COMMENTARY

May 16, 2014

Dear clients and colleagues,

We have spent the last few weeks in Jiangsu province. Bordering Shanghai and running on the North side of the Yangtze River, Jiangsu is the most important economic area of China after Shanghai, with an area of 100 000 sq. km, a population of 75 m people, and a GDP exceeding US $1T, or more than $ 13,000 per capita. Major towns are Nanjing, Changzhou, Suzhou, and Wuxi. Jiangsu is an important agricultural, high tech, pharmaceutical, and educational powerhouse. Its economy is very developed and not as reliant on low cost exports like the Guangdong province in the South. The pace of growth is unprecedented, still today. Nanjing, where we spent the most time, opened its first metro line 3 years ago. Today, 2 lines with around 40 stations are open. The third line will be open by the end of May with the 4th and 5th line opening before year end. Another 5 lines are planned before 2020.

The Chinese stock market has been a poor performer in the last few years. Talk of a real estate bubble and its consequences are often mentioned as the culprit. You may have heard about the millions of empty apartments and ghost towns in Inner Mongolia. Should we be worried? Throughout our time there, we saw many signs of weak fundamentals in the housing market.

- Regarding the empty apartments. More than 10 million homes sit empty in China, and the number could rise to 18 million within two to three years, according to CLSA. It is not uncommon for the Chinese affluent (not high net worth) to own 2 or 3 apartments. Most apartments in China are sold in rough status, i.e. need painting and decorating. Sometimes these 2nd or 3rd apartments are merely empty, unfinished shells. As a result, these apartments are not rented and in many cases, not even completed. When they are rented, it is not unusual to find rental rates as low as 2% of the purchase price.

- Cities rely heavily on land sales for revenues. Builders, with access to easy credit, are eager to erect new projects.

- Unlike North America or Europe, apartments are leasehold, i.e. the government keeps ownership of the land and leases it for 70 years. What happens after? It is surprising that few Chinese bother themselves with these very important details. Why worry when prices tripled in the last 10 years...

Are we in a bubble? Possibly. At least half of the advertising we saw was for real estate projects. Most discussions center on how much money is made on real estate. We often hear about prices in Shanghai or Beijing, but even in a city like Nanjing, prices are at least $500 per sq. ft. and more.

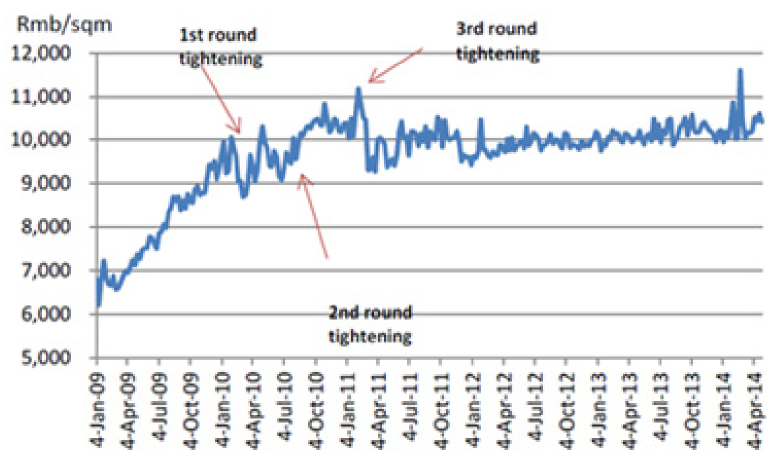
Despite these signs, most analysis indicates that there will be at least another 10 years of strong growth driven by urbanization, strong housing demand, supply insufficiency, and strong economic development. Analysts also point to relatively high down payments, low loan to value ratios, etc. The ideal scenario would be a slowdown in price increases accompanied by a rise in income, which would improve affordability.

If there is a bubble, the bubble is deflating as we write this commentary. Here is some of the latest data.

- Price increases are moderating this year, up 9.1% in April y-o-y, slowing for a fourth month, according to SouFun.
- Many developers cut prices by 10-15% since March.
- Discounts have spread from smaller cities with a massive oversupply of housing to big cities.
- Housing starts were 25% lower in Q1 y-o-y according to Nomura.
- Home sales fell 18% in April from the previous month.
- A housing-related trust in Hangzhou collapsed in March.

We believe that the correction will continue in the next 12 months by a further 10-20%. The following chart may serve as a reference. After the 3rd round of tightening, the price was down <20%.

Average Weekly ASP for the 40 Major Cities in China



Source: Deutsche Bank, SouFun

Does that mean one should sell the market? We think that the markets are already discounting a correction. Major risks in China come from developers with too much leverage and many companies in industries with overcapacity. There will be many bankruptcies, and that will hurt banks. However, the impact on China's economy and banks will be less important than one may believe. Banks loan to value ratios are fairly low, so they can withstand a drop. And the Chinese government can intervene by using the monetary and fiscal tools at its disposal.

This week, a big move of China's central bank was that it called on the nation's biggest lenders to accelerate the granting of mortgages. In the past four years, China has enacted many restrictions to cool the housing market, e.g. increased the minimum down-payment requirement for second homes in tier-1 cities to 70% last year. What exacerbated the situation was the tightening of bank lending. Chinese banks trimmed property lending by 21% q-o-q in Q1, according to PBOC. Now with low inflation (1.8% in April), there is ample room to relax. Furthermore, at least six small cities have started relaxing curbs on home purchases since April.

The most optimistic scenario would call for little or no appreciation in prices for a few years. This would be combined with serious reforms, such as imposing property taxes to reduce cities' reliance on land sales, stricter controls on real estate speculation, and the reform of the Hukou (household registration) system to allow migrants to acquire residency. The synergy of oscillating prices and reforms pooled with rising disposable income and personal consumption, and reducing China's dependence on real estate and exports would be the perfect outcome. Further strengthening this ideal scenario would be an acceleration of public housing construction and urban infrastructure related to transportation, environmental and alternative energy initiatives. This would pull up the slack from the slowdown in residential construction.

We are optimistic about the future of China and Asia. A real estate correction will certainly slow down China's economic growth, and eventually its growth rate will approach that of the US economy, probably sooner than predicted. This will, nonetheless, offer many opportunities to find companies that will benefit from what will soon be the biggest economy in the World. So, to conclude, the outlook is not so negative after all.

Have a good weekend.

The Global Alpha Team