SPOTLIGHT
Savills Research

China Residential - 2019

Housing One Billion+

savills
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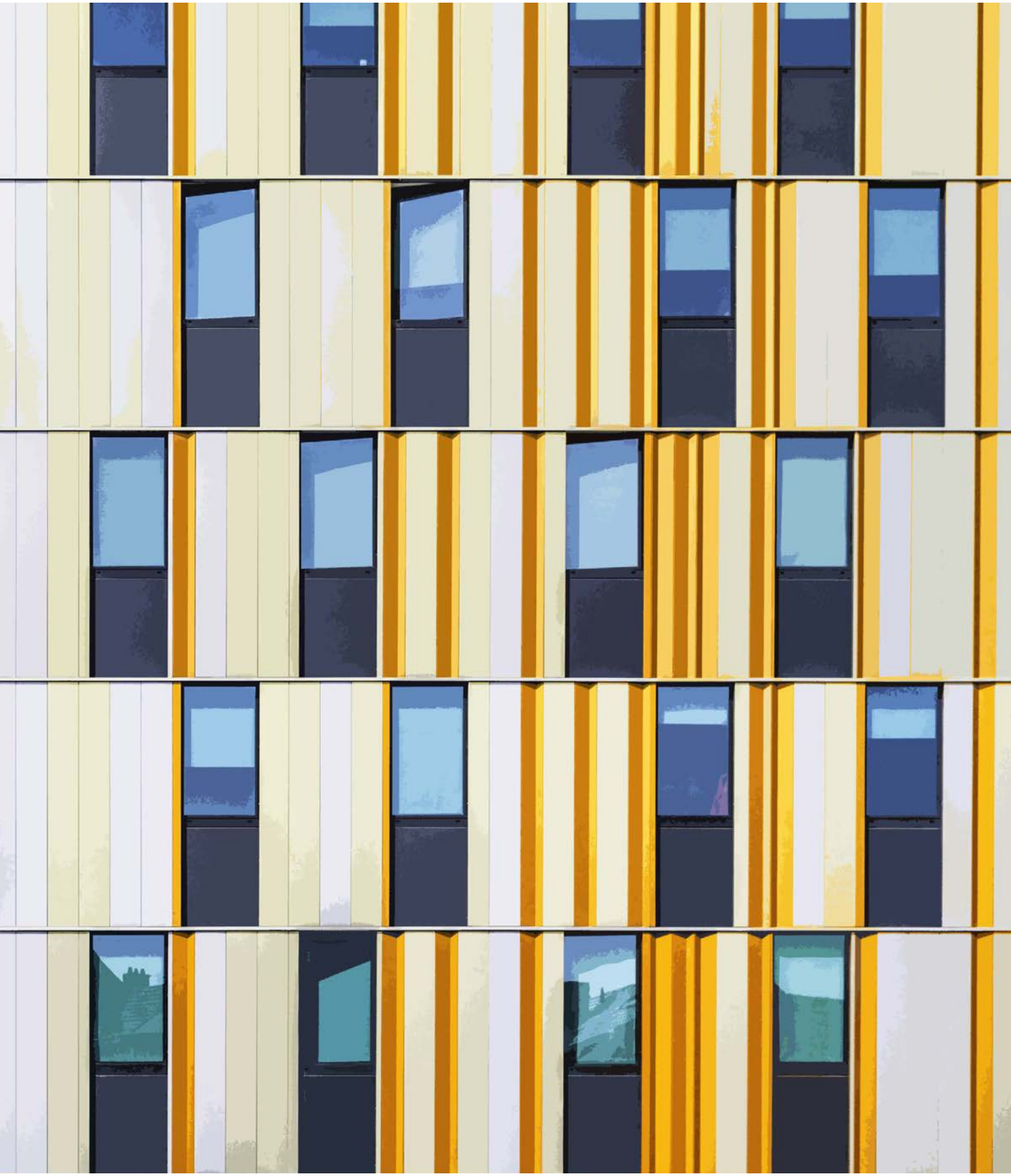


- Residential leasing models expand as traditional sales growth slows

Welcome to the 2019 Savills China Residential Market Report

China's residential market has gone through many cycles in its short history. Virtually all of these cycles have been the result of policies designed to cool overheating markets.

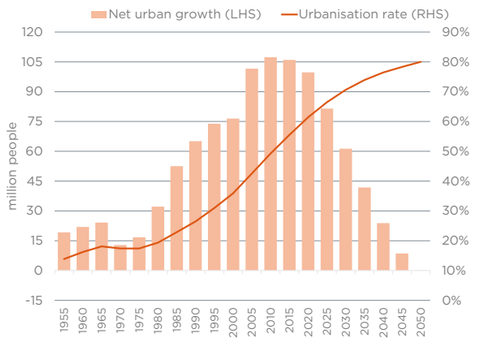
The latest round of property cooling started in late 2017 in response to the strong growth in residential prices in the first half of that year—a rise instigated in part by speculative investments and cheaper financing. The tightening measures have been the most severe to date: house purchasing restrictions were implemented in over 22 cities; loan-to-value ratios were set at 30-40% for primary residences and 60-70% for second homes; and mortgage rates in some cases were increased 20% above benchmark lending rates. This time was different because, along with the above policies designed to curb demand, several supply-side policies were instituted, including several significant policies designed to encourage the supply of housing for rent.

While the reform of the leasing market was initiated back in 2015, it was only in the latter part of 2016 and 2017 that policy support was clarified and meaningful progress was made. Supporting measures included the release of land stock specifically zoned for the development of residential leasing, and the opening of new financing channels and tax incentives. As a result of these curbs and supply-side reforms, average transaction prices in first-tier cities have plateaued.

Concurrent to the recent property curbs, there has been a broad-based effort by the government to address the issue of rising debt levels in the economy and, in particular, non-financial corporations. Many companies, including developers, have fuelled much of their expansion over the last decade by increasing their net gearing as liquidity has been pumped into the market and financing costs have fallen. The last 12-18 months have seen informal financing channels largely closed down and a much tighter rein put on bond issuances and bank lending across most industries, including real estate.

Faced with a slowdown in transaction volumes and a freeze on credit expansion, developers have been hurting, with Vanke—one of the nation's largest developers—claiming that it was struggling to survive in the current climate. Thus, the developer market at present is consolidating as bigger enterprises acquire assets from smaller ones or buy them outright. Developers are also looking to diversify property portfolios to include sectors supported by the government, such as multifamily, and therefore are more inclined to allow access to additional financing channels such as Asset Backed Securities (ABSs), with the potential for exiting via a Real Estate Investment Trust (REIT) at some point in the future should legislation provide for it.

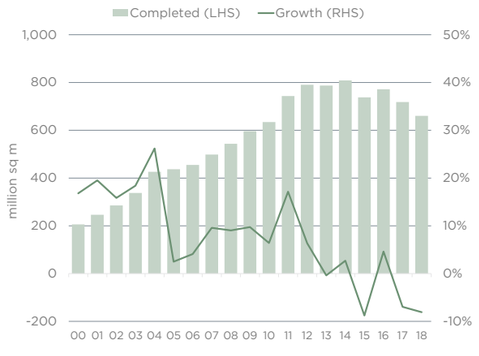
1. Urbanisation Rates



Source United Nations Population Division; Savills Research

Over the last three decades, the residential sales market has been propelled forward by economic prosperity and the rapid growth and urbanisation of the population. However, these drivers are starting to run out of steam, with population growth slowing and even forecast to start contracting by 2030. The working age population started shrinking in 2013 while the pace of urbanisation has also started to slow with the urbanisation rate already at 60%, and economic growth rates slowing to 6.6% in 2018.

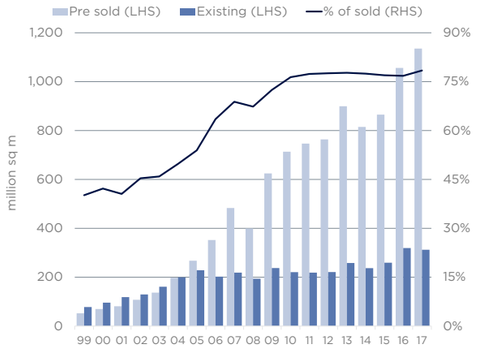
2. China Commodity Residential Completions



Source National Bureau of Statistics; Savills Research

As demand drivers slow, so does the pace of completions. China recorded peak completions in 2014 of 809 million sq m, but this figure fell to 660 million sq m in 2018. At the same time, floor area per capita in urban areas reached 36.9 sq m in 2017 and 46.7 sq m in rural areas, exceeding many international norms.

