MARKET IN MINUTES

Savills Research

China - June 2020

Coping with COVID-19 – China Residential

The Calm Before The Storm – Q4/2019

China's residential market is incredibly varied in terms of stage of development, build quality, regulations and buyer profiles.

Generally speaking, the first-tier cities and some second-tier cities, especially in the coastal regions, are highly sought-after locations and have seen prices rise significantly over the last decade. In fact, local governments have introduced a number of restrictions to keep pricing in check and limit speculative behaviours. In addition to demand-side restrictions, the government has started encouraging the development of residential leasing stock over the last three years. Yields on individual units typically stand at around 1.0-2.0%. Homeownership levels are roughly 70-80% in big cities. Given their maturity, price growth has been more limited than some smaller cities, but also much more stable. The market has also shifted towards the second-hand market, as suitable land plots for development are scarce and the pace of development slows. Some cities also have population controls that limit demand from continued urbanisation.

Financing has become increasingly important for individual homebuyers, who had previously sought to buy properties without taking on debt—this has given rise the Residential Mortgage-Backed Securities (RMBS) products and others. At the same time, developer financing has become increasingly challenging amid a broad-based financial de-risking campaign that has been waged over the last two years, which has restricted financing from shadow banking sectors. Developers have turned to the corporate bond sector, and some of these are currently maturing and will need to be rolled over.

> “The residential market, which was severely hit by the COVID-19 pandemic in Q1/2020, is gradually regaining its footing after resuming production; however, the shift in industry sentiment brought on by the epidemic will have a profound impact on the future of the market.”
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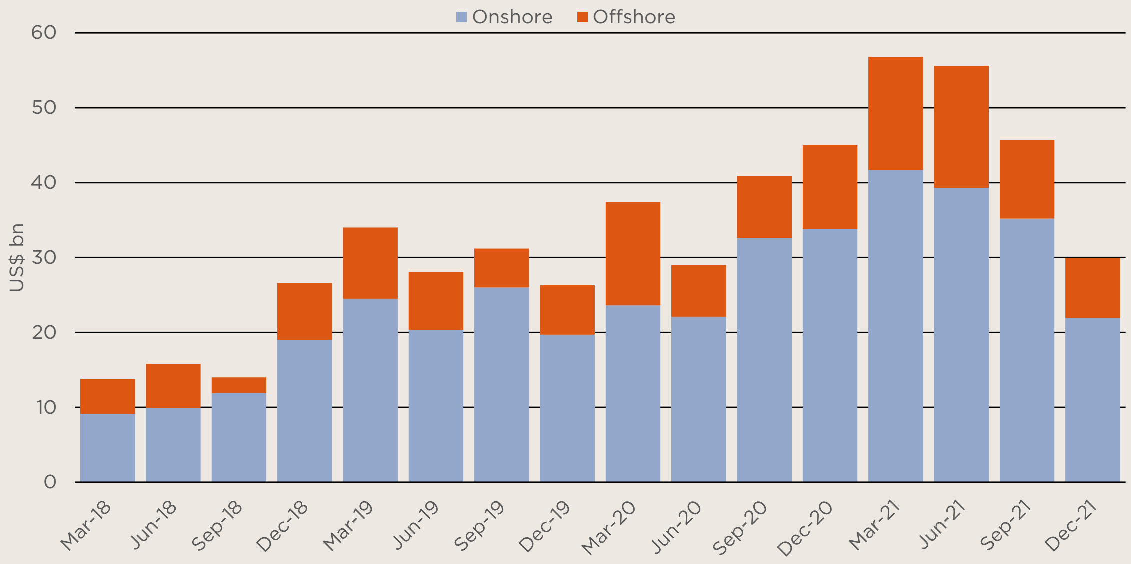
> JAMES MACDONALD, SAVILLS RESEARCH

GRAPH 1: Developer Bond Repayment



Source Bloomberg, Savills Research

Transaction volume of 18 key cities in April was 80% for the same period in 2019

100 cities average transaction price increased by **3.0%** on a Year-on-Year basis

