First Sentier Investors
首 源 投 資

Opportunities in China's consolidating property sector

China's market volatility has led investors on a rollercoaster ride over the past year, but we expect a gradual normalising with support from policy actions.

Unlike the US, Europe and Japan, China has been in tightening mode for several years, which means the People's Bank of China has more room to ease to prop up the economy. In the property market, things came to a head last year as the "three red lines"[1] policy caused overleveraged real estate developers like Evergrande to default on bonds and halt certain developments.

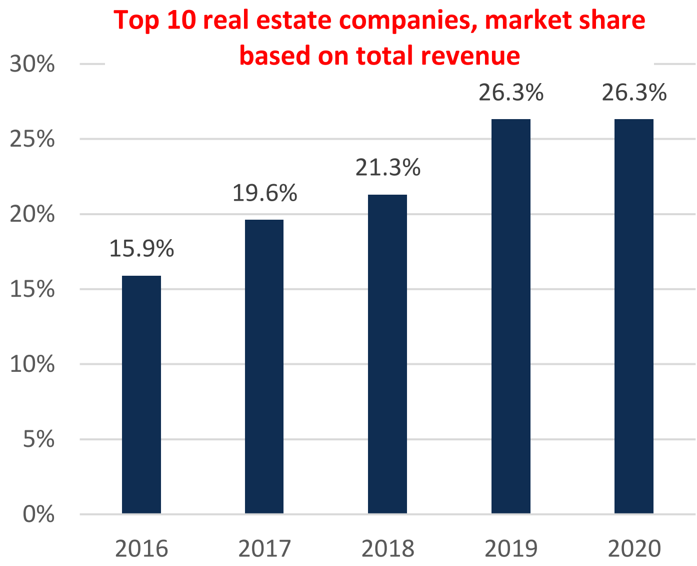
In setting monetary policy, China will need to balance its goal of tempering supply-side inflation with a slowing economy, ageing population, and weak sentiment in the property sector. Policymakers started to reverse some policies once the risks of contagion appeared too big to ignore. As rates start to tighten elsewhere, China may look more attractive to global investors as the government turns more pro-growth.

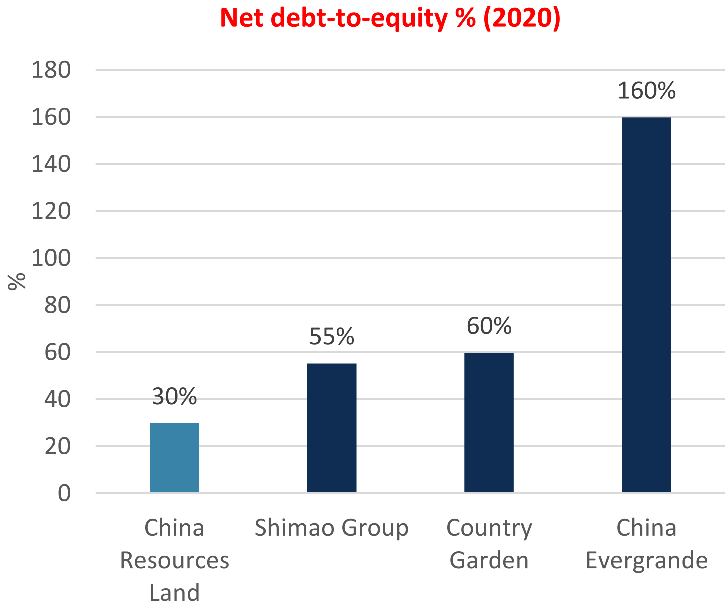
We expect further policy actions to come but the government will remain prudent and fine-tuned, as the goal is stability. Recently media reports said that policymakers plan to relax the three red lines policy by excluding debt accrued from acquiring distressed assets, which should encourage industry consolidation.

In such an environment, there are bound to be opportunities for stock-pickers, but it's important to distinguish the better investment opportunities from the rest. While policy constraints have hurt profits at the more leveraged players, these same constraints should provide a boost to less leveraged companies. We believe the stronger property developers with healthy balance sheets and a strong portfolio of investments should be well positioned to benefit from such consolidation.

[1] Outlined by the central government in August 2020, the three red lines define limits on borrowings. They are: a liability-to-asset ratio excluding advance receipts of less than 70%; a net debt-to-equity ratio of less than 100%; and a cash to short-term debt ratio of one.