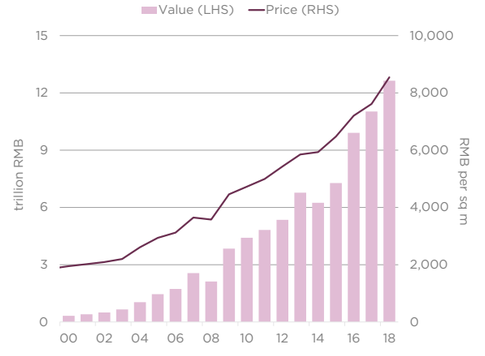
3. China Commodity Residential Sales Area



Source National Bureau of Statistics; Savills Research

Despite slowing completions and the decline of traditional demand drivers (urbanisation and population growth), government figures indicate that sales have continued to grow. This has seemingly been driven by pre-sale units, the proceeds of which are then utilised by developers to complete construction of on-going developments or to finance the next development. According to government data, close to 80% of sales were pre-sales as opposed to existing developments. Pre-sales are an important component of developer financing and have in the past made up 32.7% of developers' total financing. Nevertheless, issues can appear when handover conditions do not meet buyer expectations—either in terms of poor finishing or buyers misunderstanding what they were buying. There are also concerns about handover delays or failure to complete in the case of developer bankruptcy.

4. China Commodity Residential Sales Value and Pricing



Source National Bureau of Statistics; Savills Research

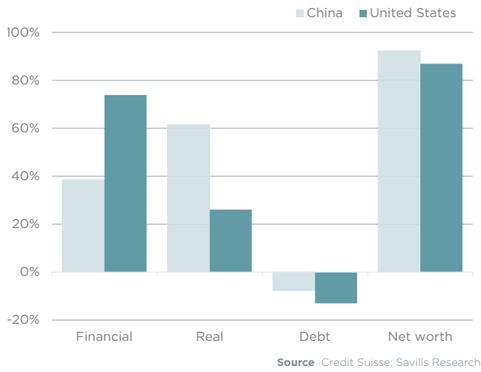
By the end of 2017, sales of residential properties had increased to RMB12.6 trillion, up 14.7% YoY, with 1.48 million sq m of property sales registering an average valuation of RMB8,544 per sq m.

Given an urban population of 831 million and an average residence size per capita of 37 sq m, there should be approximately 31 billion sq m of residential stock in urban areas. The most recent average sales price of roughly RMB8,500 per sq m applied to all urban stock makes the value of the residential market close to RMB263 trillion (US$39 trillion) or three times the size of China's GDP. Residential property is the most important store of wealth for private households. Credit Suisse, in their 2018 Global Wealth Report, estimated that real assets made up 62% of household wealth, as opposed to the United States at just 28%.

With the value and high percentage of personal wealth held in property, the steadiness of the residential market is of paramount importance for social stability. The government often looks to support demand and restrict supply to shore up pricing during times of market weakness. However, for many, owning a property is important for personal financial security, often a prerequisite for marriage and a status symbol. As one of the foundations of society, housing needs to be affordable enough for people to get on the property ladder.

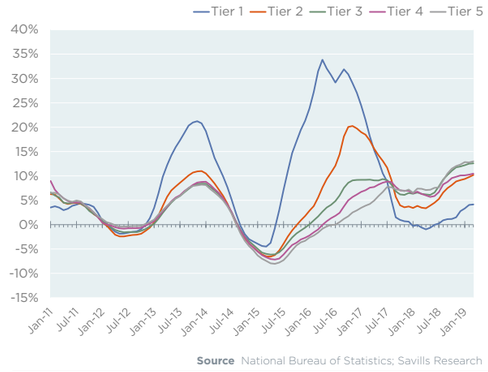
Thus, the market is constantly swinging between concerns about overheating and collapsing in addition to balancing the competition between end users and investors. Government policy looks to restrict investment while supporting end-user demand. Nevertheless, the lack of a comprehensive property register—until recently a patchwork of enforcement mechanisms—has meant that investors have been able to find loopholes, especially in small markets where enforcement is weaker.

5. Composition of Wealth Per Adult, 2018



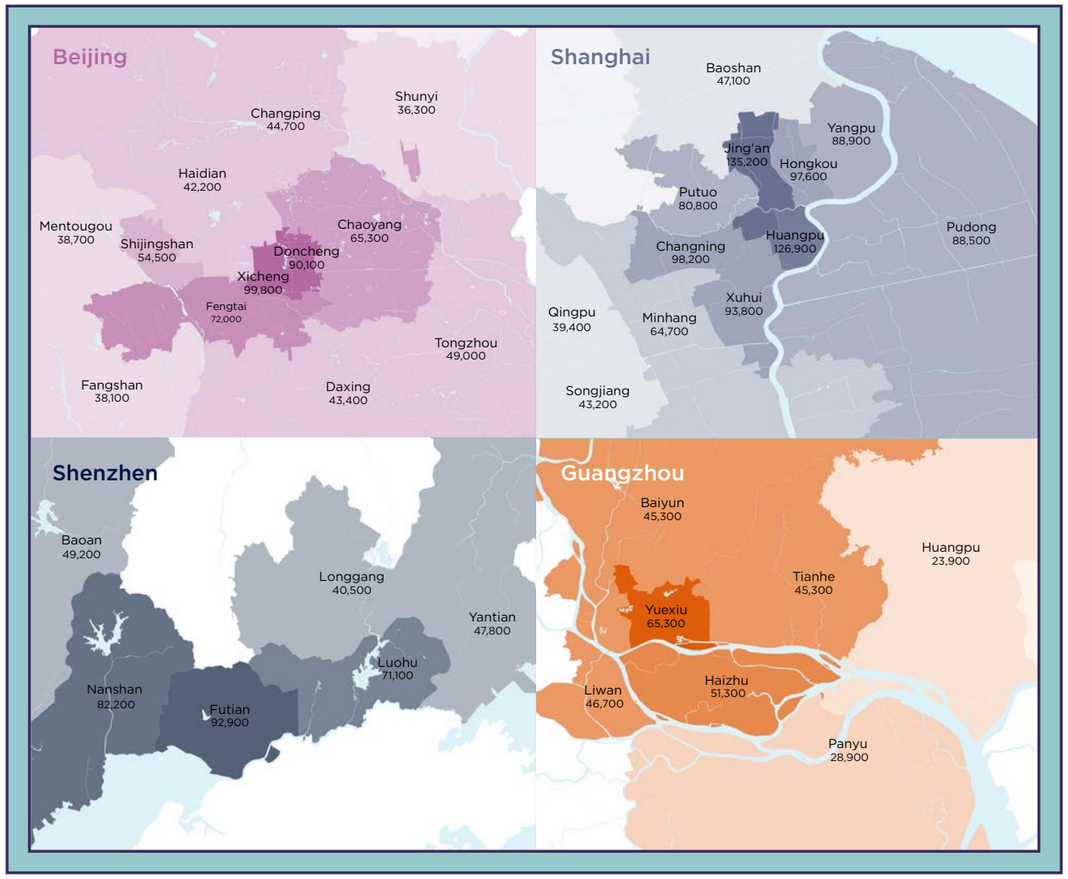
Source Credit Suisse; Savills Research

6. 70 Cities Commodity Residential Sales Price YoY Growth Rates by City Tier

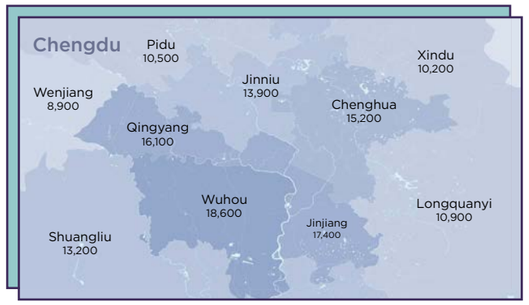


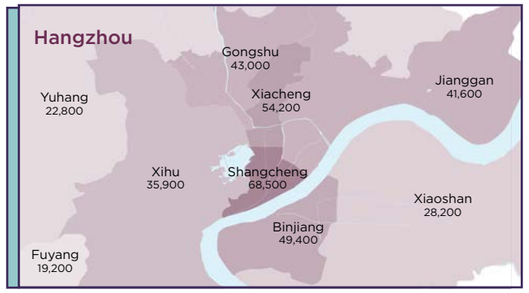
Source National Bureau of Statistics; Savills Research

