



CHINA – August 2022

CONTENTS

CANARY IN THE COAL MINE!	1
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CANARY IN THE COAL MINE!

The Largest Asset Class in the World has collapsed!

“Your house is not an asset; it is a liability”- Russell Cage.

The history of the idiom “Canary in the coal mine” is intriguing. Coal miners, while doing one of the riskiest jobs in the world, are faced with a hazardous work environment. One of the many dangers these miners encounter at work is annihilating poisonous carbon monoxide fumes. So Scott Haldane, the father of oxygen therapy, recommended: “canaries” (birds) to detect colourless and odourless carbon monoxide in the coal mines. The Canaries are more sensitive to carbon monoxide than humans and thus are good early detectors of this poisonous gas. If the canaries fell ill or died, it would warn the miners to evacuate.

Therefore, “Canary in the coal mine” became an adage for impending danger or trouble due to deteriorating health or welfare.

In today’s “globalised” world, the canary in the coal mine is the “Chinese real estate market”. The largest asset in the world, worth a whopping \$55 trillion, lately the Chinese real estate market has been in the news for all the wrong reasons.

Today, we will discuss the collapse of the real estate (RE) sector in China.

The “Hyperbolic” Growth And The Property Sector!

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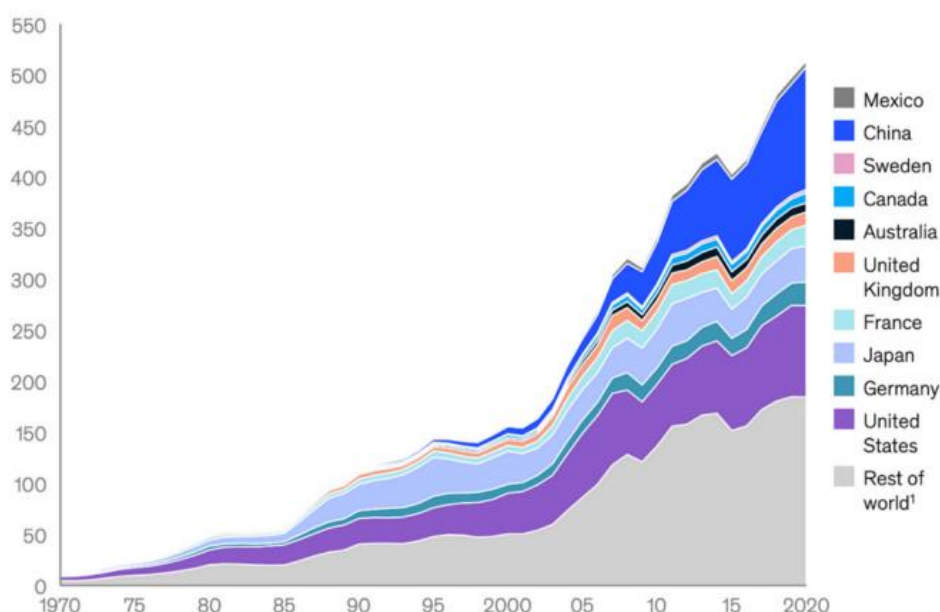
As we all know, China has witnessed hyperbolic growth in the last three decades. Led by the manufacturing sector, China took advantage of its human capital pool and became the export hub of the world.

The stupendous growth in the economy created immense wealth for the Chinese people. Thus, we saw a paradigm shift in the global net worth:

China had only a 1% share of global net worth in 1990. This figure rose dramatically to 23% in 2020.

A 50-year view of net worth highlights shifts from the United States and Japan toward China.

