

| Special Report |

Special analysis of key topics – 03 August 2010

China – Our big real-estate survey, Phase 1

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Source: Steve Harris

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- The Tier 2 and Tier 3 cities have not seen much of a correction in land or apartment prices. Moreover, developers' sentiment about sales volumes seems pretty good, and they do not appear to be postponing construction. A wave of new supply is planned for September. Developers on the whole seem to think sales volumes will be down 20-30% y/y this year, which is eminently survivable.
- This is important, since if sales and construction activity holds up in most Tier 2 and Tier 3 cities, then the economy will not tank, and the State Council will not be forced to loosen real-estate or monetary policy.
- Developers expect apartment prices to fall more in the Tier 2 and Tier 3 cities, but this is acceptable, and developers are taking advantage of lower land prices to build up their land banks. Credit conditions have tightened, but not to the extent seen in 2008. Moreover, many developers still appear to be pretty cash-rich.
- Problems such as land hoarding and accessing bank lending to fund land purchases still appear common, however. We are also seeing significant for-investment buying in Tier 2 and Tier 3 cities.

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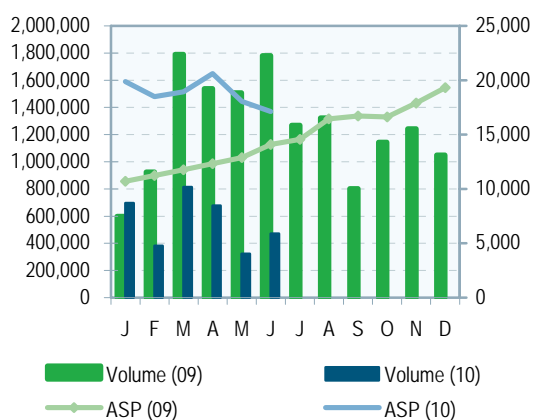
Introduction

What is really going on in China's real-estate sector? Are prices falling – and if not, will they? Are developers' finances getting tight, and if so, will they be forced to cut prices? Confronted with the State Council's stringent cooling policies, are developers postponing project starts and stopping construction? And if they do stop building, will this derail the economy and thus force the State Council to loosen policy? These are critical questions, and it is hard to get answers from the official data. So we went looking for answers from the people who should know: real-estate developers.

But we wanted to look in the right place. Shanghai, Beijing and a few other big Tier 1 cities saw the biggest price rises in 2009, and are therefore the focus of the State Council's attempts to cool down the sector (see **On the Ground, 22 April 2010, 'China – Pop!'**). As a result, sales of primary apartments in Tier 1 cities have plummeted, as Chart 1 shows.

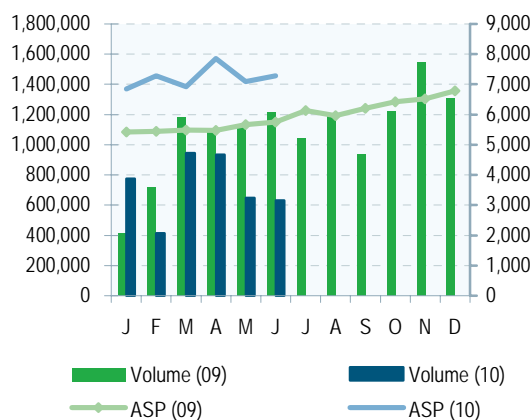
But while the focus is on Tier 1 cities, there is a good chance that they do not represent the national trend. There are, after all, hundreds of other cities around China that are busy growing, and in which people might be still busy building and selling apartments. Sales have fallen in Tier 2 and Tier 3 cities too, but not by as much as in Tier 1 cities, as Chart 2 shows. (In our chart, we have used data from 10 cities: Tianjin, Chongqing, Chengdu, Hefei, Wuhan, Changsha, Dalian, Nanjing, Suzhou and Changchun). Indeed, in some cities – Hangzhou in Zhejiang province, for instance – we have actually seen prices push up a little since April. So we went to talk with developers in the Tier 2 and Tier 3 cities – out there in the 'real' China, as it were.

Chart 1: Tier 1 cities have been worst hit
 [Total sqm sold, average selling prices (CNY/sqm)]



Sources: CRIC, Standard Chartered Research

Chart 2: Tier 2 cities have been partly shielded
 [Total sqm sold, average selling prices (CNY/sqm)]



Sources: CRIC, Standard Chartered Research

In July, we asked 30 developers active in six Tier 2 and Tier 3 cities questions about their construction and sales plans, land and apartment prices, their buyers, and how local governments and banks were treating them.

In the rest of the report, we discuss the details of what we found. We divide the results into five sections.

I. Construction activity

The typical developer we spoke to is currently building two to five residential phases of its projects. (Developers tend to divide their big projects into several phases, building a block or two at a time and then selling them. A large piece of land can thus take a decade or more to fully develop.) In sum, the developers to whom we spoke are currently building some 24mn sqm of residential floor space, which is equivalent to about 24,000 apartments at 100sqm per unit.

We asked the developers about their plans for new construction and whether they were postponing previously planned projects.

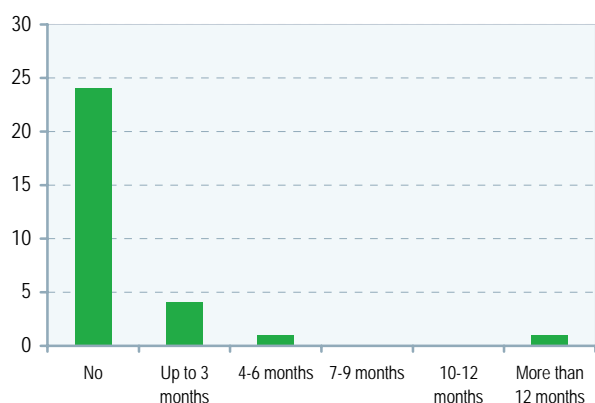
In the next three months, how much more land will you have under development?

