Orient Capital Research

October 9, 2014

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Failed Land Sales in China

Weakening Land Market Shows Rising Risks to China's Economy

Summary: Slower GDP Growth and Shortfall in Local Revenue

China's land policy is suffering a crisis. After years of rising land prices and revenue, both prices and quantity of land sold is declining. As a result of falling demand, in the past six months almost 20 percent of the plots of land offered by local governments have failed to attract a buyer.

Land sales volume in 100 major cities fell 47 percent year-over-year in the third quarter of 2014, according to the China Real Estate Information Office. Total sales revenues fell to Rmb127.8 billion, down 75 percent year on year. The average land transaction price fell 52 percent year-on-year.

The main cause of this decline is reluctance by property developers to pay the high prices requested by the local governments selling the land because they are reluctant to acknowledge the end of the property bubble. There is a "cat and mouse" game going on between governments and developers. Local governments are hoping for a second fiscal stimulus to prop up prices, while developers are waiting for the governments to acknowledge the slump and lower prices. Some developers believe that an upcoming nationwide audit of land transfer income will force some local governments to reset selling prices to reasonable levels.

In this report, we surveyed five cities to check on the state of land sales. Our conclusion is that failed transactions – virtually unheard of during the long-running property boom – have soared. We believe this signals more than just a problem for developers. The increase in failed land lots and the fall in the value of land will have a systematic impact on China's economy.

First, this collapse of land auctions suggests **further declines** in the property market are in store for China; Second, it is **negative for GDP growth**, as the property sector overall accounts for a significant portion of GDP; Third, local governments that rely on land transfer fees for an estimated 60 percent of revenue will discover a **shortfall in income**;

Fourth, land has been used as collateral for local government projects through their external companies, called Local Government Financing Vehicles (LGFVs). The decline in the value of this equity may result in **cash calls** by banks that have extended loans to LGFVs and will cause further declines in LGFV investment

Eventually, the gap between local revenue and local expenditure will have to be filled either by the banks or the central government.

Conclusions

- **Failed Auctions**. We reviewed land sales over the past six months. Of the five cities we examined, 20 percent of the 140 plots of land up for sale failed to find buyers. Another 7 percent were withdrawn from sale.

- **Sharp Decline in Land Sales.** In August alone, land sales fell 72 percent in size and 52 percent in value compared with August 2013. Some 300 major cities in China together saw a 40 percent decline in land revenue in August to Rmb144.9, based on the data of China Index Academy.

- **Ambitious Pricing.** Although the average offered price for the first eight months of 2014 increased more than 30 percent compared with 2013, the average price paid was 3 percent lower. As a result, August land premiums decreased 54 percent. The large amount of failed auctions was caused by unrealistic prices by offered by local governments. Most local governments are still too optimistic and have failed to adjust land prices, which has resulted in a gap between the selling price and what is acceptable by developers.

- **Local Governments to Suffer.** Local governments, which rely on land sales for as much as 60 percent of their total revenue, are facing a shortfall in revenue required to pay for local services such as healthcare and retirement. Some governments that have used land as equity for local investments may also face cash calls from bank lenders.

- **Negative Leading Indicator.** We believe the sharp drop in prices and failure of land auctions signals a long-term decline in the property market. This is negative for China's GDP.

Land is the Key to China’s Economy

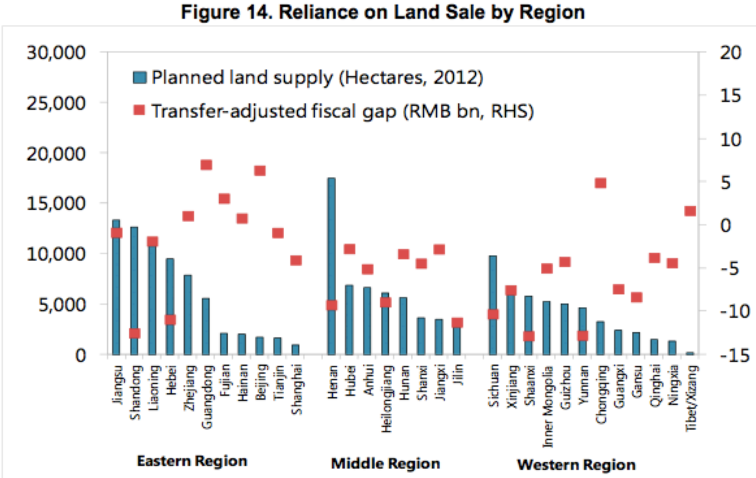
For the past decade, land has underpinned China’s economy. It has had a fourfold impact. Local governments have used land sales as a source of income to fill the revenue gap caused by the rising cost of social services and a lack of taxes to pay for them. Also, it has been the first asset sold in the economic chain that has led to the property bubble in China and to the oversized contribution of the real estate industry to China’s economy. Apart from generating income for cash starved local governments, it has functioned as equity or collateral for local government investments that are now part of an estimated 17 trillion RMB in local government debt, including off balance sheet vehicles. Obviously, the sharp decline in land sales reflects a weak property market, which accounts for a significant portion of China’s overall GDP. In 2013, property accounted for 16 percent of GDP, 33 percent of fixed asset investment, 20 percent of outstanding loans, 26 percent of new loans, and 39 percent of government revenue.

