

# Premium China *Funds Management*

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**Asian Property Q&A**  
A Closer Look at Asia's Real Estate



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# Asian Property Q&A

## A CLOSER LOOK AT ASIA'S REAL ESTATE

### Introduction

Over the past few years, the media has successfully drawn the attention of investors across the globe with stories on China's "ghost cities", which is generally considered to be symptomatic of a property bubble; and have caused investors and advisors alike to express their concerns when it comes to investing in this particular sector.

In this release, we will look past some of these overblown stories by painting a more in-depth look at China's property market, address some of the most common concerns that investors often have, and discuss reasons as to why the Asian property market is still an attractive alternative investment which should be considered as part of a diversified portfolio.

### **Q: How big is the Asian property market compared to Australia?**

**A:** In terms of market depth, Australia currently has around 60 listed property or property related securities with a combined market capitalization of approximately AUD75 billion. In stark contrast, there are over 550 listed property securities to choose from across Asia with a combined market capitalization of over AUD481 billion.

Aside from the tremendous difference in market size, the top 10 largest listed property companies in China by market capitalization accounts for roughly 10 percent of total market share only; whereas the likes of a few large property groups such as Stockland, Westfield and Lend Lease predominantly account for most of the market in Australia.

Moving forward, growth in Asia's property sector will not just be limited to China, with countries such as Indonesia and Thailand showing strong consumer confidence and robust GDP growth which is providing continued support for both residential and industrial property. Quite simply, an array of opportunities exists within the broad investment universe of Asian property, given the right resources to conduct research into individual securities.

### **Q: Do "ghost cities" exist?**

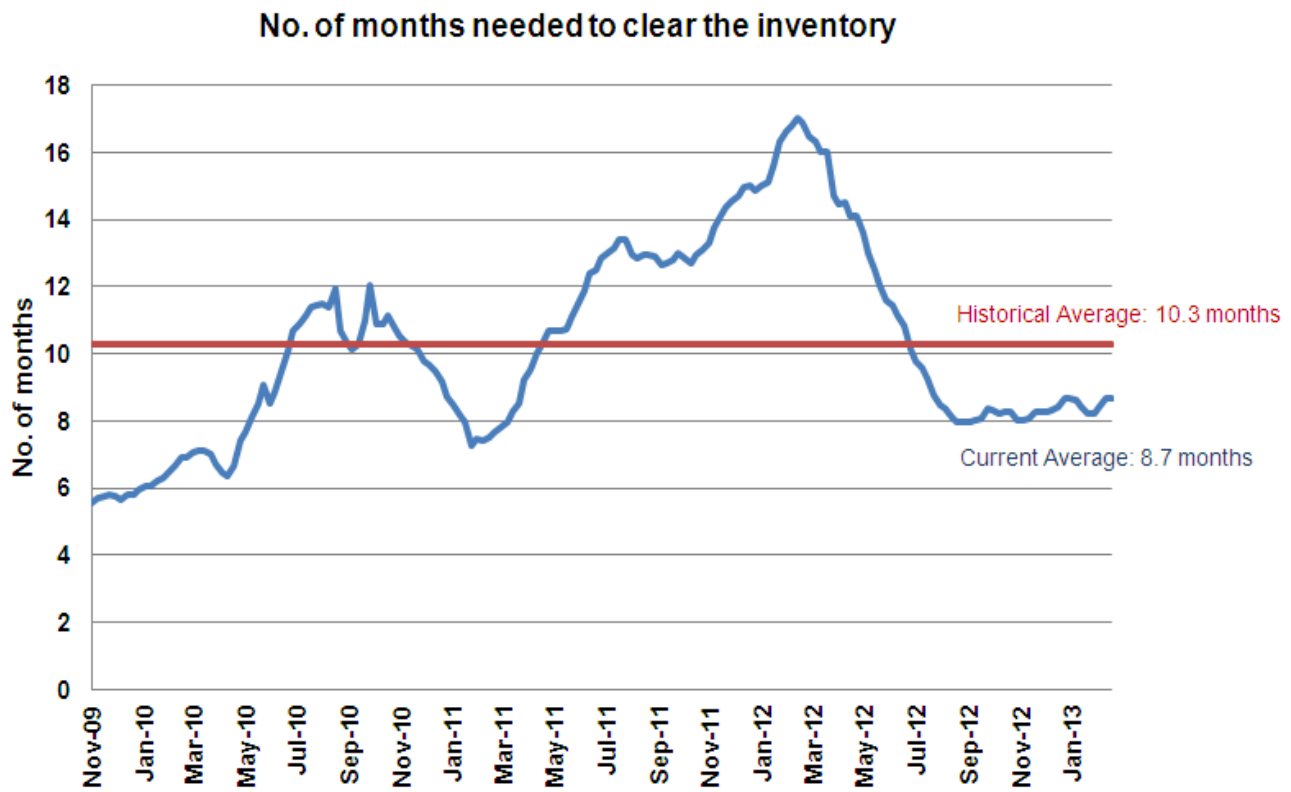
**A:** Yes. A few "ghost cities" do exist in China due to failures in city planning and irrational over-building in areas which were thought to thrive based on past economic significance; such as Ordos, once a thriving mining town which still remains one of the wealthiest regions in China, and the New South China Mall in Dongguan, a city once dubbed as the world's factory. However, there are far too many misconceptions which have been portrayed by the media, and the fact that the list of "ghost cities" have not expanded over the last few years suggests that they are quite limited.

