

October 2015

Housing & Construction Review

Rosealea Yao

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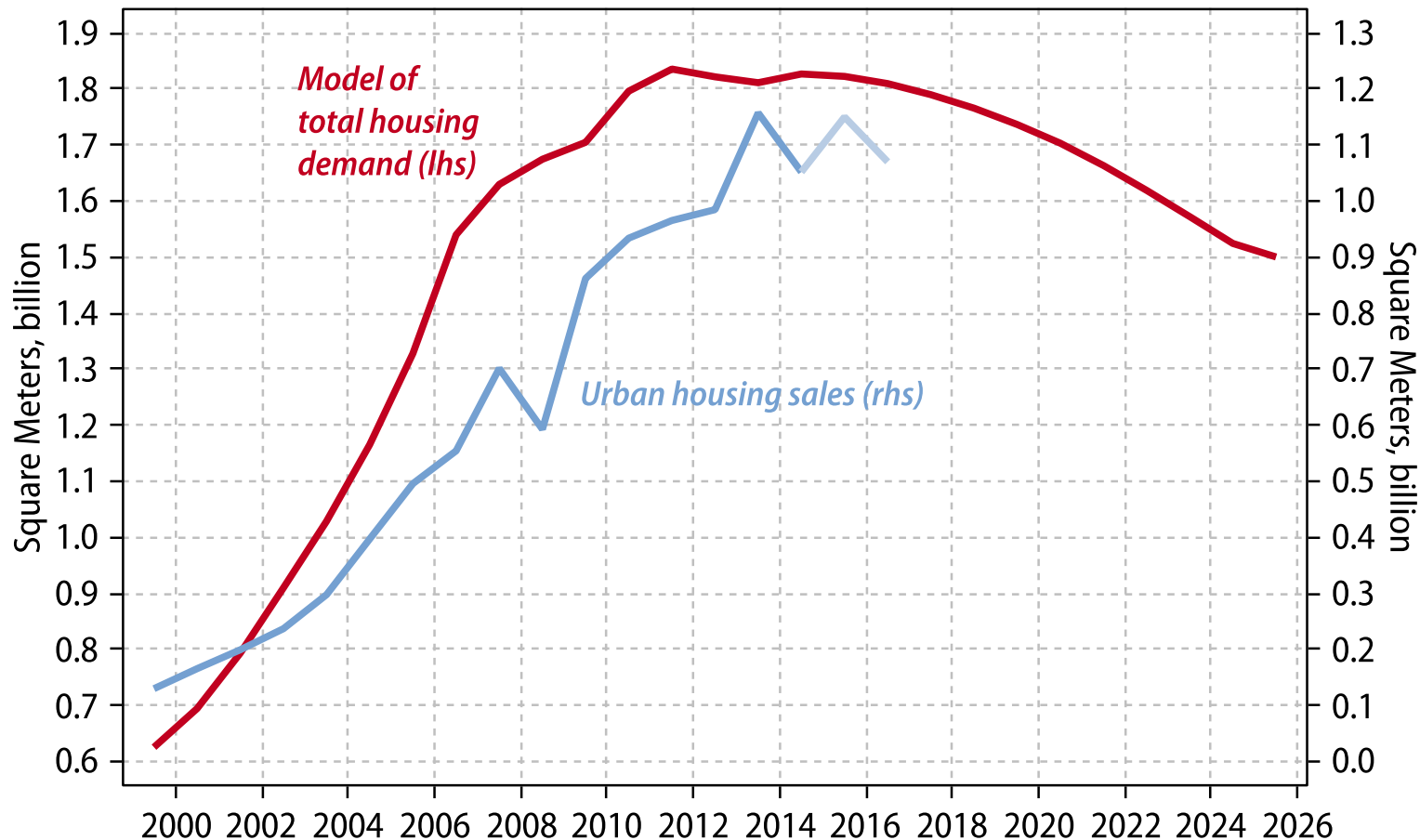
Part 1: Fundamental outlook

- The strong rebound in housing sales in has made it clear that housing demand in China is not collapsing. But this rebound is also clearly a very cyclical one. Our long-term model of housing demand points to declining rather than rising demand in the future, as Chinese households will increasingly spend their income gains on goods and services other than housing. The market is still adjusting to this prospect.
- While the trend for housing demand will evolve gradually, the correction on the supply side has been much more severe. Construction starts will mark their second consecutive year of decline in 2015, an unprecedented correction. Steel demand will also decline for first time in two decades.
- The supply-side correction reflects both an adjustment of over-optimistic expectations for future growth, and the buildup of inventories of unsold housing. The rise in housing sales has helped accelerate destocking in 2015, but we estimate another one or two years are required before inventories normalize. This means the supply-side correction will continue in 2016, with a rebound coming in 2017-18 at the earliest.
- While the property sector's contribution to GDP growth has also peaked, it is still a huge part of the economy. Government policy will therefore continue to support housing demand to avoid downside risks. Artificially stimulating construction volume, however, would risk prolonging the adjustment.

Demand

China's housing demand is peaking after a decade-long boom

Gross area of floor space, actual and projected



CEIC, Gavekal Data/Macrobond

Urban property sales have rebounded strongly in 2015, thanks to cuts in interest rates and the removal of purchase restrictions, and are on track to achieve full-year growth of about 10% in volume terms.

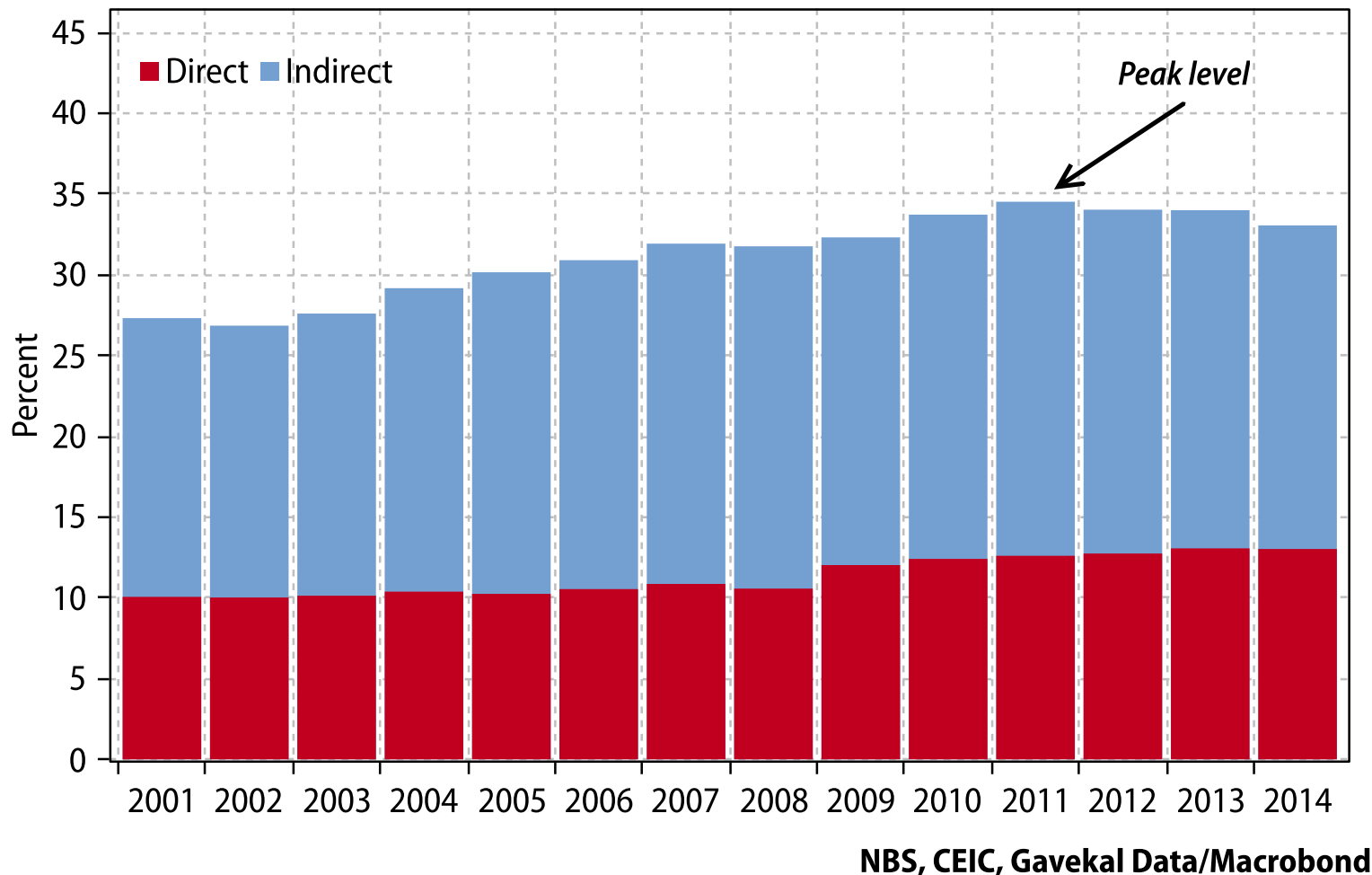
While China's underlying housing demand is not collapsing, we do believe fundamental demand has peaked. Our model of total housing demand (a broader measure than official sales) points to a gradual decline in coming years.

The area of floor space sold for full year 2015 will be very close to the level in 2013, in line with our peak housing thesis. For 2016, we forecast a modest decline in sales volume of 3%.

Growth contribution

The contribution of construction and real estate to GDP has peaked

Direct and indirect contribution to nominal GDP



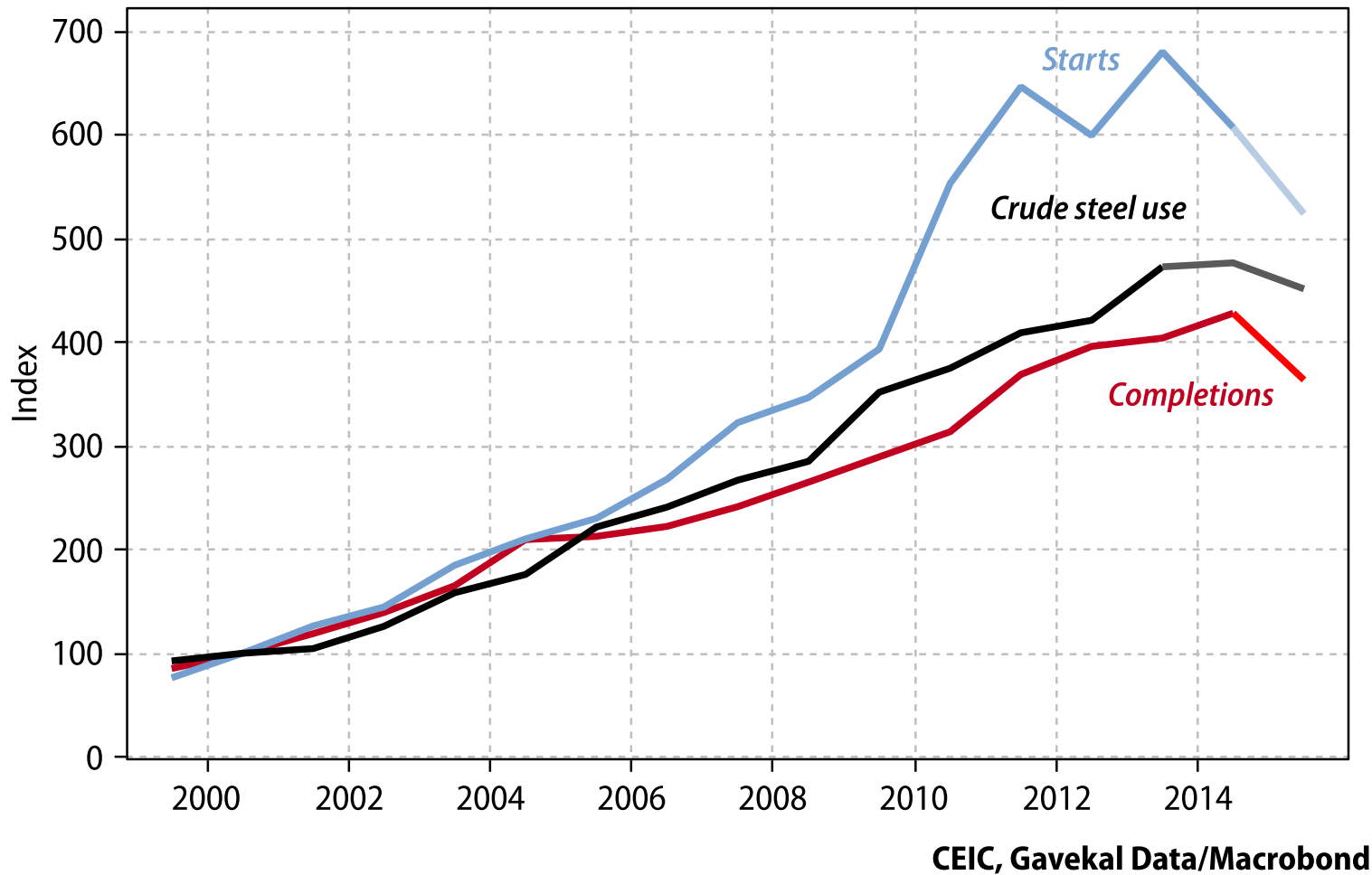
Real estate and construction continue to drive a substantial portion of China's economy: about a third once second-order effects are accounted for. But the growth contribution has gradually declined in recent years. Housing's economic role peaked in 2011.