As the chart below from the International Monetary Fund indicates, regions in China where land sales are low have a larger shortfall in revenue.

We will first discuss the recent data for the amount and value of land sold. Then we will look at the rise in failed land auctions.

IMF Analysis of Land Sales and Local Fiscal Revenue Gap

Figure 14. Reliance on Land Sale by Region

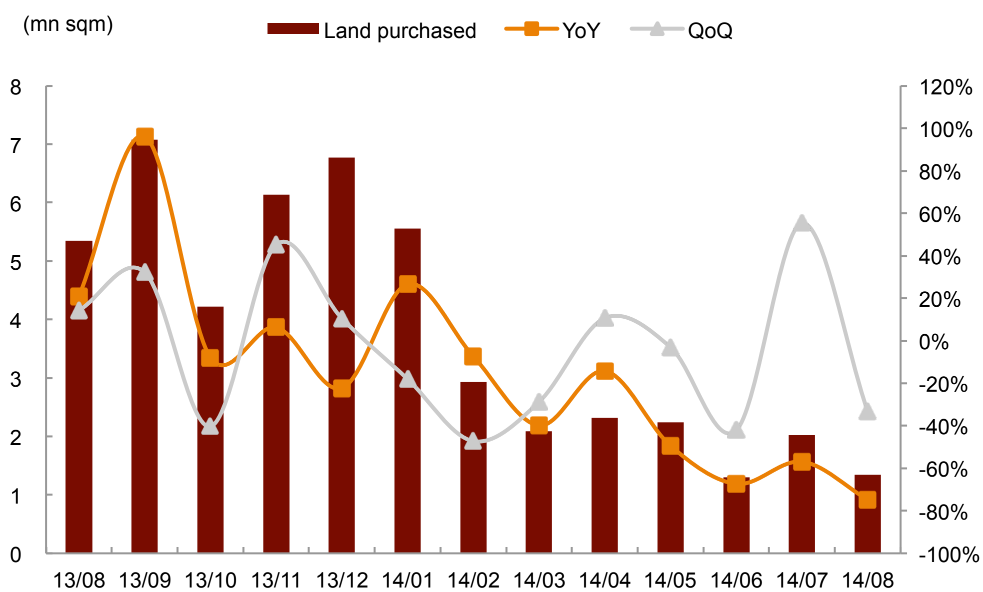


Sources: CEIC; and IMF staff estimates.

The Market is Going from Bad to Worse

We analyzed land income for 40 cities. We multiplied the average selling price by amount of land sold in all three tiers and added the totals. Four this data set, which accounts for at least half of the market, revenue in August 2014 fell 46 percent compared to a year earlier.

Total Amount of Land Bought



Sharp Rise in Failed Land Transactions

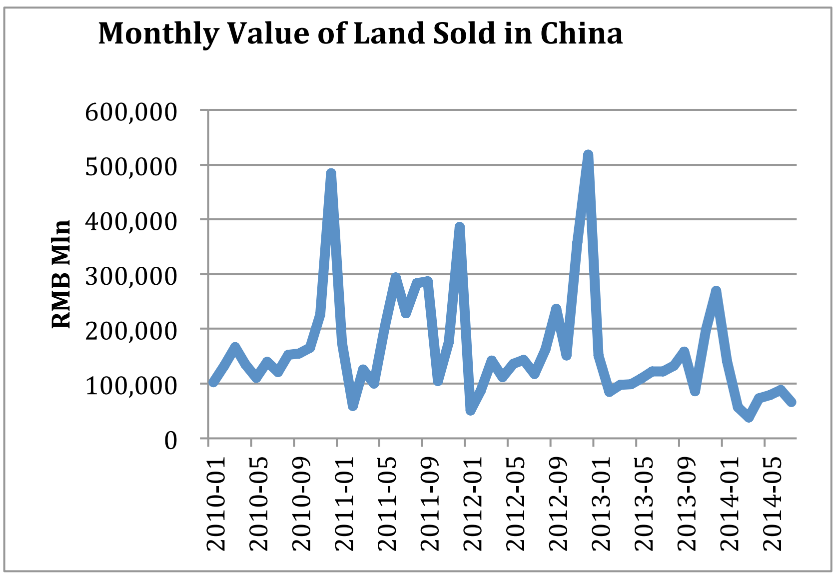
For the first time in half a decade, many plots offered for sale by local governments failed to find buyers. Our analysis of transactions over the past six months shows that 28 of 140 lots were not sold. The median percent of unsold units in five cities we examined was 32 percent.

