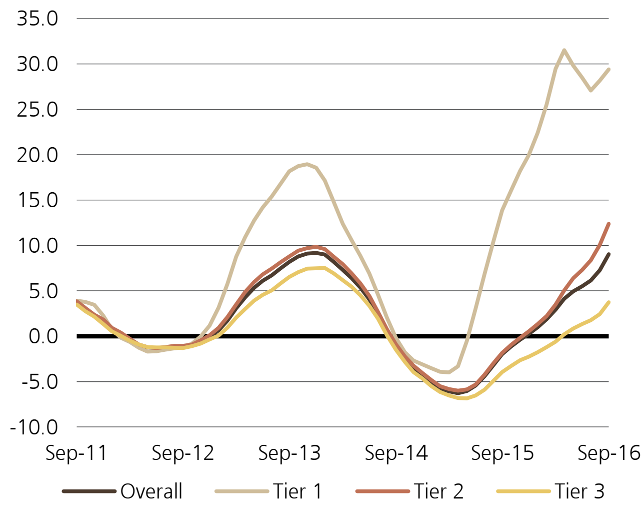


The property fervor in China is a bifurcated story and the divergence appears to be widening

Residential floor space sold (YoY, %)



New constructed residential home price (YoY, %)



Source: CEIC, National Burea of Statistics of China (3Q16)

UBS

There are merits to both arguments. China's third quarter GDP growth in 2016 was a comfortable and predictable 6.7%, much of it attributed to the direct and indirect effects of an eventful residential market. The enthusiasm in the housing sector has supported headline economic activity amid the general slowdown in exports and investment spending. Ailing sectors such as steel and cement have been indirectly given a shot in the arm despite reservations about overcapacity, and consumer sentiments have been further reinforced through the wealth channel as a result of the buoyant property market and improving household balance sheets.

Off-hand, the support for housing and selective industries seems to be an exercise to buy some time as China continues on its uneven restructuring path, but any respite from the economic drag is much needed as the leadership continues to grapple with the unenviable task of rebalancing the economy and minimizing the possibility of a hard landing while maintaining jobs growth.

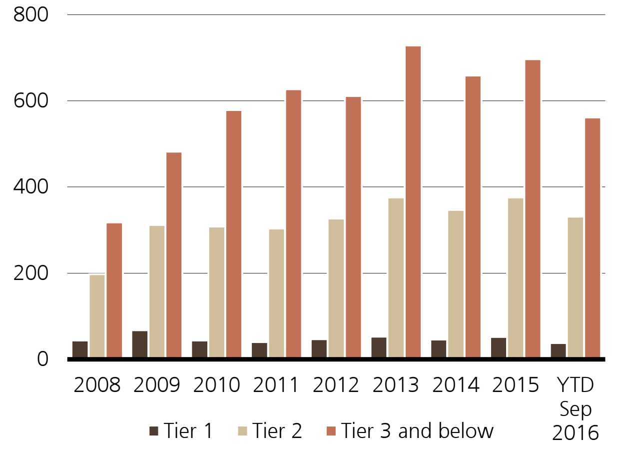
To a large extent, China's growth continues to be driven by credit and investments, and this is unlikely to change in the near term. The well documented issues of burgeoning local government and corporate debt continue to be major hurdles towards China's deleveraging efforts. Even so, the swiftest and easiest way to generate economic activity and sustain growth is still what the government is most accustomed to; i.e. credit.

Over the past year it has been apparent that China has focused its credit loosening towards households. Traditionally, this sector has been lowly geared and flush with savings. Importantly, any increase in household debt would come from a very low base and an insignificant proportion of total debt, and that may allow China more time to concentrate on other reform goals while ensuring that growth remains supported to some extent.

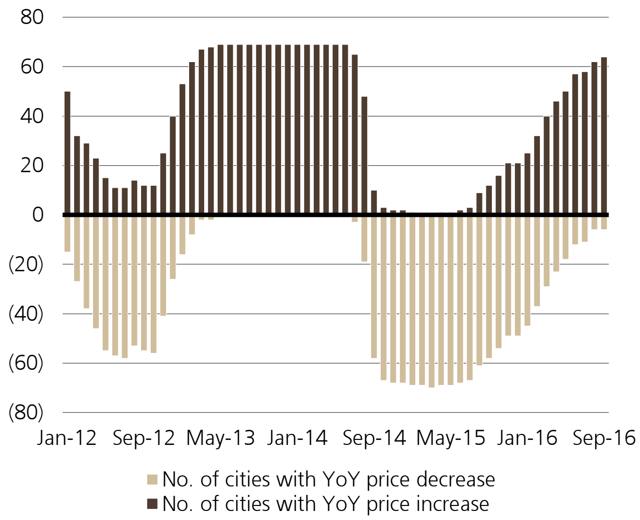
What is driving this recent property frenzy?
The property fervor in China is a bifurcated story and the divergence appears to be widening. Home price increases are polarized across markets with the top tier[1] cities seeing considerably higher gains than the many other lower tiered cites which continue to grapple with huge unsold inventory, mostly a legacy of the pre-2013 boom.