China's property sector is still consolidating





Source: Bloomberg, FSSA Investment Managers as of February 2022.

While we have limited exposure to property companies due to their generally overleveraged balance sheets, a number of consumer companies should benefit from the home upgrades trend, including a leading household drain-pipe company. There was strong growth in the retail market and the pressures from higher raw material costs have abated somewhat, as it managed to pass through price hikes to its underlying customers. Additionally, the company's culture seems prudent about business development, an important trait in these volatile times for the property sector.

Another example is the largest gypsum board company in China. The company has a strong franchise, with limited competition, resilient demand and more than 60% market share in both high-end and mass markets. Gypsum board is a good, low-cost building material and is lightweight, fireproof and a heat insulator. Consumption in China is low compared to the US, Europe and Japan, which implies plenty of room to grow. The company also plans to build new capacity in overseas markets, and recently acquired a few companies to expand into the waterproofing business.

What "Common Prosperity" means for long-term investors

China is dealing with many of the same problems as other countries around the world – widening wealth gaps, an ageing population with low birth rates, and climate change. The recent reforms are not run-of-the-mill and will likely have lasting consequences. Meanwhile the Chinese economy may continue slowing on a structural basis, even as the population's wealth rises. Despite this, China is still a relatively poor country (USD 10-11k per capita income) and there remains plenty of runway for growth, even with a compromised outlook.

We ground our observations in what we see and hear from companies, on a bottom-up basis. The scale of the property market is unsustainable, while the investment-driven nature of the economy is already leading to materially lower capital-productivity, lower growth and lower returns.

Some of China's reforms are a rational response to these observations. While the Chinese economy is three-quarters the size of the US, the property market is twice the size, which shows how far things are out of balance.

Most economists believe that property accounts for as much as 25-30% of GDP, which is two-to-three times bigger than most countries, while around the world, property (in this era of free-money) is generally regarded as being at historically high and unsustainable levels.

The newspapers have been replete with stories about ghost cities in China – empty apartments and 1.5 apartments per citizen – for the last decade. In that sense, the property market bubble has been called many times over the years, but there is now a sense that political will and economic development have collided, and there will finally be change.

On the other hand, we do not anticipate a Lehman-style bust, with the economy still mostly closed and the authorities able to provide liquidity, as well as direct the banks and other property companies to provide a solution. Absorption of these excesses will clearly take time and the most likely outcome is slower growth. In our view, irrespective of the policy risks, this should mean lower valuation multiples.

Meanwhile, efforts to rebalance the economy from investment (property and infrastructure) to consumption will likely prove challenging because it requires higher wages, which would undermine export growth. And it is imperative, for political and stability reasons, that the property market doesn't break.

"Common Prosperity" is the new name for this rebalancing and is part of the solution, with forcible redistribution from the internet companies, closure of the private tutoring industry, large "fines" and even larger "donations" across a range of businesses. This will help, but seems unlikely to lead to a significant shift in the near term. Meanwhile it is clearly negative for returns and growth, particularly in the private sector.

In such an environment, investors should continue to be cautious and focus on capital preservation while searching for reasonable growth. Such time can also be an opportunity for asset managers to buy high quality companies at more attractive valuations and hold them for the long-term growth for investors.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 24 January 2022 or otherwise noted.

About First Sentier Investors & FSSA Investment Managers

First Sentier Investors (FSI) operates as a standalone global investment management business and manages US$182.5 billion in assets on behalf of institutional investors, pension funds, wholesale distributors, investment platforms, financial advisers and their clients worldwide.

FSSA Investment Managers (FSSA) is an autonomous team within First Sentier Investors with dedicated investment professionals in Hong Kong, Singapore and Edinburgh. FSSA IM are bottom-up investors and have integrated ESG analysis into their investment process. FSSA IM manages US$37.4 billion on behalf of clients globally.

(Data as at 31 December 2021)

About HKRSA

The Hong Kong Retirement Schemes Association (HKRSA) was established in 1996 to promote the interests and best practices of retirement schemes in Hong Kong including provident and pooled retirement funds. The HKRSA is a not-for-profit, non-political association, which represents retirement schemes and their members, providing a forum for discussion of issues of current and topical interest.