12 of the 30 developers were not intending to start any new construction within the next three months. However, those who did have plans to start were planning to start a substantial amount, equivalent to some 60% of the current land they had under construction. This seems positive for activity going forward.

Have you pushed back construction of any projects?

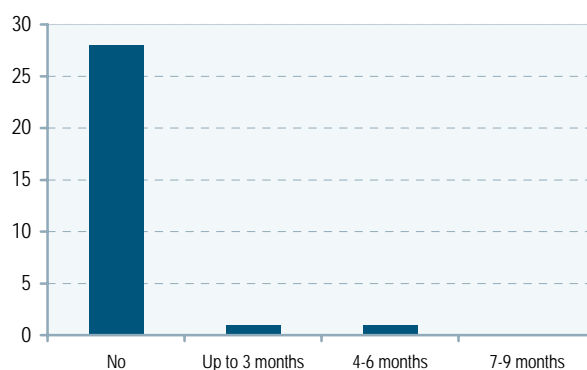
Scarcely any of the developers we spoke to have pushed back the construction of any phases of their ongoing projects or the sales launch, as Charts 3 and 4 show. This is also positive for near-term construction activity and materials demand. We asked if developers had pushed back the launch of sales of any projects since April, and the answer was again a resounding ‘no’ (28 of 30 developers). So although sales volumes are down (Chart 2), developers still see reason to push forward with projects.

Chart 3: Have you pushed back the construction of any phase of your projects?



Source: Standard Chartered Research

Chart 4: Have you pushed back the sale launch of any phase of your projects?

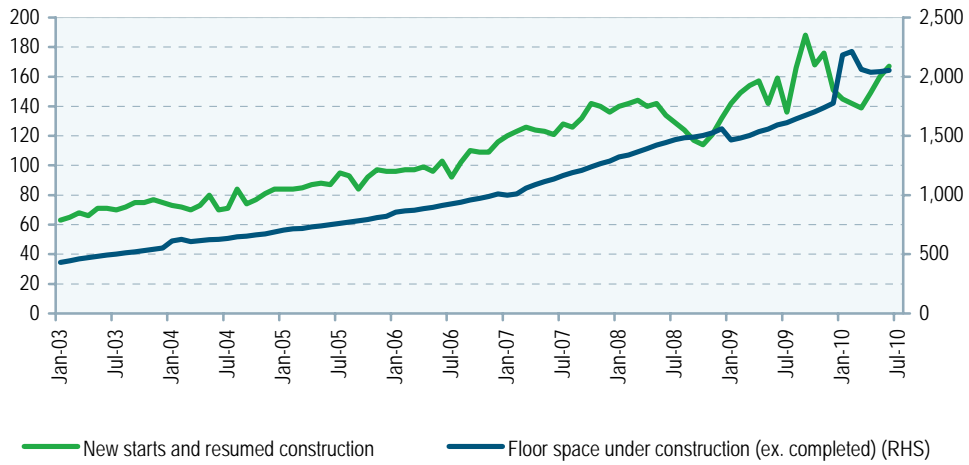


Source: Standard Chartered Research

This brings us to an important question about data: how best to track residential construction activity in China? The official ‘residential floor space under construction’ data unhelpfully includes already-completed projects. Our preferred method is to eliminate completed projects from the ‘residential floor space under construction’ numbers and adjust for seasonality. (Others chart year-on-year numbers, but we note that these numbers are a little volatile and may confuse the story.) Chart 5 shows the result, and indicates that construction is still at high levels.

I. Construction activity (con'd)

Chart 5: The right construction numbers to focus on
(Completed, resumed & new starts, under construction sqm mn, SA)

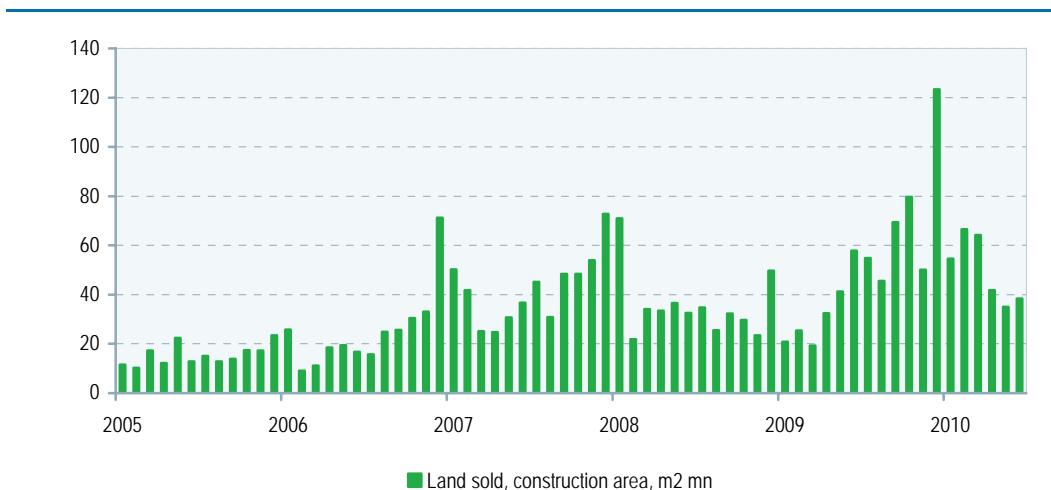


Source: Standard Chartered Research

II. Land supply and prices

Given the State Council's fierce measures in April, one might have assumed that China's land market would have collapsed. It has not. Certainly, land sales volumes have declined from their peaks, as Chart 6 shows, but developers are still adding to their land banks. In Q2, an average of 38mn sqm of land was sold each month, which remains well above 2008 levels.