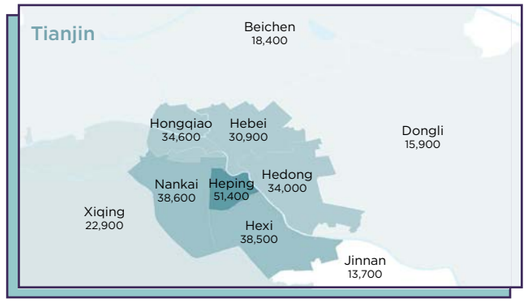
China 10 Residential Cities First-Hand Average Price by Districts, Q1/2019

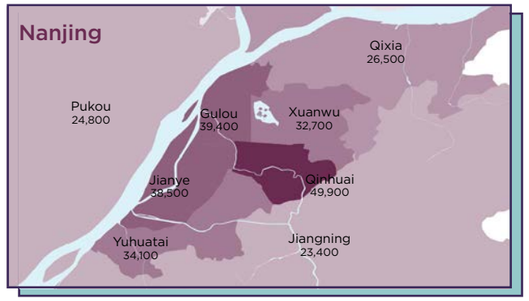


Unit RMB per sq m

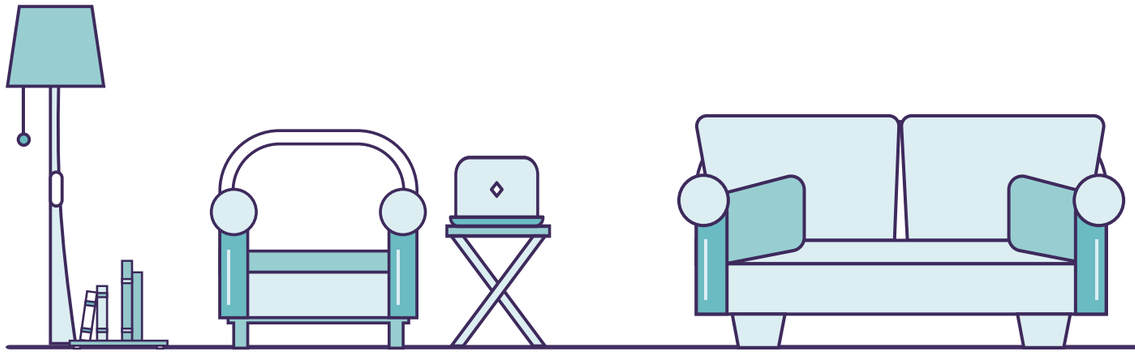








Source China Real Estate Index System; Savills Research



TRENDS IN

Luxury Housing

Under a new regulatory context, how would luxury buyers and properties change? *Shirley Tang*, senior director of Savills Residential Sales, shares her insight.

What are the trends in the Chinese luxury home market?

In addition to traditional buyers (company owners and individuals using the proceeds from their relocation compensation), more high-income households emerged as buyers in the luxury housing market, among them, professionals from the finance, real estate and trade industries, as well as rising stars from the digital economy.

With the loosening of the one-child policy, the luxury market has witnessed increasing demand for larger family units and buyers looking to upgrade their living conditions with a greater emphasis on quality and services. At the same time, others view their home not just as a place to live but as a statement of who they are and what they stand for—social calling card. Investors also continue to prize real estate for its stability and security of wealth.

In recent years, young business founders and overseas returnees have become increasingly active in the luxury housing market. There is also new money from professional stock investors, Key Opinion Leaders (KOLs), and online sellers. These more youthful buyers tend to prefer more central locations compared to traditional buyers.

What do you think are the main concerns for luxury housing developers?

Changing buyer groups and their preferences is a primary consideration. The recent increase in youthful home buyers means that more developers have to tailor developments to meet their tastes. Developers also seek out best-in-class projects from around the world to gain new inspiration and experiences.

There are very few residential land plots in the city centre today and those plots that find their way onto the market are often urban renewal projects or have a preservation order for some of the existing structures. Developers have to take time to consider how to protect and incorporate these structures into the development and breathe life into these historical gems while adding value and unique character to the larger development.

Are there any trends in the development of luxury homes in Shanghai?

While luxury homes used to be evaluated based on their location, branded facilities and overt extravagance, the market understanding has shifted in recent years. Customers are now placing more emphasis on best-in-class property management services and proactive maintenance teams, as well as design, liveability and adoption of cutting-edge technology.

Shanghai, as an international metropolis, is not only a market for domestic high-net-worth individuals but also attracts a number of international buyers. As the market has cooled in recent years and remains highly competitive, developers are taking some time to consider how they might better differentiate their product and better match the needs of future home buyers—the results of which are likely to be felt in 2019-2020. Developers will also continue to pay greater attention to the level of services provided to owners on an ongoing basis.

What is developers' attitude towards land purchases?

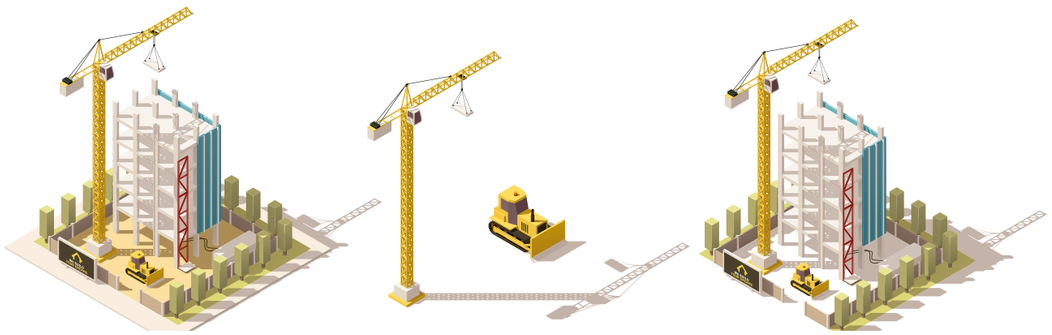
Sourcing new development opportunities is fundamental to the success of any developer and in many cities at the moment development opportunities in the city centre are incredibly scarce. Much of the new land available for development is located on the outskirts of the city centre or in new development zones and, while they are located further away from the city centre, they can still be expensive.

Given the significant input costs, long development period and changeable market conditions, developers need to spend adequate time to make a full assessment of a project's viability and profitability. Developers have turned more conservative in recent years, weighing the positives and negatives carefully.

While some developers have diversified their holding and revenues streams into commercial property markets and recurrent incomes, residential sales remain the main source of revenue and profit for many developers; therefore, residential land reserves remain essential to the success of the business.

Financing plays a major role in the real estate market, whether it be development financing or mortgage financing, and this is no different in China.

Over the past three decades, China's property market has gone from strength to strength, making it one of the most profitable investments in the world. In its earlier stages, much of the market's development financing was provided by state-owned banks. Financing risk was deemed relatively minimal with mega-trends such as urbanisation and income growth supporting continued demand for property. At the same time, there was implicit support from the government as continued urbanisation was essential for increasing economic productivity and therefore economic growth. Property price growth was also important in increasing the nation's wealth, helping the economy to move up the value chain and encouraging domestic consumption.



Alternative Financing

When the market started overheating, the government used its control over the state-owned banks to restrict lending to developers—starving them of cash and forcing them to slow investment and offer more attractive pricing to potential home buyers. In response developers started to look at diversifying financing channels, and as new sources started to emerge, equities, bonds and shadow banking became increasingly popular.

Financial De-Risking

Conditions changed significantly in 2017/2018 as the government stepped up financial supervision and strengthened moves to de-risk the economy from financial shocks. Part of this entailed deleveraging corporate China. According to the Bank of International Settlements, estimates of non-financial corporate debt reached 161.8% of GDP by Q1/2016, though levels have since fallen to 152.9% in Q3/2018. Some of the most indebted companies are real estate developers—the average gearing ratio of 35 listed developers stood at 91.9% by the end of 2018, with ten of them recording gearing ratios in excess of 100%.

The government's financial de-risking campaign included cracking down on the shadow banking sector, which as a share of GDP has reportedly shrunk by nearly 20 percentage points to 68% as of the end of 2018, from its peak of 87% two years ago. Other steps focused on tightening overall credit availability or at least slowing overall growth.

Developers found some relief in terms of offshore bond issuances—US$45 bn in 2018—as well as asset-backed securities with 265 issuances last year totalling RMB280.2 billion, according to Wind.

