

Property/Real Estate  
China  
Special Report

# 2009 China Residential Property Market Outlook

## Analysts

Michael Wu  
+852 2263 9696  
michael.wu@fitchratings.com

Frederic Gits  
+81 3 3288 2992  
frederic.gits@fitchratings.com

## Summary

- The Chinese residential property market encountered some weakening during 2008. The level of activity, as measured by floor area sold, declined by 18% during the first 11 months on a year-on-year basis, with property prices down as well. This trend is consistent with the economic climate in China, as well as the government's "cooling" policy measures launched between 2007 to mid-2008.
- Fitch Ratings' outlook on the Chinese residential property sector in 2009 remains negative. Decelerating economic growth stemming from the global economic crisis, and negative wealth effect arising from a weak local stock market, will continue to depress market sentiment. Uncertainty in the employment market also erodes buyers' confidence.
- Short-term supply, as indicated by housing starts and floor area under construction, is also on the high side. Homebuilders are keen to secure greater cash flow by speeding up construction and presales.
- In order to "rescue" the market and maintain economic growth, the central government has gradually reversed its previous austerity measures. More leeway has also been granted to the authorities at the local level, to roll out their own market-rescue packages. Common policy measures include a reduction in taxes/transaction costs, and sweeteners to first-time homebuyers.
- To maximise the policy impact, the People's Bank of China loosened the credit environment across the board. It is now easier to arrange mortgage financing for the purchase of a second residential property, and banks are encouraged to lend to sound property developers. Market sentiment has improved, as conviction grows that the regulatory environment has reached a turning point and there may be no further cooling measures in the medium term. Liquidity and refinancing risks for big homebuilders have also substantially declined.
- The medium- to long-term picture for the residential property market, on the contrary, is rather positive. There have been very few land bank acquisitions since Q407, indicating that supply of new units in the three- to five-year timeframe will be low. Additionally, government policy to maintain 1.8 billion mu (~1.2 million square kilometres) during the period of the 11<sup>th</sup> Five-Year Plan (2006 - 2010) also limits the supply of new land for residential property development. Fitch expects that the policy of maintaining adequate arable land will remain unchanged even after the current Five-Year Plan period, as securing the food supply is a key strategic objective of the Chinese central government.
- Fitch also does not see any change in those long-term fundamentals on the demand side. The current economic slowdown is not going to have any impact on the positive longer-term demographics and urbanisation trend. Demand from upgraders will re-surface once the economic growth is on the right track again.
- The agency believes that the market downturn will speed up industry consolidation. Larger and well-run property developers will gain an even larger market share, as smaller names with poorer funding access will be forced to pull out or be acquired.
- Negative industry outlook already factored in the current rating level.

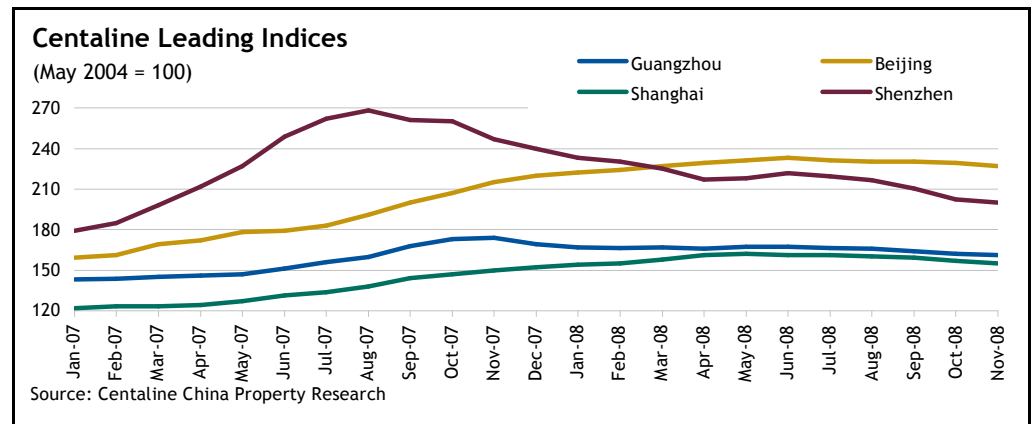
**Market Activity Level**

(sq m millions)	Commodity Building Floor Area Sold
Jan to Nov 2008	491.5
Jan to Nov 2007	601.6
Jan to Nov 2006	461.1
Jan to Nov 2005	433.9

