Dalton Investments

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Chinese Property Stocks – Back From the Dead? – Owens Huang

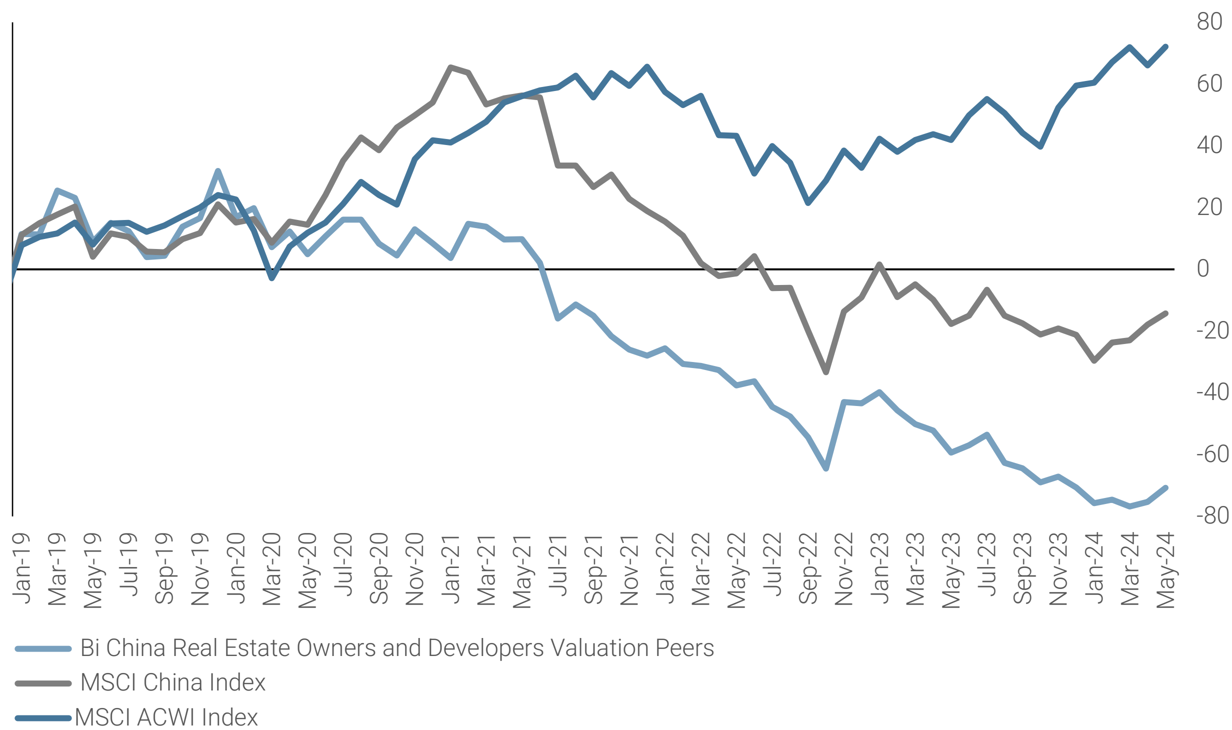
Chinese property stocks were once a material part of Dalton's regional Asian portfolios. Through partnering with skilled owner-operators, our investors were able to benefit from the unprecedented rise of the Chinese middle and upper classes. However, in recent years, Dalton has substantially reduced its exposure to Chinese stocks, due to the following related key drivers:

- The change in philosophy of the Chinese leadership, from a more progressive/business-friendly approach, to a more Maoist brand of communism
- The persecution of entrepreneurs and the discouragement of entrepreneurial behavior
- The movement of global supply chains out of China
- The rapidly worsening Chinese demographics
- Structural issues in the Chinese residential property market – one of the biggest asset classes in the world (Savills estimated the total value was around $80trn at the peak of the market in 2021 – or almost twice the total market capitalization of the S&P 500) and a key driver of wealth for Chinese families.

Despite our conviction that the above issues have not improved, and indeed continue to worsen, there have recently been signs of life in the Chinese property stocks. As the below chart shows, the performance of Chinese property market stocks (represented by the Bloomberg China Real Estate Owners and Developers Valuation Peer Group (BICH0DVP), which is an equal-weighted basket of Chinese property stocks) has been truly miserable over the last five years, with the broader Chinese market also massively underperforming the global market. However, from their trough in mid-April

2024, these property stocks rose by around 75% over a one-month period, before giving back around 15% of these gains. The broader Chinese market has followed suit, outperforming global markets by around 10% (in USD) since mid-April. As investors, we must always ask the question – "what have we missed?" In this brief update we examine the underlying problems in the Chinese real estate market and the causes of the recent rally, and consider the long-term implications for portfolios.