Because the economy's structure changes only slowly, the government still needs to continue to manage the property market to avoid shocks to growth. The focus of housing policy in the boom years was restraining demand and speculation; now the main goal is to support demand and avoid downside risks during the adjustment.

Supply

Supply-side correction is deepening but yet to end

Volume indicators, year 2000 = 100



While housing demand has been bouncing around its peak level for a few years now, supply-side indicators show a deepening supply-side correction since 2014.

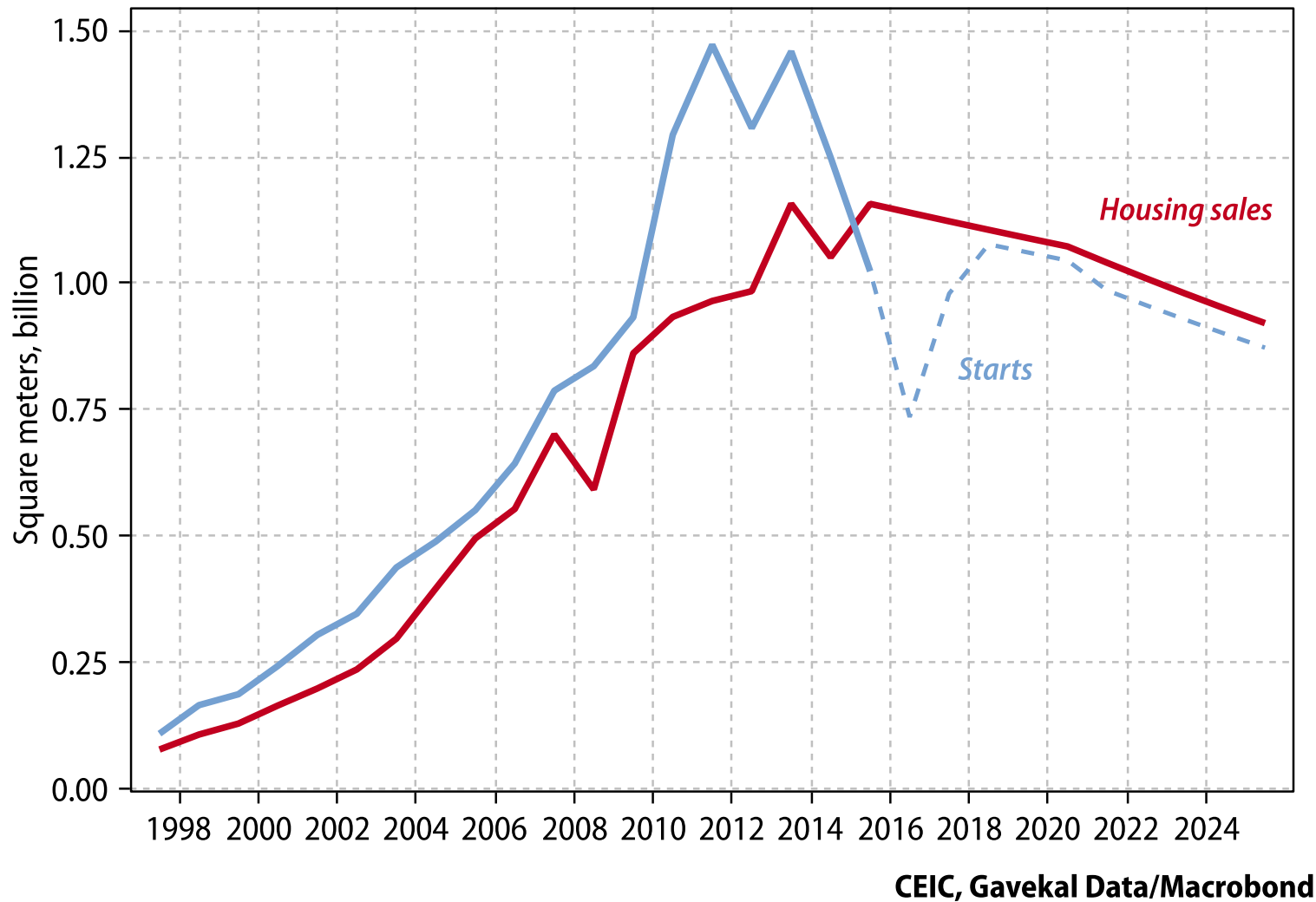
Property developers are facing the reality of high inventories and a structurally weaker trend in housing demand.

Steel consumption was roughly flat in 2014 and is declining in 2015, which will be the first annual decline in steel use for two decades.

The explosion in starts from 2010, decoupling from other indicators, led to a big inventory buildup. The fall in starts since 2014 is now showing up in a decline in completions of new housing.

Balancing supply and demand

Construction starts need to correct to get back in line with demand



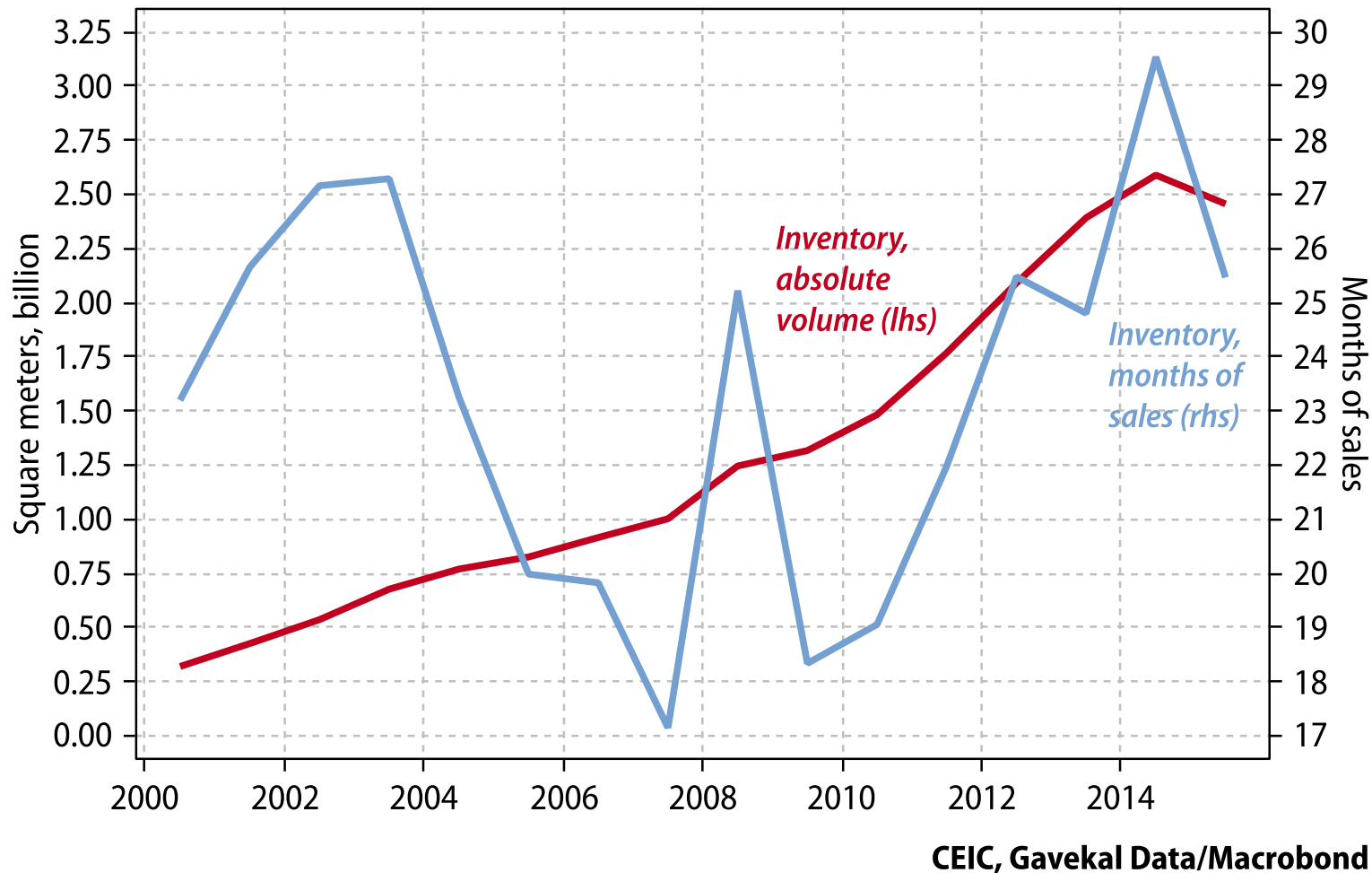
The central issue in China's housing market is on the supply side not the demand side. New construction overshot housing sales after 2010, leading to a large buildup of inventories of unsold housing. Therefore new construction needs to decline in order for inventories to normalize.

Construction starts fell in 2014, will decline again in 2015, and we expect a third year of decline in 2016. Once inventories normalize a cyclical rebound in construction is possible in 2017-18, but afterward we expect starts to track the declining trend of demand. Government support of construction activity would delay this adjustment.

Inventory

China's housing inventories have just started to decline

Nationwide inventories, estimated as cumulative housing starts minus sales



Bottom-up inventory data in China is very patchy, so we estimate a nationwide figure for inventories from aggregate data. Assuming all housing starts will eventually be sold, the difference between the cumulative amount of starts and the cumulative amount of sales at any given time will be the inventory held by developers.

This measure of inventories was about 2.6bn sq m, or roughly 30 months of sales, in 2014, and is on pace to decline to 2.5bn sq m and 25 months of sales in 2015. The historical average is 20-22 months of sales, so we believe the inventory adjustment will take at least another year.