Source: CEIC

**Residential Sector**

The year 2008 was clearly a period of slowdown for the Chinese residential property market. Indeed, the market had shown signs of weakness since Q407, and the activity level has dropped quite a lot since then. Looking at the statistics of area sold, 2008 (up to November) was approximately 18% lower than 2007, and this is consistent with both the economic slowdown and the government-driven austerity campaign.



However, the pace and quantum of falling property prices vary from location to location. The price chart *Centaline Leading Indicators* illustrates how the big four regional property markets in China peaked at different times and speeds. For instance, Shenzhen peaked during the summer of 2007 whereas Beijing topped out slightly before the 2008 Summer Olympics. Fitch maintains its view that the market is heterogeneous, with many cities with a population of over one million displaying vast differences in economic profiles and end-user expectations.

Factors on the demand side are weak, partially mitigated by a regulatory and credit environment becoming more supportive. Supply is expected to be above average in the near term, as homebuilders are keen to offload their inventories to maintain liquidity, leading to price and margin pressure.

**Weakened Demand Factors**

The unemployment rate is on the rise, and GDP is generally expected to grow at a slower rate. Fitch’s latest GDP forecast is about 6% for 2009, substantially below the typical 10%+ annual growth rate over the last few years. Negative wealth effects, brought forth by a significant correction in the local stock markets, have also eroded confidence and sentiment, which depressed the market in general.

Nevertheless, Fitch is optimistic about the residential property sector in the long run, reflecting key fundamental factors such as urbanisation and positive demographics. For instance, the current urban population accounts for an (approximately) low 40% of the total population whereas the Chinese government expects (and plans that) this ratio will hit the mid-50s% by 2020. Additionally, demand from upgraders (i.e. people who want to upgrade their residences) is expected to be huge given that the quality of residential properties built before mid-1990s is quite unsatisfactory.

**A Less Unfavourable Regulatory Environment for End-Users and Developers**

Since mid-2008, the central government has been gradually reversing its various austerity measures, and has granted “freedom” to provincial/municipal governments to take various measures to support their respective property markets. Clearly, the objective is to provide stability to the market and to reduce the impact

of the overall economic slowdown. Whilst the policy measures undertaken so far are unlikely to turn the tide, market expectations have changed. Observers have started to believe that the government will not roll out additional austerity measures, and this very expectation change encourages property purchase.

### Key Regulatory and Policy Measures Since Mid-2008

Date	Policy Unit/City	Key Contents
Since Mar 08	Various cities and provinces	<ol style="list-style-type: none"> <li>1. Reduce different kinds of municipal and provincial transaction costs and property-related tax</li> <li>2. Provide home purchase subsidies</li> <li>3. Reduce land supply</li> <li>4. Increase permitted borrowings from pension funds for property purchases</li> </ol>
Oct 08	The People's Bank of China	<ol style="list-style-type: none"> <li>1. Cut mortgage rates for first-time home buyers</li> <li>2. Reduce down-payment to 20% from 30% for first-time home buyers</li> </ol>
Oct 08	Ministry of Finance	<ol style="list-style-type: none"> <li>1. Reduction of Property Deed Tax</li> <li>2. Removal of Stamp Duty</li> </ol>
Since Sept 08	The People's Bank of China	<ol style="list-style-type: none"> <li>1. Cut interest rates by 2.16%</li> <li>2. Reduce reserve ratio by 1.5%</li> </ol>
Dec 08	Office of State Council	<ol style="list-style-type: none"> <li>1. Encourage residential property buyers by slashing some transaction-related costs, and slight loosening of credit to second-home buyers</li> <li>2. Encourage banks to provide credit to reputable and strong property developers</li> </ol>

Source: Fitch, Factiva, Various Chinese government departments, www.gov.cn

As well as the loosening of the policy relating to tax and transaction costs, there has also a healthier trend in the credit environment. First-time home buyers will certainly get some sweeteners, and buyers of second residential properties are now facing a slightly lower hurdle. At the corporate lending level, banks are now “encouraged” to extent credit to large and reputable real estate companies. This policy change effectively reduces possibility of a “fire sale” by homebuilders. In trying to avoid the adverse wealth effect a sharp reduction in housing prices would have, the current trend of policy loosening is consistent with the drive to encourage domestic consumption.

