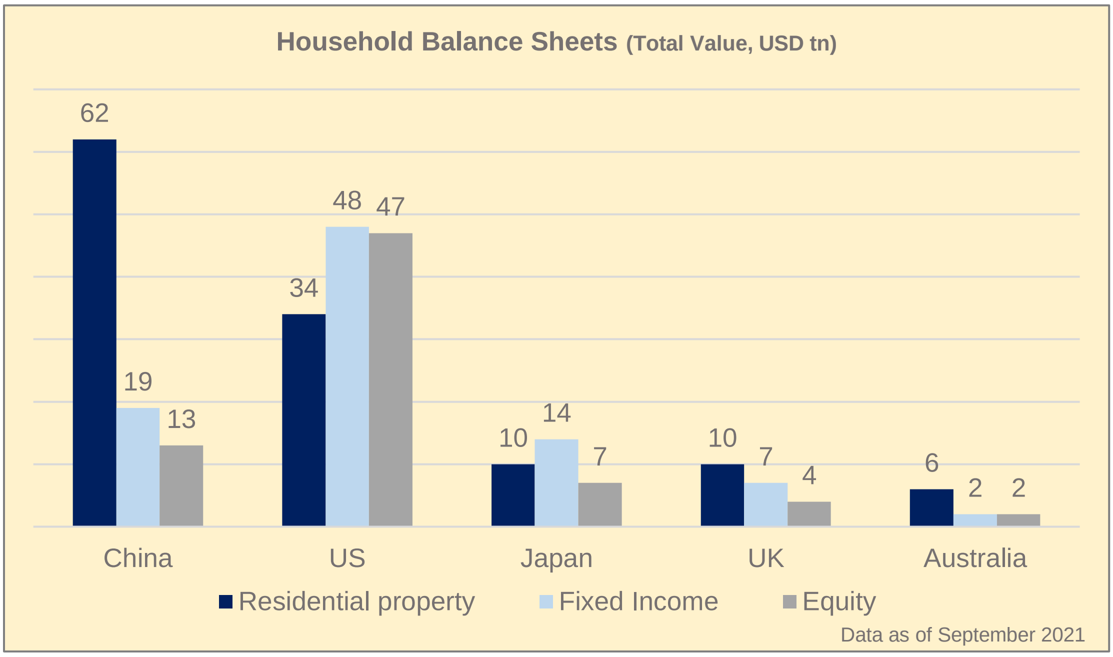
CHINA MONTHLY

NOVEMBER 2022

The Big Picture



Property is the biggest component of household balance sheet assets in China. The sector's sizeable influence on the economy would be tempered if asset mix shifts towards a more balanced distribution as seen in developed markets.

THE BRIEFING

Xi's Clean Sweep

Xi Jinping broke with recent convention, securing an unprecedented third term as China's leader in October's 20th Party Congress. He helms a 7-man Politburo Standing Committee dominated by loyalists whom he had worked with in the past. The other Politburo members have decades of governing experience, and many have technical qualifications, mainly in science and technology.

Selective Border Opening

Hundreds of professional table tennis players from 30 countries competed in the 2022 World Team Table Tennis Championships Final in Chengdu, with no quarantine required. A 25th October National Development and Reform Commission notice asked local authorities to facilitate multinational companies' executives, technicians, and their families to travel into China, to support multinational companies to set up research and development centers in China and to deepen "scientific and technological openness and collaboration". This comes against the backdrop of China resuming the processing of visa applications for Indian students pursuing long-term study, gradually increasing China international flights, and Hong Kong scrapping mandatory hotel quarantine.

PCAOB "Fast Track"

Hong Kong's audit regulator is working with China's Ministry of Finance (MOF) to set up a "fast track" for it to gain access to mainland audit working papers for its investigations. China has allowed audit materials on Chinese companies to be reviewed by US audit regulator Public Company Accounting Oversight Board (PCAOB) inspectors who arrived in Hong Kong in September.

Industrial Activity Strength

China's 3Q GDP grew by +3.9% from a year ago, marking a pickup from only +0.4% in 2Q, bringing year-to-date growth to +3%. Exports and retail sales grew +5.7% and +2.5% YoY respectively in US-dollar terms in September, while industrial production rose by +6.3% as policy makers have stepped up easing measures in recent months.

CHINA PROPERTY – ENDGAME

By Kevin Jiang

Key Economic Pillar

China's property industry has been a key economic growth engine for China over the past two decades. It is a key source of revenue and profits for banks in the form of property development loans and residential mortgages, while consistently rising housing prices meant rich financial returns for property owners. The sector and ancillary industries contribute roughly 25% of the country's GDP but has been enduring a major deleveraging process since 2H 2020, after the introduction of the "three red lines" policy. In this piece, we examine the genesis of the tightening policies and share our thoughts on the long-term impact on the economy.