Chart 6: Land sold (mn sqm)



Sources: CRIC, Standard Chartered Research

Nationwide, it looks like land prices have stabilised after a sharp fall since the peak at the start of the year, as Chart 7 shows. (We have previously discussed the issues with land price data, most importantly the fact that it is a crude national average of a few dozen cities' crude land price averages – see **On the Ground, 8 February 2010, 'China – Bubbly land, Part 1.'**)

Chart 7: Land prices, nationwide average (CNY per sqm)

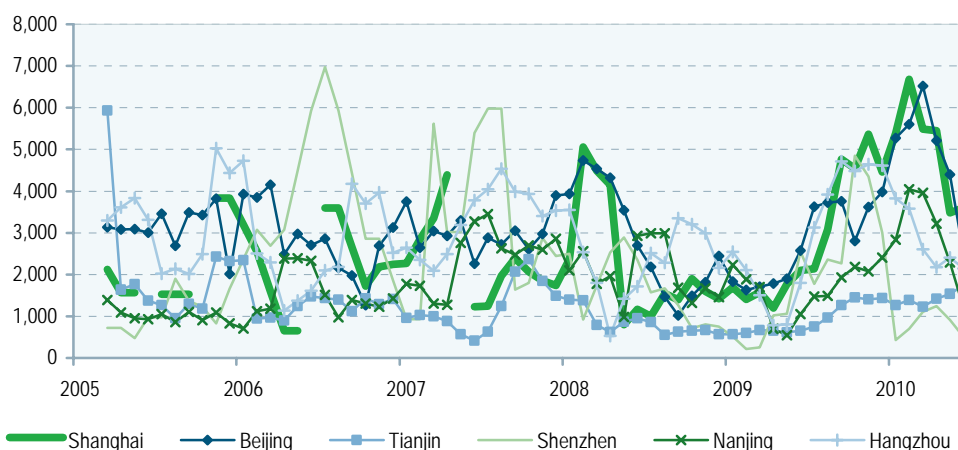


Sources: CRIC, Standard Chartered Research

II. Land supply and prices (cont)

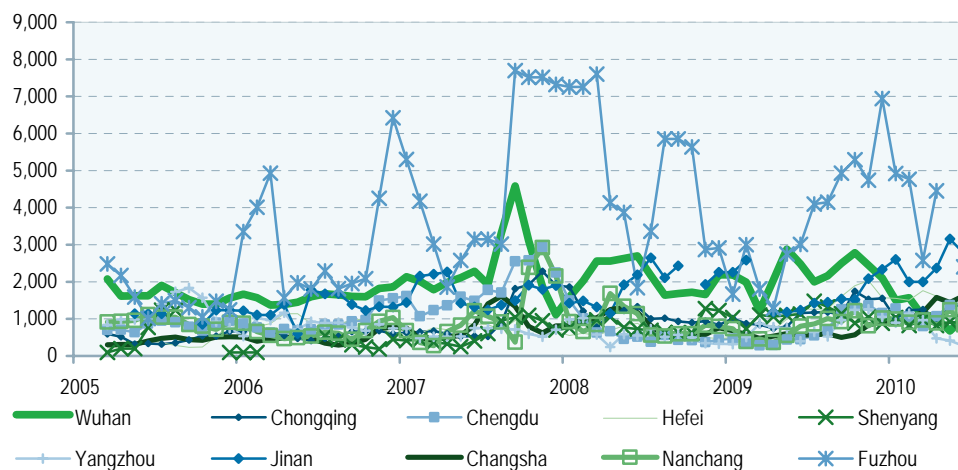
Price declines have been concentrated in Tier 1 cities. Chart 8 shows the massive declines in land prices in Shanghai, Beijing and Hangzhou since the beginning of the year. But Chart 9 shows the absence of a big rise and lack of a big fall in land prices in most of China's other cities. Apologies for the mess of lines in this chart but we hope the fact that all of the Tier 2 and Tier 3 cities' land prices shown are cramped at the bottom of the chart is a positive sign. This was a Tier 1 bubble and it looks to have been pricked without killing the Tier 2 and Tier 3 markets.

Chart 8: Land prices in Tier 1 cities (CNY per sqm)



Sources: CRIC, Standard Chartered Research

Chart 9: Land prices in Tier 2 and 3 cities (CNY per sqm)



Sources: CRIC, Standard Chartered Research

Given this background, we asked developers about new land supply in H2, and about their expectations for future land price movements.

II. Land supply and prices (con'd)

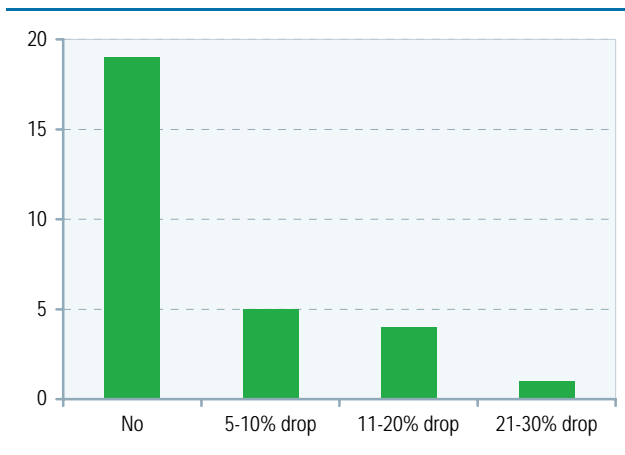
Do you foresee more land plots being released for auction in your city this year than last year?