As at September 2016, our calculations show that average home prices across China grew by more than 9% year-on-year. However, the gains have been concentrated in Tier 1 cities, which have seen price rises of approximately 29%, ahead of Tier 2 (12.4%) and Tier 3 (3.7%) cities. As such, any sign of a property bubble in terms of pricing and values are mainly isolated to the gateway and more developed cities, whereas lower tier cities continue to languish.

Residential floor space sold (sqm, million)



70 City residential price change (No. of cities)



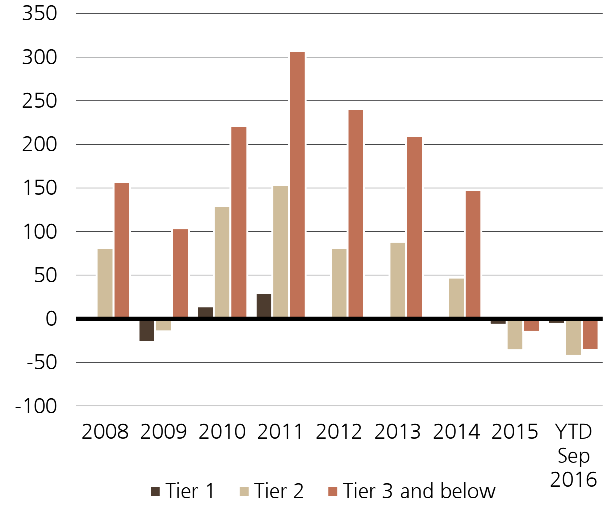
Source: CEIC, National Burea of Statistics of China (as at 3Q16)

And to throw some additional color into this discussion, the inventory overhang situation in China is mainly concentrated in the lower tier cities.

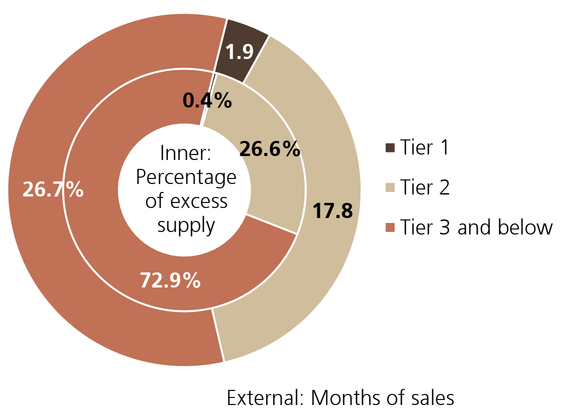
Tier 1 cities continue to enjoy healthy (or even imbalanced) demand-supply dynamics. Our estimates put the excess supply over sales ratio close to two months for Tier 1 cities, and 18 months and 27 months for Tier 2 and the rest of China, respectively. Accordingly, the inventory overhang situation continues to be dismal in Tier 3 cities despite the general impression that home prices and sales are up across China.

[1] Tier 1 cities: Beijing, Guangzhou, Shanghai, Shenzhen
Tier 2 cities: Tianjin, Shijiazhuang, Taiyuan, Hohhot, Shenyang, Dalian, Changchun, Harbin, Nanjing, Wuxi, Suzhou, Hangzhou, Ningbo, Wenzhou, Hefei, Fuzhou, Xiamen, Nanchang, Jinan, Qingdao, Zhengzhou, Wuhan, Changsha, Nanning, Beihai, Haikou, Sanya, Chongqing, Chengdu, Guiyang, Kunming, Xian, Lanzhou, Xining, Yinchuang, Urumqi
Tier 3 and below cities: All others

Excess of residential starts and residential sales
(sqm, million)



Excess supply and months of sales (%, months)



Source: CEIC, National Burea of Statistics of China (as at 3Q16), UBS Asset Management, Global Real Estate Research & Strategy estimates

In most markets, the demand for residential property tracks the economic cycle rather closely, which makes the case of China rather unique. There are several reasons why the residential market has been behaving this way despite the softening of China's growth prospects in recent years.