Composition of global net worth across countries, 1970–2020, \$ trillion



Share of net worth across selected countries, %

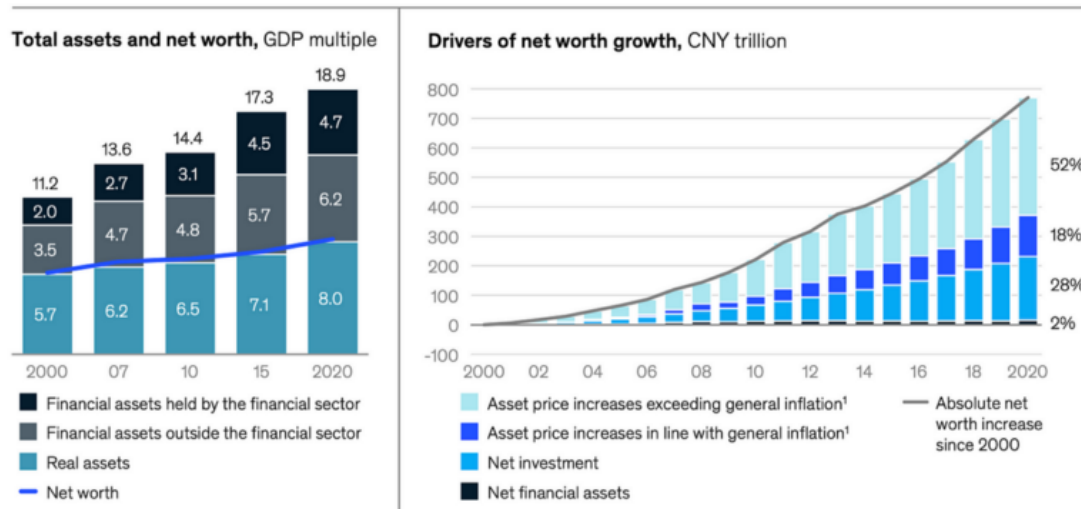
China	n/a	1	1	4	12	23
Japan	7	11	23	21	11	7
Germany	7	7	7	6	5	4
United States	37	28	22	26	18	17
Rest of world	38	39	35	32	40	36

The fascinating thing about this wealth generation is that most of the wealth created is in the real estate sector. The “Chinese” adore the property sector, which is visible in the data.

Real assets, which were 5.7 times the GDP in 2000, rose to 8 times the GDP in 2020! The biggest pie that explains the net worth growth is the “asset price increases exceeding general inflation”. This points to the fact that speculative activity was rampant in the various asset classes in China.

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An enormous proportion of Chinese wealth is in the RE sector. According to estimates, around 70% of the household's wealth is in real estate. The highest allocation to the RE sector indicates that Chinese households consider the property sector a "lucrative" asset class. The Chinese affection for RE is a headache for the ruling political class due to the deep integration of the RE sector into the Chinese economy. Let us understand:

The RE sector contributes around 29% to the Chinese GDP. To understand the property sector in China, we need to understand the local rules and regulations of the RE sector.

In China, the government owns the rights to all land in cities. Companies and individuals can purchase land-use rights from the government for up to 70 years, after which the lease can be extended.

Land sales are a significant source of income for the local governments. Furthermore, the funds generated from the land sales are used to finance various public infrastructure projects.

The banking sector exposure is massive to the RE sector. Almost 27.4% of the total outstanding loans were to the RE sector in 2020.

So, we have the property developers, the households, local governments and the banking sector. A deadly combination!

Well, we also have offshore creditors.

The Real Estate Crisis!

The Chinese RE sector was the elephant in the room. The highly "leveraged" property developers and the long-drawn "speculation" in the RE sector poised a systematic risk.

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As a result, the CCP introduced the ‘three red lines’ policy in August 2020 to curb lending to big developers.

