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The Odd Couples: Chinese Property Developers and Local Governments

China has a unique economic structure with features of both market and planned economies. The Chinese central government uses monetary policy, as well as administrative tools to steer the direction and the pace of economic development. These unique features are particularly ostentatious in the real estate market. In China, property development is closely linked to local government finance.

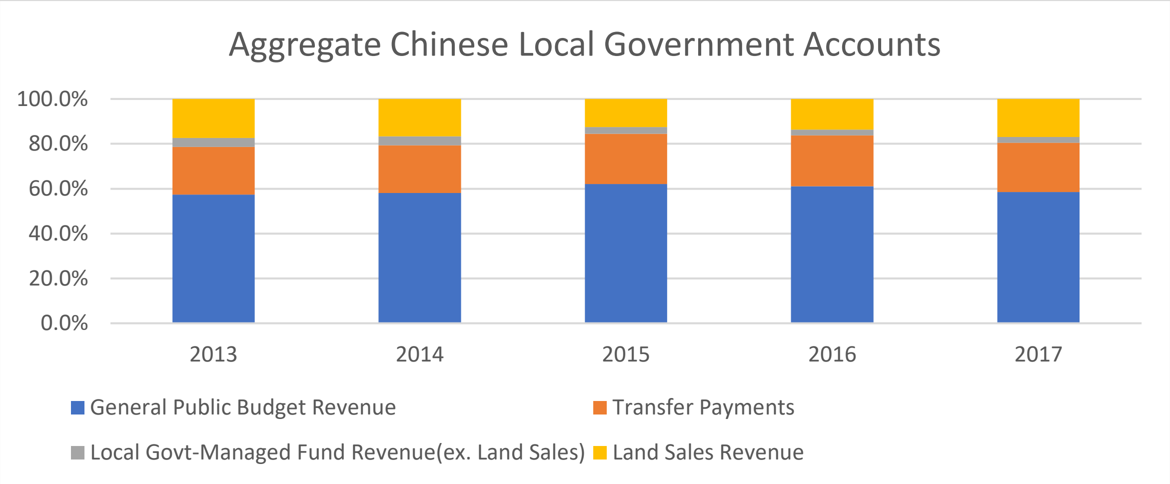
Tax Reform of 1994

The Tax Reform of 1994 empowers the Chinese central government to syphon local tax revenues from local governments while saddles them with fiscal burdens. Under the Tax Reform of 1994, Chinese local governments have to share their local taxes and fees with the central government. The central government also acts as an equaliser and redistributes portions of the syphoned taxes and fees to impovished provinces from wealthy ones in the form of transfer payments. While the central government fills its coffer with syphoned tax revenue, this leaves many Chinese local governments with a limited fiscal capacity to build and service their local infrastructures.

Local Government Revenue Source

Chinese local governments have 3 sources of income: (1) collection of local taxes and fees [1](which accounts for approximately 60%), (2) transfer payments from the central government (which accounts for approximately 20%) and (3) local government-managed funds (which accounts for approximately 20%). Within the local government-managed funds, revenue from land sales accounts for approximately 80%, on an aggregated basis. (For clarification, the aggregate transfer payments referenced are gross figures rather than net figures.)

EXHIBIT 1: Aggregate Chinese Local Government Account Composition



Source: National Bureau of Statistics of China

Unrestricted Revenue from Land Sales

Local general public budget revenue is primarily funded by local taxes and fees, which is budgeted for expenditures already, and thus it lacks fiscal flexibility. Many transfer payments from the central government are often earmarked for designated projects, which also lacks fiscal flexibility. Many Chinese local governments turn to land sales for fiscal relief and flexibility.

Property Development Propels GDP Growth

On average, total investments in real estate accounted for approximately 12.6% of China's GDP in the past decade, according to available data from the National Bureau of Statistics of China ("NBSC"). It reached a recent high of 14.76% in 2014 but declined to 13.62% in 3rd quarter of 2018 (EXHIBIT 2). These figures had not included durable goods and other services relating to property development. We reckon investment in real estate and its related sectors are still one of the growth engines for China. In aggregate, they propel China's GDP growth.