Cultural psyche

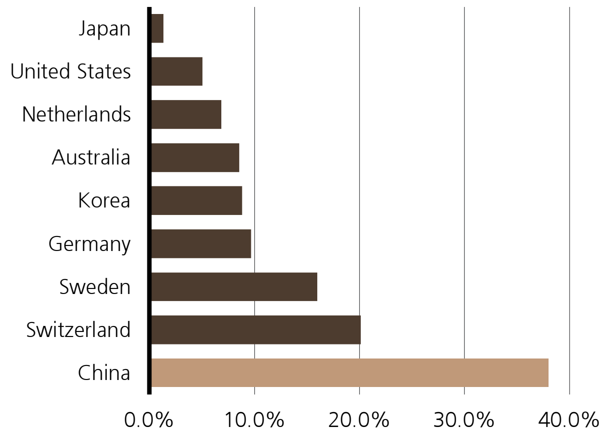
While not apparent to many, Asians – and the Chinese in particular – are keen aficionados of hard assets such as real estate. The appeal of brick and mortar has deep seated cultural roots which cannot be ignored. In the Chinese written language, the characters for home, prosperity, and peace (家,富,安, respectively), to name a few, are all formed with the basic graphical radical of a roof over the head. Having a home is a very basic must-have for those who can afford one; and for the affluent, owning several properties is never considered too much. Part of this alignment between cultural influence and practical considerations is also due to the fact that since the watershed year in 1998 when market participants were first allowed to buy and sell housing units, residential home prices have increased, helped by rapid wealth accumulation and urbanization in China. To the Chinese in general, residential real estate is a proven asset class which also carries a strong intrinsic significance.

Opening of credit floodgate

A looser credit policy is perhaps the key reason why home prices have gathered momentum despite the broader emphasis on deleveraging. In 2013, the new leadership's determination to tame the property sector and minimise the associated risks of over-investment and excessive credit growth sparked a multi-year decline in home prices and sales. This clearly had a vicious feedback on the economy and created a persistent drag on growth, giving rise to fears that a hard landing was on the horizon. Fortunately, low debt levels and elevated savings rates have meant that it has been a relatively safe bet for policymakers to boost household credit and leverage over the past year without compromising its overall deleveraging efforts.

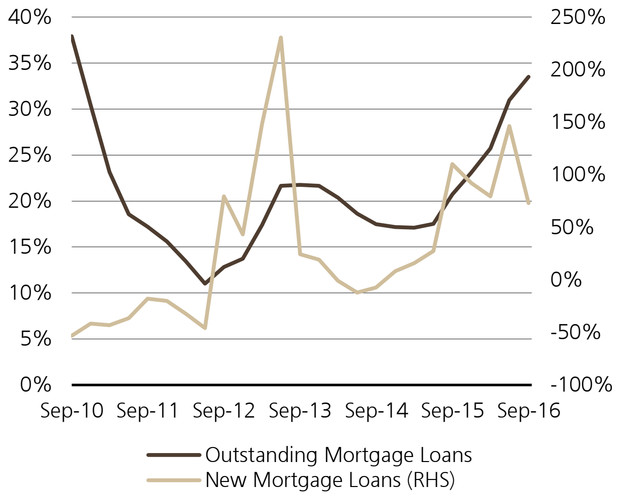
And as early as 2015, we started to observe that home purchase restrictions and mortgage accessibility were increasingly being eased across most cities. As at September 2016, outstanding mortgage loans increased by 27% in the first nine months alone, compared to 17% during the same period last year, and 13% in 2014. We have not included shadow loans and peer-to-peer lending in the consumer space, but the year-to-date percentage of net new mortgage loans to total RMB-denominated bank loans in China stands at 38% as at 3Q16, up from 22% in the same period of 2015. And with administrative restrictions on home purchases moderately eased in most cities, that made for the perfect formula to rouse the slumbering housing sector, especially in gateway cities where occupier and investment demand had been significantly pent up.

Household savings rate - 2015 (%)



Source: OECD (as at June 1, 2016)

Mortgage loan growth (YoY, %)



Source: CEIC, National Burea of Statistics of China (as at 3Q16)

Financial repression

China's financial repression had only been possible because of a closed capital account and tight governmental controls on the banking sector including the regulation of interest rates, which have allowed state-owned banks to act as price-givers on new loans. It has only been recently that lending rates have been deregulated and caps for deposit rates removed.

Relatively low returns on savings and a dearth of alternative investment channels have forced retail investors into property investments. Households are still mostly barred from transferring funds out of the country and the prevalence of local wealth management products, which are mostly backed by low quality underlying assets and implicit government guarantees, have threatened to spin out of control. This flow of capital back into the residential market also coincides with the recent volatility of China's stock exchanges.