Land Purchases

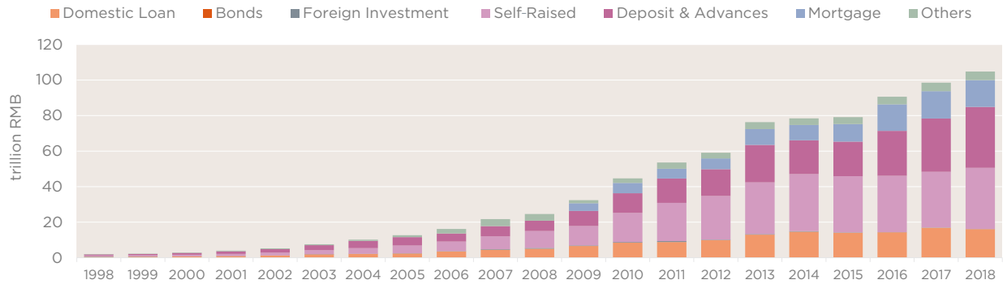
Tighter financing has also resulted in a reduction in competition for land plots with many new land auctions failing to find suitable bidders. According to CREIS, the first half of 2018 saw the same number of land auction failures for the 100 monitored cities as for the whole of 2017; the lack of investment appetite followed through to the second half of 2018 with the government having to reduce reserve pricing in order to sell plots.

Consolidation

With financial risks rising as the economy slows, creditors must be more discerning about where they lend their money. Larger-listed developers have more diversified holdings and are generally more transparent, and are therefore viewed as more creditworthy. Continued access to credit lines at cheaper rates than their smaller peers has provided them with the ability to acquire development sites from cash-strapped competitors and, in some cases, buy companies outright.

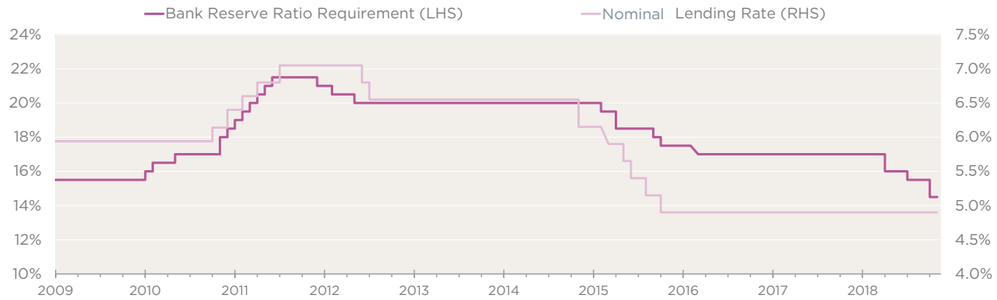
In a joint report by the Development Research Centre of China's State Council, the Tsinghua University Real Estate Research Centre and China Index Academy estimated that the Top 100 developers held a market share of 58%, up from 47% in 2017. In Q1/2019, 58 developers achieved sales considerations in excess of RMB10 billion with the top 100 developers averaging RMB21.6 billion. More consolidation is likely in the coming years as current market conditions are expected to continue.

Developer Financing Sources



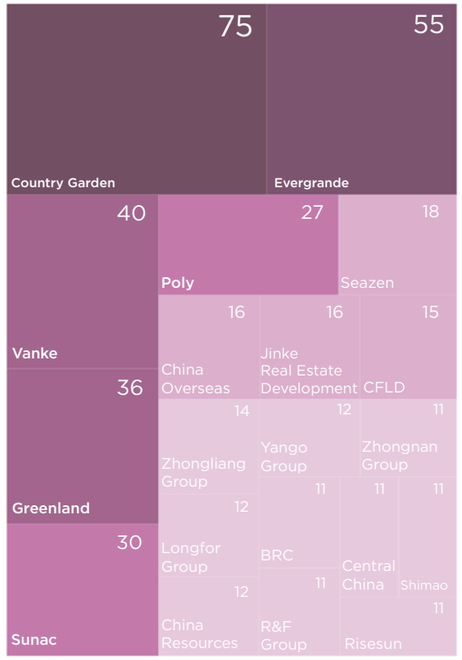
Source National Bureau of Statistics; Savills Research

Nominal Lending Rate: Over Five Year and Bank Reserve Ratio Requirement



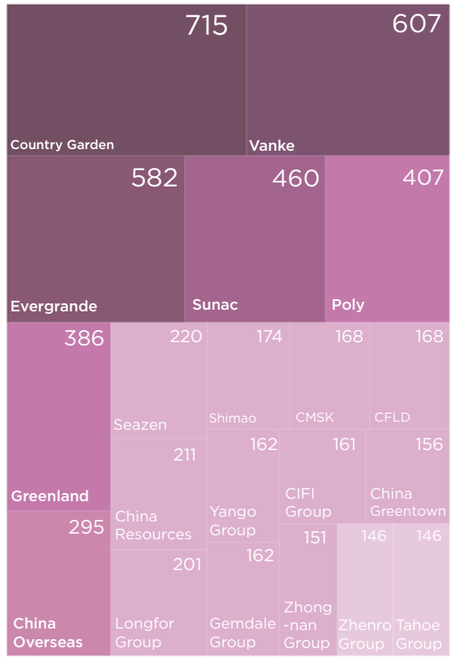
Source People's Bank of China; Savills Research

2018 Market Share Top 20 Developers by Area (million sq m)



Source China Real Estate Index System; Savills Research

2018 Market Share Top 20 Developers by Consideration (billion RMB)



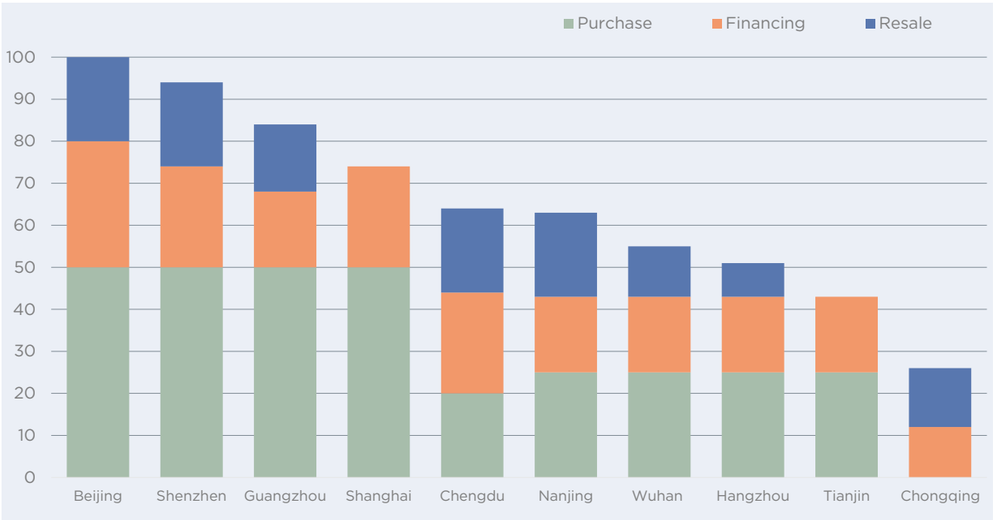
Source China Real Estate Index System; Savills Research

The future direction of the residential property market is very much defined by the policies and regulations that are issued and enforced. Regulations focus on stopping prices from growing too quickly or from falling too much. They also prioritise end-user demand over investment demand. In the past, policies have been handed down from Beijing and loosely implemented at local levels. More recently, the central government has set the general tone and overall desired outcome (stable property markets) but have allowed local administrations to determine how that is to be achieved based upon their own unique circumstances.

Regulations specific to the property market generally fall under three groupings: purchase, financing and resale of properties. The severity of and applicable criteria for these policies also vary greatly between cities and even districts within cities; however, this report attempts to, on a 100-point scale, gauge the overall strength of regulations, weighing them appropriately for the ten cities covered in this report. As might be expected, Beijing's regulations are some of the strictest in the country, given that it is the seat of government and property prices are amongst the highest in the country. Chongqing, by contrast, has relatively few regulations designed to suppress demand.