It can be at times bewildering to see the size and magnitude of these empty "ghost cities" with hundreds of uninhabited apartments and unoccupied shops; but bear in mind that China holds the world's largest population and is currently undergoing enormous economic shifts, with its' next stage of growth relying on strong domestic consumption lead by rapid urbanization .

Western economies wait until there is a bottleneck in the market before starting to investigate the need to build new housing (and infrastructure for that matter), whereas China, which is controlled by a centrally planned government, has a far more forward looking tendency when it comes to its' economic development. Aside from this, it must be noted that in reality, many real estate projects across the world start with nobody in them and fill up over time.

To put things into perspective, the current US population size is approximately 315.5 million and the current Australian population is just a mere 23 million. On the other hand, the population of China is a whopping 1.35 billion with just over half of its citizens living in urban areas as of 2012, while over 600 million still remain in rural areas. Based on a report released by McKinsey & Company, China's urban population is estimated to increase by approximately 300 million and reach a staggering 1 billion by 2030. With a planned urbanization rate of approximately 15 million a year, the government must build the equivalent of almost two New York sized cities (estimated population of 8.3 million) to accommodate its' citizens.

One indicator worthy of a quick mention when it comes to concerns about "ghost cities" and low occupancy rates is the number of months it takes for developers to clear inventory levels. The graph below shows the historical and current average number of months needed to clear inventory and indicates that inventory levels have declined to comfortable levels below the average as of late, all while property prices remained strong. In January 2013, home prices in 70 major cities across China increased by an average of 0.7 percent from the previous month, after a 0.4 percent rise in December the previous year.





The media reports overgeneralize from a very small sample and rarely ever do they mention the numerous new cities and districts in China which are now crowded with residents. With continued urbanization along with the expected growth of China's middle class (defined by their income levels and ability to make discretionary choices) to 600 million by 2020 (almost twice the size of the entire US population), there isn't much to be concerned about in terms of demand for and affordability of housing in these developing cities. China is simply playing economic catch-up.