Taking the Ministry of Land and Resources' (MoLR) plan for land sales in 2010 at face value, much more land will be put on the market this year than in 2009, and faced with this onslaught of supply, land prices will fall. (The MoLR has announced a plan to release 180,000 hectares of new land supply in 2010, compared with 76,000 hectares in 2009.) But while Beijing can set targets, it does not control land auctions at the local level. So we asked developers if they really think that there will be more plots released this year than last in their cities. Half of them said no. Only 12 said there would be. Local governments are interested in sustaining land values, so they will control supply.

Do you think land prices in the cities where you have a presence have dropped since April?

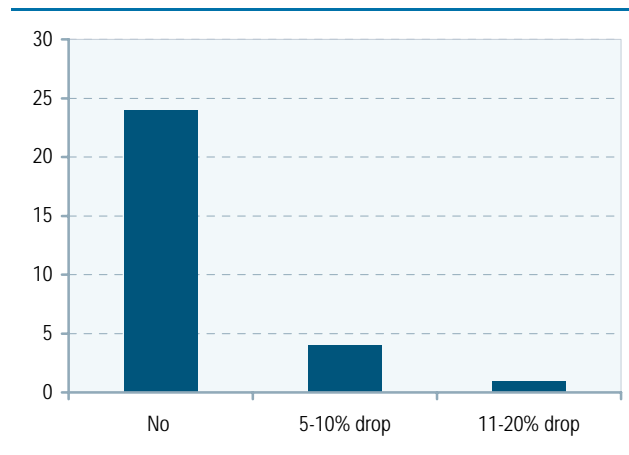
The majority of respondents (19) said land prices had not dropped since April, as Chart 10 shows. Five said they had seen a 5-10% decline and four an 11-20% drop. In short, this suggests that the April measures have not affected the land markets in most Tier 2 and 3 cities.

Chart 10: Do you think land prices in your cities have dropped since April 2010?



Source: Standard Chartered Research

Chart 11: Do you think land prices in the cities where you have a presence will drop further?



Source: Standard Chartered Research

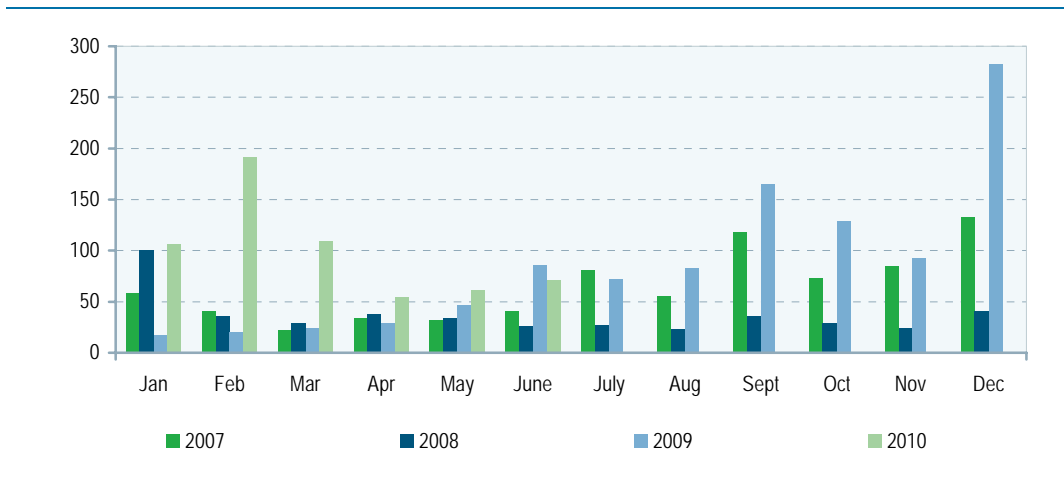
Do you expect land prices in the cities where you have a presence to drop further?

An even bigger majority of respondents (24) said they did not expect land prices to fall further (Chart 11). Again, this is pretty positive for sentiment.

III. Paying for and developing land

While land prices and land sales have both dropped, as we explained in Section II, they have not collapsed. As a result, as we show in Chart 12, local governments' land sales revenues are holding up pretty well, all things considered. On a national basis, local governments as a group generated more sales revenues in May and June 2010 than in the same two months in 2007 and 2008. This again signals that developers are still positive about the sector, and are adding to their land banks in anticipation of continued strong underlying demand.

Chart 12: Reported land revenues nationwide (CNY bn)