> Limited new development opportunities, especially within the fourth ring road, put a tremendous amount of strain on existing housing stock. Despite purchase restrictions, demand remains strong and pricing firm.
>
> Stella Meng – Beijing Residential Agency

Severity of Housing Restrictions, 03/2019



Source Savills Research

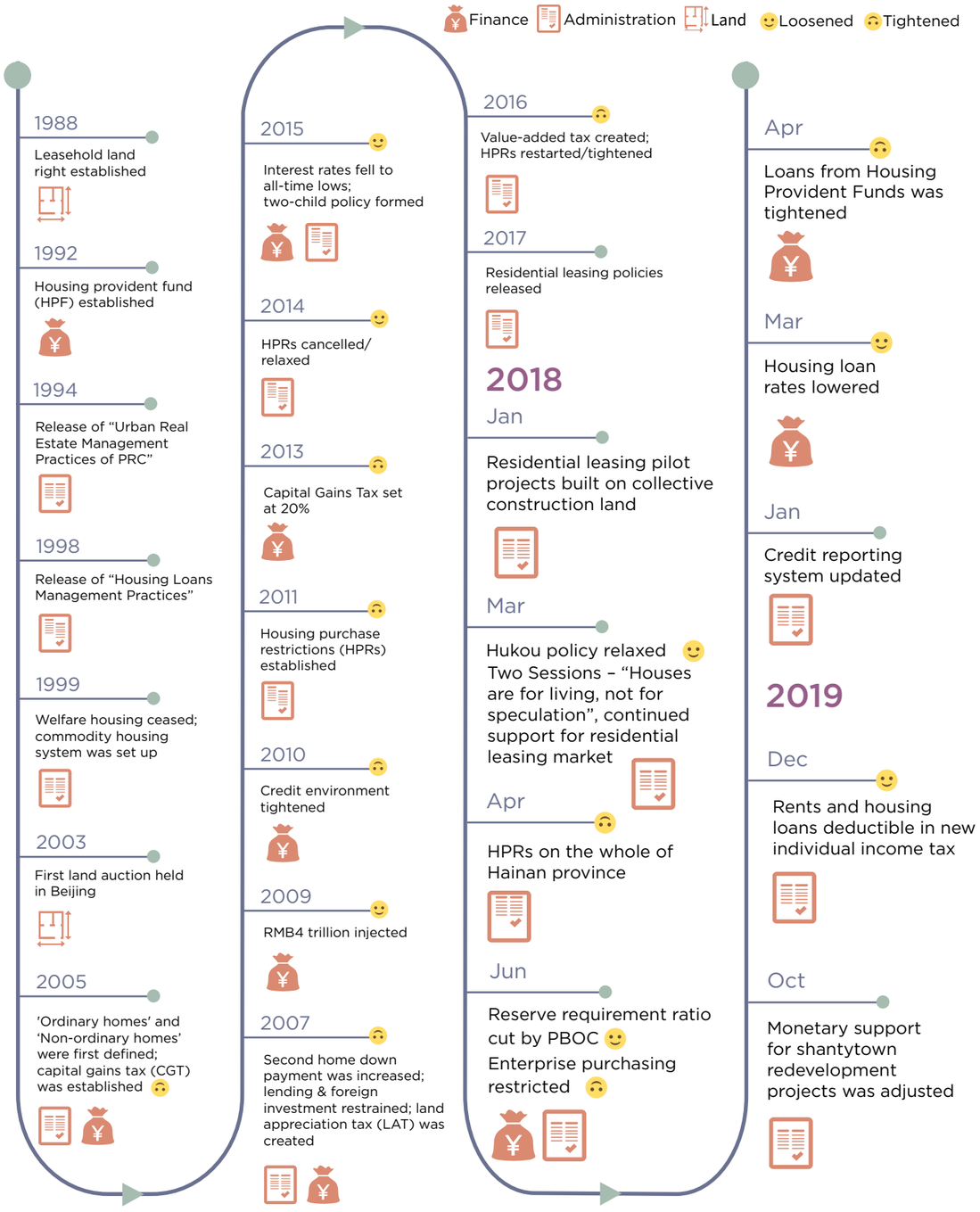
Support For The Leasing Market

The campaign to control residential prices took on renewed importance in late 2016 at the Central Economic Working Conference. The central government reinforced the importance of end-user demand with the coining of the phrase "Houses are for living, not for speculation". More restrictions were then applied to the purchase and financing of properties.

In contrast to previous rounds of regulatory tightening, emphasis was also placed on supply-side reform in the shape of the development of the residential leasing market, which had been largely ignored up until that point. Policies focused on the zoning of land, especially for the development of rental properties in first- and second-tier cities, the creation of new financing tools, and the institutionalisation of the leasing market. The new rules also addressed tenants' rights, better record keeping and the cleaning up of market practices like fake listings on housing sites.

The residential leasing market has subsequently proliferated over the last two years with a range of new companies and brands emerging to meet the needs of the Chinese public—initially targeting the younger, white-collar demographic. See page 15 "Focus: Multifamily Rental Apartments Key Models".

Residential Sales Regulatory Timeline



Source Savills Research

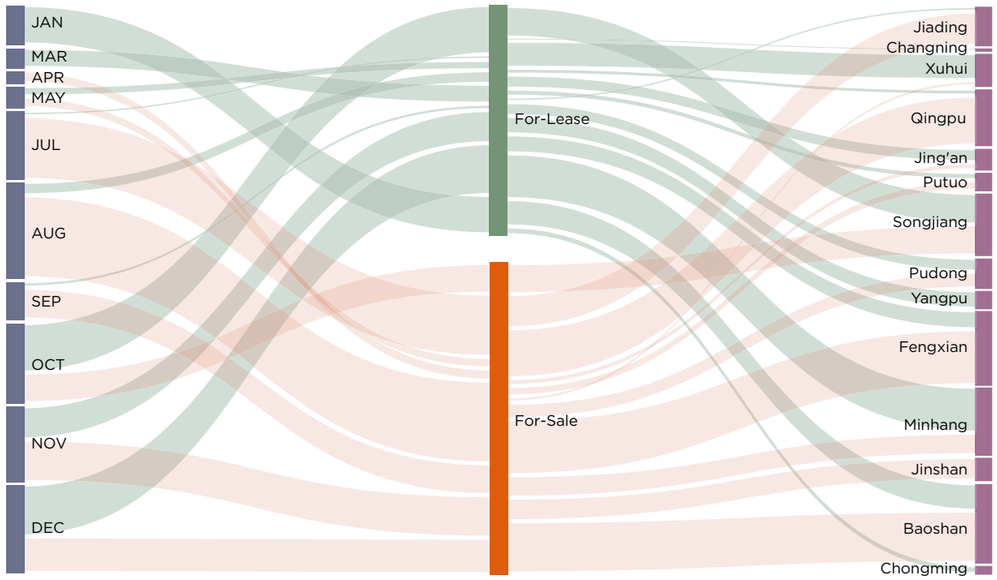
Up until recently, the leasing market has remained relatively underdeveloped with most stock either being high-end serviced apartments, strata-titled units managed to varying standards or government-run social housing and professional-talent apartments. A big reason for this was the preference of individuals to buy instead of rent as well as the meagre yields that could be achieved in mass or mid-end rental apartments, compared to commercial properties.

While it is hard to change an individual's preferences, the government did make some progress in terms of encouraging the supply of rental apartments; it released land plots specifically designated for the development of rental apartments at significantly reduced reserve pricing—roughly one-quarter to one-third of the price of residential land that does not come with restrictions on the sale of units. Indeed, the initial batch of residential plots in Shanghai was sold for roughly RMB6,000 per sq m while other residential land plots were selling for somewhere in the region of RMB20,000-RMB25,000 per sq m. As land is one of the most sizeable input costs in China's major cities, the reduction of land costs was able to dramatically reduce the all-in cost of developing multifamily properties and therefore enhance yields to satisfying levels. Investment into the residential leasing market will also allow investors to diversify their return profiles.

New land supply for the development of multifamily developments has focused on the larger rental markets of Beijing, Shanghai, Guangzhou and Hangzhou, though some plots were also released in 2018 in cities such as Nanjing, Wuhan and Hefei. According to CREIS, 322 multifamily land plots were launched in 22 cities between November 2016 and December 2018 totalling 12.37 million sq m of buildable stock. Shanghai, Hangzhou and Beijing accounted for 60% of the total supply area during this period.

An Example - Shanghai

2018 Shanghai Pure Land Sales Market (Buildable Area)



Source Savills Research

Since the first pure residential for-lease land auction, Shanghai has sold 57 multifamily land plots as of the end of 2018, which are expected to generate at least 51,000 units once construction is completed. Aside from the development of new specifically designed developments, Shanghai is also embarking on a programme to convert underutilised commercial and industrial premises into rental housing. At the same time, single-unit rental operators such as Ziroom have expanded aggressively in Shanghai, and it is hoped that the combination of these three sources can generate a total of 700,000 units (42.5 million sq m) for Shanghai's rental market by 2020, thereby reaching or possibly exceeding the government's previously stated target.