Total Unsold Land in 1H 2014

	Available (units)	Total Unsold (Units)	Failed Sales (Units)	% Unsold	% Failed
Guangzhou	77	17	10	22%	13%
Xiamen	1	1	1	0	100%
Dalian	34	8	8	24%	24%
Beijing	9	3	3	33%	33%
Chengdu	19	9	6	47%	32%
Median	**19**	**8**	**6**	**24%**	**32%**
Total	**140**	**38**	**28**	**NA**	**NA**

Source: Wind, OCR

Revenue from Land Sales



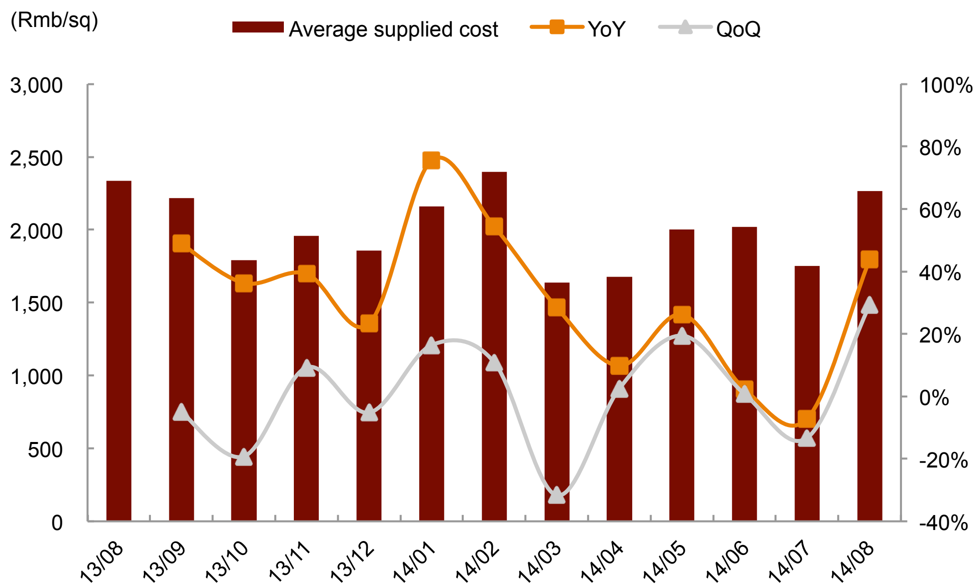
Local Government Land Prices are Too High

Despite the depressed housing market, the failure of the sale of a significant number of units of land was due to high prices asked by local governments. When the housing market was rising in 2013, the optimism of both local government and developers pushed up land prices. In 2014, although most developers still were in the market for land, their expectation of land costs prices was much lower than in 2013. However, most local governments remained optimistic and failed to adjust land prices, which resulted in a gap between the selling price and what was acceptable to developers.

In August 2014, the average price for land supplied was 2,263.37 Rmb psqm, 29.3 percent higher than in July. ***Although the average offered price for the first eight***

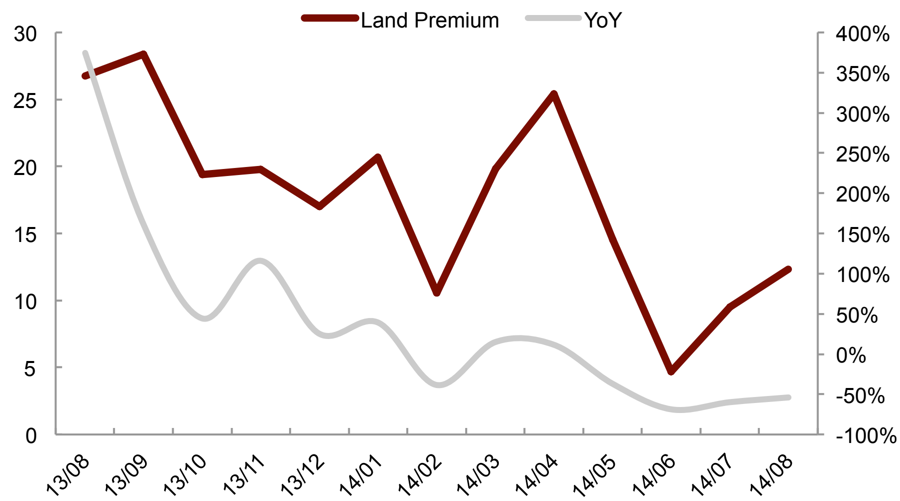
months of 2014 increased more than 30 percent compared with 2013, the average price paid was 3 percent lower compared to last year. As a result, August land premiums decreased 54 percent year-over-year.

Average price of lands supplied



Source: Wind, OCR

Historical land premium



Source: Wind, OCR

Recent City Breakdown of Failed Land Sales

Given most developers' negative willingness to purchase land, failed land sales have spread even to several Tier One cities, even though Tier One cities have had the strongest growth in prices and have been more resilient during the downturn than Tier Two and Three cities.

- **Guangzhou:**
  Among 77 publicly listed lands in the first half of 2014, 60 units were sold, mostly at the base price. The total value was around Rmb41.2 billion, far below the same period a year earlier. There were 10 failed land sales and seven terminated suddenly. Approximately 65 percent of the deals in the first half of 2014 were accomplished in the first quarter. For example, Rmb15.5 billion was achieved in the first day of the

auction of Guangzhou Steel New Town. However, the market cooled down after the Spring Festival with a turnover of Rmb14.6 billion in the second quarter. As the premium largely fell after May, failed land sales began to occur. According to Hope Fluent Group, a property developer, eight failed land sales occurred after May. Some were even high quality lands in the downtown area. Coming into the second half, the situation has become worse. Among 16 publicly listed units, 14 deals were closed at the base price. One unit was terminated suddenly. One failed land sale appeared in the Luogang development zone, which was the hottest emerging residential restrict over the past two years. “Luogang once was the developers’ new favorite as 6,187 apartments were sold last year, with a 57 percent year-on-year growth. However, it just became the hardest hit” an industry executive told us during an interview. The Guangzhou government’s August land transfer income was only Rmb1.5 billion, which was this year’s low.