LPR

The Loan Prime Rate (LPR) has been reduced by a total of **15 bps** for the five-year rate in the first four months

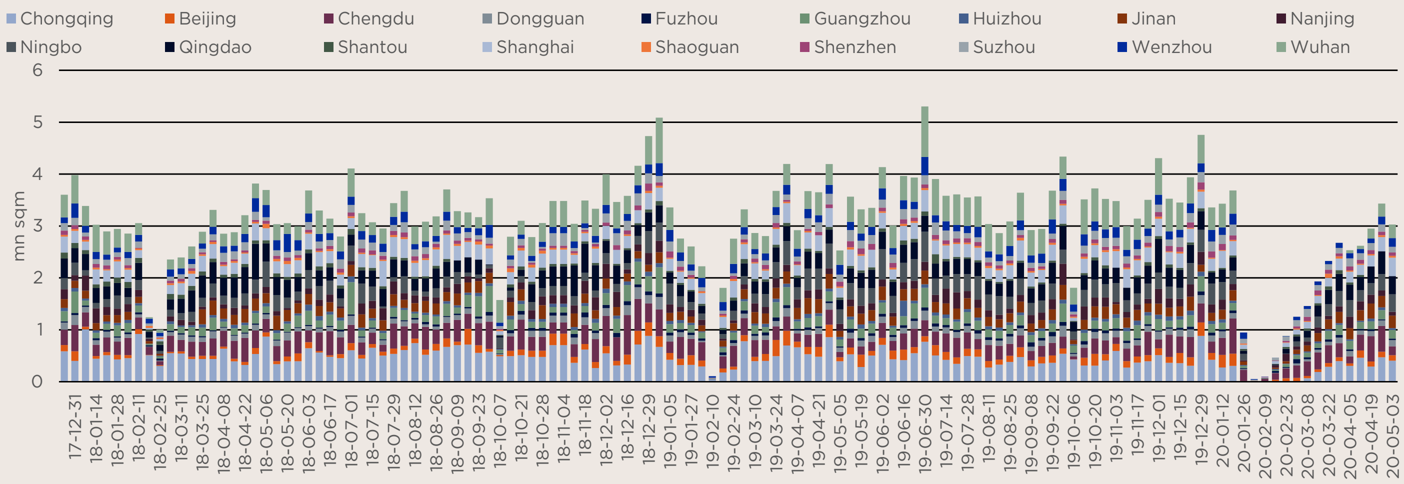
During Covid-19

Chinese New Year is typically a slow period for the residential market as people return home to see their family and go on holiday overseas instead of buying a new property. Nevertheless, offices stay open and units still trade. This year, however, in response to the outbreak of COVID-19, many cities' transaction centres and developers' sales offices/show suites were closed over Chinese New Year and a couple of weeks immediately after. During the same time, and for many weeks after, construction on projects was stalled as travel restrictions limit the ability for migrant labourers to return to their place of work, despite sites having been approved for work resumption.

Developers, uncertain as to when things would return to normal, tried to pivot to online platforms to reach out to potential buyers, including investing in mobile apps and WeChat mini-programs providing VR digital viewings and livestreaming presentations to lure more buyers. While there may not have been many online sales concluded online, it enabled developers to engage with buyers and potentially lead the conversion offline later. The online investments may also bear fruit later as developers adopt multi-channel promotion and sales platforms.