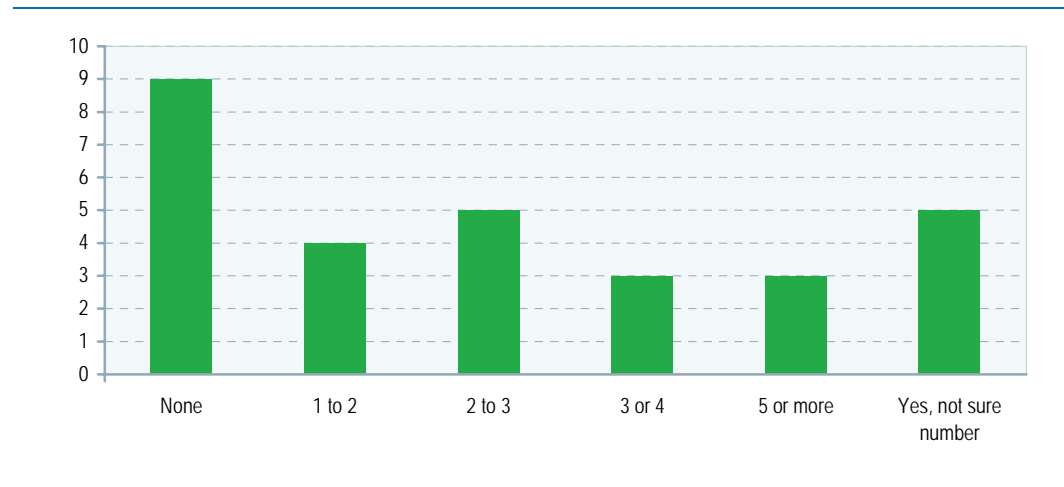


Sources: CRIC, CEIC, Standard Chartered Research

Do you know of any developers in your city who have problems paying for land they bought?

Developers do seem to be having some problems paying for the land they bought at auction, though. This should come as no surprise given the huge sums bid at auctions in recent months. Only nine respondents said that they had not heard of any developers having problems, as Chart 13 shows. Six respondents said they knew of more than three developers facing problems.

Chart 13: Do you know of any developers in your city who have had problems paying for land?



Source: Standard Chartered Research

III. Paying for and developing land (con'd)

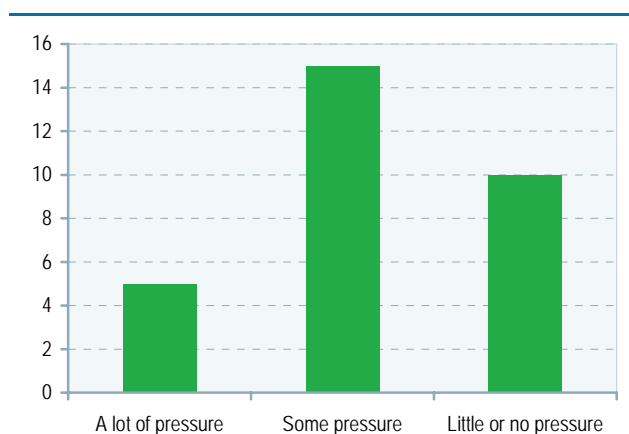
In many cases, we suspect that the problems are related to raising external finance rather than internal cash flow. In theory, developers are not allowed to borrow from banks to pay for land. But in practice, we had heard differently, so we asked.

Are you aware of any developers in your area who have borrowed from banks in order to buy land?

24 of the 30 developers we surveyed said they knew of a local developer that had done this. However, this is likely becoming harder to do, given the new regulations on fixed capital and working capital loans, which make it harder to move funds around for illegal purposes (see **On the Ground, 5 July 2010, 'China – Hanging out in Beijing'**).

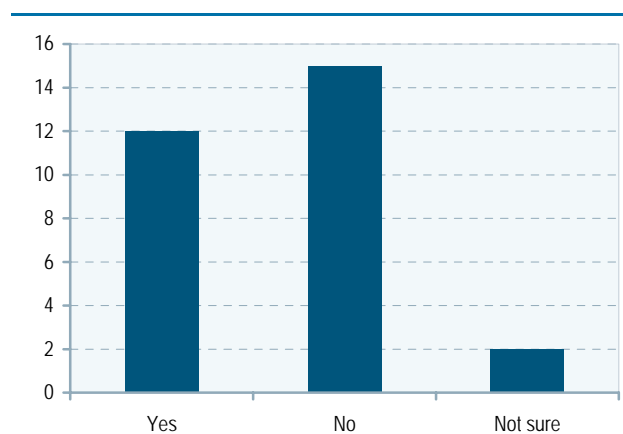
So, as local governments come under additional pressure to force developers to pay up (as the MoLR says it is attempting to do), we expect a growing number of plots to be returned to local governments by smaller developers. Medium-sized and large developers, though, will likely keep their land.

Chart 14: Are developers under pressure to develop land that has been held for more than two years?



Source: Standard Chartered Research

Chart 15: Do you foresee more land being released for auction in your city in 2010 than in 2009?



Source: Standard Chartered Research

Are developers in your city under pressure from local authorities to develop land which has been in their land bank for more than two years?

According to the letter of the law, developers are required to develop land within two years of buying it – and Beijing has recently sent out stern instructions for city authorities to enforce this rule, and to take land back if developers break the rule. However, we have been sceptical of local governments' willingness to enforce this rule. It appears we are right – only five respondents stated that there was 'a lot of pressure' on them to follow this rule in practice (Chart 14). 15 said there was 'some pressure', while one-third stated there was 'little or no' pressure. In practice, then, Beijing still really needs to find a better way to prevent developers from hoarding land.

IV. Apartment price trends

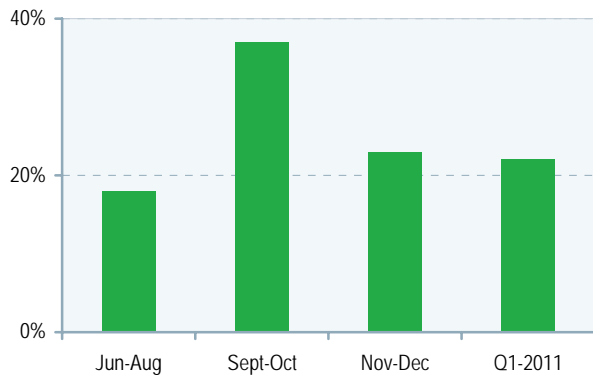
On average, the surveyed developers reported that 15% of their apartment buyers paid 100% cash and did not take a mortgage in 2009. 60% of their buyers were locals. The developers also told us that 68% of buyers were buying properties to live in; the rest were buying to invest.

