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Massive property lending, oversupply and plunging rents point to an asset crisis in China

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Major cities around the world, hard hit from financial institution failures and consolidations, are reporting record high vacancy rates from 15 to 20 per cent and most analysts are forecasting a commercial mortgage loan crisis of between US$3 trillion and US$4 trillion as commercial mortgages mature and buildings generate insufficient cash flow to refinance these properties.

In Beijing, high vacancy rates are even more pronounced. Jones Lang LaSalle's Q3 Commercial Office Property report indicates that the vacancy rate in Beijing has risen to 37 per cent and that at least another 10 million square feet of new office space due for completion this year has been pushed into 2010.

Why haven't alarm bells been ringing in China when property owners and developers are facing an unprecedented oversupply of new and existing properties and rapidly declining rents?

The source of this developing crisis began earlier this decade when many of the listed property developers bought land at record prices as they were fattening their balance sheets in advance of their long-awaited stock market listings.

Then when the initial public offering market died in March 2007, many of these developers struggled to survive as regulators systematically worked to reduce speculation in the property market by increasing interest rates, down payment requirements, reducing bank lending to the property sector and invoking a series of short-term speculation taxes to slow down runaway home prices. By November 2008, government efforts had worked and many large developers faced defaults.

In 2009, despite the concerns affecting both the commercial and residential property markets, analysts have paid lip-service to the fact that Chinese banks then pumped more than US$1.27 trillion dollars into the economy through the first nine months of 2009, much of it going to state-owned enterprises and developers

who again bought land at record prices, and speculated in stocks and commodities. Some analysts believe that SOEs could not invest all of the bank loans they were allocated, nor could they invest it in plant and equipment as their facilities were operating far below capacity due to the contraction in exports.

To meet short-term profit goals and to comply with government directives to stimulate the economy, speculation has run wild.

Most of this lending is policy-directed with an implicit government guarantee. Despite thousands of closed factories in South China resulting from the global financial crisis, and hundreds of empty office buildings, retail centres and hotels that are not meeting their debt service payments, banks are still not foreclosing on these properties nor calling the loans due. The banks prefer to rollover or extend the loans to avoid having to report an increase in non-performing loans. It is not uncommon for Chinese banks to extend a loan for as much as one year without interest payments if the lender "believes" the ultimate recovery value of the assets will be greater than the outstanding principal and interest. However, it is nearly impossible for a bank to value an empty office building, in a market with a reported vacancy rate nearing 40 per cent (30 to 40 million square feet) and declining rents.

Bank exposure to the real estate sector has been at the root of previous financial crises worldwide including the savings and loan crisis in the United States, Japan's bubble economy, the Asian financial crisis, and now Dubai World. All these crises share in common aggressive and exuberant real estate lending, an abundance of liquidity and the false belief that real estate can only rise in value.

If total exposure to real estate secured loans was transparent within the Chinese banking sector, it would approach 40 per cent of total lending - the same level of total loan exposure reached in Japan in 1989, when it was believed Japan would dominate the economic landscape for decades.

Somehow the market has rationalised away economic fundamentals in favour of China's economic growth prospects. However, no one can adequately explain why average home prices in cities like Shanghai, Beijing, Dalian and Tianjin are 30 to 40 times average incomes. Additionally, no one questions why hundreds of empty office buildings and shopping centres are not showing up as NPLs on the banks' books. Before 1999, when China began reforming its banking sector, 45 per cent of total loans were non-performing. How is it that China can double loans and triple growth in a few short years and not incur a higher incidence of NPLs?

China is poised for a huge market correction. The numbers don't add-up. Empirical evidence of a pending real estate bubble and concurrent bank loan losses is available to anyone who cares to look.

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