[1] Local taxes include land appreciation tax

EXHIBIT 2: China's GDP and Total Investment in Real Estate of the Past Decade

Source: National Bureau of Statistics of China

A Win-Win Situation for Both Chinese Property Developers and Local Governments

Chinese local governments not only receive windfalls from land sales, property development also propels local economies to meet their GDP growth targets. Some Chinese property developers expand their footprints, revenues, and asset sizes to reach the Fortune Global 500[2] list joining the rank of Alibaba and Tencent. This creates a win-win situation for both Chinese property developers and local governments.

Our analysis indicates that there is a high correlation (i.e. over 90%) between our calculated 2017 home price (per square meter in RMB) and GDP per capita (in RMB) among the 35 selected Chinese cities[3]. The table below (EXHIBIT 3) illustrates the relationship between the 2017 home price and the GDP per capita among the 35 selected cities in China.

EXHIBIT 3: Chinese Home Price and GDP per capita on Selected Cities

Selected Cities	Calculated 2017 home price per sqm (RMB)	Estimated 2017 GDP per capita (RMB)
Shenzhen 深圳	47,187	508,447
Beijing 北京	29,330	198,813
Shanghai 上海	28,522	206,586
Xiamen 厦门	27,096	177,864
Guangzhou 广州	18,165	236,919
Hangzhou 杭州	17,994	162,682
Nanjing 南京	17,077	168,063
Tianjin 天津	12,910	181,444
Fuzhou 福州	12,822	95,507
Ningbo 宁波	12,719	156,336
Wuhan 武汉	10,490	152,603
Hefei 合肥	10,219	87,117
Dalian 大连	9,764	120,393
Qingdao 青岛	9,717	134,592
Haikou 海口	9,390	79,705
Jinan 济南	8,993	109,856

[2] According to the Fortune Global 500 List published on 19 July 2018 by Fortune Magazine.
[3] We calculated the 2017 home price on the selected 35 cities based on NBSC's home price index and use the 2015 home prices as the base year. NBSC publishes GDPs on 36 Chinese cities only.

Zhengzhou 郑州	8,918	101,116
Shijiazhuang 石家庄	8,633	60,484
Nanchang 南昌	8,287	88,438
Chengdu 成都	7,929	90,598
Taiyuan 太原	7,921	84,944
Kunming 昆明	7,761	81,405
Nanning 南宁	7,345	52,108
Shenyang 沈阳	7,317	79,176
Xi'an 西安	7,208	80,398
Harbin 哈尔滨	6,850	67,993
Changchun 长春	6,798	83,872
Changsha 长沙	6,736	143,811
Lanzhou 兰州	6,527	74,352
Urumqi 乌鲁木齐	6,320	95,548
Guiyang 贵阳	5,721	83,088
Chongqing 重庆	5,698	55,615
Hohhot 呼和浩特	5,380	139,427
Xining 西宁	5,051	64,931
Yinchuan 银川	4,680	91,651

Source: National Bureau of Statistics of China and Lianhe Global

This interdependence between Chinese property developers and local governments create rapport and among other contributing factors such as a rapid rate of urbanization which fuel the runaway home price, in our view.

Recent Chinese Government Efforts to Control the Runaway Home Price

The Chinese central government has taken notice and has placed an array of purchase moratorium on 48 cities[4] so far, which covers 36 cities of the 70 major cities, since May 2010. The central government has instituted additional restrictions on the financing channels of Chinese property developers to control the runaway home prices. On 27 June 2018, the National Development and Reform Commission ("NDRC") announced that proceeds from offshore bond issuances by Chinese property developers should only be applied to repay their existing debt, instead of repatriating to onshore for capital expenditures. On 18 July 2018, it was reported that Chinese regulators further banned the issuance of Panda bonds by all offshore Chinese property developers (including their offshore subsidiaries).