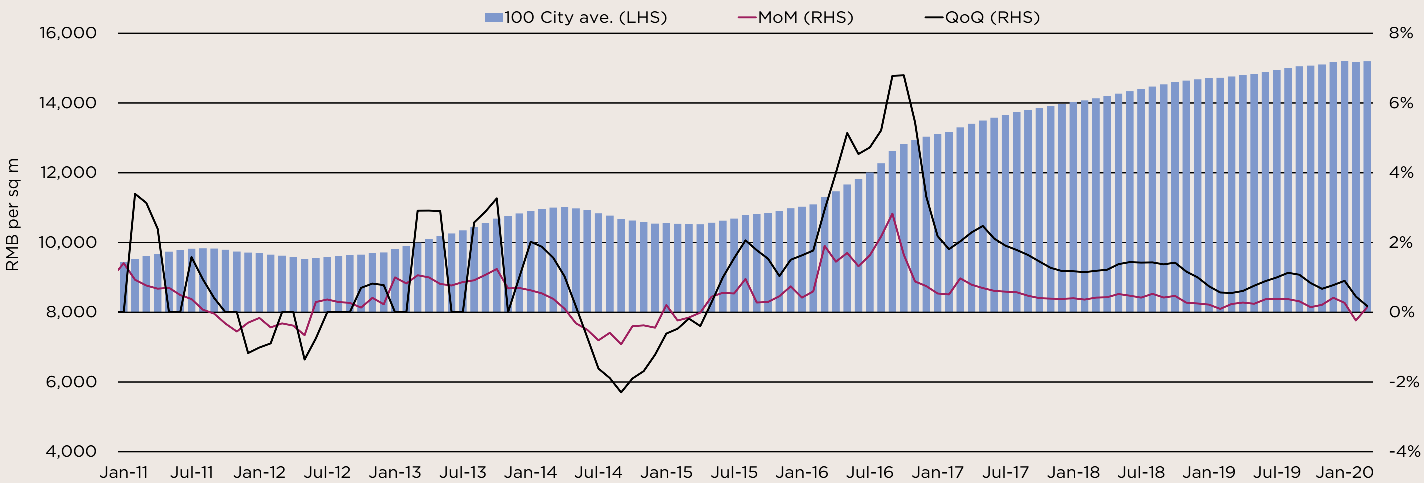
Transaction volumes only gradually recovered with people still cautious of venturing outside for all but essential travel. Once businesses started working from their offices again and the streets started getting busier, so did sales offices, and, by the end of March, volumes were at roughly 70-80% of normal volumes for some of the larger cities. While volumes were recovering, some developers are still short of their sales targets for the first quarter by 20-40% and many are eager to catch up in order to ensure continued profitability and repayment of maturing debts. Some developers have already adopted more aggressive sales campaigns with more likely to follow in the remainder of the year, depending on their situation and how the market performs.

GRAPH 2: Weekly Sales Volumes In Key Cities



Source China Real Estate Index System; Savills Research

GRAPH 3: 100 Cities First Hand Price Index



Source China Real Estate Index System; Savills Research

Where To Go From Here?

The central government has reiterated time and time again that "homes are for living and not for speculation", and that the stability in the housing market would not be sacrificed to provide short-term stimulus to the economy. So, it is unlikely there will be any targeted support of the wider residential market. However, some local governments have slightly adjusted policies to give additional support to markets impacted by COVID-19, with measures such as providing more talent attracting policies or releasing pre-sales financing to developers to improve liquidity. But these targeted local support policies are merely intended to help property developers survive the epidemic.

While, initially, interest rates barely budged as the central government focused on cash flow and work resumption, the headwinds faced by the domestic economy currently warrant a reduction in lending rates. The LPR has already been reduced twice this year by a total of 30 bps for the one-year rate and 15 bps for the five-year rate, though it is highly likely that there will be more reductions to come. While not a direct transmission to mortgage rates, these have also started falling in recent months and are likely to continue to fall. The banks have also seen their reserve ratio requirements fall, enabling greater lending—again targeted at the broader economy, though some will undoubtedly directly or indirectly find its way into the property market. In April, the Shenzhen government launched an investigation to find out whether lower cost concessionary loans to small-and micro-businesses were finding their way into the property market.

Volumes steadily improved from mid-February, but have since plateaued as deferred purchases have petered out as the full realisation of the impact on the economy and job market starts to sink in. Homebuyers are postponing purchases until the situation improves, while others may be holding out for more attractive mortgage terms or a better deal from developers offering greater discounts.

More pressure has been placed on local government balance sheets over the last year than ever before. Local governments have to balance a fall in tax collections, rate cuts, faltering revenues and incomes, increased service spending and expanded fixed-asset investment in order to get the economy humming again. Local governments are issuing more special bonds to get them over this period, but it also seems as if more land plots are coming to the market than in the past, especially those in more central/prime locations. This is likely to be a coincidence as sites take a long time to clear, though the added revenues will be warmly received.