- **Xiamen:**
  Since the beginning of 2014, Xiamen has been the city with the most buoyant home prices. However, only two developers appeared at the August auction of Xiamen’s largest land lot, which covered a total building area of 3.34 million square meters. Although the base price was only Rmb 2.641 billion, no bids were made, which created the largest and most embarrassing failed land sales in Xiamen’s history.

- **Dalian:**
  Among 34 land deals in August, eight were failed land sales. Four were residential-use with an average usable area of more than 30,000 square meters. The largest one was 51,924 square meters. The average building area for the four residential lands was above 50,000 square meters with the largest one around 77,886 square meters. Industrial lands also went unsold. Among the four listed industrial lands in Changxing island, three failed with the base prices of Rmb21.6/31.95/30.50 million respectively. “It’s rare to see a group of failed industrial land sales with a value over 10 million RMB” said a senior official at the local statistical bureau. The remaining failed one was for business and services use.

- **Beijing:**
  For the first half of August, nine units were listed for sale but only one sold above the base price. Two transfer deals along with other five cases were closed at the base price. The auction of a multi-use land in the Fangshang District failed on August 14, which was the third failed land sale this year. On July 30, two residential lands in the Sunhe area failed to sell, which broke a three-year record of no failed land sales.

- **Chengdu:**
  For the first seven months of 2014, 19 units were publicly listed for sale. Ten deals were closed at the base price, but six were failed transactions. Three were terminated suddenly. “This had never happened before. Almost everyone was shocked by the result. We have prepared for gloomy data but never expected one-third of failed land

sales like this," said a local developer with over 15 years of experience in Chengdu's housing market.

We Expect to See More Failed Land Sales in the Fourth Quarter

Usually, the second half is the peak for land supply. Recent sales show that the glut is continuing as local governments flood the market.

On August 27th, the Guangzhou Land Bureau published a notice of auction for two units of residential lands in the Huadu district with a total area around 220,000 square meters. The base price is set at Rmb 1.452 billion (Rmb 6.426/sqm). In fact, this is the second time the same two units have been offered for sale. On April 25 2013, the original auction was withdrawn by the city court. Despite the earlier failed sale, the Guangzhou government increased the asking price by Rmb660 million, which implies Rmb2,958 more per square meter. If sold, this would break the current record of ASP at Rmb6,138.5 per sqm.

On August 29, the Guangzhou Land Bureau published a notice to sell a group of 13 units residential lands in the Liwan, Tianhe, Panyu and Huadu districts. The auction was scheduled to start in late September. The base asking price for the 13 units was Rmb14.6 billion. What attracted most attention was the five residential units and one commercial unit located in Guangdong Steel New Town. The total area for the six units is over 2.04 million square meters. The base price starts at Rmb14,000 per square meter, which is Rmb1000 more than the selling price in February. According to the vice president of the Real Estate Research Institute of Guangdong Province, ***increasing land prices don't represent the recovery of the property market but local governments' need for increased revenue from land sales.*** Academic data supports this statement.

State Owned Firms are Now Becoming Big Property Buyers

In order to maintain higher land prices, some local governments have even asked China's state firms for help. On August 20, the high-profile Huajia Hutong area in Beijing was sold for Rmb7.46 billion (Rmb63,377/sqm) to Beijing Huarong after 193 rounds of bidding, at a 110 percent premium to the asking price. Excluding the commercial part, the cost of the residential area was more than Rmb100,000 psqm, the highest in Beijing's history. However, Beijing Huarong is affliated with the SASAC (State-owned Assets Supervision and Administration Commission) of Xicheng District and the controlling shareholder is the Beijing Local Government Financing Vehicle (LGFV).

Similar to the Beijing land auction, big SOEs have appeared at other auctions in the country. One example is the Xiamen International Trade Group Corporation. In our interview with the VP of Xiamen Junhe Appraisal, Mr. Wang said "the local government has to ask different SOEs to support the market during these difficult times. In this way, the negative impact of failed land sales can be delayed to work with the timing of policy changes. Usually the central government and banks change policies every six months." It appears the local governments are hoping for a further stimulus to prop up the property market.

In response to rising land price set by local governments, most developers have responded with a 'wait-and-see attitude'. The CEO of property developer Evergrande said: "We won't purchase a large amount of land in the second half of 2014 as we have to live within our means." Likewise, the CEO of Yuexiu Property, which is an arm of the Guangzhou Government, said purchases would be subject to market fluctuations. According to the Chairman of Times Property, current land prices are too high to be sustainable.

In our interview with a senior strategist of a large property company in Guangdong, we were told that most developers are waiting for the government to cut prices as a large number of units of land will be listed during the rest of 2014. Also, developers believe that an upcoming nationwide audit of land transfer income will force some local governments to reset selling prices to reasonable levels.

More failed land sales will appear in the upcoming months due to the excessive supply, over-price and inventory pressure.