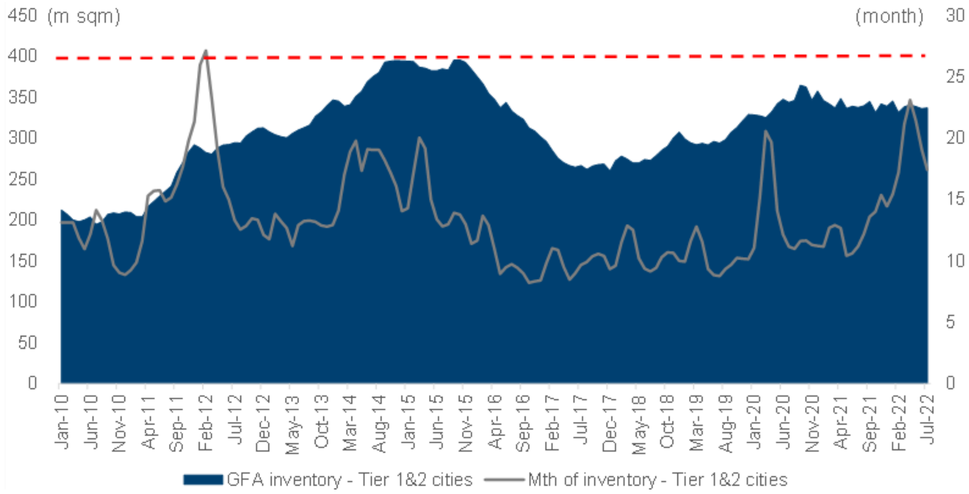
Our Thoughts on the "Three Red Lines" Policy

While most believe this round of China's policy tightening towards the property industry began with the introduction of the "three red lines" (3RL) policy in August 2020, we offer another perspective. We believe the 3RL policy was in substance a continuation of a series of restrictive policies introduced since 2014-15. To recap, when China officially rolled out its supply-side structural reforms in late 2015, reducing leverage in the corporate sector and destocking property inventory were both among the five major objectives. Known as "三去一降一补, 即去产能、去库存、去杠杆、降成本、补短板", it set out to cut overcapacity, reduce excess inventory, deleverage, lower costs, and strengthen areas of weakness. From the perspective of financing, China also introduced the Macro Prudential Assessment (MPA) framework in 2016 and new asset management rules in 2017, aiming to rein in the aggressive expansion of shadow-banking and preventing excessive capital flows into the property industry. Notably, the principle of "Housing is for living in, not for speculation" (房住不炒) was first proposed in the Government Work Report of 2016 and emphasized repeatedly by President Xi Jinping in his speeches.

As a result, China's housing stock in terms of gross floor area (GFA) inventory in Tier-1 & -2 cities peaked at c.400 million square meters in 4Q14-3Q15 and saw a multi-year decline in late-2015 to 2017. Even when housing demand turned very weak from 2H 2021, overall inventory remained below that level (see Chart 1 below). Hence, new housing sales growth was bolstered by limited new land supply, strong demand from ongoing urbanization, and a constantly growing monetary aggregate, resulting in a sequential rise in housing prices (see Chart 2 below). Aggressive property developers and local governments have seemingly misinterpreted the reasons behind the post-2015 property market bull runs. They had formulated business strategies which opposed policy goals by increasing leverage further, bidding up land prices at auctions and selling homes for lucrative profits.

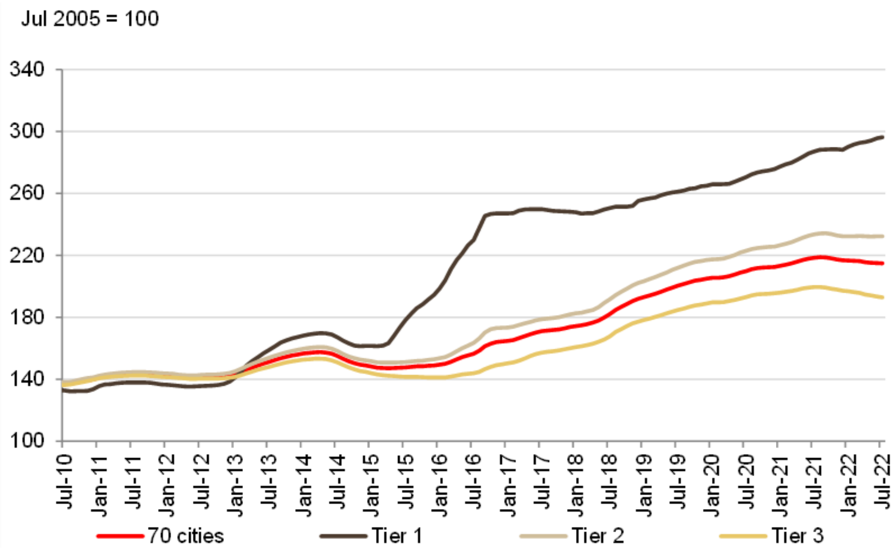
To hedge against the People's Bank of China's unconventional easing introduced during the Covid-19 outbreak in 1H 2020 and reset developers and local governments' expectations, China reiterated its "Three Stabilization" policy and launched the 3RL policies for developers in August 2020, "two red lines" policies for commercial banks in December 2020, and Centralized Land Auctions in 22 major cities in February 2021. It dawned on many that China's property policy direction was determined and would not change easily in the foreseeable future.