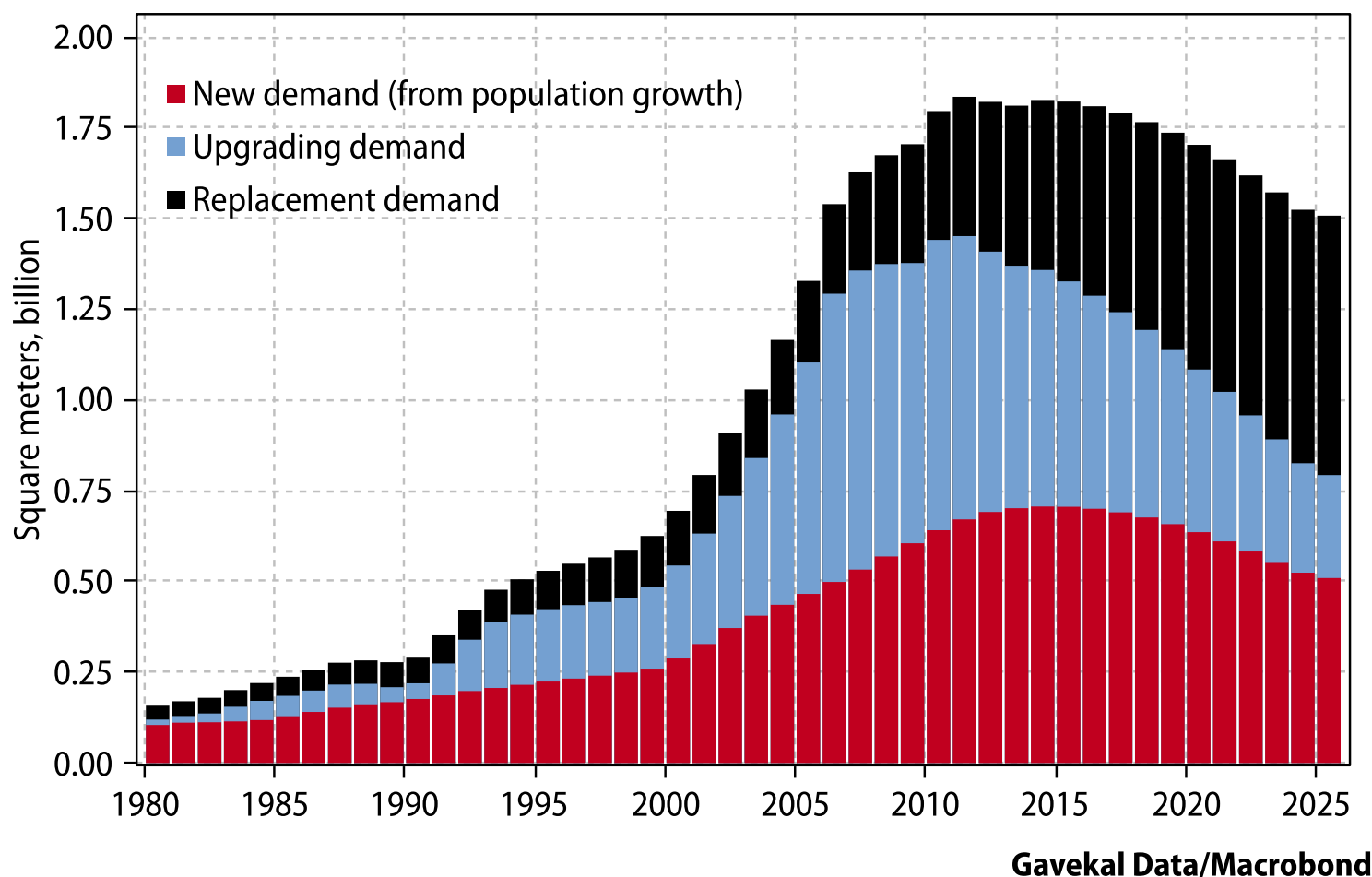
Part 2: Housing policy

- China's housing market is shifting from a situation of high demand and tight supply to one of stable or falling demand and high supply. Future housing demand will also be more driven by lower income groups.
- To adapt to this new market dynamics, the fundamental direction of housing policy is shifting. The priorities have turned from restraining speculation by high-income households to supporting demand by low-income households, and from controlling bubbles in big cities to reducing inventories in small cities.
- By the end of 2014, the government had abandoned housing purchase restrictions in all cities other than the four largest markets. In early 2015, it loosened rules on mortgages for households buying their second homes.
- In other words, as of 2015 the government had abandoned all of the policies that had been central to its repeated public pledges to control high housing prices and clamp down on investment purchases. Implicitly, the government is becoming more tolerant of rising housing prices in large cities, which are the price it must pay for looser policies that encourage sales in smaller cities.
- We expect housing policy to continue to evolve in this direction in the future. Financial liberalization will make it even easier for households to borrow to buy housing. The expansion of mortgage securitization will increase banks' lending capacity, and existing housing-savings programs could be restructured to provide even more cheap credit to lower-income groups.

The changing sources of housing demand

A decline in upgrading drives the downward trend in housing demand

Model of annual housing construction volume, by source of demand



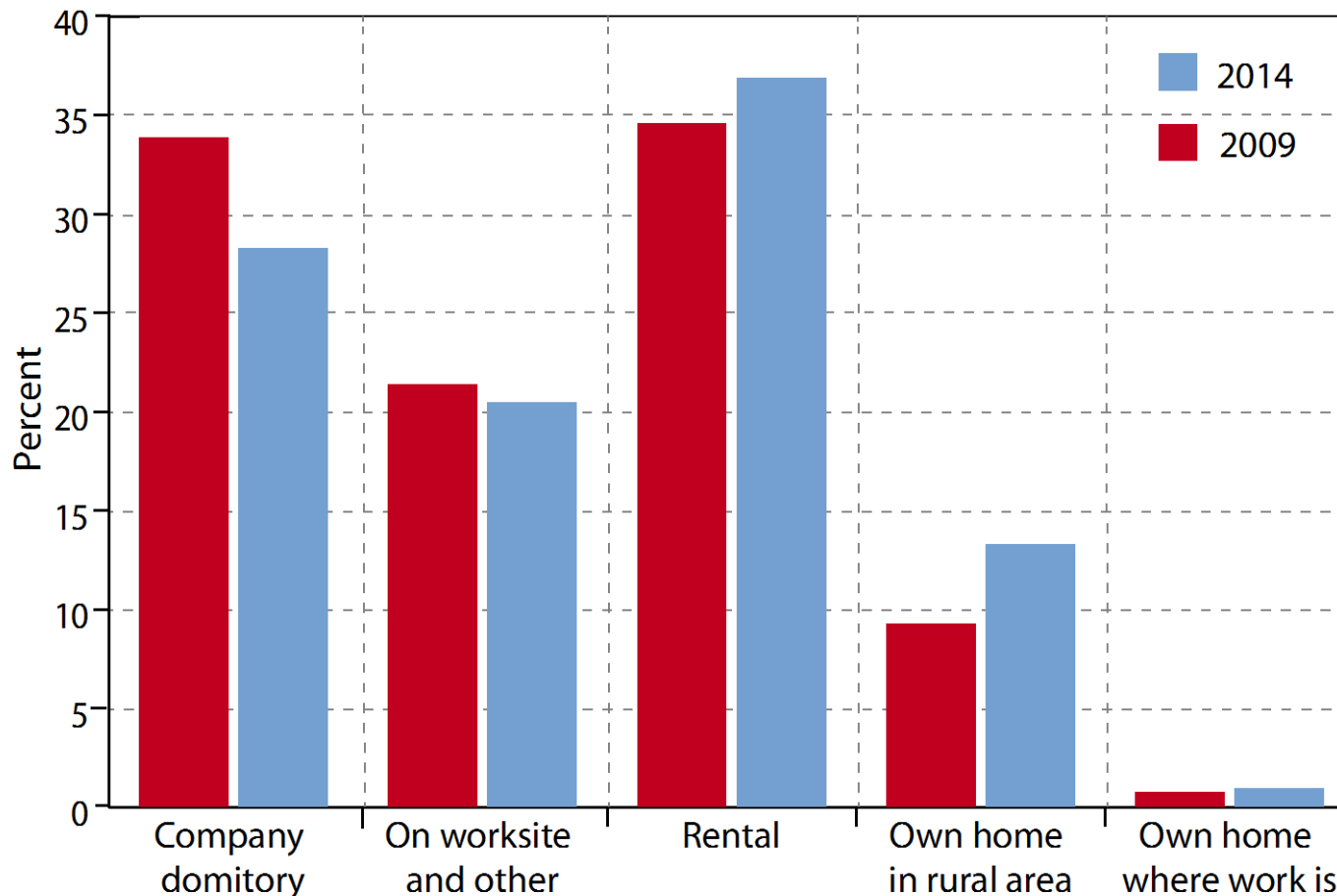
Our projection of a decline in total housing demand in the future is driven mainly by a sharp fall in so-called “upgrading” demand. This is the incremental demand for larger housing by current urban residents, and was the dominant source of housing demand during the decade-long boom.

Future demand will be driven more by population growth, urbanization and replacing old housing. Rather than asset-rich current homeowners, future demand will be driven more by first-time buyers. Future demand will thus be coming from lower-income and more price-sensitive groups, which will drive a shift in housing policy.

Migrant workers

Rural migrant workers are not big buyers of urban housing--yet

Housing arrangement for rural migrants in urban areas, share of total



NBS, Gavekal Dragonomics

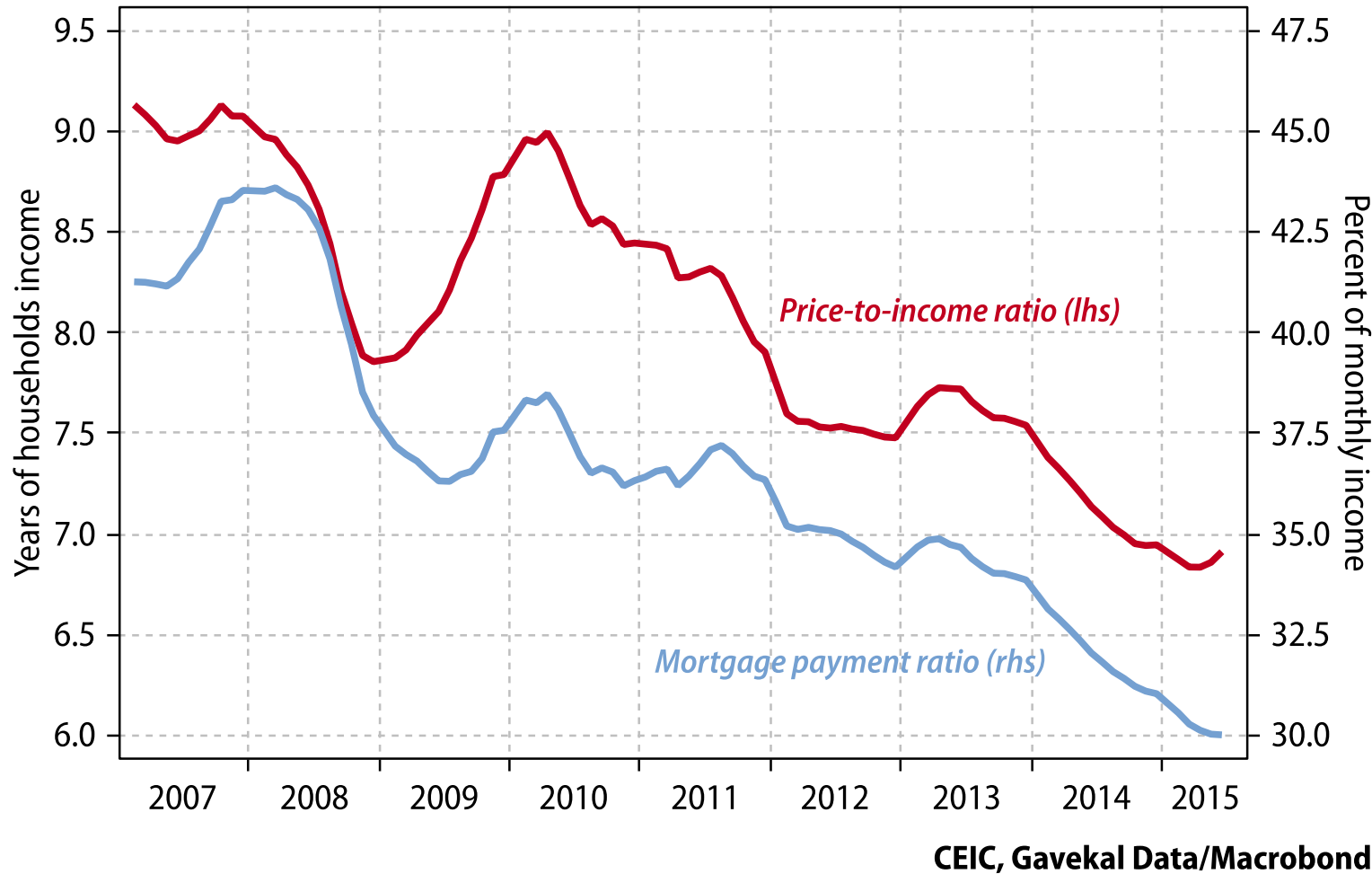
Rural migrants have never been significant buyers of urban market housing, but they will become increasingly important to the market in the future given the changing composition of demand.

