MARKET PERSPECTIVE

by Jack Rodman

Risky Business

China's Real Estate Bubble Is Set to Burst

Recent announcements by major foreign institutional investors entering the Chinese real estate market cause me great concern. The timing seems all wrong — China is facing unprecedented challenges to its domestic economy from the global financial crisis and the slowing of global economic growth.

More than one year ago, I predicted that a real estate bubble in China was inevitable and that it would seriously impact the Chinese banks. Today that view is becoming widely accepted and debated.

Most analysts still don't understand the full impact of the Chinese real estate bubble. It is not isolated to just a few high-growth cities in southern China or pricey markets like Shanghai and Beijing where speculators pushed housing prices to 15 to 20 times the local housing affordability index (the national average is 7.7 times).

What is not taken into account in studying the real estate markets in China is the huge oversupply of commercial properties, which doesn't show up on anyone's radar screen and has not been factored into either the government or bank proposals to bolster the real estate markets.

RESIDENTIAL BIAS IN REPORTING AND ANALYSIS

To begin, most analysts focus on the 65 listed A share developers on the Hong Kong and China stock exchanges because there is more public information about these companies. The vast majority of the analytical information is on the residential sector because the government and banks do a better job in tracking residential trends and mortgage applications through fees and stamp duties.

China is one of the least transparent markets in Asia because its financial reporting infrastructure is immature and the Chinese are very private in their business dealings. While there is data on the 65 listed A share developers, it is out of an estimated 59,000 developers in China. The international brokerage firms are reluctant to publish critical analysis of the real estate markets as transactions and developer representation in leasing and property management are a major source of their revenues. They also suffer from the lack of transparency that is needed to perform reliable estimates of supply and demand and absorption as well as consistent definitions of class A, premium class A or other market defining measures.

What is not taken into account in studying the real estate markets in China is the huge oversupply of commercial properties, which doesn't show up on anyone's radar screen and has not been factored into either the government or bank proposals to bolster the real estate markets.

REAL ESTATE EXPOSURE IS AT RECORD LEVELS

Property is a major component of the Chinese economy, accounting for as much as 25 percent of fixed-asset investment and 6 percent to 7 percent of GDP. At the banks, real estate–related loans (loans to developers and mortgages loans) are officially reported at between 22 percent and 30 percent of total lending and have been one of the fastest growing loan segments. However, the loans made to general contractors (6 percent to 7 percent of total lending) and loans to state-owned enterprises (as working capital loans) that embark on real estate development projects on company-owned land increase bank real estate loan exposure to 40 percent of total lending.

For much of the past 18 months, the Chinese government has been trying to rein in real estate speculation and the rapid rise in home prices throughout China to maintain "social harmony" and keep home prices affordable to average Chinese citizens. Every imaginable measure has been taken, including controlling land sales through government auctions, mandating land use policies to require more allocation of land to smaller homes (90 square meters or less), increasing mortgage interest rates and downpayment requirements, and restricting foreign investors from buying properties. Tax policies were introduced to tax short-term gains from selling properties within five years of acquisition and to impose penalties on developers holding land for speculation purposes. Chinese banks were ordered to slow down and reduce the supply of credit to real estate developers, and consumers were penalized if they wanted to purchase a second home.

BE CAREFUL WHAT YOU WISH FOR

The result was predictable. Developers face a massive

credit squeeze, home sales have declined by 20 percent to 40 percent, home prices have declined across China, and listed developer shares are down 70 percent or more from their peak in October 2007. In some cities, more than half the residential brokerage offices have closed their doors.

For the past two years, the largest Chinese banks are reporting “negative new NPL [nonperforming loan] formations” in spite of a global real estate recession and severe credit problems facing developers in China. This trend is expected to reverse itself in 2009 as real estate values continue to decline.

This is all pretty much public knowledge, and the government has acknowledged that a real estate meltdown could have severe systemic risks to the banks and recently lowered mortgage interest rates. Local municipalities have given incentives to first-time homebuyers purchasing assets of 90 square meters or less and softened their stance on downpayment requirements for both primary residences and second homes.

Despite these measures, we’re already into a down cycle, and the banks are late in acknowledging any problem on the quality of their loan book. For the past two years, the largest Chinese banks are reporting “negative new NPL [nonperforming loan] formations” in spite of a global real estate recession and severe credit problems facing developers in China. This trend is expected to reverse itself in 2009 as real estate values continue to decline.

In Beijing alone, I estimate that from 2007 to 2009 the supply of class A commercial office buildings will increase by as much as 5.6 million square meters. In addition, the supply of class B or strata-title (condominiumized buildings sold to investors) could add another 3.7 million square meters to the market. To put that into perspective, the class A office market was estimated at about 3.7 million square meters at the end of 2006. My estimates exclude government buildings such as the new CCTV Tower, or new buildings being built by banks, insurance companies and oil companies for their own use.