Conclusion: A Crisis Awaits Local Governments

Local governments rely on land sales for as much as 60 percent of total revenue, up from only 10 percent fifteen years ago. According to a report by researchers at the IMF, between 1998 and 2011, the gap between local government fiscal revenue and expenditure was Rmb18 trillion. Land sales during that period accounted for three-quarters of that gap, or Rmb13 trillion. The remainder of the gap was filled by loans to LGFVs of Rmb4.97 trillion. Many of these loans were "shadow loans" outside of the formal banking sector.

According to the IMF report, declining land sales will hurt local governments:

"A potential decline in land value could affect LGFPs' investments in two ways. One is the collateral-damage effect—the decline in land value would inevitably reduce investments. The second is the internal-liquidity effect—with reduced borrowing capacity, a firm has to rely more on internally generated cash to finance its investments."

One example of both the collateral and liquidity effects cited by the IMF is the Fushun Development Investment Corporation. As a separate IMF paper notes:

"The Fushun LGFV issued corporate bonds using land usage rights as collateral to support its credit ratings and reduce borrowing costs. Relatively more liquid assets account for a majority of FSDIC's total assets, this includes land, public buildings, roads, and other infrastructures. However, much of the land is pledged as collateral and other assets, such as buildings and roads, may have limited liquidity and weak potential to generate profit." A decline in the value of the land would hurt the underlying collateral for the bonds, along with the value of the land injected into the LGFV.

Thus, there is likely to be a "feedback loop" downwards for local governments:

- First, local government reliance on land sales for financing has resulted in an oversupply that is resulting in a collapsing property bubble;
- Second, governments will have to cut spending as proceeds from land sales fall, while revenue from the property industry is in decline.
- Local governments often inject land into LGFVs as collateral for borrowing. A correction will make it harder for LGFVs to borrow, further slowing local growth.
- Meanwhile, falling land values will make it more difficult to sell land to pay down debt.

There are 31 provincial governments, 333 prefectural governments, 2,859 county governments, and 40,828 township governments. According to the World Bank, local governments provide 70 percent welfare expenditure with more than 55 percent being spent by sub-provincial governments. There is little incentive for Beijing to provide additional funds to keep these local governments solvent – unless there is the threat of protest. Local governments tend to sell more land when they need additional revenue – regardless of whether the property market is strong or weak and prices are rising or falling.

Other academic studies have shown (Victor Shih, "Determinants of Fiscal Transfers in China) that fiscal transfers from Beijing tend to go to the cities with the most government employees – not the cities in need of revenue. Currently, there is no system in place available to provide capital to these governments.

Can Local Governments Handle A Widespread Fall in Land Sales?

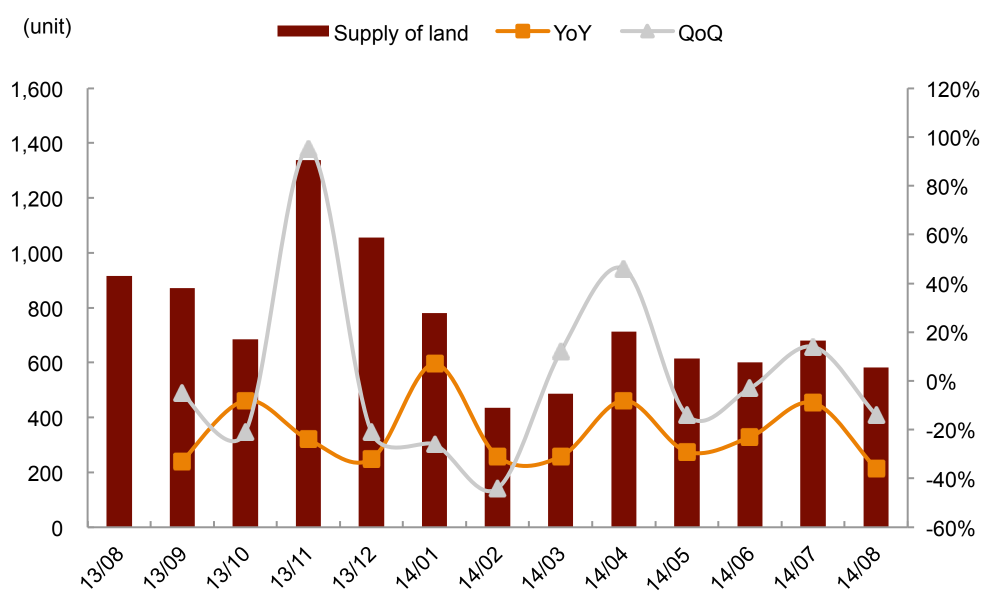
The current decline in income from a key source – land – will only exacerbate the rising debt burden among local governments. There is approximately Rmb17 trillion in local debt. The state banks have Rmb73 trillion in assets. A default of 50 percent of local debt would require 11 percent of state banking assets. No doubt this is fiscally possible. However, a default of this scale would significantly reduce overall lending, further slowing the economy.