In 2018, Shanghai recorded the sale of 61 residential land plots. Only 27 of those plots (1.26 million sq m) allowed the developer to sell the eventual units strata-title; the other 34 plots (893,700 sq m) were zoned for multifamily usage.

Focus: Multifamily Rental Apartments Key Models

New Builds

While land plots are less expensive than traditional residential land, there are still concerns about the payback period and booking in investments for long periods of time. Many of the developers that acquired sites are state-backed and have issued asset-backed securities to finance the development and ongoing operation of their properties. While many sites tend to be greenfield and further away from the city centre, a handful of properties are more centrally located. Given the requirements on the number of units to be built in each project, unit sizes tend to be relatively small and limited to one- and two-bedroom units. The risk lies in developing rental units in locations within a city that do not have enough demand for rental properties.

According to CRIC, the biggest developer by the end of 2018 was Guanyu by Longfor, with 54,000 units and plans to grow to more than 100,000 units, followed by Port Apartments by Vanke with 50,000 units and plans to build to 230,000 units. These two lead the pack, but there are also several other developers building out their platforms including Live You by CIFI, Big+ by Country Garden, and Luxgem by Gemdale.

Redevelopments/ Renovations

Redevelopments tend to be in city centre locations/urban refills and take an existing, older, underperforming commercial or industrial property and redevelop it into residential units. Similar to new builds, units tend to be smaller while providing common areas to increase the appeal to tenants—somewhat akin to co-living concepts—improve affordability and generate higher returns for the investors. Roll out can be slow with developers/investors having to first enter into negotiations with existing owners, then come up with a tailored design for the property, apply for the appropriate planning permits and carry out renovation works all on a case-by-case basis. The redevelopment is very much dependent upon government support both at a city and district level.

According to CRIC, the biggest operator is Mofang with 70,000 units, followed by World Union's Homeplus with 35,000 units and Lefull and Coming Space with roughly 30,000 units each.

Secondary Landlords

Rental management companies or secondary strata-title operators such as Ziroom are the fastest growing segment of the market. Companies typically take a long-term lease of an individual unit, conduct a simple renovation of the unit, standardise furnishings and install various IT systems, and then list the unit on their platform and lease it out on shorter-term leases while pocketing the difference between the master and sublease, minus expenses. The lower upfront cost and quick turnaround have enabled operators to grow quickly, and some of them also have significant financial backing from local real estate brokerage houses, tech firms like Tencent and Alibaba, and private equity-like Warburg Pincus and Sequoia Capital.

According to CRIC, the biggest operator in this sector by the end of 2018 was Ziroom with 800,000 units, followed by Yizu with 700,000 units and Danke Apartments with 400,000 units.

Breakout Section -
Serviced Apartments

As competition continues to intensify, operators have to make sure they have a clearly defined brand and market positioning, as well as provide a consistent standard of quality service. Traditional serviced apartment operators are diversifying their brand offerings, and many operators have created new younger brands in their portfolio to suit millennials and the co-living trend. Savills Residence, for example, has created the new brand 'Just Living' for this purpose.

Ingrid Kamphuis – China Savills Residence

The serviced apartment market in China has undergone significant changes in the last five years thanks to a broadening and deepening of the domestic labour pool, the rising prominence of domestic enterprises, cost-cutting measures for seconded personnel, and increasing competition/rising standards of more mass- and mid-market multifamily operators. Once catering heavily towards international clients, serviced apartment operators and developers have experienced an increase in demand from domestic and regional tenants, forcing them to modify their services and properties to cater to these new clients. While western managers still make up a significant portion of tenants in certain locations and brands, the trend towards market localisation for domestic and pan-Asian clients is increasing.

Serviced apartments have not only localised their offerings in the past but have also provided more flexibility to tenants in terms of lease duration, with more properties offering units for nightly rates. While at a premium to rates normally charged in a serviced apartment, prices are still often at a discount to hotel rates. Other serviced apartments are moving toward more selective services to reduce costs and pass those savings on to the tenants. Newer developments also tend to offer more one- and two-bedroom units as fewer seconded personnel are bringing their dependents with them.

The first-tier cities in China are still the main demand drivers for serviced apartments, thanks to their status as headquarters for major domestic and multinational companies, which provides a steady stream of high-level managers who need short- to medium-term accommodations. While lower-tier cities do have serviced apartment properties (Ascott, for example, has properties in Chengdu, Chongqing and Hangzhou, among others), the four first-tier cities offer the most mature and robust overall markets. Shanghai and Beijing have roughly the same-sized serviced apartment markets, standing at approximately 8,400 units a piece.

The leasing market is seeing its biggest change in over a decade with a raft of new options available to tenants and a shift in the tenant makeup in the high-end market to domestic tenants. Understanding the changing landscape is essential for both landlords and tenants.

Liza Wu – Shanghai Residential Leasing

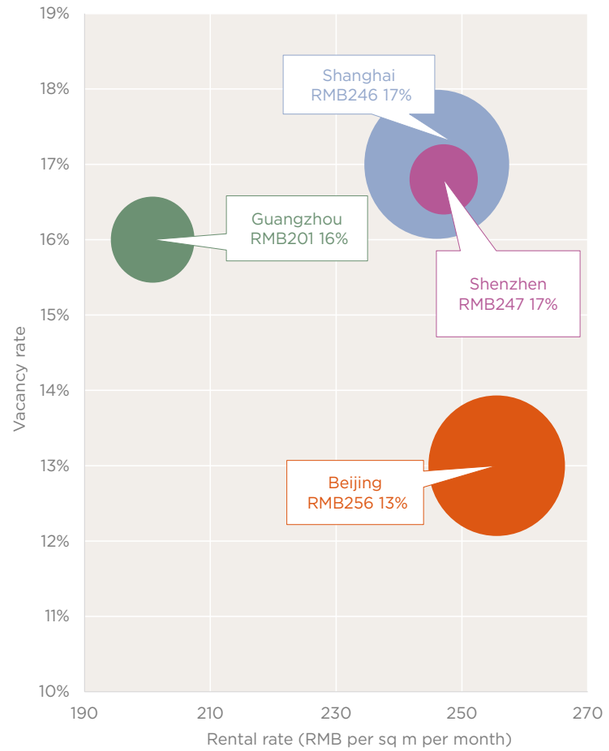
Shanghai, as one of mainland China's most cosmopolitan cities, is home to one of the largest expatriate communities in the nation along with the China headquarters of numerous multinational companies—with the frequent transfers/rotations of staff that that entails. Serviced apartments tend to be scattered around the city with a slight focus on Lujiazui and downtown Puxi for the finance and professional services industry, respectively. As Chinese nationals replace international staff, particularly in the financial industry, and domestic firms expand faster than their international peers, serviced apartments, particularly in Lujiazui, are catering more to locals than they ever have in the past.

As China develops its presence on the world stage we are seeing increasing demand from rotating diplomatic teams and, at the same time, a potential opening up of the financial sector to foreign competition.

Sunny Cai – Beijing Residential Leasing

Beijing's services industry dominates the economy, and the city is headquarters to many of the nation's largest domestic companies. While there are business clusters spread throughout the city—Beijing Financial Street, Zhongguancun, Wangjing and the CBD—many of the serviced apartments are situated in the Lufthansa, East Second Road and CBD areas in the east of the city, near embassies, retail amenities, and with easier access to the city's main airport and railway station.