Chart – Chinese Real Estate Stock Performance Vs MSCI China and MSCI ACWI (%, USD)



Source - Bloomberg

The problem

Year to date in 2024, gross floor area (GFA) sold in primary developments (i.e. new house sales) in China is down over 40% on a year-on-year basis, and down 60% from its 2021 level. Linked to this, average inventory months (an estimate of how many weeks it would take for all the current homes for sale on the market to sell) has increased to 28 weeks. Secondary (i.e. pre-owned housing) GFA sold is also heavily down (around 20% on a year-on-year basis). Despite these decreases, it is tough to say that the Chinese real estate market looks "cheap" or even fair value - according to a recent analysis by Goldman Sachs, the Chinese housing market remains 25% above its fair value, determined by the spread between rental yield and the real debt service rate. With real estate prices having declined by 29% from their peak in July 2021, it could be the case that the Chinese property market is only halfway through its bear market downturn.

The tough situation described above has clearly had a direct impact on Chinese property developers, with major companies such as Evergrande, Country Garden, and SUNAC facing bankruptcy. S&P also recently slashed property giant China Vanke's credit rating to junk. Vanke, owned by a state-owned enterprise, is considered 'too big to fail'.

While the direct impact is negative, we also need to consider the indirect impact of this downturn. Firstly, property developers in China directly employ some 15 million people, who now have their livelihoods threatened. If employment in sectors related to these developers is included, the total rises to a staggering 50 million people. Real estate also remains the key asset of Chinese households, with Fortune recently estimating 70% of Chinese family assets are tied up in real estate. In a market where real estate prices constantly went up, these households felt richer and were able to comfortably spend their disposable income, driving a consumption boom, commonly referred to as the "wealth effect". We now have the reverse scenario – with prices falling, Chinese families feel poorer, leading them to save their cash. This scenario leads to a very challenging outlook for Chinese consumer companies and the broader economy.

The government response

In response to the worsening the real estate situation, the Chinese government recently implemented several measures designed to stabilize the real estate market. These measures include establishing a national company to purchase unfinished housing projects and removing purchase restrictions in several major cities, notably in Changsha and Chengdu, which has led to speculation about similar policies being implemented in first-tier cities. However, what has had an even more significant impact is the potential for material changes in real estate policies, aimed at reducing housing inventories. Under these new policies, local government financing vehicles will be encouraged to buy existing housing inventories and convert them into public rental properties. If implemented, this plan will help significantly recoup property developers' cash flows. In addition, the government may standardize the deed tax (the tax rate for documents that transfer an interest in property) to 1% from the current 3% on second or third houses, with the idea of spurring demand from Chinese investors.

Long term, the Chinese government plans to increase the share of public housing to at least 30% of the nation's total housing stock, from around 5% currently. This could equate to around RMB20tn of government spending. Dalton believes that while this may be a short-term salve for property companies, the long-term implications of this major shift are quite concerning.

Long-term implications

Unfortunately, the scenario unfurling in China has echoes of Japan in the 1990s, where the government "kicked the can down the road" and allowed its banking system to absorb the pain of its real estate market collapse over the following decade. Dalton's senior members witnessed firsthand how those actions ultimately led to the Japanese market's "lost decades" of extremely poor returns to shareholders.

Through its actions, the Chinese government is making it clear that it will not tolerate a housing market collapse (as indeed such a collapse could cause major civil unrest and instability for the regime). Its ability to control housing prices through the measures described above suggests that we are unlikely to see a full-blown housing market collapse in China, similar to that experienced by the US in 2008. Nevertheless, the policy of having local governments (which already have serious budget issues) purchase existing housing inventories, in our view, merely prolongs the downturn without offering hope for a sustainable recovery. In fact, by implementing this policy, China is simply passing the default risk from the property companies to the country's banks and insurance companies.

Impact on Dalton portfolios

While Dalton continues to admire the entrepreneurial spirit of many Chinese families in the real estate market, given the fundamental changes which China has undergone in recent years and the deeply concerning future for the property market in China, we feel that bottom fishing may not be advisable at this time. For now, Dalton believes the best use of client capital is to find opportunities elsewhere in Asia, particularly in the leading democratic nations of Japan, India, Taiwan and Korea.

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