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Tuuli McCully 65.6305.8313
tuuli.mccully@scotiabank.com

China's Real Estate Recovery Lifts Sentiment — Fundamental Imbalances Persist

The recovery in China's real estate sector continues as implied by various price and activity indicators, promoting positive financial market sentiment globally. Real estate accounts for almost one-third of China's economic output when associated activity — e.g. materials and household appliances — is considered (roughly 15% direct), according to the International Monetary Fund (IMF). However, real estate's overall significance may be even larger as more than half of Chinese households' assets are tied to property and land sales to developers represent 30% of local governments' fiscal revenue. Accordingly, property market developments — both positive and negative — are core determinants of China's economic outlook. This article aims to summarize the latest real estate sector developments and juxtapose recent gains against key fundamental weaknesses.

The property price recovery is extending to smaller cities

Fresh April data show that new residential property prices in 46 out of 70 major Chinese cities recorded year-over-year increases; this contrasts starkly with late-2014 and early-2015 when almost all cities suffered falling valuations. House prices across the 70 cities covered rose by 4.2% y/y in April, yet regional price divergence remains in place (see Chart 1). Real estate in Tier 1 cities (Beijing, Shanghai, Guangzhou, and Shenzhen) is in very high demand, with prices in these mega cities rising 31.5% y/y in April despite the recent roll-out of policies aimed at slowing such gains (e.g. higher second home down payment requirements). Meanwhile, prices in smaller Tier 2 cities — which are still of considerable economic significance (such as provincial capitals) — rose by 5.2% y/y. Given that Tier 3 and 4 cities account for two-thirds of excess housing inventory, they are lagging the price revival and continue to record small annual declines; however, on a month-over-month basis, prices in most of these lower-tier cities are recuperating as well.

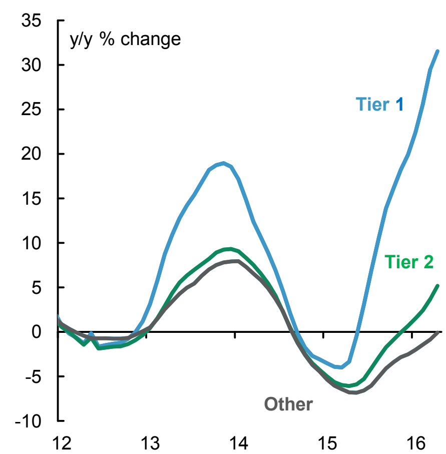
The real estate recovery is attributable to China's loose monetary and credit policies. In addition, housing demand remains supported by the lack of domestic investment alternatives. Low bond yields and a bear market in equities add to the asset allocation challenge. Moreover, tight capital controls limit investment diversification possibilities abroad. Finally, regulatory changes that promote destocking activity in lower-tier cities (such as reductions of down payment requirements) have supported the house price recovery in these areas.

Given the real estate sector's economic significance, recent price gains bode well for China's economic outlook and have contributed to some easing of global concerns regarding the country's growth performance. In addition, the wealth effect of higher house prices will support household spending and assist the government in its efforts to rebalance the economy's growth model toward a consumer-based framework. Meanwhile, fiscal revenue from land transactions will help local governments reach their development goals. Nevertheless, the real estate sector's importance and deep linkages with the financial system continue to represent a major risk to the Chinese outlook.

Weak fundamentals undermine the real estate outlook

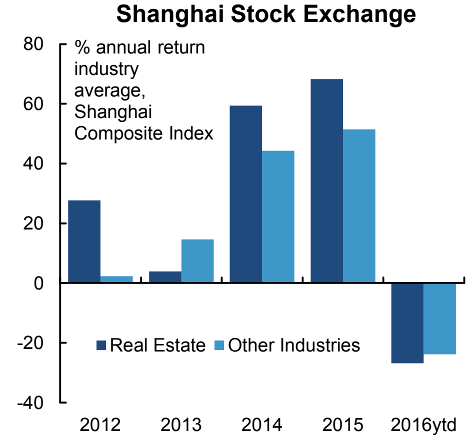
Despite positive house price dynamics, listed property developers in China are underperforming the market, highlighting investor concerns regarding the underlying strength of key industry players (See Chart 2). This is further highlighted by the fact that 15% of real estate companies listed on the Shanghai Stock Exchange have temporarily suspended trading (potentially in an effort to limit share price declines), compared with 8% of all other listed companies.

Chart 1 Chinese House Prices



Source: Scotiabank Economics, Bloomberg.

Chart 2 Real Estate Performance In Shanghai Stock Exchange



Source: Scotiabank Economics, Bloomberg.

The relatively anemic performance reflects real estate sector companies' fragile financial standing, which we assess to be the most significant fundamental weakness undermining the sector's outlook. Real estate has been the largest contributor to China's rapid rise in leverage since the global financial crisis. Real estate debt is equivalent to 45% of GDP, according to Oxford Economics, accounting for a substantial portion of China's total non-financial corporate debt load (165% of GDP). Reflecting years of overinvestment, China's real estate sector suffers from declining return on assets and deteriorating financial soundness. According to the IMF's Global Financial Stability Report, real estate is among the least profitable and most highly indebted sectors in China; the median firm's debt relative to earnings ratio (debt/EBITDA) is slightly under four, yet the ratio in real estate is over nine. The IMF shows that around 5% of real estate sector debt is in loss-making (i.e. negative EBITDA) firms and 11% of the sector's total debt is at risk, which means that the borrowers are unable to generate sufficient income to cover interest payments.