Appendix

Slowing Land Sales in August

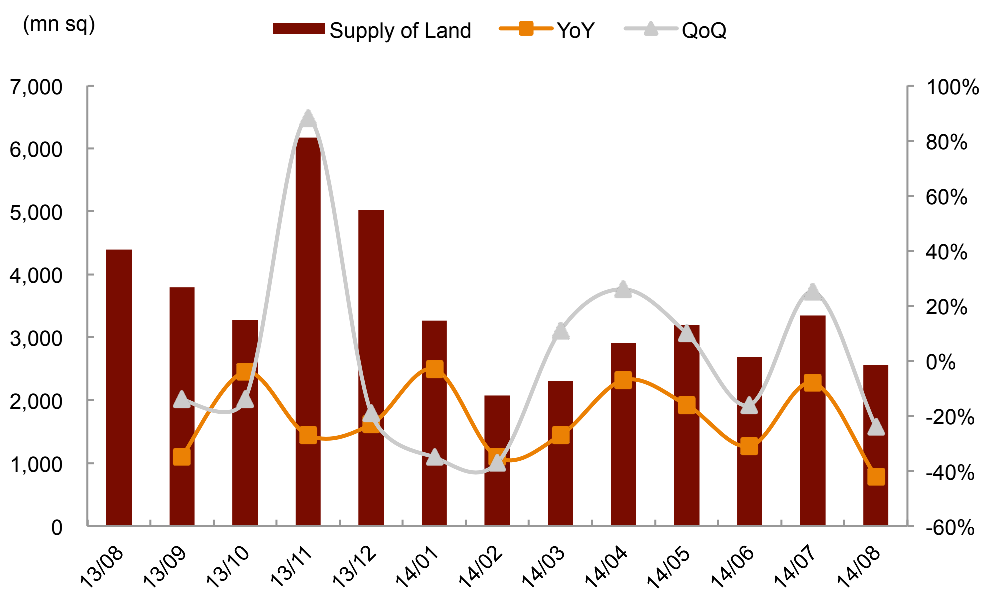
The most recent data for August show a sharp slide in sales. From the supply side, 583 units were offered. This represents a 36 percent decline year-over-year and 14 percent quarter-over quarter. This consisted of a total area of 25.59 million square meters, down 42 percent YoY and 24 quarter-over-quarter. The average price was 2,263.37 Rmb per square meter.

Supply of lands in unit



Source: Wind, OCR

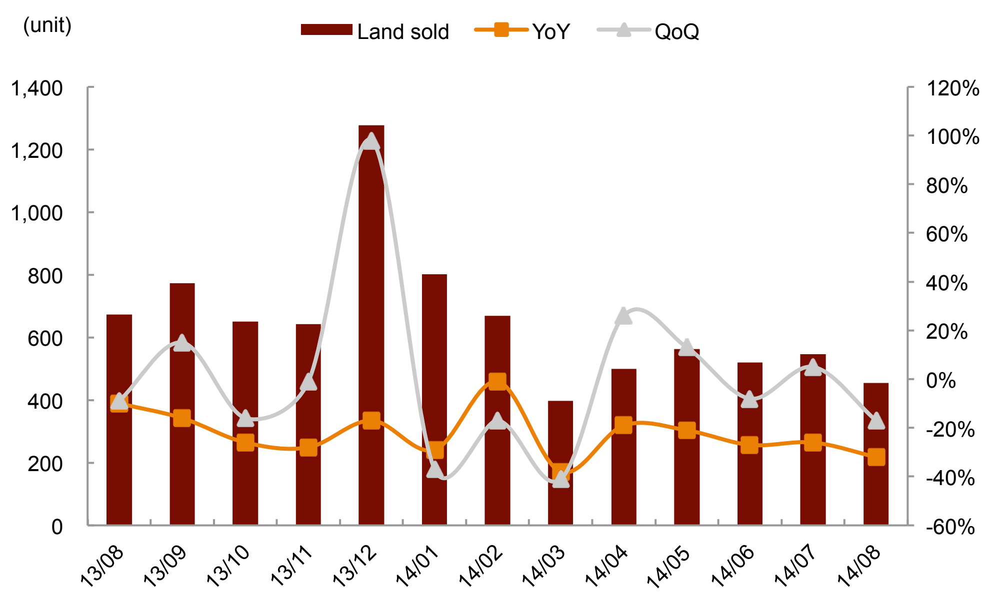
Supply of lands in area



Source: Wind, OCR

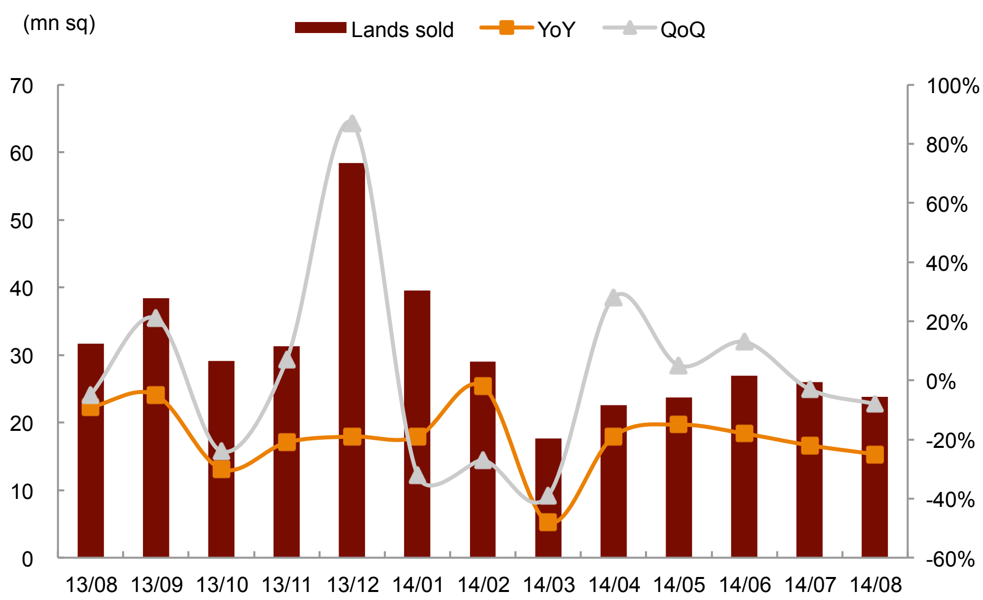
However, not all of the land offered was sold. While 583 units of 25.59 sqm were offered, demand was only 454 units or 23.83 million sqm. Purchased units fell 32 percent YoY and 25 percent in square meters. The average price paid of 2,035.77 Rmb psm was 10 percent below the offering price. The premium rate was 12.32 percent.

