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Threat or opportunity?

Weaker economic growth and a struggling property market have made real estate fund managers more wary about their China residential exposure. But some still sense opportunity

CHINA'S PROPERTY SLUMP CONTINUES. The National Bureau of Statistics announced earlier this week that home prices fell in July for a third straight month. The number of cities that saw price drops – 70, up from 64 the previous month – is the most since the bureau started publishing statistics in 2005.

Residential property developers, particularly the smaller players, are being battered by slowing pre-sales, squeezed margins and vanishing working capital. Yet it remains to be seen whether the central government will help them out by winding back policies intended to restrain price growth have been in place for four years.

This uncertainty strangling the property market is placing a tighter grip on the broader economy, prompting fears of a painful crash rather than the standard cyclical downturn. But what does it mean for offshore real estate fund investors?

"Real estate fund managers are very cautious on selecting property segments in which to invest," says Regina Yang, head of research in real estate consultancy Knight Frank. "Ten years ago, most funds would invest in residential. However, over the past two years barely any residential transactions have been conducted since the government announced a slew of regulations to curb the sector."

Policy initiative

To be fair, there have been some changes in recent months. In June, 30 local governments began easing restrictions on individuals purchasing second or subsequent homes. But this small-scale stimulus has so far made little impact on the market as a whole. Residential building sales volume and new construction starts are expected to fall 20-30% this year. It is bad news, although perhaps not for everyone.

"While the market has generally slowed down, I think it is important to recognize that China isn't one market. It's a collection of a hundreds of markets, not only by geography and but also by property segment. For example, the residential market will differ from the office market in one city, and when you compare that to another city, it is again different," says Brian Chinappi, global head of principal finance in real estate at Standard Chartered Bank.

Many investors regard the slowdown as a sign of the Chinese real estate market gradually coming to maturity.

For the more sophisticated developers and investors, times of hardship can bring fringe benefits as less disciplined participants fall out of the market. China's property sector remains highly fragmented, with over 85,000 developers, so the consolidation story has many chapters still to run. Larger real estate players are more comfortable with private equity financing because it is long-term capital that enables them to strengthen their market position.

"In the past many developers could sell products with little regard to what was really the best product for the market, and in many cases they were bailed out by significant price increases. To be successful today developers and investors must understand their specific market, and provide the correct products at reasonable prices," says Tom Delatour, CEO of Century Bridge Capital.

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Century Bridge's $170 million China Real Estate Fund, which closed two years ago and is now nearly fully deployed, focuses exclusively on middle-income, residential real estate in second- and third-tier cities. Since 2005, average household income has grown faster than average housing prices in lower-tier cities and the firm expects affordability in these geographies to continue to improve.

Middle class residential development does not offer the highest potential yields in the market, but Century Bridge believes it has the most attractive risk-adjusted returns. "We bring to market a product that the Chinese people want and can afford, and it is line with the type of development the government is encouraging," Delatour adds.

Unless China stops its urbanization process – which is hard to envisage – residential housing markets will still have significant room to grow over the next decade, ANZ said in a recent report.

Earlier this month, the State Council said it would promote urbanization by easing restrictions on the issue of urban residency permits, thereby allowing more of the rural population to register as urban citizens. CBRE Capital Advisors expects the policy will spur stronger demand for real estate assets over the longer time in lower-tier cites.

However, investments are only successful where they are underpinned by robust of end-user demand, which is typically driven by rising populations and employment. Some fourth-tier cities, and even some of the weaker third-tier hubs, do not boast these characteristics and so over-supply remains.

Spoiled for choice

While there are PE investors in residential real estate that have become more cautious – hanging back for the the right opportunity to materialize – others have addressed their concentration risk by targeting mixed-used commercial and residential complexes.

Last month, Standard Chartered Private Equity (SCPE) led a $124 million round of financing for a mixed-used project in China. It will be developed by Longfor Properties, covers more than 312,000 square meters of gloss floor areas in Chongqing's central business district. SCPE paid $69.4 million for a 28% interest in the joint venture.

"Our investment with Longfor is a great example of our overall strategy in China," Chinappi says.

The firm's strategy is two-pronged: first, seek out top-tier developers that have long-standing relationships with Standard Chartered Bank; and second, only invest in high-quality projects. In addition, since the project is of significant size, SCPE was able to bring in co-investors, mostly from among the bank's clients.

Another option is to avoid residential real estate altogether on the basis that it is driven by hard-to-predict government policy rather than the fundamentals of supply and demand. CBRE Investors Global Multi Manager, which will deploy

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one third of its recently closed $236 million Asia Alpha Plus III Fund in China, is targeting de-centralized offices in tier-one cities as well as logistics developments.

"The issue of residential is that obviously you don't earn any income until it's sold and completed. So returns are impacted significantly by timing and the need for pre-sales as a form of leverage," says Adrian Baker, head of Asia at CBRE Investors. "Logistics is different. Once you develop the facilities they are income generating, provided you have mitigated the leasing risk. Even if you have to hold for longer than anticipated, at least you are earning income, whereas a longer hold for residential will dilute the IRR very quickly."

Moreover, the current situation presents a window of opportunity for investors to negotiate lower prices and yield-enhancing investment terms on projects in upper-tier cities. This could deliver higher-quality assets at less competitive prices.

Conscious of the risk that comes with equity exposure to projects, CBRE is very selective in deal sourcing. China Resources, which last year formed a joint venture with leading property player China Vanke to develop a prime integrated residential development project in Shanghai's Hongqiao district, is also selective – but focuses more on projects than big-name developers.

"Rather than purely looking at brand names, we spend a significant amount of time evaluating the quality of the actual projects. As a result, even some medium-sized developers, who have strong local relationships and experience in specific provinces, can be a good choice for us, given their ability to secure attractive sites at prime locations," says Charade Poon, investment director of China Resources Capital.

Structured solutions

Finally, for those uncomfortable with equity risk, investing through structured debt positions is an increasingly attractive proposition.

Over the past few years, Chinese developers have tapped the shadow banking market in ever greater numbers as the three traditional funding sources – bank loans, bond issuance and proceeds from pre-sales of new properties – have struggled to varying degrees. In a recent policy move, the government is trying to clamp down on the trust companies that are the source of many of these loans.

Real estate funds have become a significant source of capital. "At the moment, international private equity and banks are lending to Hong Kong developers' listed and unlisted structured offshore vehicles investing in China – with listed Hong Kong-based vehicles able to provide stronger credit guarantees," says Nick Crokett, executive director at CBRE Capital Advisors.

The slowing market also provides offshore groups the opportunity to build relationships by providing capital to high-quality developers. They had previously struggled to do this because local developers could easily source cheap capital onshore. Needing to diversify their funding sources, these developers are opening up.

China has become the largest portion of Forum Partners' Asia portfolio through the provision of structured debt solutions to sponsors who are developing, acquiring or already own specific properties. By contrast, the rest of the portfolio is dominated by standard equity investments. The firm has $150 million of dry powder left its third Asia-focused fund, which has a corpus of $373 million. China is likely to account for $200 million.

"The risk-return profile is different from in every market. In China, we can take less risk but still receive a good return by investing in a debt position. In Japan, we're taking more risks when buying direct assets. However, the return might not be as compelling compared to China." says Gregory Wells, managing director and head of Asia at Forum Partners.