At the same time, many cities have seen a backlog of high-end property pre-sales permits at prices closer to what developers were originally targeting (previously, overly-expensive properties saw pre-sales approval delayed to control the growth in average transaction price—a key metric used to assess market conditions). New launches of these high-end properties are, in many cases, oversubscribed with buyers having been starved of new stock. At the same time, volatility in global equity and bond markets (though mot as much in China) will have spooked some investors and they may have reallocated a portion of their net worth to the property market, which has historically proven more stable during previous periods of market volatility.

In many cities, the high-end of the market is likely to outperform the mainstream market in the remainder of the year as buyers of mainstream properties, which have outperformed high-end properties in recent years, are more likely to take on mortgages and be financially stretched than the buyers in the high-end market.

How Has The Market Changed?

Periods of self-quarantine are likely to encourage more people to reflect on their home life situation, whether this be the social situation or the physical surroundings of their property. There were expectations of a mini-baby boom as newlyweds found ways of spending of the lockdown, or divorces as couples were forced together in a stressful situation, both of which could result in the need for more housing as another family member is added or one household becomes two.

When it comes to the property itself, many people live in relatively small apartments with the average living space per capita in urban China in 2018 being 39 sq m, though in cities like Shanghai, with a residential stock of 672.8 million sq m (2017) and a population of 24.18 million (2017), the average living space is closer to 28 sq m. Extended periods of time at home, especially if you are in a multigenerational household and have to cook and work at home, would encourage you to either split the household up or look for a bigger property. To achieve this with a tight budget, some people might choose to live further from the city centre. Living in the suburbs is much more possible than it has been in the past with improved public infrastructure, sub-business districts and regional malls, especially if working from home becomes more accepted by society and businesses. These larger properties then may come with larger communal areas and kitchens, as well as potentially a private study.

Property owners and residents, in general, will place more importance on property management who, over the last few months, have played an incredibly important role in preventing the spread of the virus, through disinfection of public spaces, enforcing home quarantines, limiting access to compounds by non-residents and many other services. While being firm with compound guidelines, they have also had to strike a balance to ensure residents' lives were not disrupted too much. They are also one of the largest at-risk categories, coming into contact with a large swathe of society and having to continue to work through the lockdowns. Property managers are also maturing by investing heavily in new technologies to ensure greater security and comfort for residents as well as creating greater operational efficiencies and a broader service offering. They are evolving their offerings and becoming a platform that can meet the needs of an increasingly demanding population, in the same way that WeChat or Alipay is a platform for a whole range of mini-programs and services.

The country-wide shut down, economic slowdowns and the stress brought to the financial sector, businesses and the property sector are likely to result in blowouts and crises for the rest of 2020. The property market is one of the more leveraged sectors and is highly dependent on sales volumes to cover its financing costs; it is also an asset class that is used as collateral for a lot of the country's debt market. To protect the market from future shocks, there may be new regulations and restrictions that look to mitigate future risks in the same way that financial de-risking has been applied over the last three years. Regulators are likely to look at sources of developer and homebuyer financing and better integrate record-keeping with social credit scores. Additionally, there may be future legislation with regards to pre-sales and what the sales proceeds can be used for.

These are just some of the changes that may take place in the coming years, though the eventual impact on the industry is still uncertain, and more fundamental changes to the industry could take place.

Savills team

Please contact us for further information

RESEARCH

James Macdonald
Senior Director
China
+8621 6391 6688
james.macdonald@savills.com.cn

RESIDENTIAL

Shirley Tang
Senior Director
Shanghai
+8621 6391 6688
shirley.tang@savills.com.cn

Stella Meng
Director
Beijing
+8610 5925 2025
stella.meng@savills.com.cn

INTEGRATED SALES & CONSULTANCY

Frank Li
Director
China
+8621 6391 6688
frank.li@savills.com.cn