Chart 1: China's GFA Available for Sales and Months of Inventory in Tier-1 & -2 Cities



Source: Wind, National Bureau of Statistics

Chart 2: China's Residential Housing Price Trends in Major Cities



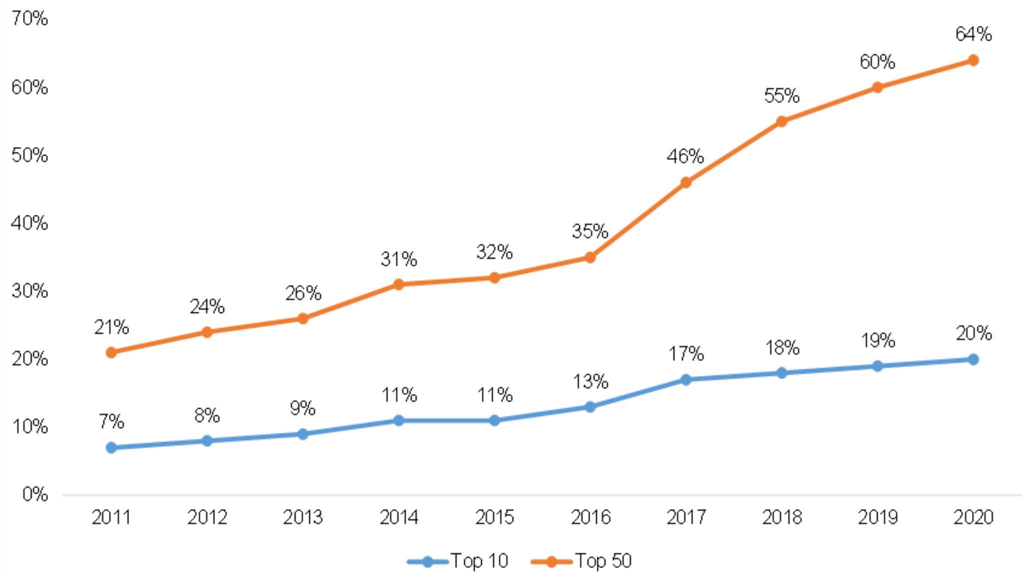
Source: Wind, National Bureau of Statistics

How Will "The Survivors" Navigate This Downturn

When China adopted fiscal stimulus measures to boost the domestic economy in the post-Asian Financial Crisis period (1998-2007), it used real estate and infrastructure investments. Ample land supply and financial aid were provided by the government, which provided developers substantial growth opportunities. China's GDP growth saw a major acceleration during this period, with housing sales and property investments posting 25% and 20% CAGR respectively. This stimulus plan successfully insulated China from the aftermath of the Global Financial Crisis in 2008-15. It constituted a large part of the CNY4 trillion infrastructure stimulus package.

However, speculative demand for housing, especially in the urban areas, led to bubbly prices. This resulted in a distorted, unhealthy developer market. Developers with advantages in financing accessibility, government support, and strong management teams started to rapidly consolidate the market, while weaker players started to face bottlenecks for further development. China's Top-50 developers saw their share of contract sales rise from 21% in 2011 to 35% in 2016 and increased further to 64% in 2020 when supply-side policy tightened. This consolidation continued until the sector showed signs of slowdown in 2H 2021.

Chart 3: China's Top 10 & Top 50 Developers' Market Shares by Gross Contract Sales



Source: Wind, National Bureau of Statistics

While there were reckless and aggressive developers before the meltdown, there were also smart and prudent ones that prepared well for the brewing storm. We found that quality developers displayed these traits — forward-looking, disciplined in financing, and careful in picking locations. For example, Vanke, China's leading property developer, was one of the first in the market to be aware that the industry had moved from the "Golden Age" into the "Silver Age" in 2014, and the first to use the slogan "To Survive" since 2018. Longfor, another Top-10 private-enterprise developer, has demonstrated strong discipline in using leverage. China Resources Land, a leading Central-SOE developer, had focused on higher-tier cities and adhered to a market-oriented approach in commercial property investments and operations. These traits will inevitably put them in the category of "Survivors". We expect them to be cautious in bidding for land in the next 1-2 years.