I have lived in Beijing for the past seven years and worked for one of the big four international accounting firms as well as the largest law firm in China. Despite rapid employee growth to keep up with the pace of development and growth in China, I am amazed how little office space both firms occupy as major tenants in this market. Even extrapolating for the onslaught of foreign banks, international law firms, investment banks and consulting firms that came to the market in droves for the past five years, the average net absorption of office space in Beijing accounted for only 464,515 square meters per year. Many analysts rationalized that construction would stop in Beijing at the end of 2007, which would grant the market a “cooling-off period” before new buildings could be brought to market starting in late 2010 and 2011, but as we all saw during the Olympic Games, construction continued right up until the athletes started to arrive in late July 2008 and continues unabated today.

UNANSWERED QUESTIONS

Given these factors, two questions continue to puzzle me: 1) Why haven’t the banks started to reflect problems in the real estate sector by increasing their loan loss reserves in the face of declining collateral values? 2) And why do foreign institutional investors want to enter the China real estate market at this time (especially in light of their domestic investment choices due to the credit crisis)?

My answer is the banks want to ignore the problem as long as possible because at the end of the day the government will be forced to bail them out with another massive transfer of nonperforming loans to yet another state-owned asset management company as they did in 1999 and 2003–2004 when they recapitalized the banking sector and listed the largest Chinese banks. Meanwhile, the banks’ profit margins are eroding due to slowing of loan demand, government credit tightening (until quite recently) and rising costs (salaries, IT infrastructure and overhead).

In addition, several Chinese banks fell victim to foreign investment securities (subprime, Lehman Bros. or other debt instruments) and have been forced to take major writedowns, as everyone knows these assets cannot continue to be valued at their original book value. What better way to shore up a margin and profits squeeze than by continuing to delay and obfuscate emerging real estate losses by lowering their domestic provisions for nonperforming (mostly real estate) loans.

I take some comfort that since September 2008 many of the large investment banks and other analysts have started to downgrade Chinese banks for their exposure to real estate loans.

I take some comfort that since September 2008 many of the large investment banks and other analysts have started to downgrade Chinese banks for their exposure to real estate loans. Most soft sell their reports for fear of offending Chinese banks and regulators. Some analysts suggest that the listed developers that are

the most cash starved can sell off land holdings or restructure their development loans with the banks. I would only comment that virtually all the developers

Investors are constantly circling the market and somehow feel compelled to get a piece of the elusive China Dream.

in China are cash strapped, and I don't think any are in a position to buy more land from troubled developers. Also, foreign investors still face tough restrictions to register capital onshore to buy Chinese real estate.

As to "restructuring" loans or Western-style workouts with developers, in the seven years I have been living and working as a financial consultant to the banks, there has not been one traditional troubled debt restructuring or a real functioning creditors committee organized to successfully work out or restructure a troubled debtor! Most such efforts were "government directed."

WISH LIST FOR RECOVERY

One of the great joys of living in Beijing is witnessing this dynamic market and observing how little foreigners know about how business is actually conducted. Investors are constantly circling the market and somehow feel compelled to get a piece of the elusive China Dream. Fortunately, I make a living helping foreign investors "extricate" themselves from the challenges in the China market.

There may be a time in the not too distant future for foreign institutional investors to enter the China real estate market, but first the following must and will (over time) occur.

1. Real estate as an asset class will reprice to reflect cash flow and market fundamentals of supply and demand.
2. Banks must be allowed to write-down their problem real estate loans and to enter into troubled debt restructurings with problem debtors, including enforcing foreclosure rights, guarantees and liquidation (instead of loan extensions and evergreening of loan terms).
3. Regulations affecting foreign investors' registration of capital and foreign exchange to invest in real property must be relaxed, and accelerated approval processes are needed.
4. Market information and transparency must improve to allow financial investors to better understand the property markets and risks.
5. Asset management and property management firms that have grown rapidly with the Chinese economy must improve all aspects of their business from training and retention of staff to management development, reporting and IT systems.
6. The pitfalls in Chinese due diligence must be addressed and studied to improve diagnostics during due diligence with problems of forged documents, fake corporate seals, hidden liabilities, unpaid land use fees, unfunded worker compensation and worker relocation stipends, as well as problems in registering title.
7. Foreign investors have to better understand the Chinese legal system, its risks, and how and when it applies to property and commercial transactions in China (even if the investment was structured offshore).

Until then, my view is the market is best suited to opportunity funds or high-yield investors knowledgeable about how to do business in Asia and who understand the concept of "high risk, high returns" when investing in China. Until that time, the market is unsuitable to foreign institutional investors, and they should be well advised of the risks related to doing business in a developing country.

For those institutions (pension funds and endowments) that have a mandate to invest long-term in developments in China, I offer the following advice: stick to the top tier cities (Beijing, Shanghai, Tianjin, Dalian); invest alongside a major international developer who is co-investing their own funds and has a decade of international development experience under their belt ....

For those institutions (pension funds and endowments) that have a mandate to invest long-term in developments in China, I offer the following advice: stick to the top tier cities (Beijing, Shanghai, Tianjin, Dalian); invest alongside a major international developer who is co-investing their own funds and has a decade of international development experience under their belt with a solid (verifiable) track record of performance and who has in place a seasoned development team with tenured executives on the ground in China who will bring the full resources and expertise of their organization to your project. I can think of only a handful of developers in China who meet those criteria today! ❖

Jack Rodman is a member of **Crosswater Realty Advisors'** Senior Advisory Group based in Beijing.