These potential home buyers have lower incomes than the households who drove the market in the past decade, who had some financial assets already and generally higher incomes. This means that future housing demand in China will likely be more debt-financed than in the past, and so the role of government support for housing finance will increase.

Affordability

Housing in urban China has been getting more affordable since 2010

Affordability measures for a 100 sq m unit at the average price

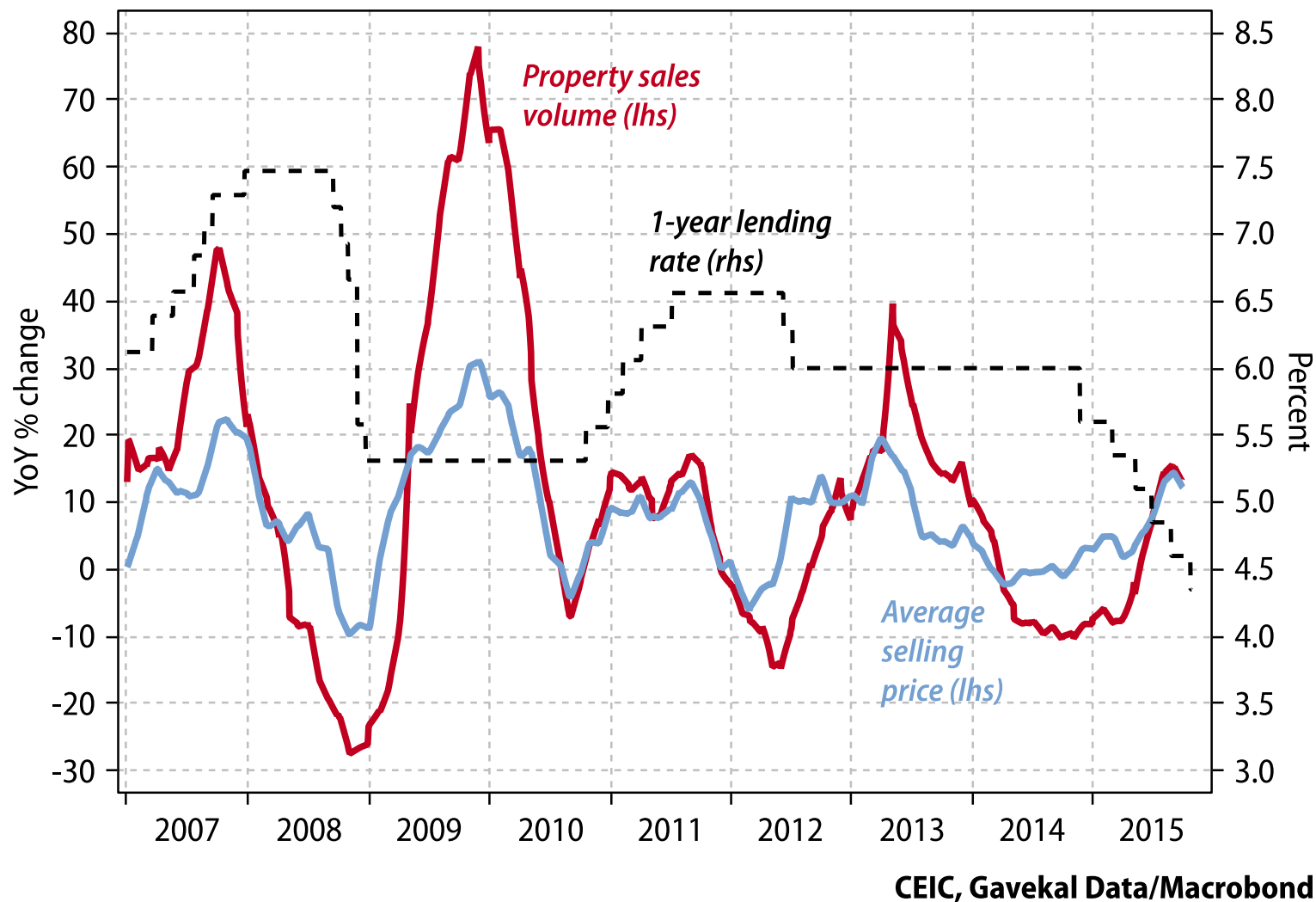


Price trends are supportive of the shift in housing demand: housing affordability, on a national aggregate basis, has been steadily improving since 2014. Housing prices have risen but by less than incomes.

The rebound in sales and prices did little damage to affordability this year, quite different from previous up-cycles. Mortgage servicing costs kept falling thanks to multiple rate cuts, and the price-income ratio stayed below 7. The government does not want housing prices to collapse, but so far has been generally successful at keeping increases contained relative to incomes.

Policy loosening

Record low interest rates are supporting housing sales and prices



China's central bank has cut interest rates six times in the past 12 months, the most sustaining easing of monetary policy in two decades.

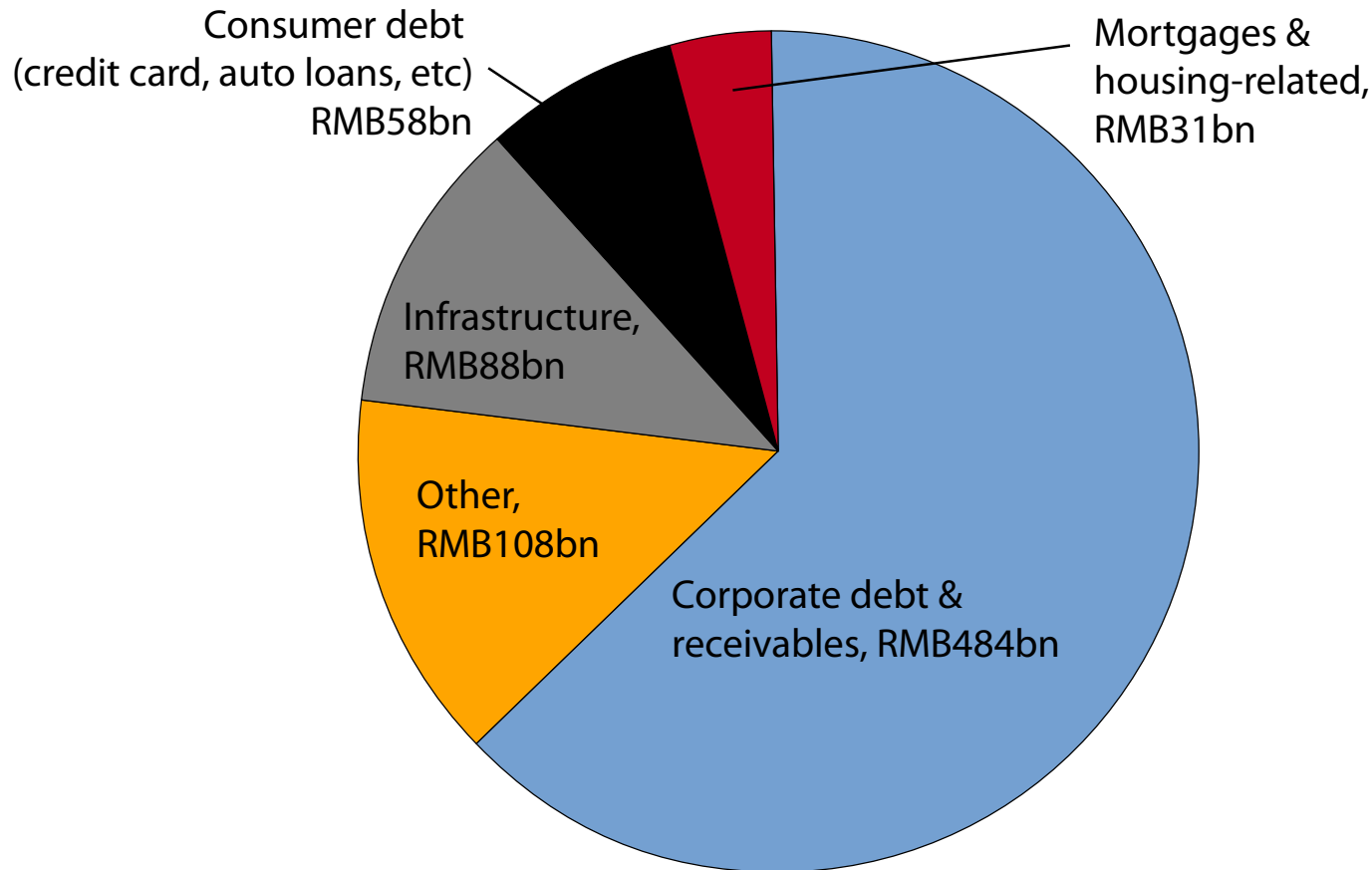
Banks reduced mortgage rates in line with the cuts in benchmark interest rates, and mortgage lending has grown faster than other bank loans. Housing sales duly rebounded. However, mortgage rates never fell as far as they did in 2009, when banks were willing to price them at a substantial discount to the benchmark.

The response of housing sales to loosening has been less than in previous cycles, and further easing policies will likely be required to sustain sales growth.

