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Elevator going down

Let it be said, writes Evan Lorenz, that China has the best airports, the fastest trains and the comeliest empty residential towers in the world. I can say this with some authority after spending last week in the People's Republic.

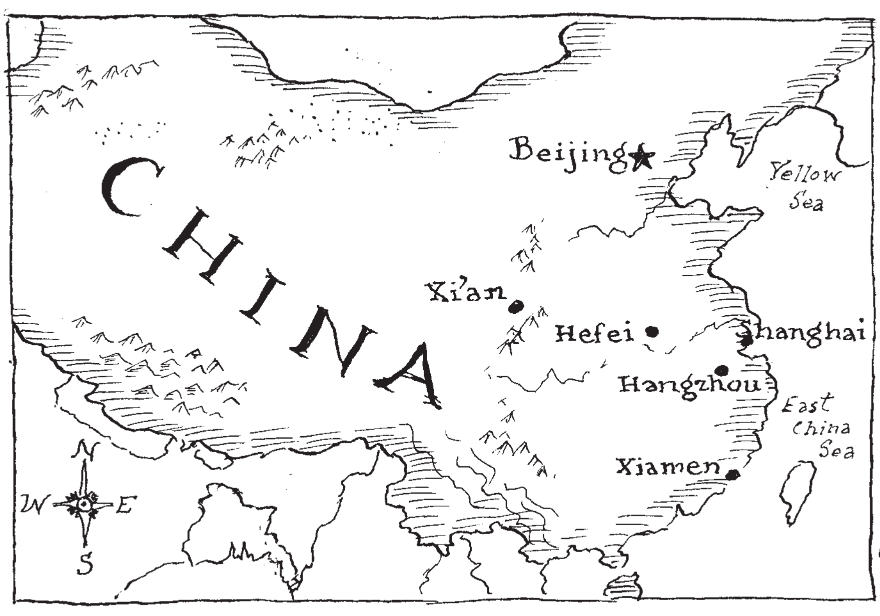
China is also home to the hottest stock market since dot-com mania electrified the Nasdaq. "In downtown Shanghai," Singapore-based *Straits Times* reported on Sunday, "crowds gather across People's Square on weekends to trade stock tips." Women over 50 are giving up mah-jongg for day trading. College students are using funds from mom and dad to buy stocks instead of ramen. A real estate developer complained to me that punters with cash to burn now buy stocks instead of tony apartments on spec. In the week I was away, brokers opened over four million new trading accounts.

What brought me to China wasn't the stock market but the fortunes of a $23.1 billion market cap Finnish elevator company: Kone OYJ (KNEBV on the Helsinki Exchange; KNYJY as a U.S.-listed American Depository Receipt). You may or may not care about Kone, but China's real estate market is everyone's business. The building of new and—for now—empty towers drives China's once insatiable demand for concrete, iron ore, copper and, more importantly for this dispatch, elevators. In fact, Kone estimates that the People's Republic accounted for 69% of worldwide elevator sales in 2014.

We served up Kone as a short candidate a year ago on the conviction that the company's reliance on the slowing Chinese real estate market would lead to disappointment (*Grant's*, May 30, 2014). We did get half of the story correct: China's real estate market is slumping. Residential property sales fell 10% in the first three months of 2015 compared to the same time last year. Over the same period, property starts and completions fell by 18% and 11%, respectively. Looking at housing inventory, you wonder why they even bother. According to IMF deputy managing director Zhu Min at the Fund's annual meeting the other week, empty houses cover land in excess of one billion square meters—an area greater than 11 Manhattans.

Yet, Kone reported a 5% year-over-year increase in sales to China (adjusting for exchange rates) in the company's first-quarter results released on April 22. The People's Republic accounted for around 35% and 45% of Kone's first-quarter sales and orders, respectively. Since our initial report, Kone's shares have rallied by 33% (though by 7% in U.S. dollar terms).

How can the sale of elevators hold steady when developers are completing fewer buildings? To answer this question, I joined J Capital managing partner and co-founder Tim Murray on a research trip to Xi'an, Xiamen, Hangzhou and Hefei to investigate property-related activity. These four cities have populations ranging from 3.5 million (Xiamen) to 8.7 million (Hangzhou). With the exception of Xiamen, each is the capital of its respective province. The cities range from the northwest region of China



(Xi'an), the southeast (Xiamen), and the east (Hangzhou and Hefei).

In preview, my views on Kone and the property-intensive and debt-dependent Chinese economy have hardened. The decline in real estate activity to date has been concentrated in the weaker property developers that tend to buy domestic elevators. As the real estate-related malaise has deepened, even larger developers are reducing activity and starting fewer new towers. Across the cities I visited, I saw many signs that the slump has worsened since the Chinese New Year in February.