Elevated financial stress among real estate companies is not the only area of weakness within the sector. While land and housing sales point to improving prospects (See Charts 3 and 4), this recent performance may prove temporary; much of this activity may have been spurred by attempts to complete transactions before the May 1st rolling-out of the Value Added Tax to cover real estate.

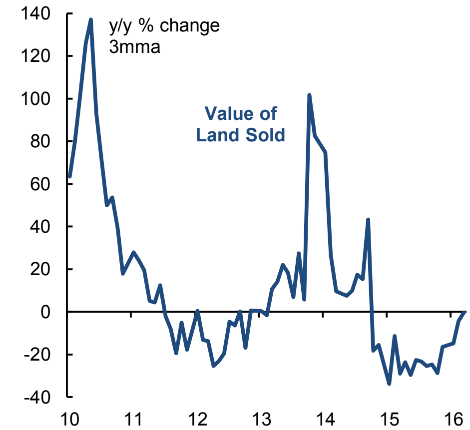
Deteriorating affordability, particularly in higher-tier cities, represents another fundamental imbalance and poses a risk to the property market outlook. The house price-to-income ratio is over 20 in the Chinese mega cities (and over 30 in Beijing), making New York City appear cheap (<10).

Finally, a persistently large housing inventory overhang is a major weak spot within the real estate sector's outlook. While the government's mortgage and tax policy changes are supporting demand and reducing excess housing supply, the stock remains significant (See Chart 5). The nationwide inventory — including all projects that have been started but not necessarily officially completed — is hovering slightly above two years worth of sales. However, there are large differences between cities; while homes sell fast in large metropolises, smaller Tier 3 cities have an inventory equivalent to over three years of sales. Meanwhile, the stock of officially completed housing is significantly smaller (less than five months) suggesting that not all projects following the post-financial crisis construction boom have been formally completed. Regardless of the inventory tracking methodology, excess capacity in lower-tier cities undermines China's construction sector outlook given that such cities account for around half of the country's real estate investment. The destocking process will likely advance only gradually over the coming years, a task made more difficult by the fact that recent price gains have precipitated a newfound increase in housing starts (See Chart 4).

Current boom pushes problems further down the road

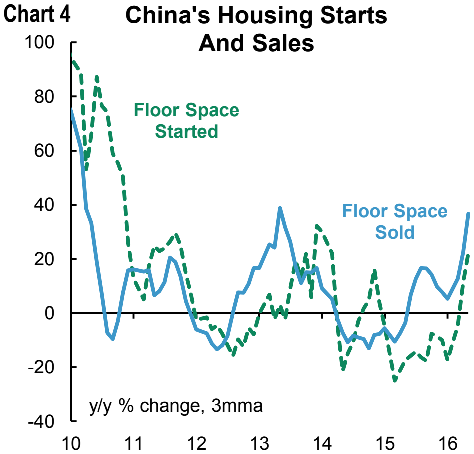
The economic impact of the ongoing real estate recovery in prices, sales, and housing starts is substantial, supporting China's real GDP growth in the near term as well as bolstering global trade and commodities demand. Nevertheless, we assess that the Chinese real estate sector remains on precarious footing and may not be able to bear the weight of future challenges without government intervention. In the absence of policymakers' supportive housing market and credit policies, current real estate demand would be more subdued. In addition, eventual capital account liberalization would materially increase the range of investment alternatives and could provoke a rapid fall-off in Chinese property demand. This would add substantial financial strain on already-stressed developers, potentially causing adverse ripple effects throughout the country's financial sector due to its large real estate market exposure. Nevertheless, we assess that the risk of a disorderly adjustment in the longer term is relatively small; given the Chinese government's notable financial means and an established track record of intervention, the real estate sector will likely receive official support when needed.

Chart 3 China's Land Sales



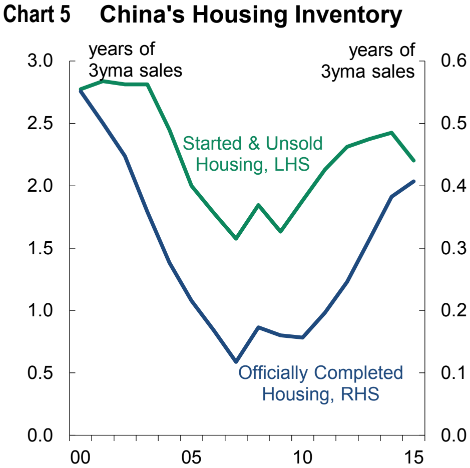
Source: Scotiabank Economics, National Bureau of Statistics of China.

Chart 4 China's Housing Starts And Sales



Source: Scotiabank Economics, National Bureau of Statistics of China.

Chart 5 China's Housing Inventory



Source: Scotiabank Economics, Oxford Economics.

INTERNATIONAL ECONOMICS GROUP

Pablo F.G. Bréard, Head
1.416.862.3876
pablo.breard@scotiabank.com

Erika Cain
1.416.866.4205
erika.cain@scotiabank.com

Tuuli McCully
65.6305.8313
tuuli.mccully@scotiabank.com

Estela Molina
1.416.862.3199
estela.molina@scotiabank.com

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: 416.866.6253 Fax: 416.866.2829
Email: scotia.economics@scotiabank.com