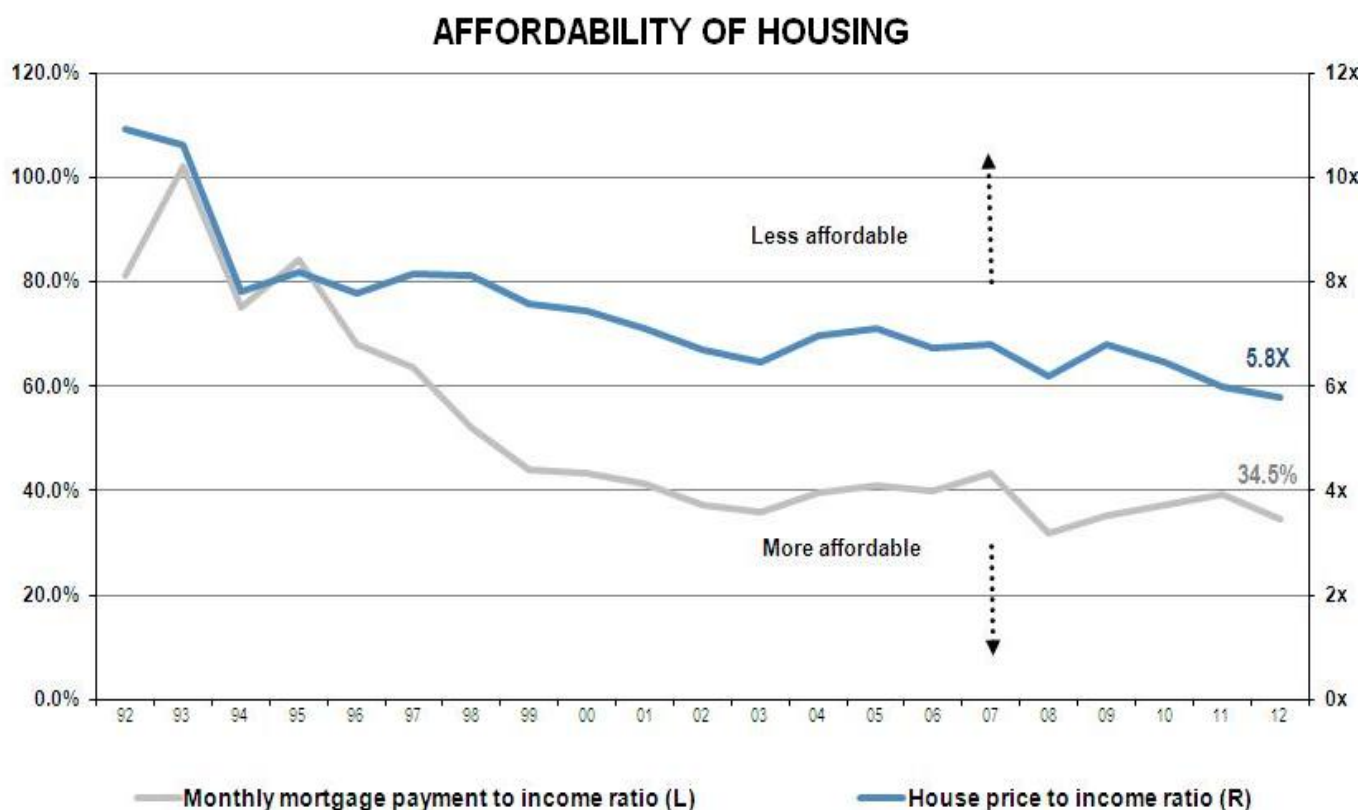
Our **Premium Asia Property Fund does not invest in "ghost cities"**. We undertake in-depth analysis of the market when sourcing our investment options, breaking down developments individually to determine whether or not to allocate them to our portfolio.



**Q: Since “ghost cities” do exist, is their existence driven by rapid construction of unaffordable housing; in other words, is housing still affordable?**

**A:** We refer once again to the media reports on “ghost cities” which either imply or claim that their existence is due to the rapid construction of unaffordable housing by the government in order to boost GDP, and that this will eventually lead to a huge property bubble. As such, one of the main concerns raised is whether property prices in China have spiraled to unaffordable levels.

Below is a graph showing us two key indicators of housing affordability; (1) the *monthly mortgage payment to income ratio (L)* and (2) the *house price to income ratio (R)*.



Source: CEIC, NBS, JP Morgan Research; Dec 2012

As can be seen, the *monthly mortgage payment to income ratio (L)* has fallen significantly from over 100 percent to 34.5 percent over the past 2 decades, while the *house price to income ratio (R)* dropped from 10x to 5.8x.

As a comparison, Australian homeowners currently spend approximately 32 percent of their household income on mortgage payments and the house price to income ratio is approximately 8x.

From these figures, we can see that housing affordability has in fact increased. Increases in property prices are a result of rising income levels, unlike what occurred during the US housing crash and the Japanese bubble; which we will explore further in the next section.

## Q: Will there be a property bubble in China?

**A:** A real estate bubble describes a phenomenon where property quickly increases in value to unsustainable levels in comparison to other economic indicators such as income and demand.

With all the “talk” of a real estate bubble occurring in China, it is understandable for most people to shy away from this particular sector. However, while many market commentators have drawn parallels between China's property market and the US housing crash in 2007, a closer comparison of the figures tells us otherwise.