At 27 times trailing earnings, Kone's share price seems not to reflect these worrisome facts. Management is guiding for 2015 sales to China to be "approximately at previous year's level." Given the aforementioned 5% year-over-year gain in the first quarter, management would seem to be preparing the ground for a decline in Chinese revenues over the balance of the year. Sales may very well hold up for the next quarter or two as Kone delivers on its backlog.

A decline in that backlog, of which Chinese orders account for around 40%, should be the leading indicator of weakening revenue growth. In the nature of things, the company will be hard-pressed to maintain the size of its order book if Chinese developers pull back (which they seem to be doing). Kone requires substantial deposits from customers before accepting an order. Between year-end 2014 and March 31, advance payments on hand increased to €2 billion ($2.1 billion) from €1.6 billion. The increase in those payments was greater than Kone's cash balance of €208.2 million net of debt and minority positions. The slowdown in Chinese activity should thus register as a draw on Kone's cash resources. The company reports second-quarter results on July 17.

My trip started in Xi'an. On the drive to the city center from the Xi'an Xianyang International Airport at night, I was struck by just how many 30- and 40-story tall apartment buildings were empty; there were no lights in any of the windows as I passed by. Driving around the city the next day, I was struck by how many new buildings are going up alongside the evidently vacant ones.

Abandoned in Hangzhou?

Though cranes were ubiquitous, very few were in motion. While I could spot workers on many of the construction sites, the tempo of activity seemed calculatedly slow. Work on a light rail project looked as if it had come to a dead stop.

My observations were confirmed as I spoke with Xi'an residents. A sales manager for American Standard (a home-furnishing brand owned by Japanese roll-up Lixil Group) estimated that around half of all projects under construction in Xi'an were delayed in April, delays that were a new factor in the market. The estimate was corroborated by a purchasing manager for Shaanxi Jiali Property Development Co. Ltd., a local builder, as well as two elevator distributors that sold Kone, Otis and Mitsubishi brands.

There are no hard figures for how much housing stock is available relative to demand, but sources I spoke with estimated that there are enough apartments for at least five years of sales in the city. "Why," I asked, "are developers continuing to construct buildings that they will struggle to sell?" After purchasing a parcel of land, my source at Jiali related, a clock starts ticking. If a developer fails to put up a building in a certain period of time (typically three years), the developer is assessed a penalty fee of around one-third the price of the land.

"Can developers afford to pay the penalty?" I asked Murray. "God no," he replied. "It would kill them." The upshot is that developers are cutting back, building three towers, perhaps, instead of a budgeted 10—just enough to avoid the assessment. From which it follows that government data on residential starts may understate the extent of the slowdown.

Western elevator brands typically require developers—nowadays, the biggest and best-financed Chinese developers—to pay a 30% down payment when an elevator is ordered, 60% to 65% when the elevator is delivered, and the balance upon installation. When the market was healthy, customers would order elevators at the start of construction and take delivery a year later, when the roof of the building was completed. Now, I learned, developers are ordering elevators near or at the same time the roof of a building is finished.

As the slowdown has set in, developers are managing their businesses for a lower level of activity. The two elevator distributors I met both estimated that Kone's new orders in Xi'an might decline by 30% to 50% this year.

Later in my trip, a Kone general manager with whom Murray and I fell into general conversation confirmed my impression that the Xi'an market is hurting. "But," Murray shot back, "who needs the northwest?" The Kone manager replied: "We do."

Xi'an is not an economic basket case. The city is no ghost town like Ordos, Inner Mongolia. My hotel, the Xi'an Westin, was near a bustling shopping center and near the well trafficked Big Wild Goose Pagoda, a seventh-century Buddhist temple. The city is at the heart of the Silk Road economic belt, a development region that has been a party focus since president Xi Jinping assumed office in 2013. That is to say while the overbuilding was evident in Xi'an, it is one of the better cities in China's northwest region—a fact to which Murray attested.

In other economic sightings in Xi'an, I had lunch with a geologist who audits data from state-owned miners. Banks use his work to form credit judgments, the state to allocate resources. Over the past four months, he told me, his business has declined by 40%. This is not a good sign for companies like Caterpillar Inc., Zoomlion Heavy Industry Science & Technology Co. Ltd. (*Grant's*, Oct. 21, 2011), and other manufacturers of mining equipment.

On my way back to the Xi'an airport to catch a flight to Xiamen, I drove past a coal-fired power plant. Only three of the plant's five boilers appeared to be in operation—a good description for what I saw in the city.

Xiamen, which is set on an island and the land facing the island (another island, Taiwan, lies 50 miles to the east), is blessed with tree-lined beaches and a subtropical climate. The people appear wealthy and fashion-forward. If you ignore the signs in Mandarin, you could easily imagine that you were in southern California.

Xiamen's real estate market is faring much better than the rest of Fujian. Because land is scarce on Xiamen Island, prices can range between rmb. 40,000-50,000 per square meter ($597 to $747 per square foot). Off the island, where land is more plentiful, prices are half that level.