Mortgage securitization

Mortgage securitization has not yet taken off

Outstanding asset-backed securities, by type, Oct 2015



Wind Information, Gavekal Dragonomics

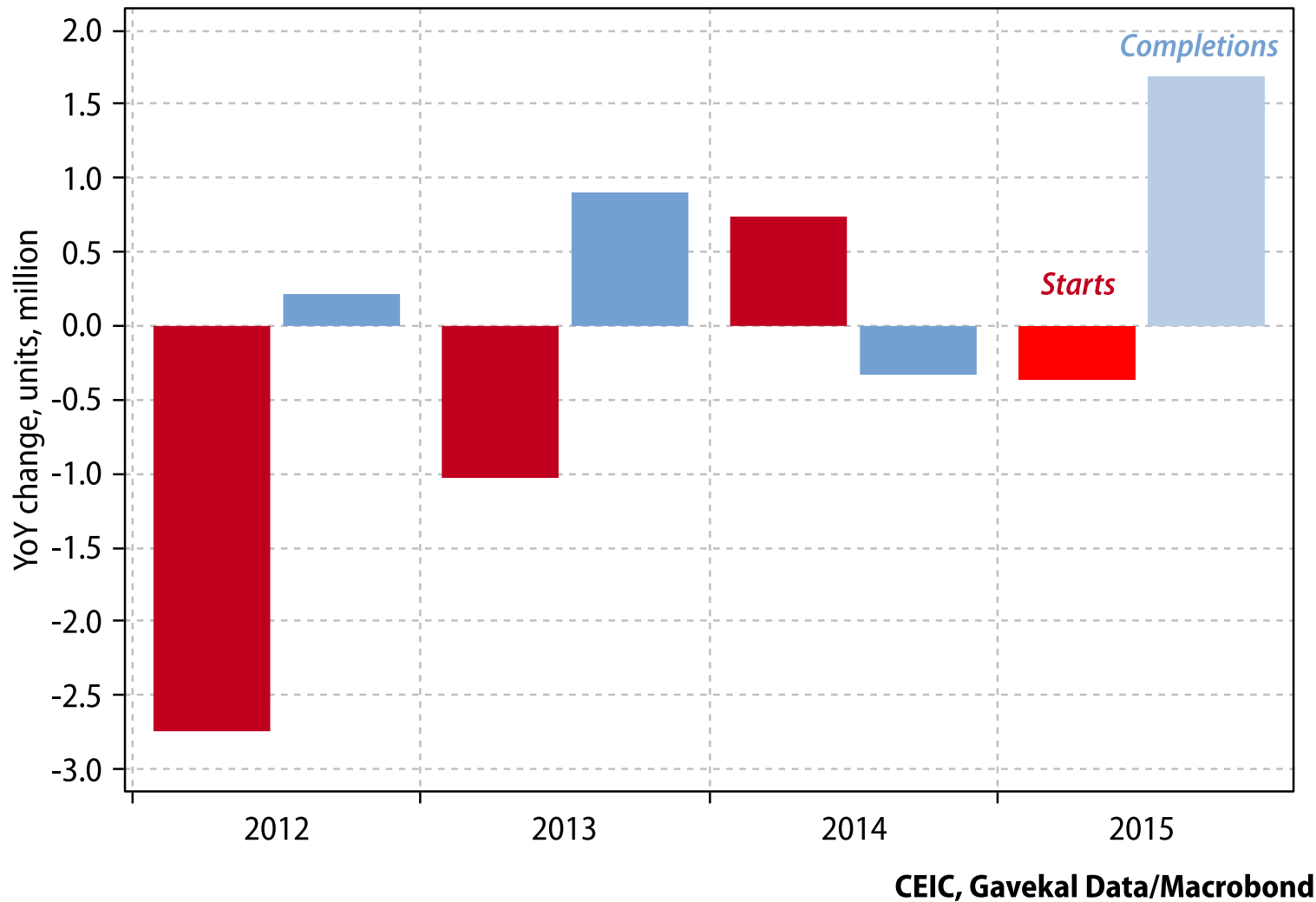
Securitization is one option to allow banks to increase their capacity to extend mortgage loans.

The market for asset-backed securities surged in 2014-15, but mortgages still account for a tiny share of this activity. In July, the central bank approved four commercial banks to issue as much as RMB220bn in MBS, but even this number is not large relative to the RMB11.5trn size of the total mortgage market.

In addition, China's housing provident fund, a compulsory savings program, could be restructured to make it more effective and provide more low-cost credit to new homebuyers.

Supply-side policies

Social housing starts are down in 2015 amid large new supply



The government's policy for the supply side is less clear cut. The social housing program was used to support construction after 2010, and again in 2014, but not in 2015.

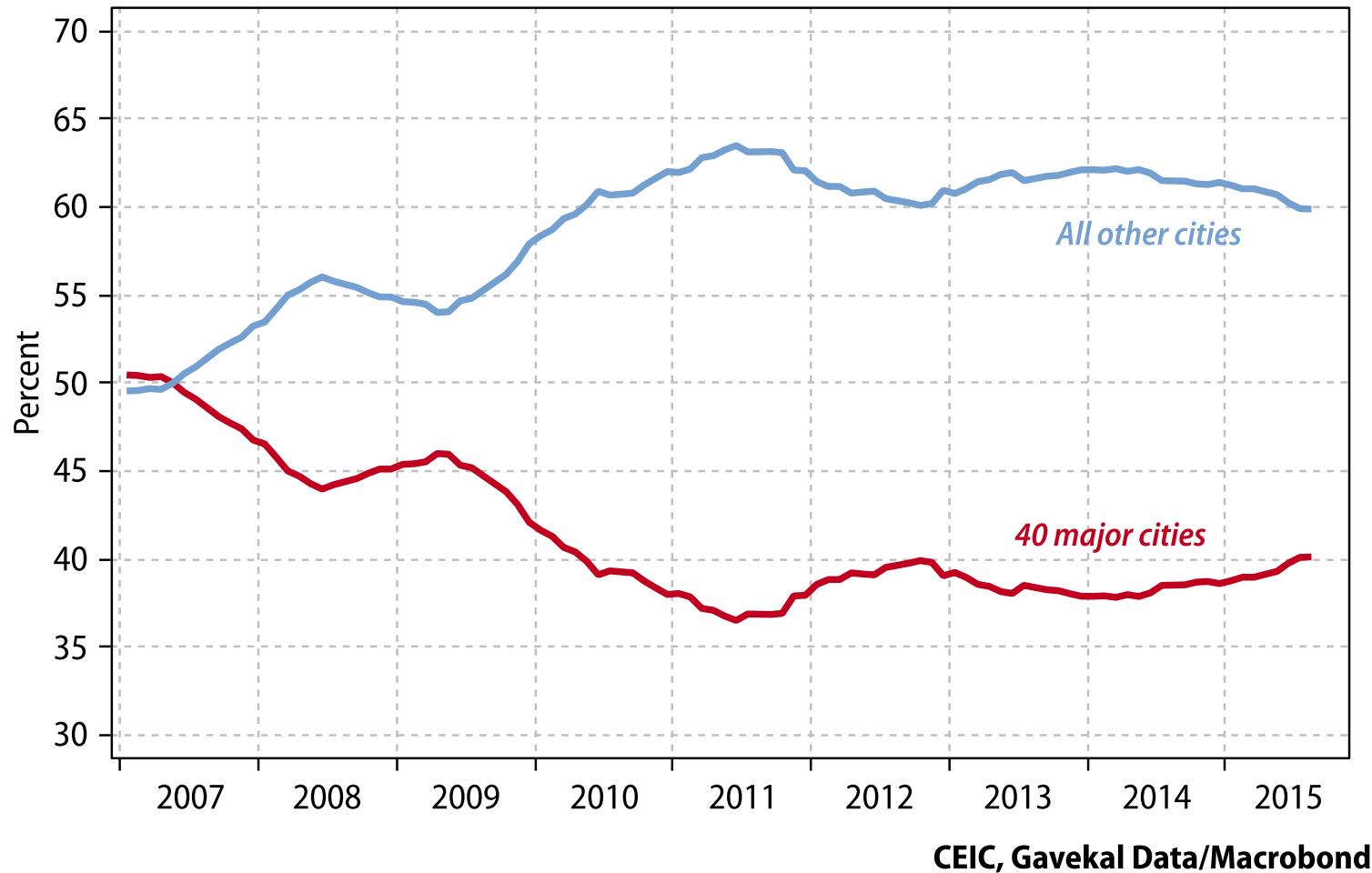
Social housing starts and investment declined 12% and 9% in Jan-Jul, a sharp turnaround from 37% and 18% growth in the same period of 2014. But social housing spending started to grow again in August.

The weakness in social housing, and an emphasis on slum redevelopment rather than brand-new projects, is helping destocking and market balance. But it's unclear if this hands-off policy will continue in 2016.

Big versus small

China's smaller cities account for a majority of the market

Share of total property sales



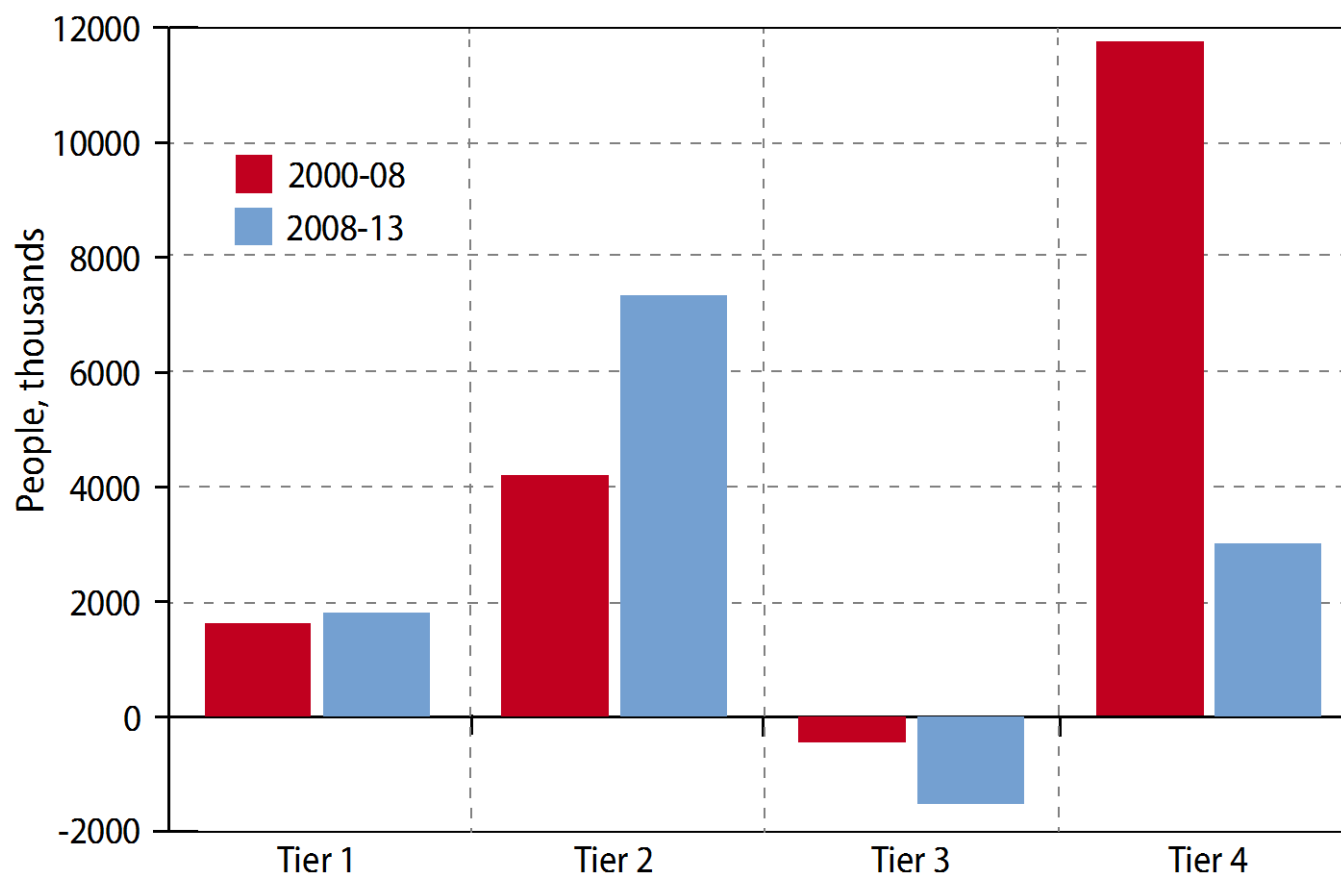
The sharp increase in smaller cities' share of the housing market since 2007 reflects a surge in residential construction outside the big Tier 1 and Tier 2 cities. Large cities were tightly regulated and developers saw an opportunity in smaller markets. But fundamentals worsened rapidly in smaller cities, as rapid urban sprawl outpaced the growth of the employment and public services that attract residents.