Risk considerations: pockets of concern

We believe that the key risks remain focused on Tier 1 (and some Tier 2) cities, given that home prices have deviated from fundamentals. Recent mortgage loans are likely to be based on frothy valuations and while household leverage remains relatively low, a sharp pullback in the property sector would hit household balance sheets and equity levels. Although we believe the authorities have the resources to minimize the fallout for the broader economy, a sharp housing-led slowdown would weigh on China's economic transition.

The housing market recovery is uneven, and inventory hangover remains high, particularly in lower tier cities. Encouraging a multi-speed residential sector can only intensify the weakness of these cities, as destocking of housing inventory is not picking up pace. The risk of obsolescence increases each day the unsold stock is left vacant.

Policy dilemma

Tilting the weight of overall leverage towards households is a temporary fix that may have long lasting repercussions. Complacency around state-owned enterprise reforms and corporate deleveraging may slow the progress of China's reforms, which offer structural solutions to China's credit and growth conundrum.

Also, given the multi-speed nature of the housing markets, it remains to be seen how the central government can manage the delicate balance between stemming price inflation in some cities while boosting sales in others.

Key views: different cities different strokes

Across most pricing metrics, we believe that China's overall residential market has not moved into bubble territory. The same view applies to the majority of China's cities. In fact, local governments have already started to put in place targeted cooling measures to reduce the rate of price inflation. In the near term, although the risks are rising, the likelihood of a sharp pullback in all the local residential markets remains small.

In early October 2016, a senior official from the China Banking Regulatory Commission made public some statistics which were previously rather opaque, throwing some much needed light on the simmering risks arising from the recent property frenzy. For one, the value of mortgage loans in China accounts for slightly more than half of the value of underlying properties, on average. Effectively, at an LTV of 55%, every dollar of home sales has a 45% equity backing up the buyer. The possibility of a negative equity situation is still present, but considerably remote in the absence of a global economic shock which would trigger a sharp pullback in domestic credit.

Secondly, monthly payments on mortgages made by Chinese borrowers represent less than 50% of their monthly incomes on aggregate. This number is a blended figure for the whole of China, as granular official statistics on household income and home prices would paint a stark picture of extreme unaffordability in Tier 1 cities despite higher income levels. But given that data on lower tier cities is not readily available, the repayment ability of Chinese mortgagees in lower tier cities can be inferred to be relatively healthy. Of course this is a function of average home prices being significantly lower in secondary cities, and household incomes continuing to match or even outpace home price growth in lower tier cities.

We believe that 'different cities, different strokes' is likely to be how the Chinese government will approach the residential market.

In Tier 1 cities, strong demand and limited new land supply will support housing sales and pricing over the longer term, despite real risks of overheating. We cannot, however, ignore the fact the Tier 1 cities enjoy the best social, lifestyle and healthcare resources, and that continues to be a magnet for domestic capital. Local governments would do well to further expand land supply near the city fringes or newly built up areas, and selectively target administrative measures at speculators or investors. That said, significant grey income will continue to defy logic and lean toward the key Tier 1 cities, and this upward pressure on price expectations may be harder to tame than we can possibly imagine. In these cities, prices will likely stabilize once the recent cooling measures take effect but latent demand remains resilient regardless.

Most Tier 2 cities and gateway cities in proximity to Tier 1 cities, such as Hangzhou, Nanjing and Tianjin, have benefitted from spillover investment demand from buyers who have been priced out of Tier 1 cities such as Shanghai and Beijing. Insofar as we are concerned, and counterintuitively, the destocking process in these cities requires some form of incremental price support, which will enhance the appeal of residential property to buyers. Selective cooling measures will also help ensure that the speculative components of home purchases are toned down. However, we expect that the next phase of China's urbanization will usher more real residential demand into these cities, and thus keeping home prices affordable is critical to the government. So, Tier 2 cities enjoy a good mix of investment and occupier demand for homes, and with the marginal economic growth potential relatively strong, we believe selective Tier 2 cities may offer the best tactical value for both developers and homebuyers.

The lower tier cities continue to be markets where inventory destocking should take precedence over home price gains. Without the investment attractiveness of their gateway city counterparts, Tier 3 cities are likely to face the greatest challenges in the next few years, even as urbanization efforts continue to direct real demand into these markets. However, urbanization needs to come hand in hand with rural land reforms, jobs creation and income growth, which we believe are still lagging in most cities in the Tier 3 and below category. The residential boom post the global financial crisis led to many developers moving aggressively into lower tier cities where land cost was relatively cheaper, of which the vestige now is the inventory overhang threatening to cripple both the corporate sector and the physical market. Several local governments have also initiated plans to acquire and convert commodity housing into social housing, seeking to relieve some burden off the massive oversupply situation. It remains unclear as to what may transpire, but as of now, we do not find Tier 3 residential markets an exciting play, on a risk-adjusted basis.

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