Xiamen's, though, is a relative prosperity; its real estate, too, is under pressure. At a local emporium of building products, Murray and I walked through shops selling local Chinese finishing goods—toilets, bathtubs, sinks. Two shops reported flat sales compared to the same period last year, while another reported a decline of 10% and a fourth a decline of 20%.

We had lunch with a sales manager from Xiamen Aigesidun Trading Co., a company that imports western brands for higher-end properties. He said that so far this year, sales are down by 5%. Though sales and completions of higher-end property units are performing better than lower-end units, activity is slumping across the market.

After Xiamen, I hopped onto a flight to Hangzhou, one of the most prosperous cities in China. Headquarters to such companies as the Alibaba Group Holding Ltd. (the Amazon of China), Wanxiang Group Corp. (China's largest maker of automobile components), and Hangzhou Wahaha Group Co. (the largest beverage producer in China.) Hangzhou has a diversified economy that isn't dependent on a single resource or industry.

You'd have supposed that Hangzhou would be the best performing real estate market in China, and the level of construction in progress there appeared to be on par with that of Xiamen that is, not excessive on its face. However, after setting out in the morning for meetings, Murray and I quickly came across a very large construction project with over a dozen towers in which all activity appeared to be halted (see picture).

I managed to speak to two elevator vendors, one who sold Kone and a second who sold a local Chinese brand. I learned from the Kone man that the higher-end market he serves will be flat to down by 5% this year. His domestic rival said that Kone is bringing cheaper elevators to market to compete in the low-price stratum of the domestic market. Unlike western manufacturers, said the domestic manufacturer's rep, he doesn't require a down payment when an order is placed; rather, he takes a lien against apartments in a building project. If a developer can't pay its bill, his company seizes the apartments and sells the units. He reports that his company is taking over units in orders accounting for 50% to 60% of sales today and that he has seized units in Hangzhou.

From Hangzhou, we set out on a high-speed train to Hefei. The plan for the city is to grow rapidly by immigration. A decade ago, one source relates, the city housed one million people. Today, Hefei is home to five million people. The city plans to attract another three million over the next several years. In terms of construction projects dotting the landscape, Hefei lies between Hangzhou and Xi'an.

After the market for mass affluent finishings grew by 10% to 15% in 2014, a sales manager for American Standard told me, sales of brands like Toto, Kohler, and American Standard are down by about 10% in 2015. Sales decelerated after the Chinese New Year because property developers have slowed the tempo of building.

A Kone sales person, who had recently worked at ThyssenKrupp Elevator, told us that the elevator market in which Kone competes may contract by around 10% in Hefei this year. In general, he said, customers are taking longer to sign contracts and to pay deposits.

In the course of my travels, I met with sales managers from Zijin Mining Group Ltd. and Jintian Copper Group Co. Ltd., large copper companies in the mainland. Both told a similar story. While copper sales to large companies have declined by a bit, sales to smaller firms are positively collapsing. In the past, small firms typically shut factory gates one day a month; today they are closing eight days a month. The Zijin manager said that banks are not lending to smaller firms, although they continue to lend to larger state-owned enterprises. In the past, SOEs flush with cash would borrow at up to 5.5% and re-lend to smaller companies at up to 15%. No more. Economic uncertainty has put a crimp in this financial arbitrage.

The man from Jintian told me that some shadow lenders have entered the market and are charging small firms 2% per month, or 24% annualized. Lending to smaller companies is too risky a venture, our source went on, because the business owners can flee when the going gets bad. That's why many of these shadow lenders require a borrower's parents or children to pledge assets in order to secure a loan. "When people run," he explained, "there are usually not enough assets in the company to repay a loan, but family always stays around."

From the sightings on my trip, it seems clear that China's economy is slowing. The People's Republic reported year-over-year real GDP growth of 7% in the first quarter, although no one seems to believe that figure. Lombard Street Research and the Conference Board's China Center peg growth at 3.8% and 4%, respectively. GavekalDragonomics, for one, believes that the boom in financial activity stemming from the stock market may have contributed 1.4% to first-quarter growth. Adjusting for this, it seems like the rest of the economy is barely growing. The U.S. Bureau of Economic Analysis will release U.S. first-quarter GDP figures on Wednesday after we go to press; the consensus is for a 1% print on a seasonally adjusted quarter-over-quarter basis. If so, real activity in the U.S. and China may be growing at around the same rate.

The quality and scale of China's infrastructure is genuinely impressive. While the Party wants to increase spending on infrastructure to boost GDP, it isn't entirely clear where incremental funds can be invested—at least in the cities I visited. I think that the party may have come to the same conclusion. Note that president Xi announced a $45 billion investment program in Pakistan on April 21 to develop energy and infrastructure assets. While this will generate welcome revenue for any Chinese firms that win contracts to execute this program, Pakistan—not China—will capture much of the economic benefit of the projects.

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