Lands sold in units



Source: Wind, OCR

Lands sold in area



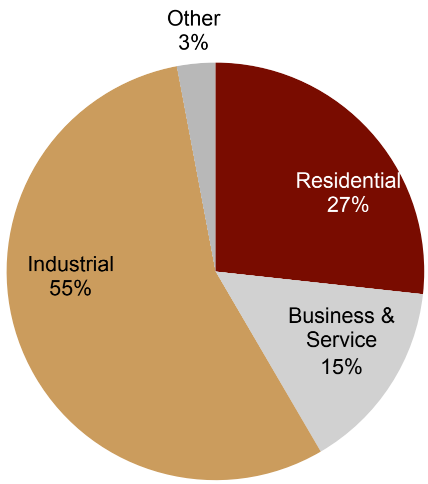
Source: Wind, OCR

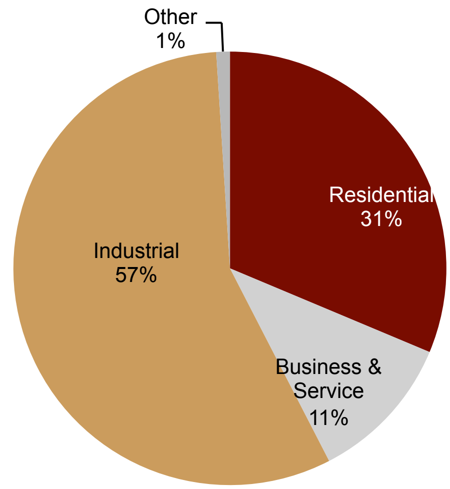
Breakdown of Land by Use

Industrial land accounts for over 50 percent of total supply and demand. Residential land ranks second on the supply side but third on the demand side, losing around 2 percent to business and service use.