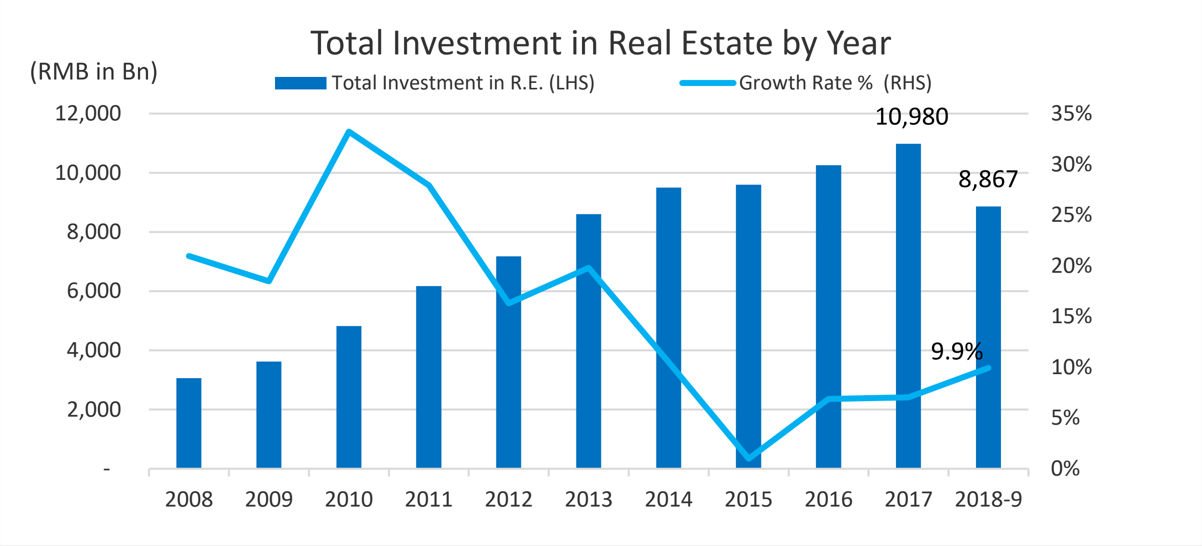
Despite these seemingly draconian measures, they largely aim at the financing channels of Chinese property developers, in our view. According to available data from NBSC, total investment in real estate had not contracted and stood at RMB 8,867 billion, which represented a year-on-year increase of 9.9% as of September 2018 (EXHIBIT 4). In terms of land sales, it also recorded an increase and stood at 194 million square meters, which represented a year-on-year increase of 15.7% as of September 2018 (EXHIBIT 5). Nevertheless, this land sales figure represented a marked decline from its peak. The land sales figure peaked at 410 million square meters in 2010 and 2011, and started to decline precipitously to a recent trough of 228 and 220 million square meters in 2015 and 2016, respectively (EXHIBIT 5). As land supply has nearly halved from its peak, land price increases. As land prices increase across China, many smaller Chinese property developers face hurdles and force medium-to-large ones to form joint ventures to share the burden and risk of high land prices. In China, property developers are required to fund at least 30% of land purchases with their free cash. Some small-scale property developers caught with a few slow-selling projects would likely find themselves in a vicious circle. These small property developers saddle with large unsold inventories at less desirable locations lack free cash to acquire premium land banks. As land price increases, they are being priced out of the premium land bank market. Some of them may choose to acquire cheaper land at less desirable locations which in turn feeds the vicious circle. We expect this situation to continue, which may lead to consolidation within the Chinese property developer industry. Additionally, we believe the Chinese central government is likely to open the financing spigot again for the property developer industry if the underlying economic growth slows.

The increase of investment in real estate has further been validated by a year-on-year increase in both GFA under construction and GFA new starts at 3.9% and 16.4%, respectively, as of September 2018. However, we do notice a decline in terms of GFA completion rate at -11.4% year-on-year. These draconian measures only aim to curb the