We asked the developers when they intended to start ramping up sales.

When will you begin selling the majority of your newly built apartments?

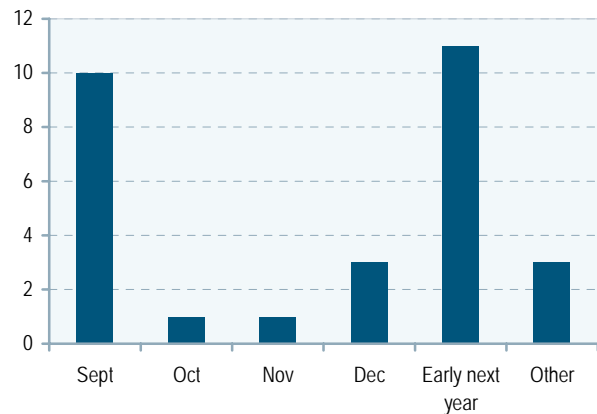
The largest portion of new apartments appears set to come onto the market in September-October, but a significant number of our developers intended to start selling the majority of their new apartments in November-December 2010 and in Q1-2011, as we show in Chart 16.

Chart 16: When will you begin selling the majority of your apartments in new projects?



Source: Standard Chartered Research

Chart 17: When do you expect sales volumes to begin growing again?



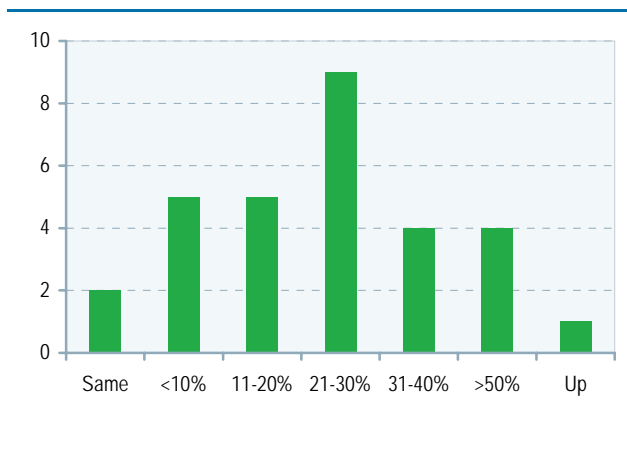
Source: Standard Chartered Research

When do you expect sales volumes to begin growing again?

There was a sharp divergence in responses to this question, which attempted to shed light on developers' sentiment towards both supply and demand. One-third of the surveyed developers said that they believed sales volumes would pick up in September along with increased supply (Chart 17), while most of the rest expected to have to wait until "early next year" for this recovery.

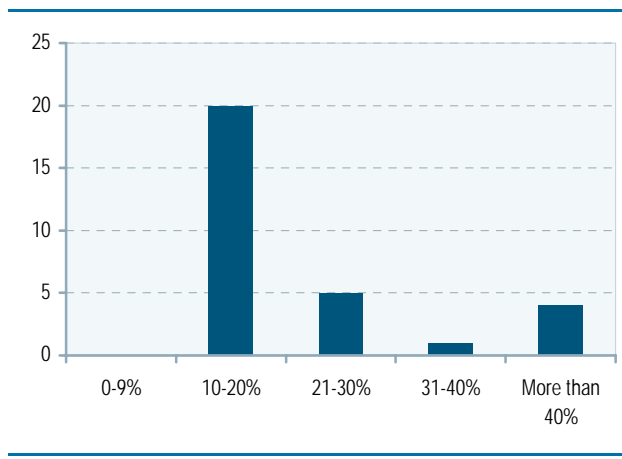
IV. Apartment price trends (cont)

Chart 18: By how much do you expect floor space sold to rise or fall this year versus 2009?



Source: Standard Chartered Research

Chart 19: How much did secondary-market apartment prices rise from mid-2009 through March 2010?



Source: Standard Chartered Research

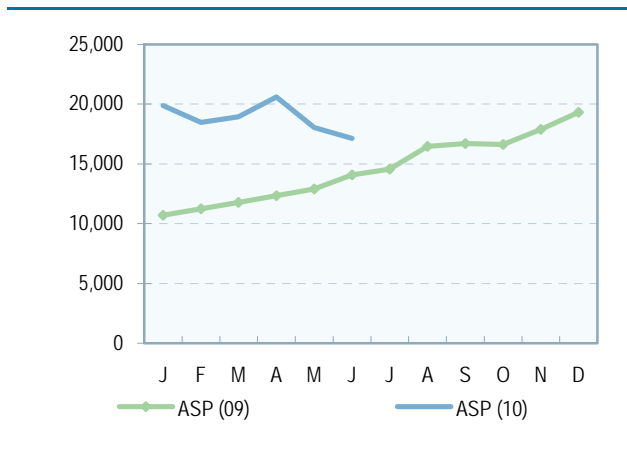
How much do you expect floor space sold to rise or fall this year?

There was a wide range of expectations about sales this year. The majority of developers, though, thought that sales volumes would be 21-30% down from 2009 levels, as Chart 18 shows.

We then talked about prices. The data we have suggests that primary prices have fallen in Tier 1 cities, but not in Tier 2 and Tier 3 cities, as Charts 20 and 21 show. The developers suggested, however, that prices have indeed fallen a bit in their cities – and they were expecting more weakness in H2.