As the agency has pointed out in the past, the objective of different policies – whether they are of a tightening or supportive nature – is to reduce market volatility. The top priority of the Chinese government is to secure solid development (and deflate bubbles, if any) on a long-term basis. The government has been reasonably successful in this regard, leading to a moderate recovery in market activity and sentiment.

Combining different fundamental and regulatory factors on the demand side, the outlook is considered to be moderately negative. Pressure on unemployment will similarly pressure the residential property market from the demand side, and a friendly regulatory/policy environment can only provide partial alleviation. Stabilisation in the unemployment rate is the key for a full-blown recovery.

### Supply Side more Positive in the Medium to Long Term

On the supply side, the picture is positive in the medium to long term. Land acquisitions have been minimal since Q407, as many land auctions/tenders have been cancelled due to a lack of buyer interest. Supply of new property in the three-to five-year timeframe is likely to decrease.

Another factor constraining long-term supply is government policy over arable land, as the objective is to ensure adequacy of domestic food supply and to minimise

reliance on imports. As stated in the 11<sup>th</sup> Five-Year Plan, the government aims to maintain at least 1.8 billion mu by 2010. Comparing this policy goal against the current size of arable land in China, the difference is merely 0.02 billion to 0.03 billion mu, or 4,000 sq km of new land for property development (and other infrastructure purposes) on an annual basis. This theoretical supply of new land (4,000 sq km) is substantially lower than that of the 10<sup>th</sup> Five-Year Plan, during which over 12,000 sq km is supplied annually to the market.

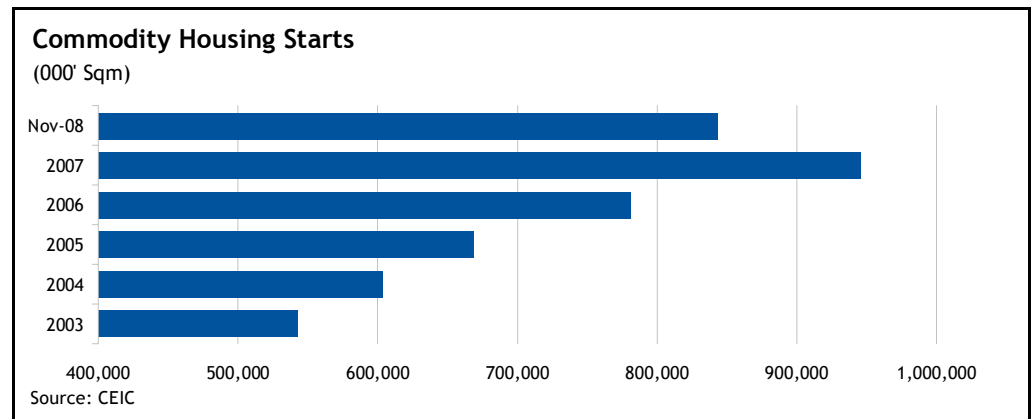
### Near-Term Residential Property Supply

(sq m (m))	Commodity Building Residential Floor Area Completed	Residential Floor Area Under Construction
1 Jan to 1 Nov 2008	286.3	2,022.6
2007	498.3	1,867.9
2006	454.7	1,517.4

Source: CEIC

As for subsidised housing, its impact on the residential property market should be limited given that the business focus of private homebuilders' is on mid- to high-end residential properties. In addition, government-subsidised housing is primarily aimed at the low-income group, with a stringent set of eligibility criteria. Given that China is largely copying the Hong Kong public housing model, the public housing market and private housing market would evolve to become two separate markets with a minimum overlap.