Below is a table showing us a comparison of China's “real estate bubble” compared to Japan's in the late 1980's and the US in 2007 right before the GFC hit.

**Comparison of real estate bubble**

	China 2003-2009	Japan 1985-1991	US 2000-2007
Status of economy Then potential growth rate	High growth 10%	Lower growth 3-4%	Matured economy 3%
Property price hike rate (CAGR.) Period of bubble (Total price hike)	12% 6 years 2x	30% 6 years 5x	10% 7 years 2x
Market	Residential	Commercial	Residential
Size of credit to property sector	40% of GDP	50% of GDP	80% of GDP
Leverage	Low	High	High
Lenders	Banks	Banks	Securitization

Source: PIMCO estimates

The table shows us some significant differences between the economic state of China's property hikes compared to that of Japan and the US during their respective period of strong property price growth. First of all, in the time period stated, GDP growth remained high at 10 percent year-on-year in line with property price increases of 12 percent year-on-year, whereas property prices increased 30 percent year-on-year during the boom in Japan and 10 percent year-on-year during the US housing sector boom while GDP growth for both countries remained low at 3 percent.

Average salaries have also for the most part, kept pace with property values, growing at 13.2 percent CAGR which is higher than the 12 percent CAGR in property prices from 2003-2009. When you compare the figures, China's property prices simply aren't growing unsustainably in comparison to other economic indicators such as GDP and average income growth.

Another key differentiating factor between China, the US and Japan, is that leverage is low in China. Fiscally, the Chinese government and its citizens have always been fairly conservative, with home owners borrowing around only 17 percent of the value of their property in comparison to US home owners who borrow up to 80 percent of the value of their property. The average household saving rate in China is around 38 percent compared to 0.4 percent in the US in 2007, right before the downturn. As at the end of 2012, China households'

mortgage debt was only 16 percent of GDP compared with 87 percent in the US, and mortgage loans accounted for a low 14 percent of total bank loans which is remarkably lower than that of the US and Japan which was at 72 percent and 64 percent respectively.

The importance of low leverage cannot be overlooked as a sudden increase in interest rates or change in market conditions will have little impact on the ability for borrowers to meet their mortgage payments. It is highly unlikely for China to see default rates similar to that of the US which caused the country's housing crash.

One final thing to note is that China's centrally planned government has the added advantage of being able to fine tune the economy through its capacity to directly control the ability for banks to lend, and can also react much more swiftly and decisively to shifts in the economy in comparison to most western countries. As of late, we have seen numerous initiatives and policies implemented to cool the overheating market, including increasing mortgage rates and down payment requirements in cities where property prices are rising too fast, applying a 20 percent capital gains tax on home sale profits, restricting housing purchases and imposing stringent restrictions on developers to ensure development land can be converted into affordable homes.

To claim that the whole of China's property market is a big bubble is an exaggeration. Low leverage levels, strong economic growth, high saving rates and strong demand for homes across different income levels along with limited access to bank loans all point to an unlikely crash in the housing market. With a strong growing middle class population; consistent, steady, and most importantly, sustainable growth is possible.

### **Q: What are the reasons behind the government tightening measures and how will they impact property and stock prices?**

**A:** Wen Jiabao, China's outgoing premier, reaffirmed his legacy of tightening on the country's overheating property market by reiterating and expanding the current policies in reaction to accelerating price hikes in select first-tier cities; leaving the office with a clear message that there should be no relaxation of property market controls.

The issue here is that the government wishes to eliminate speculative demand which is the source of the overheating problem, while at the same time protecting end-user demand to ensure housing remains affordable for first-home buyers amongst the rising middle class. Property has a great significance to the Chinese who view it as a gateway to social status, wealth, marriage and stability. Pricing the poorer citizens out of the market is that last thing that the government wants to do, as this would create significant social unrest in a country which has seen an increasing gap in wealth and social disparity over the past decade of high growth.

The State Council issued a notice on the 1<sup>st</sup> of March 2013 calling for action at the local level to further suppress speculative housing demand, in an attempt to curb price hikes seen during the first quarter of this year. Such measures included the imposing of Home Purchase Restrictions, implementation of a 20 percent capital gains tax and asking local governments to raise down payments and mortgage rates for second-home buyers.