Chart 20: Tier 1 primary prices falling

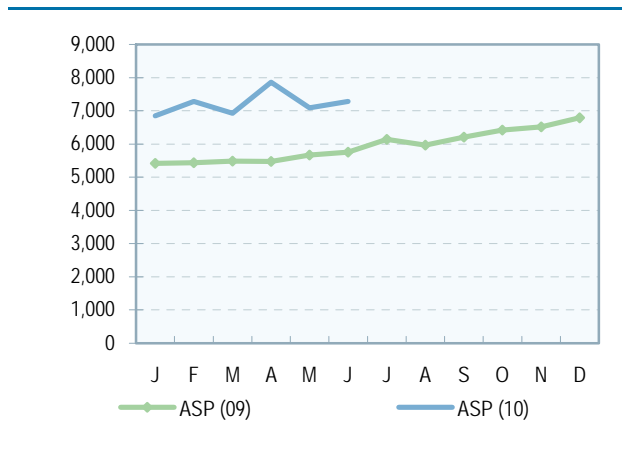
Average selling prices (CNY/sqm)



Sources: CRIC, Standard Chartered Research

Chart 21: Tier 2 and 3 primary prices stable

Average selling prices (CNY/sqm)



Sources: CRIC, Standard Chartered Research

How much did secondary-market prices in your city increase from mid-2009 to March 2010?

The majority of respondents reported that prices rose by only 10-20% in their Tier 2 and Tier 3 cities, as Chart 19 shows. This is important. While prices in parts of Tier 1 cities rose spectacularly during this period, this was not a nationwide

IV. Apartment price trends (con'd)

phenomenon. This distinction undermines the view that the whole country is experiencing a real-estate bubble. Price rises of 10-20% in cities where urban incomes are likely rising at a similar pace are entirely reasonable, in our view.

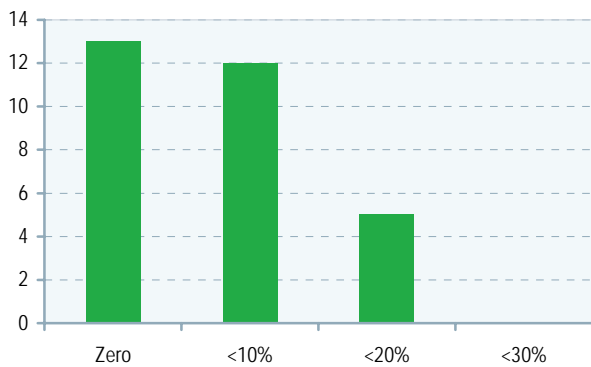
For middle-class housing, roughly how much have prices fallen since the peak in early 2010?

Prices nationwide appear to have reacted moderately to the April measures. The majority of respondents (17) said that prices had fallen by 10% or 20%, while 13 developers said prices had not moved. Only in a few places have prices reacted by more than 20%, as Chart 22 shows.

Have prices for middle-class apartments in your city risen or fallen in the last four weeks?

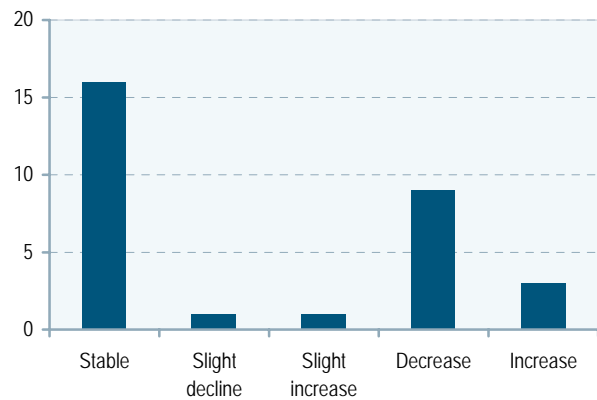
We wanted to get a sense of how prices were moving in July. The majority of developers reported that primary-market apartment prices in their cities had been stable. Just under one-third, however, said that prices had fallen, as Chart 23 shows.

Chart 22: How much have primary prices for middle-class housing fallen since early 2010?



Source: Standard Chartered Research

Chart 23: Have market prices for apartments in your city risen/fallen in the last four weeks?



Source: Standard Chartered Research

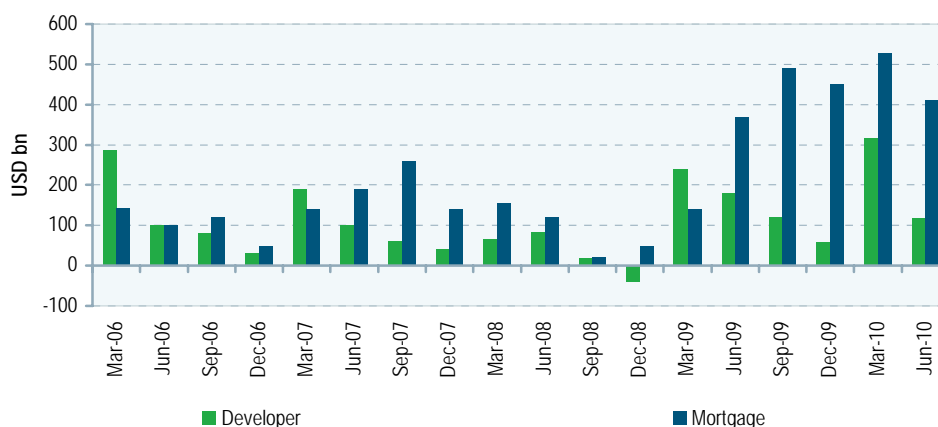
We also asked if our interviewees had heard of other developers planning to cut prices later this year. One-third said 'none', 18 said 'a few', and only two said 'a lot'. When asked if they believed apartment prices were 'bottoming out' now, 25 of the developers said no.