The majority of nationwide housing inventories are in smaller cities, where demand is not as strong. Maintaining supportive nationwide policies is the only way to accelerate the destocking.

A supply-demand mismatch in smaller cities

Population flows have swung in favor of China's bigger cities

Average annual change in population, by city tier



NBS, Gavekal Dragonomics

Easier financing and other demand-supporting policies will not necessarily cause the inventory overhang in smaller cities to disappear. The divergence of population growth among cities continues, so market fundamentals are still stronger in large cities. Easier policy could even exacerbate the polarization of China's housing markets into strong and weak ones.

The fundamental reason for the inventory overhang in smaller cities is that smaller cities have less vibrant job markets than larger cities. Various government policies encourage migration to smaller cities instead of large ones, but these have a mixed track record.

Part 3: Cyclical outlook

- Property sales rebounded strongly in 2015 in response to multiple rates cuts and easing of mortgage policies, and full-year growth should be close to 10%. But the traditional two-year cyclical pattern, and the diminishing marginal impact of further easing, means that housing sales growth will almost certainly weaken next year. We expect sales volume to fall 3% in 2016, which assumes continued policy support.
- The disconnect between demand-side and supply-side indicators that began in 2014 became even more apparent in 2015. In the first three quarters of the year, construction starts fell 13% YoY, land sales declined 34%, and crude steel use fell 5%. With inventories still high, strong sales do not create as much of an incentive to expand construction.
- The officially reported inventory figure, the floor area of completed buildings, has more than quadrupled from 2009 and only recently stopped rising. Our estimate of inventories implied by nationwide data shows a much higher level but a similar trend. Various city-level data also show high inventories outside the biggest cities. We think it will take at least another year for inventories to return to a historically normal level.
- This means overall construction and investment activity will still be poor in 2016, as sales will be cyclically weaker and the destocking process not yet complete. We expect construction starts to fall about 20% in 2016. A cyclical recovery in construction will arrive eventually, but we expect this in 2017 at the earliest.

Key forecasts

The supply-side correction will continue in 2016

Annual change in major property indicators

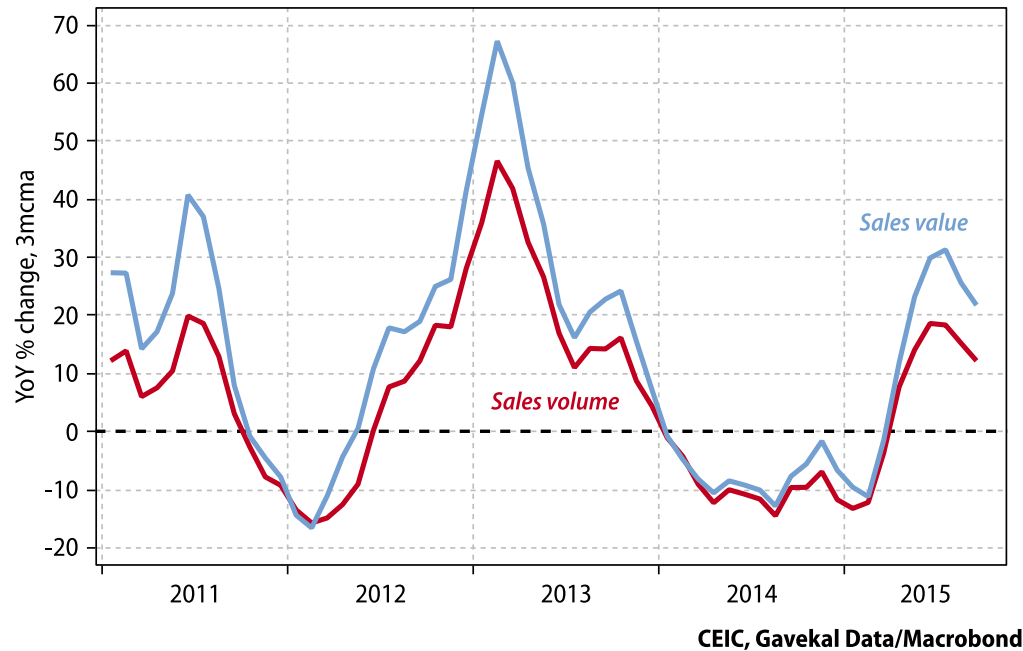
	2014	2015e	2016f
Property sales (floor area)	-9%	10%	-3%
Construction starts (floor area)	-11%	-15%	-20%
Completions (floor area)	6%	-10%	-10%
Fixed-asset investment in real estate (nominal)	11%	2%	0%

CEIC, Gavekal Dragonomics

Sales

Housing sales rebounded strongly after policy easing

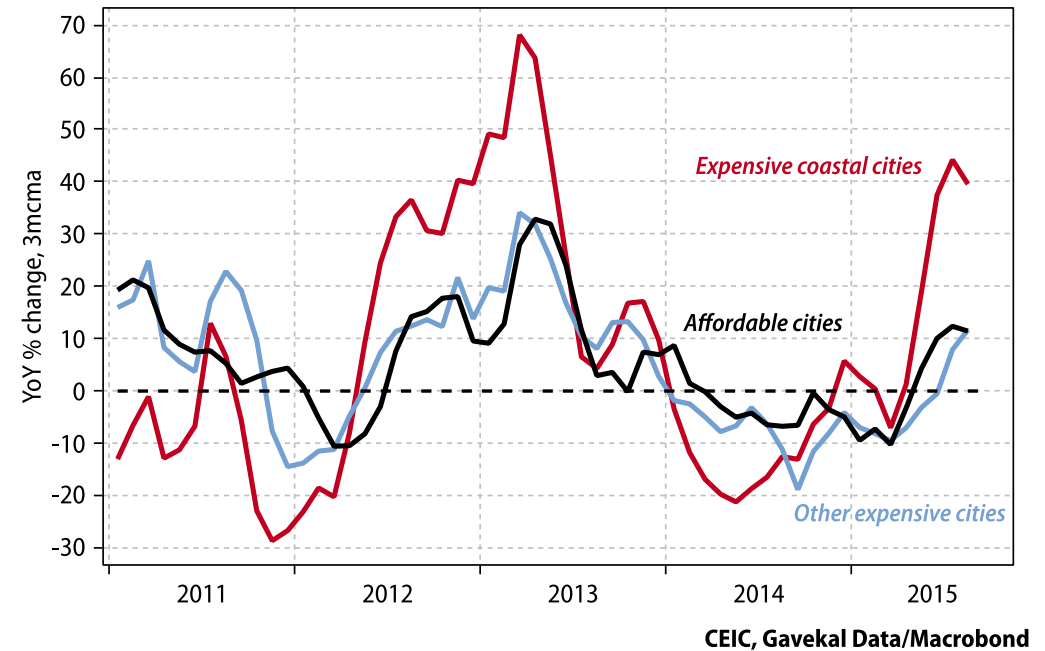
Residential property sales, value and volume



Sales started bottoming out in Q4 of 2014 and rebounded strongly from the spring of 2015, following rate cuts and relaxation of mortgage credit. Sales volume growth was 9% YoY in Jan-Sep and is likely to reach 10% by the end of the year. The level of housing sales, however, will be roughly the same as in 2013, meaning no growth over the past two years. This is in line with our view that China is most likely already at its peak level of housing demand.

The cities that led China's correction also lead the recovery

Housing sales volume in 40 major cities, by groups of cities



The geographical pattern of sales is similar to 2012 when coastal cities with high prices led the cycle. The strength of the rebound however is weaker in this cycle compared to the last one: this is a cyclical upturn within a longer-term declining trend. Even assuming favorable demand-side policies continue, sales growth will be weaker in the future. We expect a 3% decline in full-year housing sales in 2016, with H2 likely to be particularly weak.

Prices

Housing prices rebounded strongly only in major cities

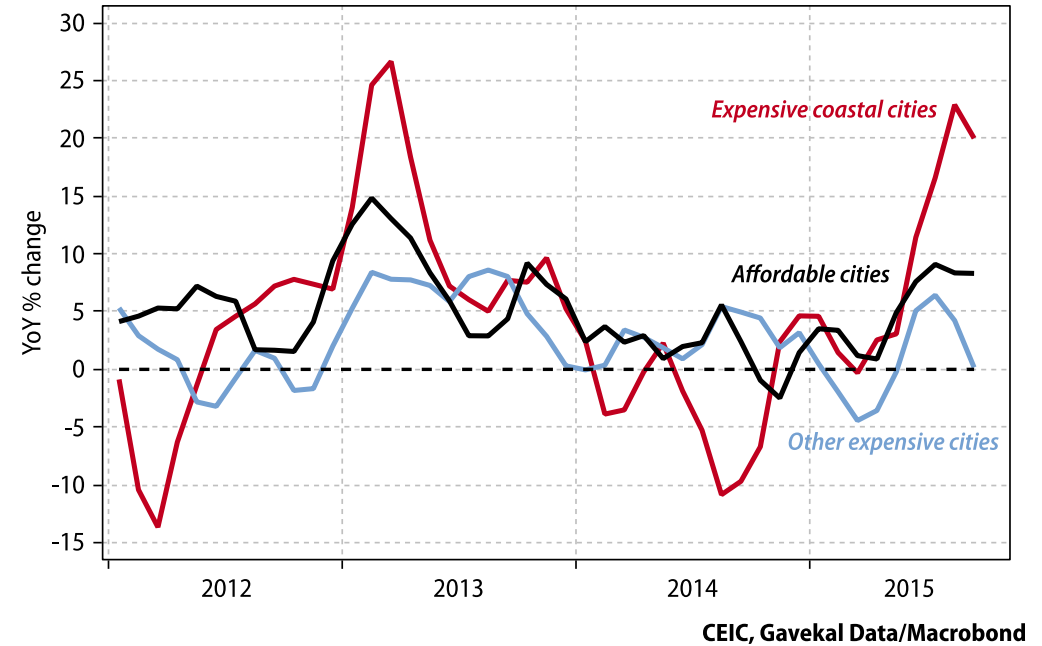
Average annualized MoM change in 70 cities' price index for new housing, by city tier



Despite strong sales, prices did not rise substantially in all cities. The simple average of housing prices across the 70 major cities tracked by NBS has still not exceeded last year's level. Prices are rising sequentially by an average of 2-3% annualized, but most of this gain came from the four biggest cities (Tier 1). We expect prices will rise modestly for the rest of 2015, but will stop increasing in 2016.