Serviced Apartment Key Indicators, Q1/2019



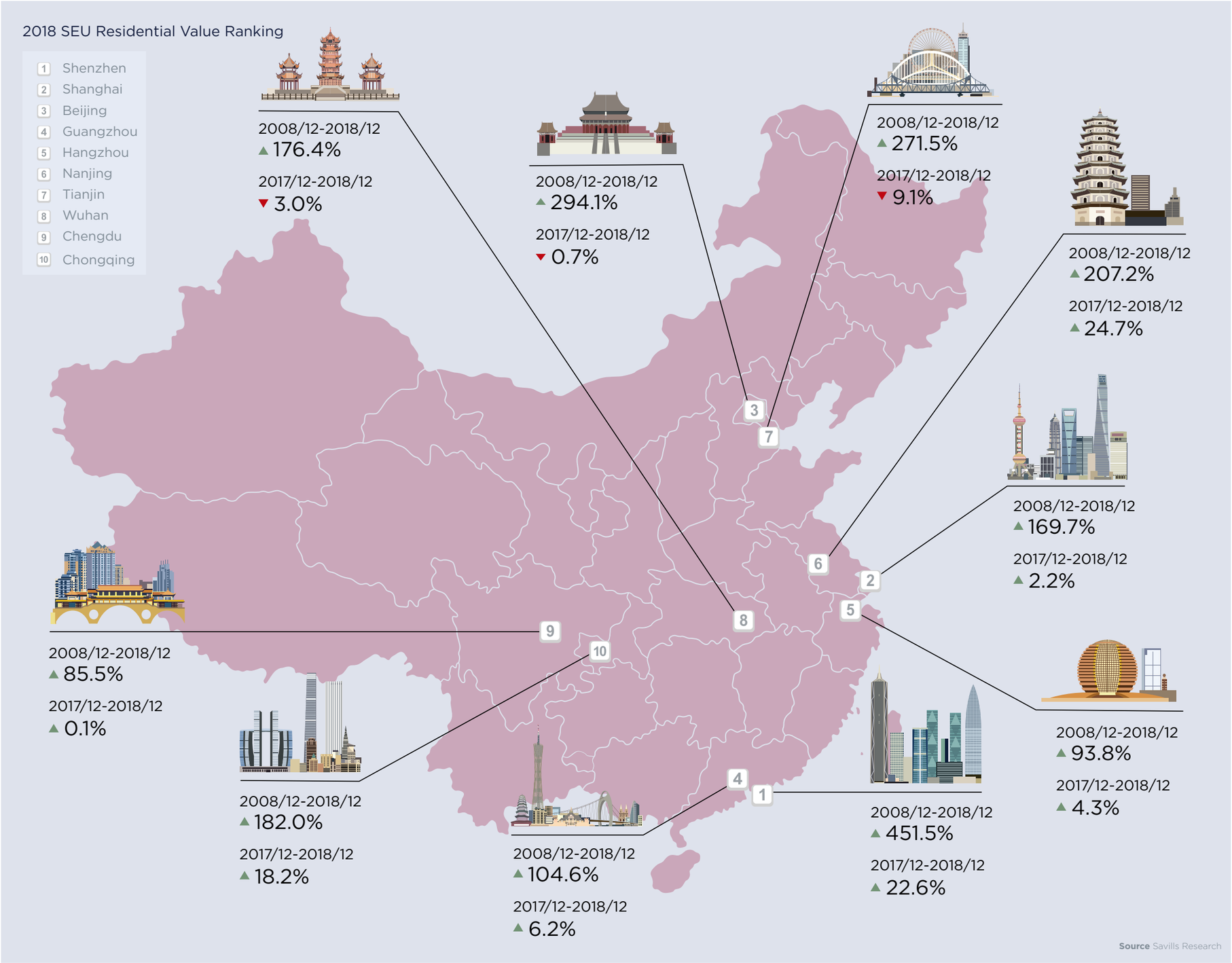
Source Savills Research

Shenzhen and Guangzhou are smaller cities with much smaller markets, both in terms of population and GDP. Shenzhen has roughly 3,800 serviced apartment units while Guangzhou stands at just 2,700 units. Most of Shenzhen's serviced apartments are located in Nanshan in the west of the city, home to many IT firms and close to Qianhai—the city's future CBD. The area also boasts well-developed surroundings and is now connected to Hong Kong by the new Hong Kong-Zhuhai-Macau Bridge. The second-highest concentration can be found over in Futian—the city's current CBD. Guangzhou's serviced apartments are located mostly in Tianhebei with a few in Zhujiang New Town and a couple in Panyu.

The serviced apartment markets in both Guangzhou and Shenzhen are likely to be irrevocably changed by the newly unveiled plans for the Greater Bay Area—the eleven-city economic hub that is key to promoting development in the area. Both cities stand to gain from the increase in business professionals flowing into the region.

Additionally, the potential for the opening up of the financial sector to more foreign competition as well as the growing adoption of serviced apartments by increasingly mobile local professionals could enhance demand going forward.

SEU 10 Cities Price Map

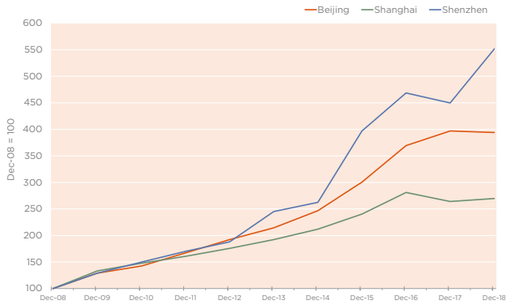


> While leading markets like Shanghai remain a key focus for developers and investors, competition is incredibly fierce. A number of developers see increasing upside potential in neighbouring cities as greater intercity integration creates new business opportunities and jobs.
>
> Frank Li - Integrated Sales & Consultancy

The average value of the SEU properties in the ten mainland China cities tracked in this report almost trebled over the last decade, rising 195% from 2008 to 2018, which translates into a compound annual growth rate (CAGR) of 11%. Price growth varied significantly between cities depending upon the relative starting price point used for the comparison back in 2008, levels of migration, and economic growth rates. For example, Shenzhen SEU prices have grown at a CAGR of 19% over the last decade; over that same period, its economy has also trebled from RMB780.7 billion in 2008 to RMB2.4 trillion in 2018, while its permanent population has grown by close to 3.5 million people to 13 million. The average SEU capital value of Shenzhen reached RMB93,700 per sq m, also ranked highest among the ten cities. Other cities have recorded much slower rates of growth; for example, Chengdu, Guangzhou and Hangzhou have recorded CAGRs over the last decade of just 6-7%, with much of that growth coming in the last couple of years.

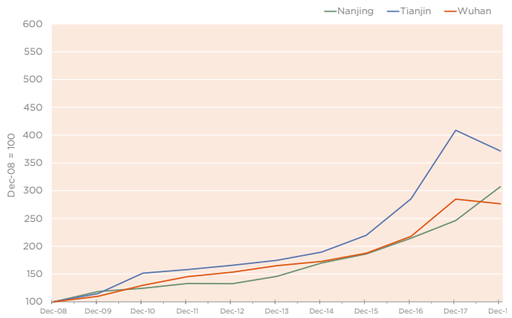
Savills Executive Unit (SEU)

Market Leaders



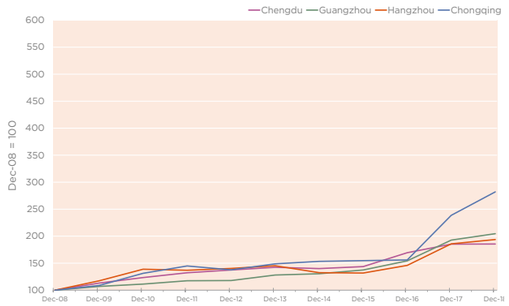
Source Savills Research

Middling Markets



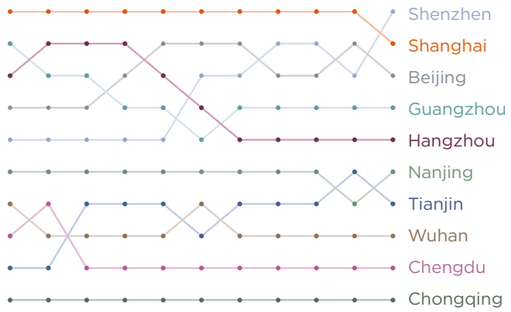
Source Savills Research

Playing Catch-Up



Source Savills Research

SEU Capital Value Ranking, 2008-2018



Source Savills Research

Market Leaders

Shenzhen, Beijing and Shanghai are in a league of their own when it comes to the housing market; no matter which data source or metric you look at—these three cities are head and shoulders above the rest. They are heavily regulated, enjoy strong demand and offer vibrant economies and business environments.

Shenzhen, pivotal to the GBA and long influenced by the price arbitrage with Hong Kong and the various tax incentives and special economic status it holds, maintains its position as the most expensive market in Mainland China. Beijing remains the most heavily regulated and supply-controlled city in China but is also the seat of power and home to the country's wealthiest individuals. Shanghai, the international financial capital, has seen property values at the high end of the market leak into its mass market with higher-quality new builds following the diffusion of its business community and spreading throughout the city, but demand remains very strong.