V. Bank credit for developers

The regulator has guided banks away from lending to developers since late 2009, we understand. However, unlike in 2008, credit is still getting through. In H1-2010, banks extended developers an additional CNY 435bn (USD 65bn) in financing, as Chart 24 shows. This is nothing like the credit famine the government imposed in 2008. A friend in the private equity business commented that this is likely a case of the government learning a lesson: when the developers were starved of financing last time, they stopped all construction, supply inevitably fell, and prices skyrocketed then when demand returned. This time, the authorities seem to be aiming to provide enough credit to support construction, but to suppress land speculation, force down land prices and squeeze developers that hoard land.

We hear that small and medium-sized developers have had the biggest problems in getting bank loans. In response, they have turned to trust companies for funds (see **On the Ground, 14 July 2010, 'China – A lack of trust'**). Trusts were able to raise large-scale funds from retail depositors, which allowed them to issue products which reached more than CNY 1bn in size. However, the bank regulator closed this avenue in late July, and now trust companies must once again rely on their traditional client base of wealthy individuals and issue products of only CNY 200-300mn in size. This will affect funding for developers – an increasing number of medium-sized firms will not be able to raise external finance. Rates on trust loans have risen to 15-20% for medium-sized developers and 10-15% for larger ones. Size matters in this environment; the large-scale developers are probably even enjoying the shake-out a bit.

Chart 24: Bank credit, quarterly change



Sources: PBoC, CEIC, Standard Chartered Research

Do you have bank credit? Is credit harder to get now?

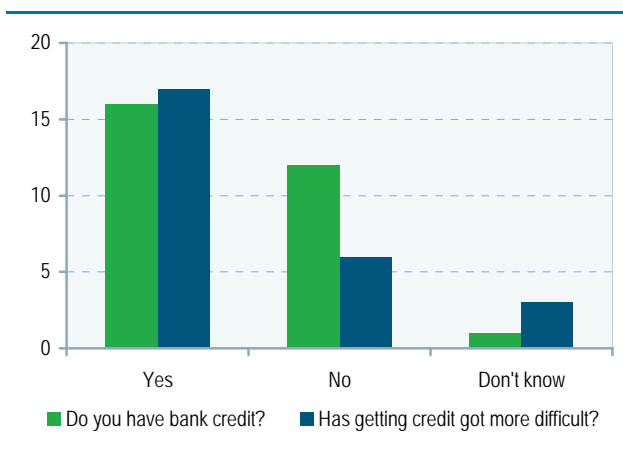
The developers we spoke to seemed remarkably cash-rich. We asked if they needed to pre-sell apartments in order to fund current construction. Only eight of them said they did, as Chart 25 shows. Just over half of the developers said they had outstanding bank credit, supporting the view that they are cash-rich. We also asked if bank credit had become harder to access since the April measures. 17 said it had, but five said it had not.

V. Bank credit for developers (con'd)

Are banks generally insisting that developers sell units in order to get construction loans?

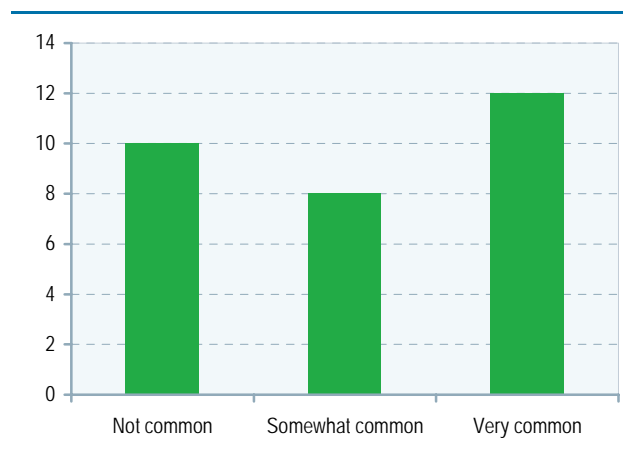
12 developers said this was very common, and eight said it was somewhat common, as Chart 26 shows. The idea here is that the bank needs to see cash flow, so it demands that the developer sell apartments rather than hoarding them. If developer needed to move inventory in order to please their bankers, this could be one factor encouraging them to cut prices in H2. However, the fact that only half of our developers reported having outstanding credit suggests that this pressure does not affect the majority of developers.

Chart 25: Do you have bank credit? Is it now more difficult to access credit?



Source: Standard Chartered Research

Chart 26: Are banks insisting that developers sell units in order to get construction loans?



Source: Standard Chartered Research

And there we come to the end of our report. We are hoping to go back to talk to our developers in a couple of months time to see how things have changed for them. For the moment, here we sum up our findings from the July interviews:

1. The Tier 2 and Tier 3 cities have not seen much of a correction in land or apartment prices. Moreover, developers' sentiment about sales volumes seems pretty good, and they do not appear to be postponing construction. A wave of new supply is planned for September. Developers on the whole seem to think sales volumes will be down 20-30% y/y this year, which is eminently survivable.
2. This is important, since if sales and construction activity holds up in most Tier 2 and Tier 3 cities, then the economy will not tank, and the State Council will not be forced to loosen real-estate or monetary policy.
3. Developers expect apartment prices to fall more in the Tier 2 and Tier 3 cities, but this is acceptable, and developers are taking advantage of lower land prices to build up their land banks. Credit conditions have tightened but not to the extent seen in 2008. Moreover, many developers still appear to be pretty cash-rich.
4. Problems such as land hoarding and accessing bank lending to fund land purchases still appear common, however. We are also seeing significant for-investment buying in Tier 2 and Tier 3 cities.



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