The price recovery in less expensive cities was modest

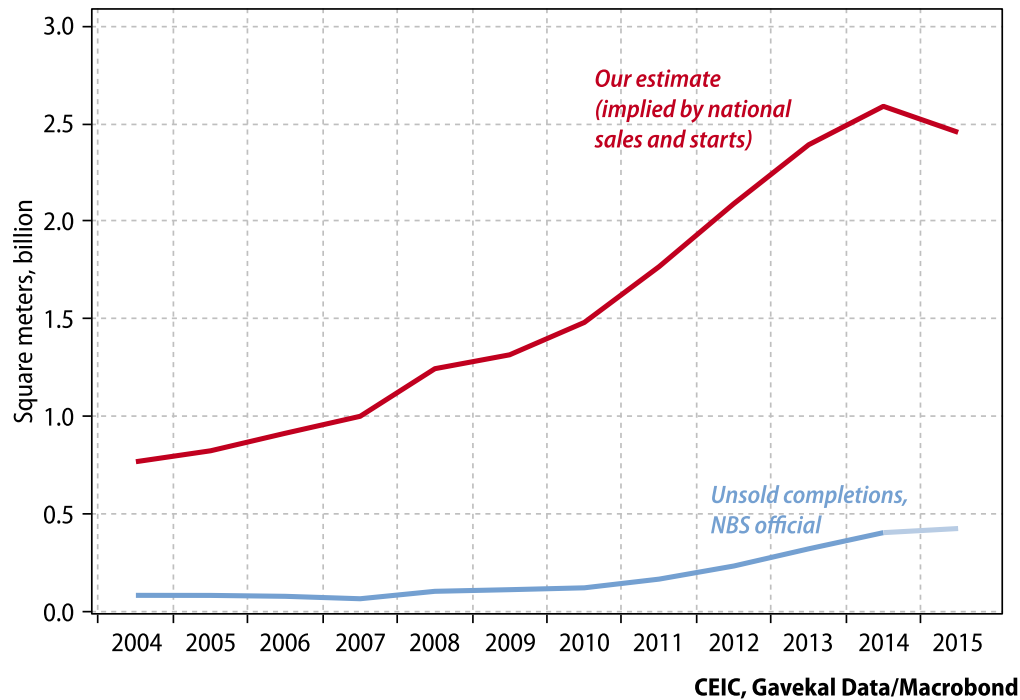
Average selling price in 40 major cities, by city group



Other price measurements show a similar differential pattern in price behavior across cities. Prices in the most expensive cities are still rising rapidly, albeit no longer accelerating, while other cities seem to be losing momentum. Given that housing prices tend to follow the trend of housing sales, our expectation of weaker sales in 2016 will check price growth. Prices in overheated markets could decline again.

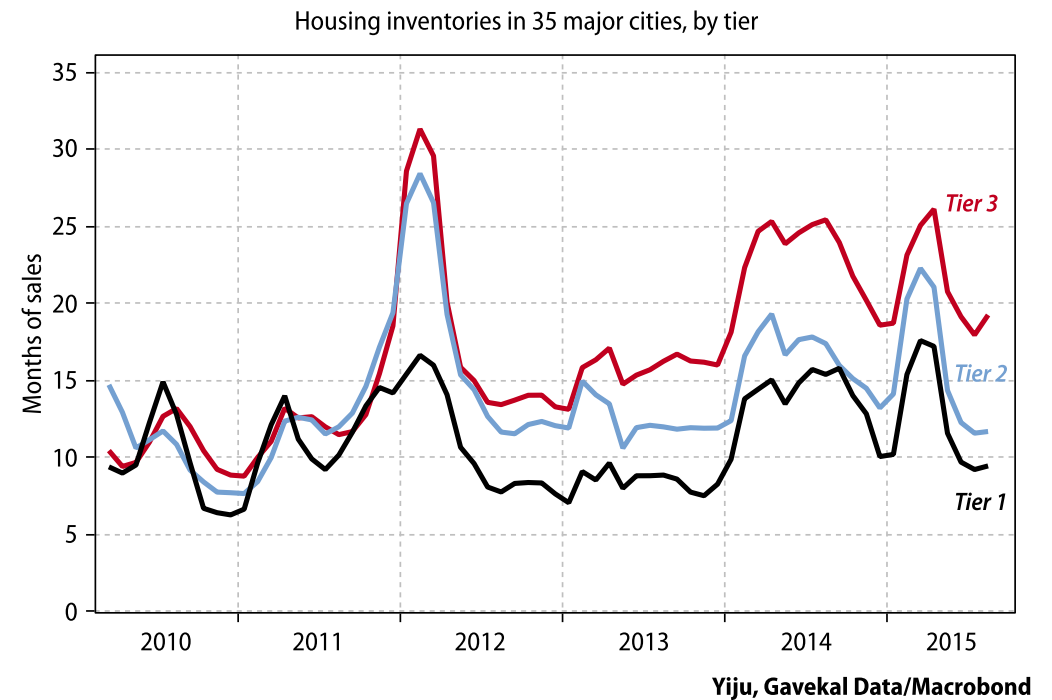
Inventories

China's housing inventories are still elevated



The fact that price gains are sluggish even with strong sales momentum is another reflection of the serious inventory overhang. The official inventory measure, floor area of completed buildings held by developers for sale, rose sharply after 2010 and only stopped growing very recently. Our own estimate shows a similar trend, but the level is much larger as it includes uncompleted supply still in the pipeline.

Inventories in smaller cities are still a long way from normal

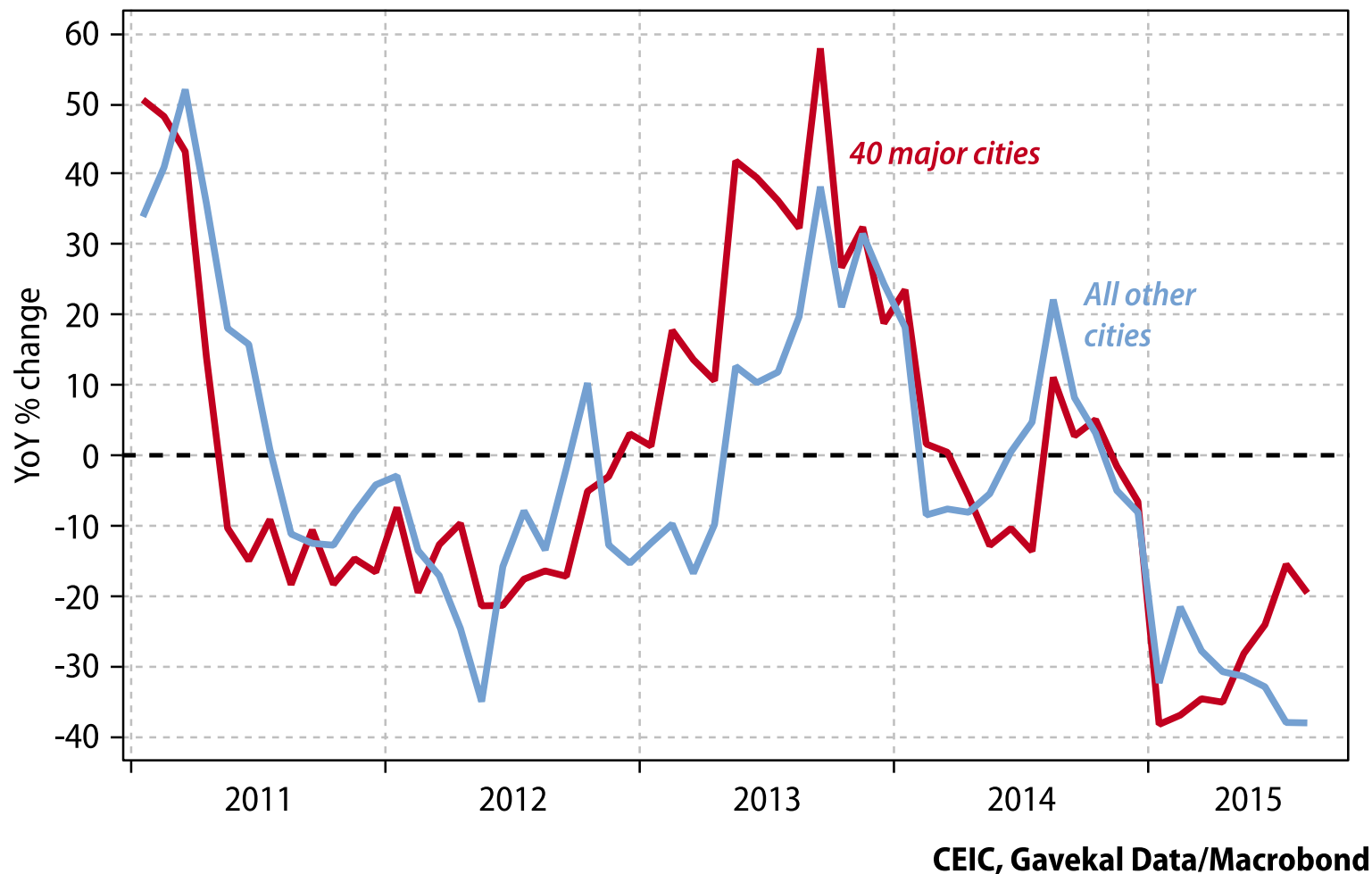


City-level inventory data of units ready for sale shows that inventory is a bigger problem for smaller cities. Inventory level in Tier 1 and Tier 2 cities has already normalized in months-of-sales terms, but Tier 3 cities are still elevated. Data for Tier 4 cities is scarce but the situation is clearly even worse there. High inventories constrain the extent to which sales growth translates into new investment and construction.

Land sales

Land sales are hopeless in smaller markets

Land area sold, 5m²



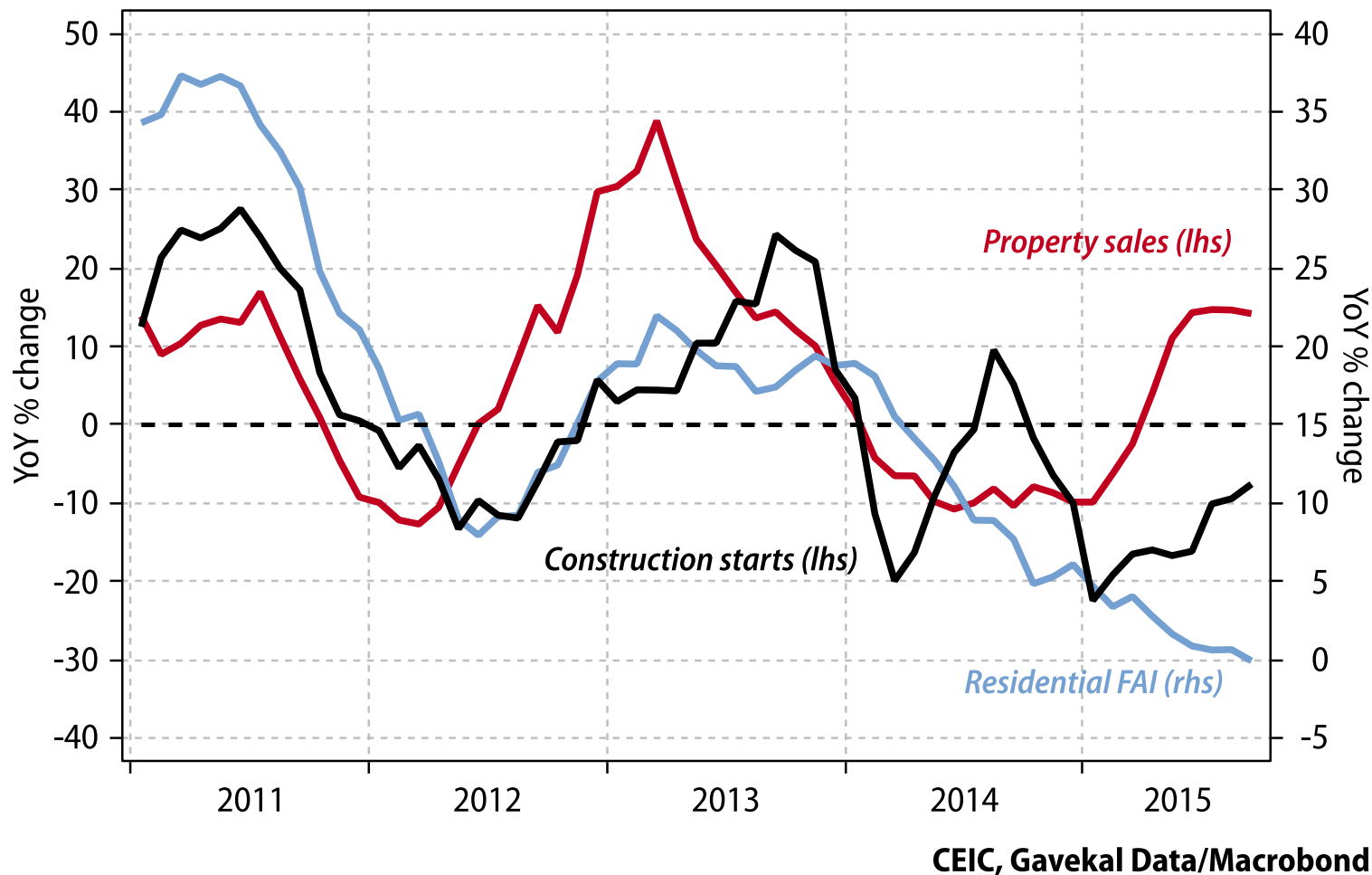
Total land sales volume fell -34% YoY in Jan-Sep 2015, extending the 14% full-year decline in 2014. Despite some news reports of high-priced land deals in some locations, developers generally have little appetite for new investment while they are busy running down inventories.