When the further tightening measures were announced, property company share prices in both the Hong Kong and Shanghai markets suffered after real estate stocks were heavily sold off, with some shares sliding as much as 10 percent.

Irrespective of the stock prices, developers are still enjoying strong sales growth given the healthy demand from rapidly growing middle class consumers who have seen double digit income rises in recent years. Leading developers have all gained market share since the government started policy tightening over the past two years, which can be attributed to their ability to access cheap financing from the banks and also acquire land cheaply.



The balance sheets of the developers will remain safe even in a downturn. China is still one of the best residential property markets in the world in terms of risk versus reward.

Our fund managers, Value Partners, employ the deep-value investing style of Graham and Dodd which is also famously advocated by Warren Buffet. They are stock pickers and base their investments on the fundamentals of a company without being heavily influenced by price movements caused by market sentiment.

As such, price drops caused by the overreaction of investors provides a perfect opportunity to hunt for bargains as company stocks become cheap while their fundamentals remain the same. There is a key distinction between price and value.

**Q: How do property developers in Asia manage their cash flows, their biggest source of risk?**

**A:** The main source of cash flow for developers is through property presales. In China, developers can receive all the presale cash within 1 to 2 months after the bank approves the mortgage loan. The main sources of cash outflows include construction spending, land premium payments and tax.

In situations where presales are weak, developers usually reduce their cash outflow by cutting down their budgets on construction spending and new land acquisitions. Furthermore, they can also negotiate with local governments to delay committed land payments.

After going through a few market cycles, developers have become more detailed, prudent and timely in their cash flow management by adjusting their cash flow budgets from annual or semi-annual to monthly reviews, better assessing cash inflows before deciding on outflows. Stress tests are also carried out to prepare for extremely poor market scenarios.

Overall, developers have been particularly capable in optimizing their debt profile with carefully balanced allocations between both long and short term debt, creating a close match in the timing of their cash inflows and outflows. Many Chinese developers listed in Hong Kong have also diversified their funding channels by issuing USD bonds in order to increase global liquidity.

**Q: What are REITs, what attractive features do they offer and how big is the market?**

**A:** In the past, listed property exposure for investors in Asia could only be obtained through major listed real estate companies. However, Real Estate Investment Trusts (REITs) have become ever increasingly popular, offering investors with an alternative method for gaining exposure to property with a stronger focus on real estate investments compared to real estate development. REITs are similar to managed funds in that they are a portfolio of investments, which in this case are a mixture of residential, commercial and industrial income-generating properties.

Compared to direct investments in property where buying and selling requires a greater deal of effort and involves potentially higher expenses and management fees, REITs provide investors with low entry costs, divisibility, proper disclosure and a highly liquid method of investing in a diversified portfolio of real estate as their shares are publicly traded on a stock exchange.

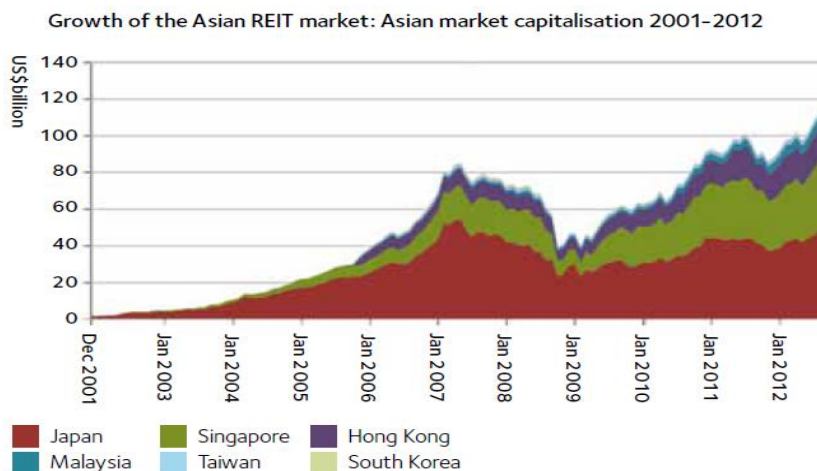
REITs typically offer steady revenue growth, regular distribution payouts and high distribution yields from sales and rental income. Aside from these, REITs also have the attractive feature of being lowly correlated to bonds



and equities (annual correlation of about 0.4 to the S&P500 and -0.2 to 5-year Treasuries). Given its portfolio-like nature, REITs provide an attractive investment to help increase diversification and reduce volatility.