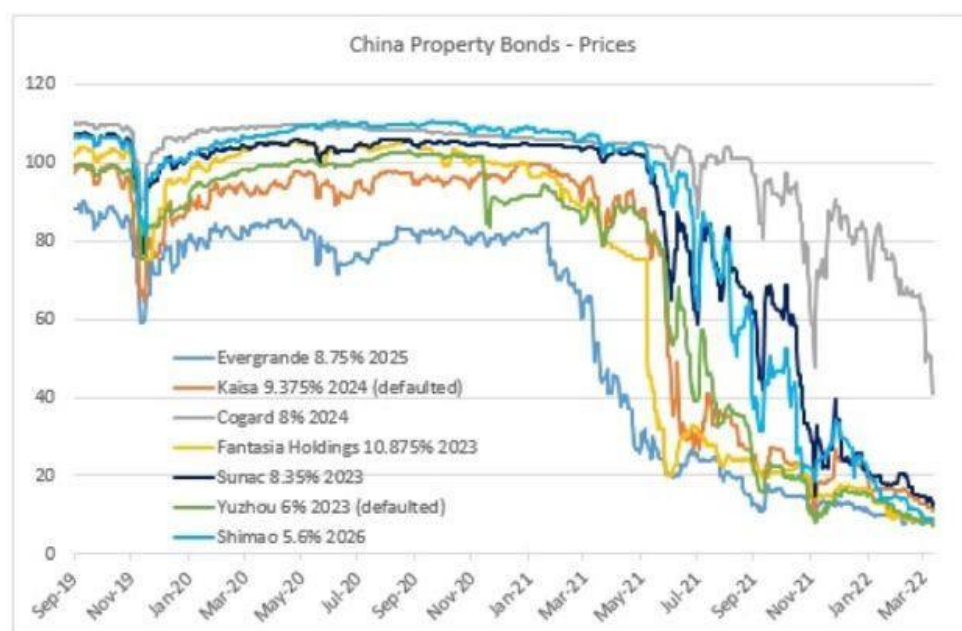
An asset-liability ratio (after excluding advance receipts) of no greater than 70 percent.

A net debt ratio of no more than 100 percent.

Cash to short-term debt ratio of one or below.

By the end of 2020, only half of the 66 largest developers were compliant with the new regulations, exposing the vulnerability of the property sector.

The crisis started to unfold in early 2021 when the second largest property developer Evergrande Group, with \$310 billion of liabilities and deemed too big to fail by the Chinese government, halted construction on its projects, and the bond prices of all the major property developers, including Evergrande, tumbled. In Dec 2021, Evergrande defaulted on US\$1.2 billion of its overseas bonds.



To understand the property developers' precarious position, one needs to know how the property developers work in China.

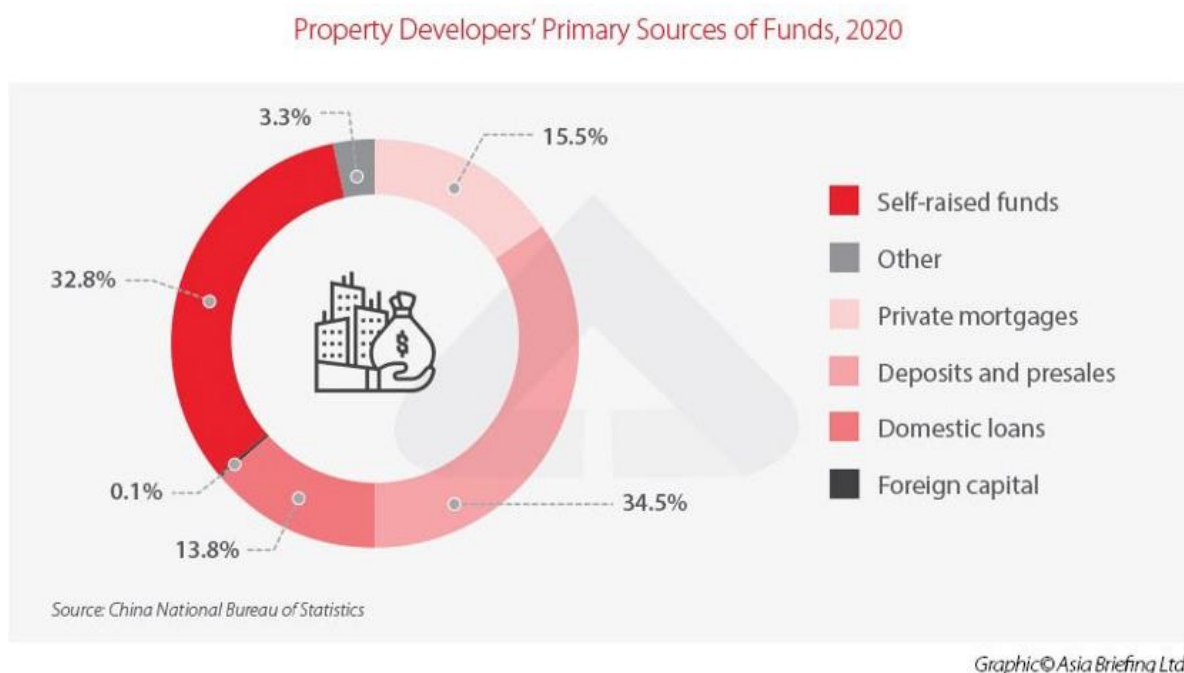
Firstly, we need to understand the primary sources of funds for the developers. The two most significant components are:

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Deposits and Presales: The largest source of income indicates that the developers are highly reliant on the “speculative” activity to fund their projects. Any halt in speculative activity can have disastrous consequences for developers and result in acute liquidity shortages. Developers raised over RMB 6.6 trillion (US\$1 trillion) from these two sources in 2020.

Self-Raised Funds and Private Mortgages: These funds are raised from offshore global investors who, in search of higher yields [due to depressed yields in their home markets (EU and USA)], invest in the Chinese debt. Furthermore, a high % of private mortgages suggests the involvement of shadow banking in the RE sector.



Secondly, we need to understand the capital structure of prominent Chinese developers.

The capital structure is comprised primarily of offshore bonds. Usually, offshore bonds make up 50–80% of the total capital structure. The two reasons to raise the offshore debt are:

Raising too much onshore debt may breach the three red lines policy.

All the secured debt of the developers is the onshore debt. The offshore debt, thus unsecured, entails a higher coupon than the onshore debt.

Thirdly, developers have most of their cash balance in the project companies instead of holding companies. As a result, the holding company's repayment capability weakens, as they cannot access all their cash for debt repayment.

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These were the reasons that led to the current crisis in the RE sector in China. What commenced with Evergrande spread like a wildfire and led to a series of unstoppable defaults.

A total of 18 property developers have defaulted in the offshore market so far this year, close to the whole-year total of 21 in 2021. The defaults by Chinese issuers exceeded US\$20 billion so far this year, compared with about US\$9 billion for all of last year.

According to Goldman Sachs Kenneth Ho:

“2022, we have a base-case estimate for a China property high-yield default rate of 19%. Last year was over 28%, so it’s still at very elevated levels of defaults.

The downside case of 31.6% for default estimation.