At the other end of the spectrum, highly leveraged private developers experienced colossal refinancing difficulties. To make matters worse, homebuyers stayed away from their projects — fearing project completion risks and uncertain zero-Covid policies. Many had delayed principal and interest repayments of their bonds and wealth management products. We believe about 20 out of the top-50 developers will eventually file for Chapter 11 protection.

Ramifications for the Economy and the Financial System

The first question to ask is, "Why didn't the central government adopt more aggressive measures to cool down the bubbly property market in 2015-16, because it directly contributed about 15% of China's GDP and 25% when the upstream and downstream industry chain was included?". We now believe the Chinese government had taken a defensive stance to pre-empt any systemic risk, heeding the lessons from the Asian Financial Crisis of 1997-98. There was also the worry of the US Federal Reserve hiking rates from late 2015 after the massive Quantitative Easing post-GFC. Around that time, China also started reforming the CNY exchange rate regime, shifting from the bilateral CNY-USD exchange rate to a basket-currencies exchange rate regime. In this way, China could enhance the independence of its central bank's monetary policies and the pace of the internationalization of the Yuan. On 1 October 2016, the CNY was officially added to the IMF's basket of currencies that make up the Special Drawing Rights. All these measures to decouple from the USD, in our view, had added to the fractious Sino-US relations.

The property sector had played a crucial role as a growth engine for China in the first two decades of the 21st Century. It also helped lift China's urbanization rate from 33.4% in 1998 to 65% in 2021. However, the top leadership's policy directives make us believe that this industry has largely completed its mission of driving domestic demand, converting China's land resources into assets that are also financialized, and supporting the banking system. Though the urbanization ratio can continue to grow steadily, and China's property industry will remain large, the upside will no longer be significant. The relative importance of the industry will gradually decline, and we estimate its broad contribution to GDP to fall from the current 25% to 15%-20% by 2030. Hence, China must find new growth engines to fuel its next phase of domestic economic growth. Green energy, advanced manufacturing, and rural revitalization are some of the promising sectors.

In the near-term, the sharp decline of the property industry in China had caused a contraction in aggregate domestic demand and an asset shortage for the financial system. Given the fact that the PBOC and the China Banking and Insurance Regulatory Commission have been persistently instructing banks to control their property loan growth, bank exposures had dropped to 4.9%-6.9% as of June 2022.

In the first seven months of 2022, new mid-to-long-term household loans (i.e., residential mortgage loans) sharply declined by 55% YoY, versus expansions of +2% YoY for full-year 2021 and +9% YoY for 2020, reflecting significantly weakened homebuyers' confidence. In terms of the mix of all new loans, housing loans only contributed 12% of the total in the first 7 months of 2022, versus about 30% in the past three years.

Since residential mortgages are regarded as one of the highly profitable and safe loan assets for commercial banks in China, they are forced to explore alternative loan categories such as short-term corporate loans or bill financing to meet their loan allocation targets, at the expense of their net interest margins and asset quality.

Investors have been concerned about residential mortgages due to the non-repayment risks in some regions, triggered by prolonged suspensions of project construction. We believe this would not lead to systemic risks in the financial system, as banks have sufficient NPL buffers and China's relatively high down-payment ratios of 30% and 50% for buyers of their first and second homes respectively. We also expect local governments and their affiliated financial institutions, such as banks and asset management companies (AMCs), to ultimately take over the responsibility of ensuring smooth project completions and deliveries.

Endgame

We think this cycle of deleveraging and oversupply consolidation will likely last for another 1-2 years. After the adjustment, the residential property industry will likely enter a stable phase, with a more limited growth in terms of sales until 2030. On the demand side, we think urban housing demand will be supported by continuing organic growth in the number of urban families, continued migration from rural areas, as well as upgrading. On the supply side, local government's land supply actions will be more rational to meet the new demand, to ensure a stable housing price trend, in our view. The number of new housing units per year will likely start to see a low-single digit decline from 2025 onwards. Even so, the real estate sector will likely remain as one of China's largest industries in terms of revenue for many more years, at over CNY10 tn per annum.

This still leaves ample room for the survivors to grow again. Going forward, we believe firstly, the survivors will earn reasonable IRRs as seen in developed economies, secondly, top developers will increase market share as the weaker ones would have exited the market and thirdly, high-quality players will diversify into property management services, investment property (shopping malls, offices, logistics properties, rental apartments) and asset or investment management.

After the consolidation, investment opportunities will emerge as most property stocks are selling at deep discounts to their underlying asset values. They will also adopt more prudent growth strategies. Metaphorically speaking, throwing the baby out with the bathwater would be unwise, as there would be precious gems amongst them.

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