Although the long-term supply picture is positive, the short-term situation is vastly different – with supply expected to be high in 2009 and early 2010. Housing starts and floor area under construction are still on the high side, reflecting property developers' intention to speed up the construction work of existing projects and, ultimately, pre-sales. Since many projects are built on a “bare-shell” basis (i.e. with no decoration inside the unit), the pre-sale process can usually begin one year after construction has started.



While both the supply and demand factors are relatively weak, the good news is that the regulatory environment has swung to a supportive bias, providing a good cushion to the downward trend. Additionally, the long-term fundamental factors – such as limited supply and strong inherent demand – are still positive.

### Implications for Real Estate Companies

#### Negative Industry Outlook already Factored into Current Rating Levels

Fitch has a negative outlook in general, and further price reductions are expected. Given that margins are still quite decent, many of the homebuilders can take the hit and remain profitable. As for the Fitch-rated entities, the current rating level has already factored in a moderate downside scenario – and therefore near-term

rating actions are unlikely. However, since the Chinese property developers still predominantly rely on home sales, any sudden change in market conditions or homebuyers' expectations can disrupt their cash flow position and, ultimately, their credit ratings.

### Industry Consolidation

Fitch continues to maintain the view that industry consolidation and polarisation is on its way. As the property market becomes less robust, and business risk rises in the near term, some small and less well-run players will inevitably have to pull out. Management quality, operating scale, and execution capabilities will differentiate the good homebuilders from the bad.

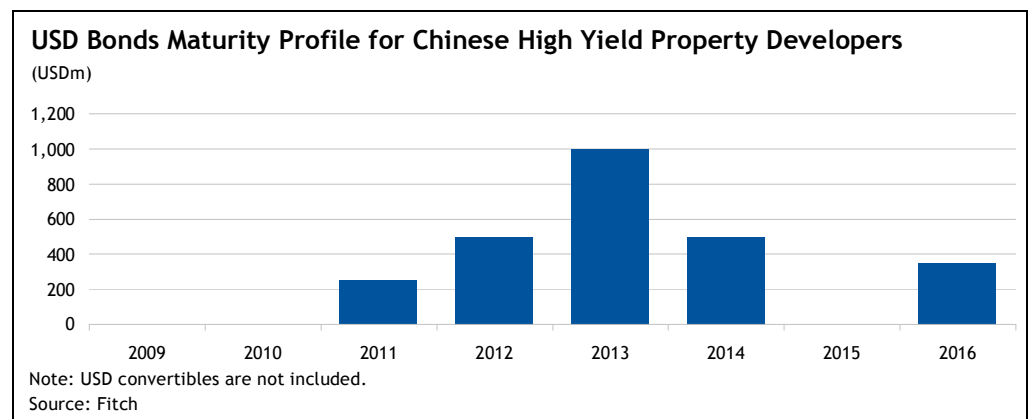
Larger and well-run property developers with multiple funding channels are well positioned in the current environment, and the agency expects them to gain market share when the industry evolves. Smaller companies, usually those rated in the 'B' category or below, are likely to be forced to focus on niche markets.

### Reduced Liquidity Risks for Bigger Names

The credit environment was tight for homebuilders during the first half of 2008. But since the government began to unwind the austerity measures in Q308, Fitch has noted a change in banks' credit appetite. A number of property developers, such as Shimao Property Holdings Limited ('BB+' / Stable), have successfully raised new facilities with the major banks in China. This is consistent with the policy to relax credit quotas, as banks are encouraged to extend credit to "large and reputable" corporates. However, unsecured creditors have to pay extra attention to this trend as subordination could occur if new facilities are of a secured nature or located at operating subsidiary level. If the subordination is material, it could lead to a notching down of the senior unsecured rating from the IDR.

Fitch takes moderate comfort from this policy, as liquidity and refinancing risks are reduced for the bigger players – and this policy in turn will accelerate industry consolidation, as smaller players will be placed in a less competitive position in terms of funding.

In terms of US dollar refinancing, Fitch expects a peak of activities in 2012 and 2013. Since those requirements, even if convertible bonds are also taken into account, are at least three years away, they do not pose any major credit concerns to the sector.



Copyright © 2009 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.