

Chinese Real Estate

Housing crises are among the most dangerous because they impact the private homeowners, the corporate building sector and the financial sector. It affects many more economic actors than e.g. the dotcom bubble of 1999, which only impacted some financial speculators.

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China's real estate sector (around 25% of GDP) is often described as "the most important sector in the world" because of the importance it has amassed in recent decades in the Asian giant's growth model. The country's growing urbanisation, the development of the financial sector and the appetite of domestic and international investors, among other factors, have led to a real estate boom in recent years. Therefore, a potential Real Estate crisis merits our attention.

The Chinese Real Estate sector has been an ongoing worry to many analysts over the past years, but how bad is the situation? The news about Evergrande defaulting on his debt in Dec 2021 was probably the first time the main public became aware of it. We have taken a look at the main drivers and examined the situation. Individuals are seeing their wealth evaporate to some extent and we want to give some perspective on the scope of this current crisis. There appear to be two focal points, the real estate bubble and banking turmoil.

1. REAL ESTATE BUBBLE

Back in 2020 China implemented a three red lines policy, which concerns three leverage criteria real estate developers have to meet if they want to borrow more money.

- Liability to asset ratio (excl. advance receipts) of less than 70%
- Net gearing ratio of less than 100%
- Cash to short-term debt ratio of more than 1x

If the developers fail to meet one, two, or all of the 'three red lines', regulators would place limits on the extent to which they can grow debt, simplified in the table underneath.

Back in October 2021, when Evergrande was making a lot of the headlines because of their struggles to meet their debt obligations, nearly half of the Chinese developers violated at least one of these three criteria. This means that many of these companies saw very strict crackdowns in their borrowing capability to fund their operations. It might not sound that impactful given that it only limits the growth of credit, but it revealed many problems with the real estate market in China, that many describe as a quasi-Ponzi Scheme.



To understand this we need to know how Chinese Real Estate works, because it is very different from how we know it. In China the government owns all the land, and individuals can only lease the land from the government. So when they purchase a property they actually buy the lease of the land and the value of the materials used to build the structure. Over the last decade many developers excessively increased their leverage to expand their business and to sell properties, which lead to expanding leverage in the country, as shown in graph 1.

This increase in leverage was partially caused by strong demand for property from the Chinese citizens, because unlike many other countries, homeownership in China is very high. Roughly 90% of the Chinese population owns real estate to some extent. Reason being, is that it is seen as the main way to invest your private capital. Here in Europe and the US we see the Stock Market as the main platform to invest, but again, in China this is different. Less than 5% of the total corporate fund raising is accounted for by raising Equity. Bank loans and retained earnings remain by far the biggest source of financing. Also, less than 7% of urban Chinese have any capital in the market. (Renminbi Internationalization, Barry Eichengreen and Masahiro Kawai 2015). These numbers have been growing though.

Due to (1) this preference towards Real Estate as well as (2) this heightened loan activity, the sector has seen its prices skyrocket. Remember that this all gets encouraged by the government, who's earning more and more leasing revenue. According to Forbes since the year 2000 the house prices in China have more than quadrupled. Making it some of the most expensive real estate in the world. By the early 2018's the price-to-income ratio for a house in China's top cities was a startling 34.9 years – meaning that it would take nearly 35 years of the median salary to pay for a median home. To put that in perspective, New York has a Price-to-Income of 5.4 (Forbes, 2019). Although this didn't mean the demand has since lowered, since housing prices kept increasing. This led people to using multi-generational wealth or even multi-family wealth. To meet this demand developers had to leverage further and financed themselves with different methods such as pre-sales, which is basically where you pay mortgage upfront for unfinis-



Photo: nytimes.com

Tabel 1: Three Red Lines

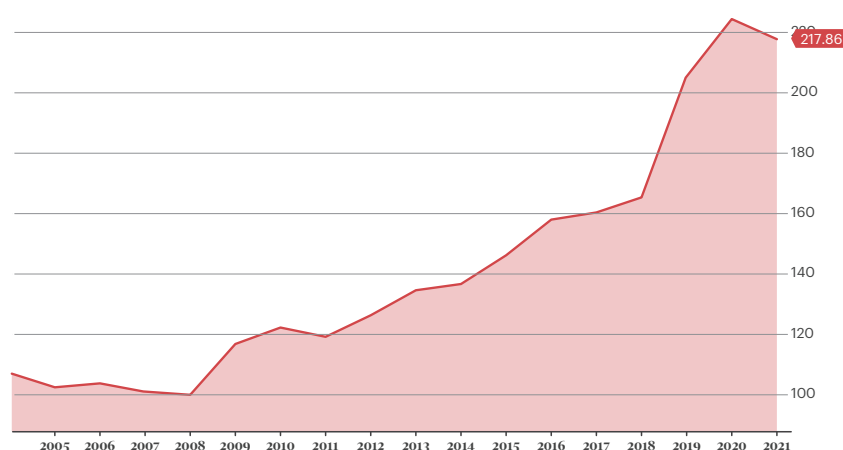
Source: UBS Asset Management "China's Three Red Lines", 11/01/2021

# Red lines violated	Annual debt growth permitted
0	15%
1	10%
2	5%
3	0%

Over the last decade many developers excessively increased their leverage to expand their business and to sell properties, which lead to expanding leverage in the country

Graph 1: Chinese Corporate Debt as % of GDP

Source: Bloomberg 22/9/2022



hed projects. These pre-sales make up 70%-80% of new home sales in China. Developers would then use these pre-sale funds to finance the construction of older buildings that they had already committed to. This is why we saw liquidity problems in 2020 and the government interfered with their three red lines. This bubble could only continue to expand as long as the developers got new pre-sale funds coming in. But since July 2021, home sales started to decline as shown in Graph 2.