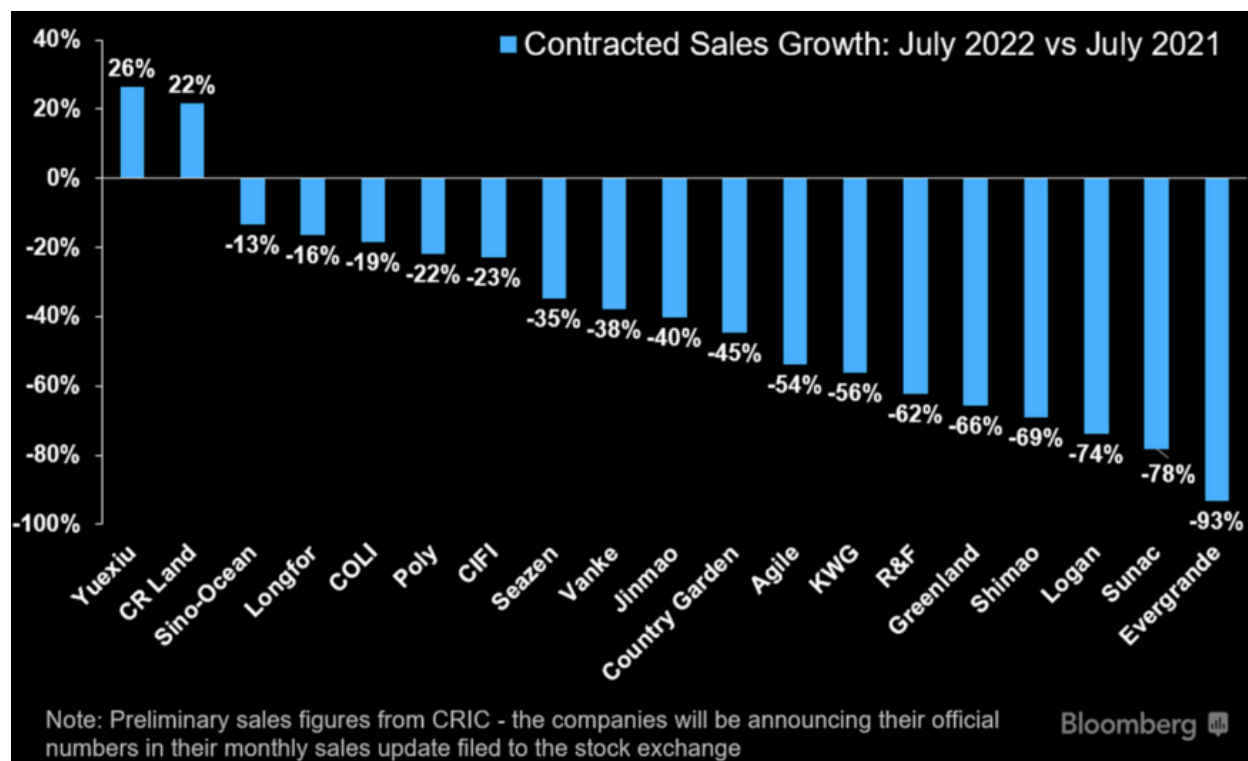
Though many analysts see the defaults peaking this year, however, it’s too early to call the peak because:

Developers are still highly Leveraged: As of June 2021, the property development sector has RMB 33.5 trillion (US\$5.2 trillion) in debt, according to Nomura.

Sales Contraction: The most significant income source, the sales are contracting, leading to tighter liquidity conditions. As per IHS Ratings, the contracted sales will drop by 10–20% in 2022. To generate liquidity, the developers have resorted to extreme measures such as accepting payments in wheat, garlic and peaches!!

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With housing starts declining to levels last seen in 2015 and completions lagging, the unfinished projects have seen an astronomical rise. As a result, homebuyers have ceased to pay their mortgage payments. A nationwide embargo on mortgage payments has compounded the problems for the government and the regulators.