Middling Markets

Tianjin, Nanjing and Wuhan had good property markets and reasonable growth in pricing during 2014-2017 but have lost some momentum over the last year, with the slowing in Tianjin and Wuhan being the most evident. However, there is a clear rationale behind why these markets should be attractive:

Tianjin, a municipality with potential spillover demand from Beijing, has been negatively impacted by slower economic growth in the northeast of the country. Nanjing, the capital of one of China's richest provinces, has strong student resources and is close to Shanghai. Growth rates in 2018 remained positive. Wuhan, pivotal to the rebirth of the central plains and the recipient of a large injection of fixed asset investment, is struggling with growing pains as the market overbuilds.

Playing Catch-Up

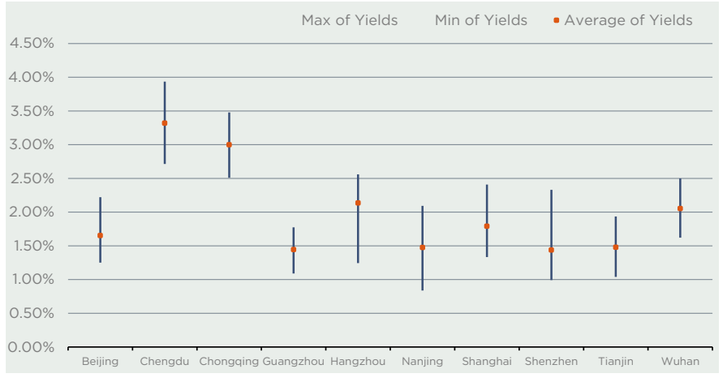
The laggard cities of Guangzhou, Chengdu, Chongqing and Hangzhou have seen renewed interest in the last two years; home buyers and investors alike have accelerated growth as they look for more affordable homes or investments with more upside potential.

Guangzhou, despite being the provincial capital of Guangdong, has lagged behind its more dynamic southern peer, Shenzhen, from both a commercial and residential perspective. New measures to attract business combined with companies/employees being priced out of the Shenzhen market have driven renewed interest in Guangzhou and pushed up pricing in recent years.

Chengdu's market is starting to turn a corner as liveability, affordability and talent pool attract businesses to relocate to the leading city in the west. Chongqing has been the country's best performer over the last two years with prices climbing by close to 80%, admittedly from a low base and it is still the least expensive out of the ten cities tracked. The city benefits from its status as one of China's four municipalities under direct administration of the central government as well as its large permanent population—31 million people.

Hangzhou, long one of the most expensive second-tier cities in China, has found it difficult to continue to build on its already relatively high pricing. Nevertheless, as home to Alibaba and attempting to position itself as China's Silicon Valley, the city could serve as a Palo Alto if the Hangzhou government succeeds in its positioning.

Residential 10 Cities Yields, 12/2018



Source Savills Research

RENTS

The total annual cost of renting all the accommodations needed to house the SEU for one year averaged RMB1.1 million by the end of 2018, ranging from less than RMB583,000 in Tianjin to RMB2.0 million in Shenzhen. The average rental value of all SEU properties rose by just 66% from 2008 to 2018 or a CAGR of 5.2%.

Slower growth in house prices, greater rights for tenants and a larger variety of options for tenants should enhance the attractiveness of renting over purchasing properties in the future. Nevertheless, deep-seated cultural and financial habits will take time to overcome.

YIELDS

Residential property sales prices over the last ten years have easily outstripped rental growth, pushing yields, especially in first-tier cities, to all-time lows. Compared with world cities such as London (3.7%) or Singapore (4.2%), rental yields in Chinese cities remain incredibly low, with an average gross yield of 2.0% in December 2018. Chengdu and Chongqing have some of the highest yields in China at 3.3% and 3.0%, respectively, followed by Hangzhou and Wuhan.

Despite having some of the lowest yields in the world, China still has high mortgage rates, ranging between 5.2% and 6.1% as of the end of 2018. Rental income from an investment property is therefore nowhere near enough to cover the cost of mortgage financing, so investors are either buying without financing in place or are looking to make high enough returns on capital value growth to offset financing costs—a strategy that might make sense in the short term but is by no means a long term sustainable investment model. In more mature markets such as London or Paris, while yields are also relatively low, mortgage costs are even lower, meaning that if a unit is leased out the rental income is typically enough to cover the cost of the mortgage financing.

Conclusions

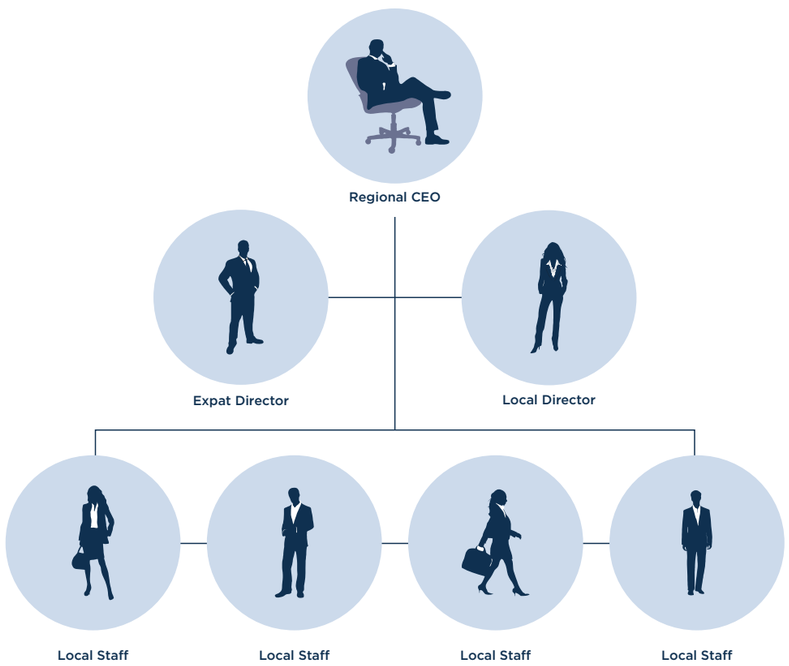
In 2018, China witnessed the most severe-to-date regulation tightening of China's residential market. At the same time, 2018 was a changing year for the residential market in other ways. While curbing the excessive rise in housing prices and speculation, the government also took active measures to prevent financial risks. Different from the previous rounds of regulation, the government's moves were designed to encourage the development of the residential leasing market while keeping restrictions on purchases, financing and resales.

In early 2019, after a year-long tightening period, China, especially in the first- and second-tier cities, began to show signs of warming up in terms of residential supply and transaction. Capital-limited developers slowed down their investment activity and took several initiatives to speed up their return of funds. For them, diversified financing channels are now favoured while they passively accept restrictions on traditional financing.

When it comes to the residential leasing market, first- and second-tier cities continue to launch their residential for-lease land plots as new financing tools, such as quasi-REITs and asset-backed securities, gain traction in assisting businesses. Due to the lack of management experience in residential leasing, especially in the long-term rental apartment market, the government is also stepping up detailed specifications and strengthening market supervision to help institutionalise the market.

With the continuous improvement of the facilities and services offered by high-end, long-term rental apartments in the market, the tenant structure of the serviced apartment sector is also changing—gradually shifting from European and American seconded employees to Pan-Asian and local customers. As they localise services, operators are beginning to offer more flexible lease options to cope with the changes.

SEU Illustration



To compare the costs of residential properties across different Chinese cities, a typical 'executive unit', a group of people that might start up or expand a global business in any country, is taken and then compared with the residential accommodation they would likely inhabit in each Chinese city. This methodology has been used by World Research to enable global comparisons.

Savills Executive Unit (SEU) includes one regional CEO, one senior expat director, a locally employed director and four locally employed administrative staff. They each live in different types of households, some with children, some with partners and some without. Each member of the group lives in a different location and type of property.

The following 10 Chinese cities lead their respective regions economically, politically, commercially or in liveability. The list includes the four first-tier cities of Beijing, Shanghai, Guangzhou, Shenzhen and six second-tier cities: Chengdu, Chongqing, Tianjin, Nanjing, Hangzhou and Wuhan. These ten cities form an index of residential price movements since 2005. An index is used as it is more important to see the trend and relative cost of buying/renting, rather than absolute values.

By comparing the accommodation costs of SEU, the cost of residential property across different Chinese cities and its impact on local businesses and the economy can be effectively compared. This analysis seeks to shed light on the market from a different perspective, helping to generate unique and important insights.

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