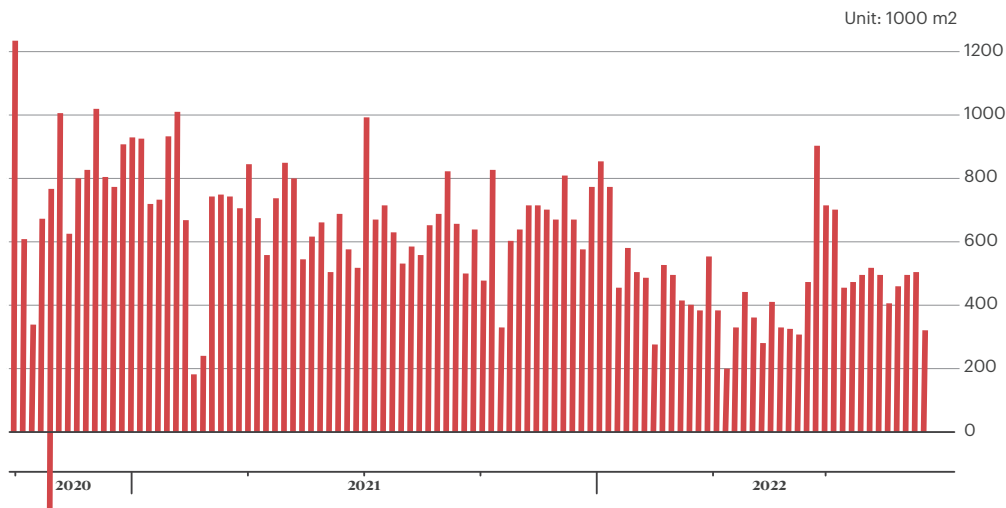
2. BANKING TURMOIL

Earlier this year, in April 2022, clients at the rural-based People's Bank of China in Zhengzhou discovered that they weren't able to withdraw cash from their accounts, as funds were frozen. This triggered bank runs in China, which accounted for 40 billion yuan (USD 6 billion). Whilst the government ordered the release of some of these funds, the main issue had become trust whereas clients didn't no longer believe their funds were safe.

Another hit to China's banking system occurred through a sweeping mortgage boycott, which was initiated by an angry letter to Evergrande with a serious complaint about the half-built Dynasty

Graph 2: New Home Sales in China's Tier One Cities

Photo: Bloomberg "China Real Estate Information Corp" 21/9/2022



Mansion project, for which they had been paying pre-sales but didn't seem to get what was promised to them. As a reaction they refused to repay their mortgage, which led to a more widespread similar reaction against more than 300 project developers. S&P Global ratings estimated that 2.4 trillion yuan (USD 356 billion), or 6.4% (!) of mortgages are at risk. All this is happening in an already stressful economic scenario, where there is high global inflation, severe Covid restrictions and a less favorable demographic situation.

Is this enough to assume China is on the brink of collapse?

It is certainly not a good situation so never say never, but we would argue that it's probably not.

First thing we want to look at is Leverage, which is quite high for the product developers. But this isn't so much the case for individual households. Household leverage stood at 62% of GDP and 112% of household disposable income at end-2021. By global standards, this is very moderate, whereas in the US the household leverage as a % of GDP lies at 67%. One might thus argue that the mortgage boycott in China is currently more of a confidence problem than a solvency problem.

Additionally, we would conclude that the usual main disadvantage of China now could be used for the good, which is the control of the government on the country's monetary situation, citizens and corporations. This resulted in (1) the government mandating the release of some of the frozen deposits, (2) appeasing the mortgage stress by easing down-payments, (3) injecting money in the system

and (4) in August 2022 cutting key rates.

A lot of this pain started with rightfully introducing the three red lines policy. In the meantime the Chinese government has eased some of these rules specifically for companies that chose to absorb assets from troubled developers, in order to complete their projects. It appears that one of China's strategies is to transfer these incomplete development projects to solvent developers and/or state-owned enterprises, leading to a quasi-nationalization of these assets.

Regarding the banking sector, many are concerned that more bank runs could contribute to a currency crisis, which in all fairness is valid. However, China has a high level of capital control and a massive trade surplus, which gives it a lot of room to increase money supply and support operations. 28.7% of global manufacturing comes from China alone, meaning that the country has a vast demand for its goods, which should support the value of its currency. So even though they are not immune, there is wiggle room.

Conclusion

China is a very secretive state so we might not get the full story, as most of the information originates primarily from state-run media. Hence, it is likely that we simply can't fully assess the situation due to the opaqueness. However, we do think that the Real Estate bubble is very much there and that the loss of trust in banks could transform liquidity problems in solvency problems. On the other hand, it seems that China is doing the right things to protect its' economy. •

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