Globally, there are more than 500 REITs, accounting for a total market capitalization of over USD850 billion (approximately AUD828 billion) and represents 45 percent of all listed real estate exposure. The leading markets are currently US, Australia, France, Japan and UK whose global market shares are 55 percent, 10 percent, 8 percent, 6 percent and 5 percent respectively. The establishment of REITs in Asia over the last decade has been an important addition to the real estate investment landscape for both retail and large institutional investors, fostering the development of high quality real estate investment portfolios that deliver attractive yields. Asian REITs are still in their development stage, accounting for approximately 13 percent of global REITs with an overall market cap of over USD120 billion (approximately AUD117 billion).

The figure below highlights the significant growth in the Asian REITs market over 2001-2012. Note that although the Asian REITs market was impacted by the GFC, it has recovered significantly and increased its market capitalization by over 190 percent, significantly exceeding its pre-GFC levels and also the extent of recovery seen by many of the mature REIT markets.



Looking ahead, Asia's real estate sector and REITs market are well positioned with an ever increasing role being played by emerging markets such as Malaysia and Thailand; backed by increasing transparency, sophistication and consumer demand. Asian REITs should be an essential component in an investor's portfolio, and for this reason a quarter of the funds in our Premium Asia Property Fund are invested in REITs.

## Q: What distinguishes the Premium Asia Property Fund from other funds?

**A:** With healthy economies and corporate balance sheets, loosening credit conditions and a market depth much greater than what our domestic market has to offer, investing in the Asian property market should be seen as a compelling alternative for global investors to consider.

The Premium Asia Property Fund has a long track record of providing consistent returns. As at the end of March 2013, the fund has an overall performance of 127.6 percent or annualized return of 18.6 percent net of all fees since its launch in June 2008<sup>1</sup>. The fund is Lonsec and Zenith Recommended<sup>2 3</sup>, endorsed by van Eyk<sup>4</sup>, and rated 4 stars by SQM Research<sup>5</sup>.

<sup>1</sup> Source: Macquarie Investment Management Limited, in AUD, NAV to NAV, with dividends reinvested. Performance data is net of all fees. This information is quoted as at 28 March 2013. Investment involves risk. The price of units may go down as well as up and past performance is not indicative of future results. Investors should read the Product Disclosure Statement for details and risk factors in particular those associated with investments in emerging markets.

Through Value Partners' capacity to internally generate research on a wide range of stocks, a large investment team of over 40 are constantly searching for opportunities which are either overlooked or undervalued by other investors. Along with their disciplined deep value investment style, our fund managers conduct over 2,500 company visits each year and ensure their process covers the three most important "R" elements: "The **Right** Business, The **Right** People, The **Right** Price".

**Q: How is the fund currently positioned? (End March 2013)**

**A:** In the earlier part of the first quarter, the fund continued to take profit on some Chinese property stocks which were on rich valuations as policy risk was mounting up with rising property prices. The fund managers preferred to realize earlier gains and wait for a better entry level. Overall, the fund's holdings were concentrated on those developers with strong balance sheets and good growth prospects.

Progressing through the quarter, exposure was added to Southeast Asia, particularly Thailand, as the growing economy and income levels continued to drive property demand. Thailand's geographical exposure was increased from 4 percent at the beginning to 9 percent at the end of the quarter.

Towards the end of the first quarter, the fund manager added exposure to ASEAN countries. ASEAN governments are expected to continue with expansionary fiscal policies and infrastructure developments, which will help boost the domestic economy and may have a positive impact on asset prices in the medium term.

The fund manager also increased the holdings of property bonds with attractive yields. Late in the first quarter, the financial results for 2012 were announced by listed Chinese developers, which showed robust sector fundamentals, particularly for the key players. By the end of 2012, the sector's average net gearing was lowered to 53 percent from 69 percent in 2011, and cash positions increased to record highs. With lower insolvency risk and ample global liquidity, the high-yield bonds issued by Chinese developers continue to see good investor demand.



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