[4] According to publication from Fang.com as of May 2018

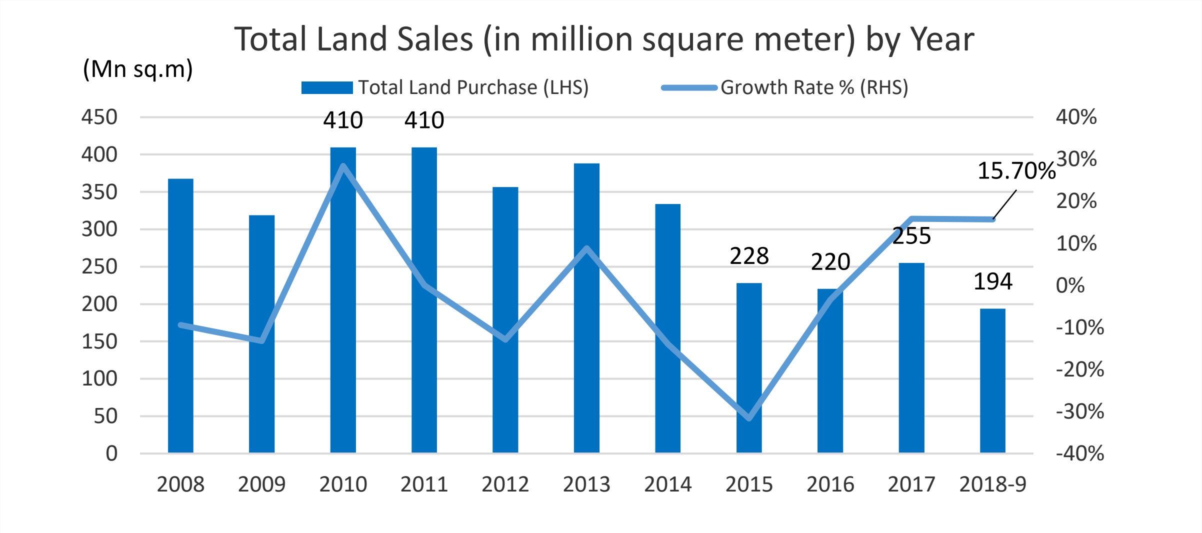
runaway home price but not the real estate market as a whole, in our view. These figures lead us to believe that the supply side of the equation remains intact.

EXHIBIT 4: China's Total Investment in Real Estate of the Past Decade



Source: National Bureau of Statistics of China

EXHIBIT 5: China's Total Land Sales of the Past Decade



Source: National Bureau of Statistics of China and Lianhe Global

When the financing channel tightens, it is likely to increase the cost of funds for some property developers as they compete for available fundings. We expect debt growth rate would likely to slow and reverse a decade-long trend of debt growth outstripping revenue growth rate for the first time in 2018. The sixty-four-thousand-dollar question is whether their revenues would follow the same path. We think not, at least not in the near-term. We believe highly ranked Chinese property developers either by GFA or asset size are likely to report solid revenue growth in 2018 as they have had already pre-sold a majority of their projects under construction in 2016 and 2017. They are likely to recognize these contracted sales as revenues for 2018 upon completions and deliveries.

Real Estate Market Remains Stable in the Near-Term

Meanwhile, on the demand side, we notice a moderate pickup in September 2018. The overall residential unit sales in terms of GFA recorded a 3.3% increase year-on-year according to available data from NBSC. These figures lead us to believe that the demand side of the equation remains intact. While the completed unit sales, a component of the overall sales, recorded a marked decline of 24.1% year-on-year. In fact, the completed unit sales had recorded a marked decline in the range of 22% to 24% since the beginning of 2018. In other words, unsold inventories have been decreasing at a slower pace. But the presales units, the other component of the overall sales, reported an increase of 11.0% year-on-year. Interestingly, the same had not occurred in the presales unit component over the same period.

Home Price Remains Firm in the Near-Term

In the meantime, land price remains elevated in China, based on the latest data from NBSC. Land supply remains stable while investment in real estate sector stays strong. Meanwhile, Chinese local governments continue to rely on land sales revenue for fiscal relief and flexibility (EXHIBIT 1). While Chinese property developers are being squeezed between escalating funding costs, arrays of purchase moratorium and an increasingly restrictive financing environment, the Chinese home price remains stubbornly high based on the September 2018 home price index published by NBSC. It was reported that only 2 (i.e. Shanghai and Nanjing) out of the 70 major cities recorded a year-on-year price decline on the newly constructed units or the primary residential market. While it was reported that only 4 (i.e. Beijing, Shanghai, Xiamen, and Fuzhou) of out the 70 major cities recorded a year-on-year price decline in the secondary residential market.

Externality Leads to the Restarting of Investment-Driven Growth Engine

The escalating trade war between the U.S. and China could possibly jeopardise the latter's targeted GDP growth rate. The Chinese central government has since announced initiatives to stabilise its economic growth by increasing investments in infrastructure projects which includes real estate development. We reckon Chinese property developers and local governments are likely to receive boosts from these stabilising efforts. We believe Chinese local governments will continue to rely on revenue from land sales for both fiscal relief and flexibility which in turn provides a buttress for the Chinese property market in the near-term.

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