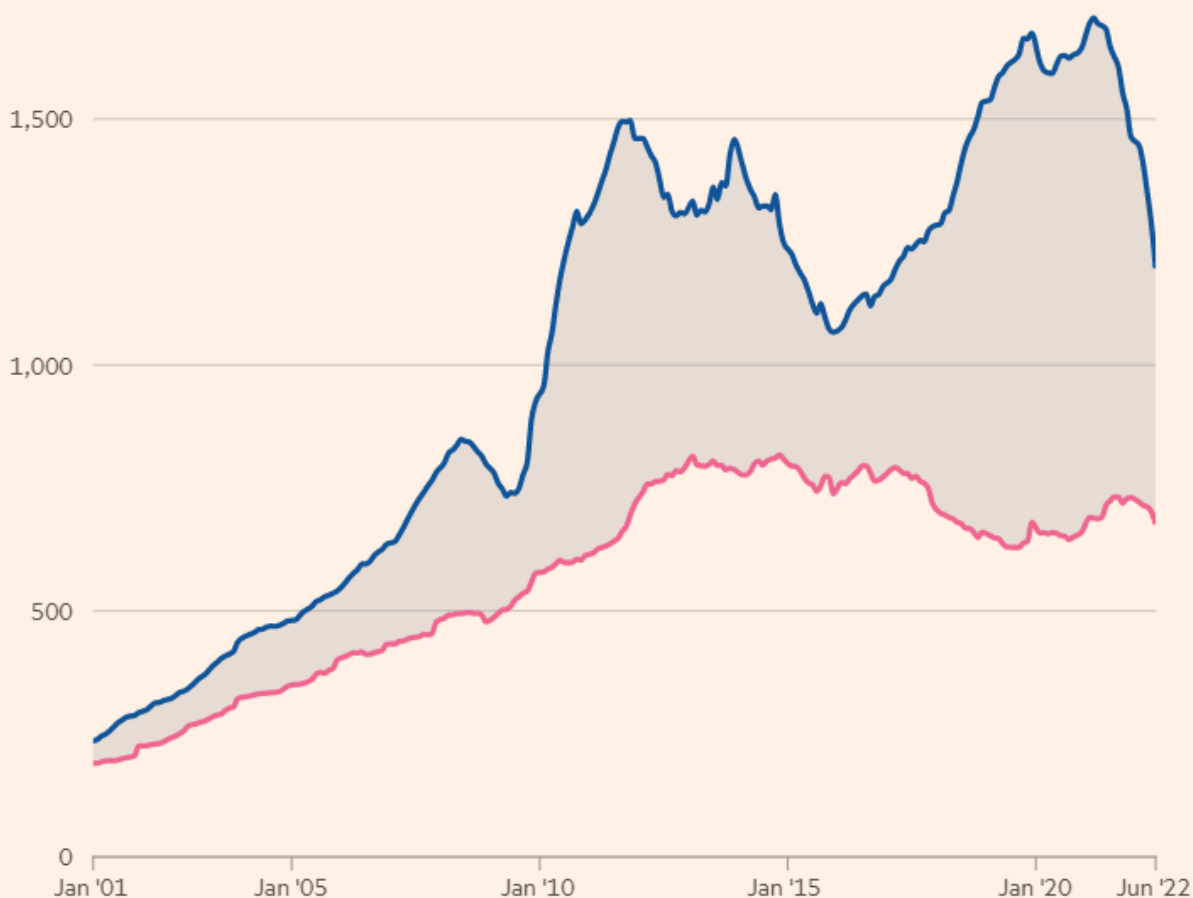
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Unfinished real estate projects have piled up in China as housing starts ballooned and completions lagged

12-month cumulative housing starts and completions (mn m²)

— Starts — Completions



Source: National Bureau of Statistics of China
FT Data: Andy Lin/@imandylin2

FINANCIAL TIMES

Roughly 1.5 trillion yuan (\$220 billion) of mortgage loans are linked to unfinished residential projects. This move by homebuyers has raised suspicions about a potential contagion in the banking sector.

Possible Solutions!

There are few options for the CCP to clear the property mess. This year, the CCP has proactively taken steps to ease the liquidity crunch in the RE market.

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The ultimate solution to finish the stuck projects is to take over the “stuck” RE projects. The CCP has to date, taken the following measures:

CCP plans to exclude merger and acquisition loans from the calculation of property developers’ debt and allow them to increase their debt level by 5%. This will make it easier for companies with better liquidity to buy assets from indebted developers.

\$148 billion financing for cash-strapped developers to complete the stalled projects.

Launching a real estate fund worth \$44 billion.

For the cash-crunched state governments, the Chinese regulator, last year, for the first time, announced a five-year pilot property tax scheme in some regions.

