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A Real Estate Bubble in China?

More details emerge as to why this is not the case

The most persistent worry hanging over China continues to be the potential for a real estate bubble. We have written about (and discounted) this issue before, but being here this last week has helped put this issue into better perspective.

We try to keep these notes short, but there's really no choice on this one. Here are the main points we cover---read on for more detail and supporting evidence:

- Nationwide or even city-wide affordability ratios are misleading
- Housing subsidies have created lots of housing wealth in private hands
- Price increases are not being driven by increased debt levels
- Incomes have increased faster than apartment prices
- Zero property taxes create strange incentives
- Land sales instead of taxes finance government at the local level

Affordability: Apartment prices in Chinese cities are very high compared with average incomes---about 10 times annual family income for a 1,000 square foot apartment. That's double or more the ratio in the United States. Why isn't this evidence of a bubble?

We'll cover two issues: 1) What's "average", both in incomes and housing units, and 2) the role of housing subsidies. (The second is not as boring as it sounds)

The chart below is for Hong Kong prices, but the idea applies to the major cities in China also. As in most major cities in the world there are two markets: one is the super luxury apartment and the other is the "average" apartment owned by an "average" family.

Hong Kong has the highest luxury apartment prices in the world and the red line below shows a doubling of those prices in the last 7 years. Just as in New York and London these are multi-million dollar units purchased with cash, more as an investment than as a home.

The black line in the chart is for the rest of us. It shows a much more subdued increase, pretty much in line with incomes earned by the average family. These are small apartments. The 40-60 square meter number translates into a 400-600 square foot apartment. The average American wouldn't call this an apartment---it would be a self-storage facility. (a more detailed description of this chart is at the end of this message)

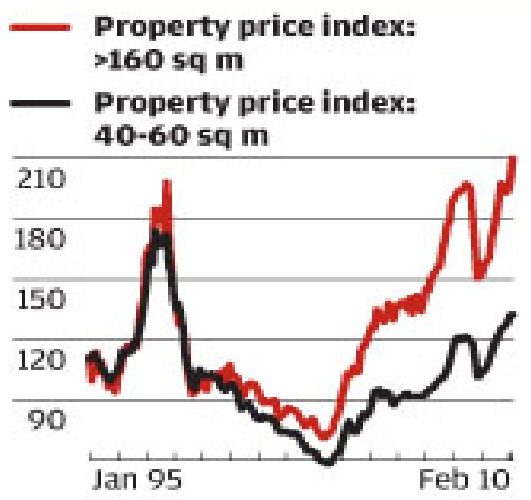


Figure 1 Hong Kong Residential Real Estate

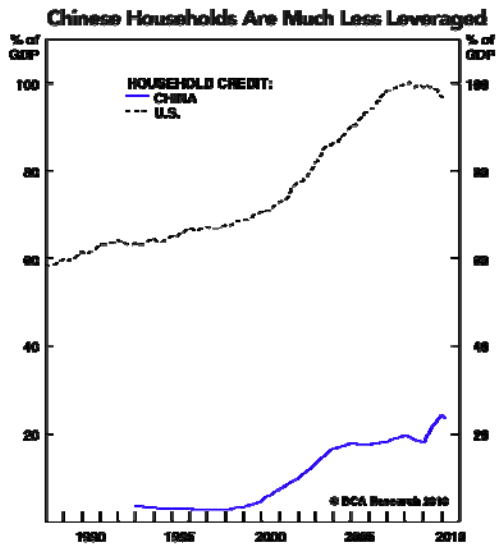
Since super-high incomes and prices drive up the averages, if you don't separate the high-end from the low-end markets you get strange numbers. In China where the income disparities are even greater than in Hong Kong, the averages don't tell you much. Just as in Hong Kong, smaller apartments in the suburbs owned by the average family are much more affordable than the total averages would suggest.

Then there are subsidies. Thirty years ago governments owned all the land in China. These city and provincial governments have been selling land and turning over apartments to families for the last ten years, since the privatization of property began.

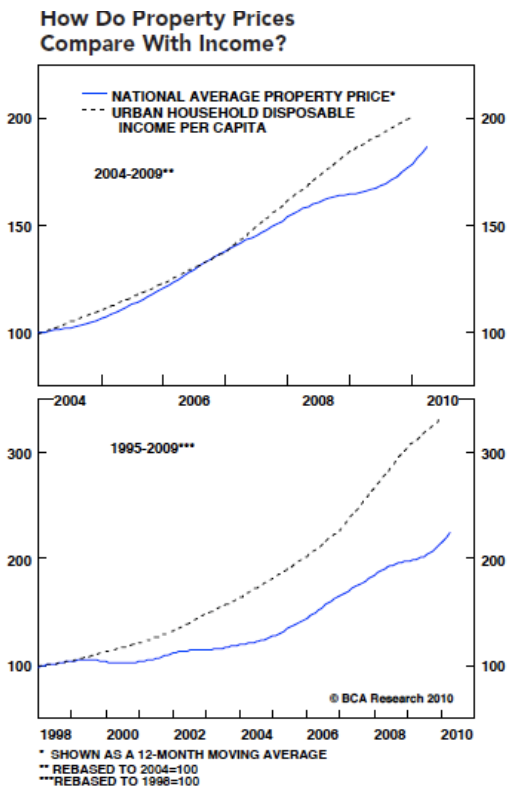
Using a New York analogy will help. Imagine that New York City decided to start selling public housing units to the tenants for about 10% of their market value. Nearly 60% of the urban homeowners in China received their apartments in this manner. This helps explain how so many city dwellers in China can own their apartments while their incomes remain low. Very little money down and no mortgage!