Weak land sales may have a big impact on local government revenue this year. The national budget in March was based on a 5% annual decline in land sales revenue from RMB4.1trn in 2014. But in revenue terms land sales are already down 38% so far in 2015.

Construction and investment

Rebound in starts is out of sync with weak sales and investment

Property indicators, 5mcm



The decoupling between strong sales and weak construction starts and real-estate investment is the most important phenomenon in 2015.

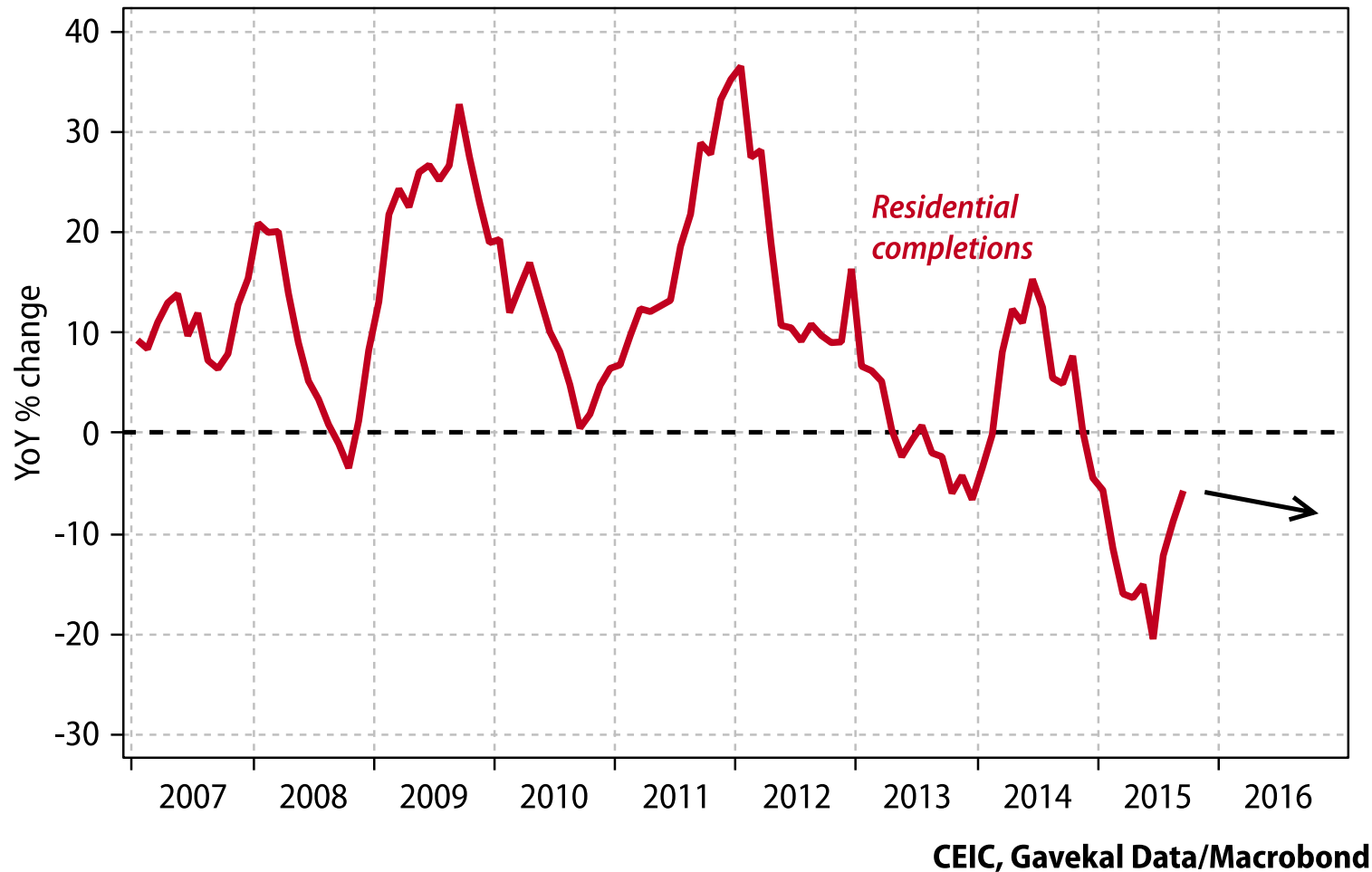
The inventory overhang explains this disconnect well enough, and our estimates suggest it will take another one or two years of decent sales to get inventories back down to historically normal levels.

But since sales growth is likely to be weaker in 2016 than in 2015, this will be an additional drag on construction. We expect another step down in starts, and forecast the decline to deepen to 20% in 2016 from about 15% in 2015.

Completions

Housing completions are declining, and should fall again in 2016

Area of floor space completed, 5mcma



The decline in starts will lead naturally to a decline in completions of new housing, thereby contributing to the destocking of inventories.

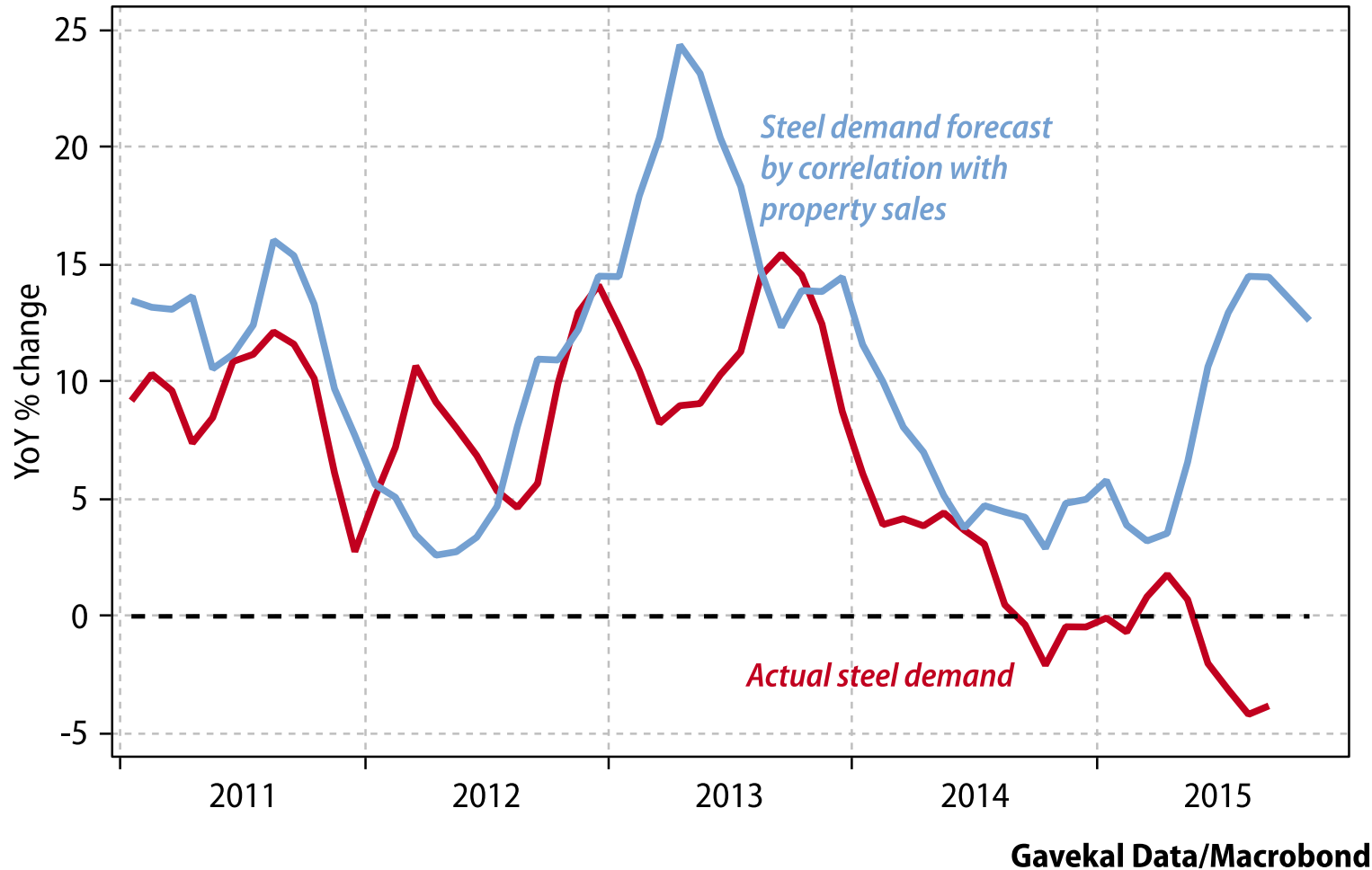
Completions generally follow starts with a lag, though the length of this lag has varied over time. Historically a 22-month lag worked well but in recent years it has not, possibly because high levels of inventories give developers much more discretion about when they release completed properties.

Completions have declined for most of 2015, reflecting the decline in starts in early 2014. The continued decline in starts since then means completions should decline again in 2016.

Steel demand

China's steel demand did not rebound when sales improved

Apparent steel demand, actual and model



The decoupling between construction and sales is also reflected clearly by declining steel use—a pattern that breaks a longstanding correlation between sales activity and steel demand.

CISA reported apparent crude steel use declined 3.4% YoY in 2014, though other sources reported a modest increase of 1%.

A full-year decline in steel use for 2015, the first in two decades, now looks inevitable, with consumption down about 5% in the first three quarters of the year.

Contact and disclaimer

**This presentation was prepared by
China investment analyst Rosealea Yao**

ryao@gavekal.com

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Head Office
Suite 3101, Central Plaza
18, Harbour Road, Wanchai, Hong Kong
Tel: +852 2869 8363 | Fax: +852 2869 8131

Beijing Office
603 Soho Nexus Center
19A Dongsanhuan Beilu, Beijing 100020
Tel: +86 10 8454 9987 | Fax: +86 10 8454 9984

www.gavekal.com

For more information contact sales@gavekal.com