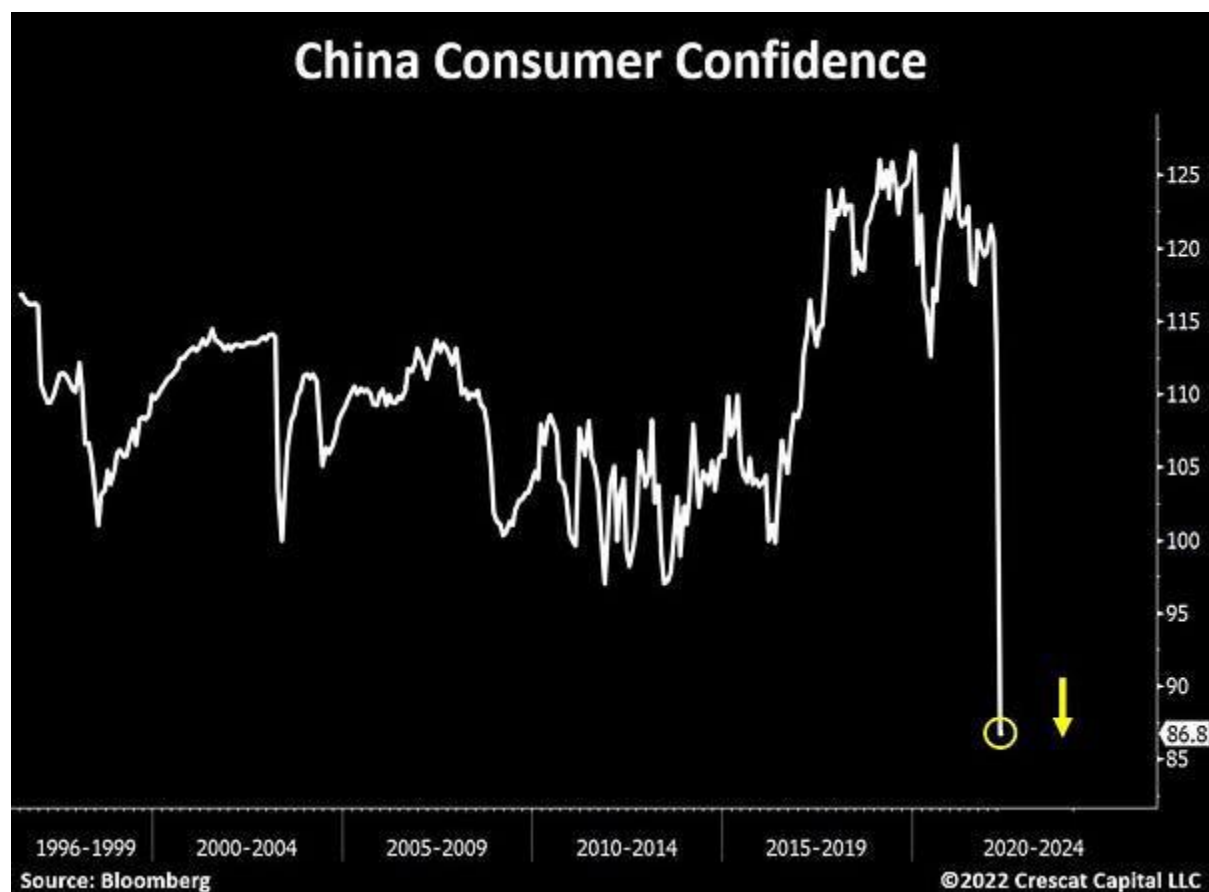
The property tax can be beneficial in two ways:

It will supplement the finances of state governments which dried after the land sales plummeted.

It can potentially curb the speculative activity in the RE sector as it will become costly to own a house after the imposition of the tax.

Conclusion!

The sentiment in the RE sector in China has become extremely sour. The negative wealth effect (tumbling prices) coupled with a gloomy sentiment does not bode well for Chinese consumer confidence, which plunged to an all-time low this year.



Source: Crescat Capital

Even though PBOC and the CCP are working round the clock to cleanse the malaise in the property sector, it would take years for normalisation to happen as homebuyers have lost their trust in the developers.

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