It screws up the affordability ratios, but it has worked wonders when it comes to upgrading living standards of the average family and transferring wealth into private hands.

Low Debt: By definition a bubble is a debt-financed phenomenon. The chart below shows how little debt Chinese consumers carry when compared with the United States.



With so little debt and 20% to 40% down payments as the rule, how can prices rise so fast? The chart below provides the answer: incomes are rising at incredible rates, even faster than real estate prices.



In contrast, house prices increased three or four times faster than incomes in the United States during our housing boom. China's prices are well supported by income.

No Real Estate Taxes: City and provincial governments are largely financed by land sales, not taxation. From the perspective of a US homeowner, this sounds wonderful, but the absence of real estate taxes on all types of property creates some strange incentives.

First, local governments, which sell property to developers, prefer commercial projects to residential ones since at least commercial tenants pay business taxes. That's the main reason for the glut of office construction in many Chinese cities. See-through office buildings are everywhere, but since the debt levels are low developers sit and wait for tenants and are not forced to sell. (Local officials also like new skyscrapers for reasons of prestige) But even with these artificial supports, commercial development is only 20% of the real estate industry.

Without real estate taxes residential speculation is encouraged since carrying costs are lower. The Chinese solution is to drive up the required down payments on second homes to 50%. Why not just put in a property tax? Taxpayers want a say in how government is run. Not something Chinese governments at any level want to encourage.

Restricted Supply of Land: The goofy incentives for local government don't end with their preference for commercial development. Governments borrow against the land they own rather than selling to developers. In fact the largest borrowers against real estate are local authorities, which really makes them into land speculators. Again, instead of raising down payments, Beijing could make it harder for local governments to sit on undeveloped land and increase the supply thereby driving down prices.

For political reasons Beijing fails to act and so prices keep rising, even as land sales have stalled at 2005 levels.

In conclusion: Much of this debate centers on your definition of a bubble. All price increases are not bubbles. If tulips in Holland had paid dividends, and dot-com companies had earned profits and all the condos in South Florida were rented, then these famous bubbles would have had cash flows to support them.

A bubble can be defined as price increases unsupported by rising cash flows, but supported by increasing levels of debt. Debt is a necessary ingredient, since without debt owners are not forced to sell, which is the event that bursts the bubble.

If debt levels were rising faster than incomes in China and if average apartment prices were rising faster than incomes you would have the necessary set up for a bubble. We think we will see that happen down the road. But it hasn't happened yet and for that reason rising property prices should not scare us away from China-centered investments.

Best regards,



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PS Some photos are included at the bottom of this message

From the South China Morning Post, April 23, 2010

Hong Kong homes are now among the least affordable in the world, typically costing 10 times the city's average income.

That certainly makes it sound as if there is a bubble in the market.

But what the survey actually shows is that Hong Kong homes are expensive, not that they are unaffordable. Affordability is usually measured not as a ratio of price to income, but in terms of the cost of mortgage

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payments relative to income. And thanks to low interest rates, mortgage charges are eminently affordable at the moment at just 36 per cent of income, less than half the 1997 level and lower than at any time during the 1990s.

Panic about a bubble would be understandable if low mortgage rates were fueling speculation or encouraging buyers to take on dangerous amounts of leverage likely to come back and haunt them when interest rates rise.

At first glance, it looks as if that might be the case, with property loans making up about 50 per cent of new bank lending and the total value of outstanding mortgages rising to an unprecedented HK\$650 billion (see the second chart).

But on closer examination, the picture is less troubling. The value of new mortgages made by the city's banks fell to just HK\$17 billion from HK\$26 billion in July last year (see the third chart). And loan-to-value ratios have dropped to a moderate 62 per cent, indicating that there is little or no rush to leverage up.

Meanwhile, speculative activity remains low, with the proportion of buyers flipping properties back to the market for a quick profit standing at under 2 per cent, less than half the level during 2007-08.

That doesn't mean the government's concern is misplaced. Property prices are high and rising. And with liquidity plentiful and mortgages available at interest rates as low as 0.75 per cent, considerably lower than the rate of inflation, they are likely to go on climbing for a good while yet.

But with leverage levels low among both homebuyers and banks, and with the Hong Kong Monetary Authority leaning on mortgage lenders to maintain tight prudential standards, there are few signs yet of a 1997-style credit-fuelled speculative bubble in the city's housing market, whichever way you want to look at it.



The most vertical city in the world....and they aren't finished. (below)

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