Supply breakdown in units

Supply breakdown in total area

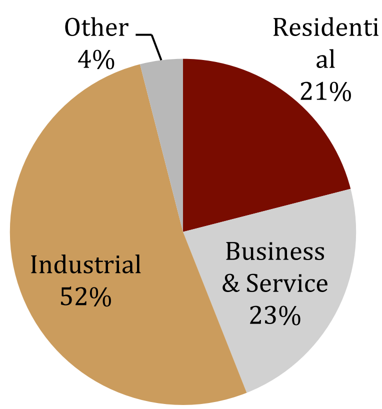




Source: Wind, OCR

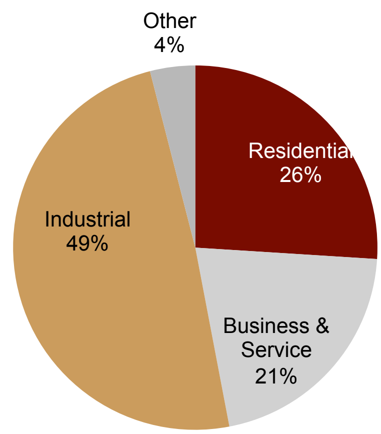
Source: Wind, OCR

Lands sold breakdown in units



Source: Wind, OCR

Lands sold breakdown in total area

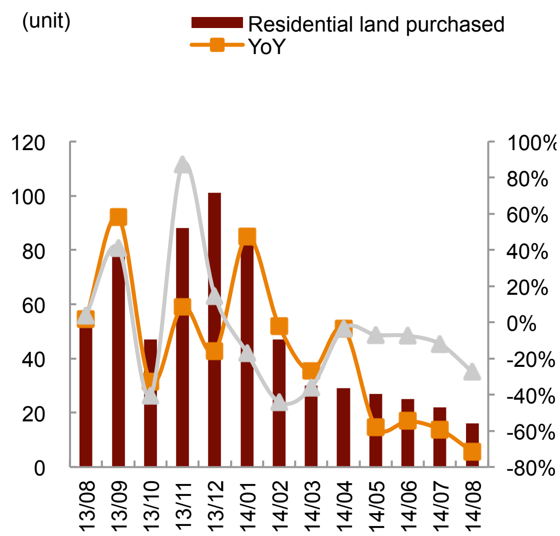


Source: Wind, OCR

Developers Are Backing Away from the Market

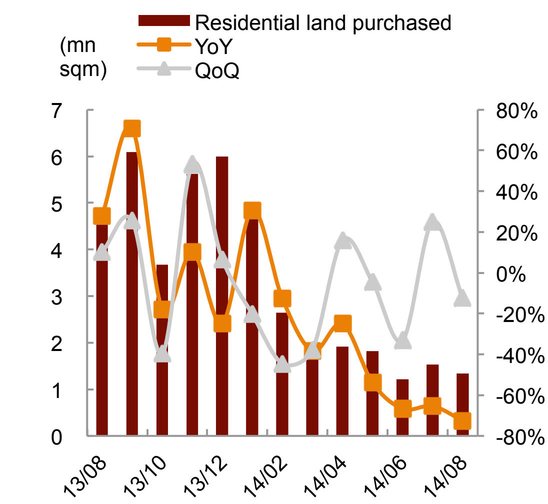
Major developers are cutting their purchases of land due to the slump in the property market. In August, the major developers acquired 18 units of land, down 73 percent YoY, with a total area of 1.35 million square meters, a drop of 75 percent. The total amount of cash paid fell 56.4 percent to Rmb19.6 billion.

Figure 1: Lands purchased by major developers in units



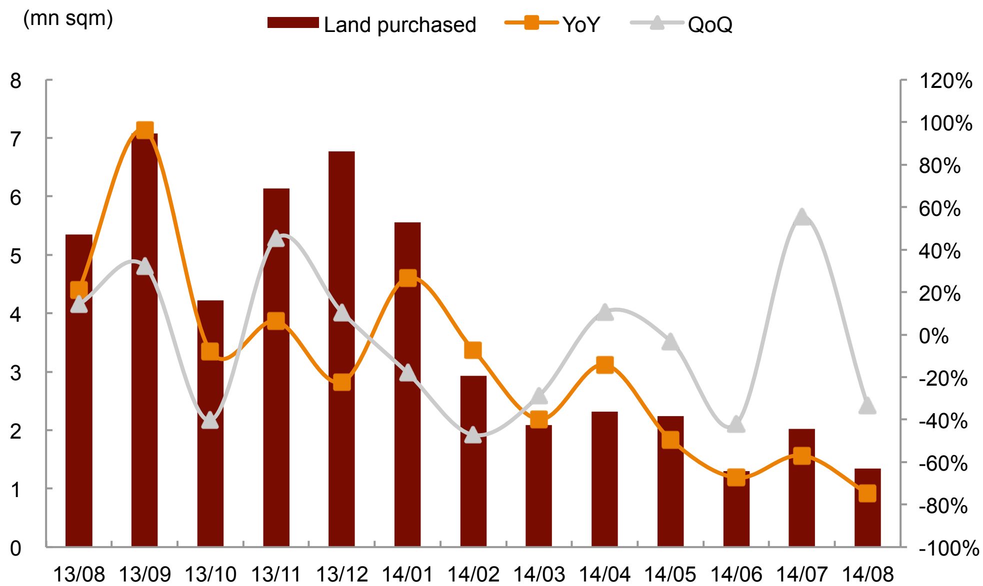
Source: Wind, OCR

Figure 2: Lands purchased by major r developers in area



Source: Wind, OCR

Total Amount of Land Bought

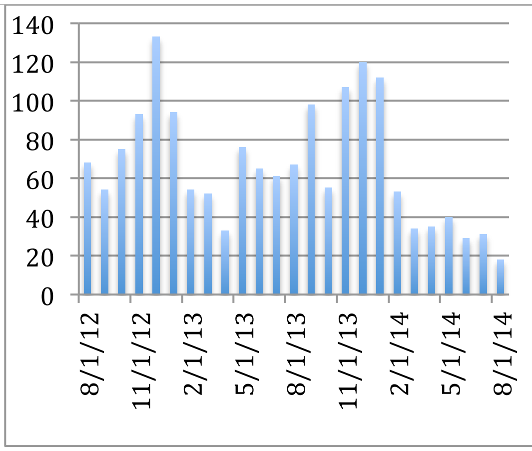


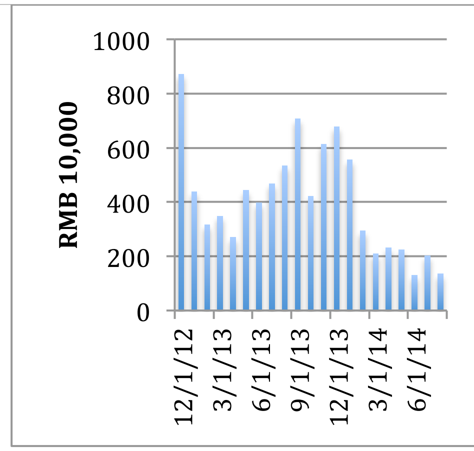
Source: Wind, OCR

The primary cause for lower land sales was a sharp drop in residential land purchased by developers. On average, residential land accounts for 89 percent of the total cost of property development. In August, 16 units were purchased by major developers for residential use, a 71 percent decline, with a total area of 1.33 million square meters, down 73 percent. The total amount paid fell 52 percent to Rmb18.74 billion.

Residential-lands purchased by major developers in units

Residential-lands purchased by major d area





Source: Wind, OCR

Source: Wind, OCR

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Andrew Collier