SOANE

CAPITAL

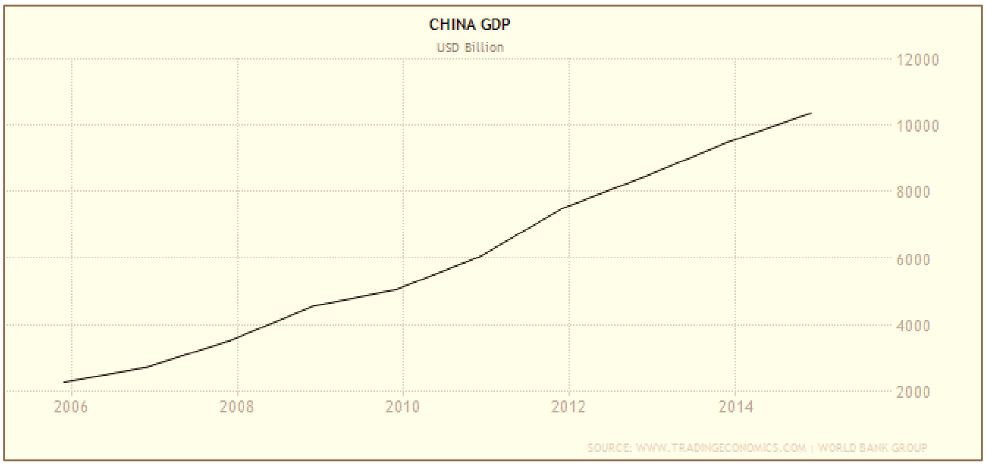
China's Economic Slowdown

The Impact on UK Real Estate

September 2015

Introduction

Since the introduction of the economic reforms in 1978, China's economy has experienced monumental growth and as a consequence catapulted the nation to become the second largest global economy behind the US. Twenty years ago, the Chinese economy was generating just half a trillion Dollars in GDP, a fraction of its current size, which now sits at ca. $11 trillion, 15% of the global total. Nevertheless, after years of unrelenting economic expansion, China's economy has lost substantial pace and witnessed its GDP growth rate halve from 14% in 2007 to 7.4% last year, the slowest growth in more than two decades.



China's Economic Downturn

The slowdown of China's economic growth was considered inevitable, as the larger a nation's economy becomes, the more difficult it is to sustain superlative growth rates. However, China's economic decline is worse than many had anticipated. For example, the International Monetary Fund in 2012 forecast that annual growth above 8% would continue until 2017. This being said, in March 2011, economist Barry Eichengreen and colleagues released an academic paper supporting the current scale of China's economic deterioration. The paper focused on the rapid growth of large emerging markets in the late 20th and early 21st centuries and in particular the double digit growth emerging out of China.

- The evidence suggests that rapidly growing economies slow down significantly, in the sense that GDP growth rates downshift by at least 2%, when their per capita incomes reach around US$17,000[1], a level China is expected to achieve by or soon after 2015.

The nation's working-age population peaked in 2012 and investment appears to have topped out, although at 49% of GDP, this is a level few countries have even reached. China's technological gap with wealthy nations is narrower than in the past, implying that productivity growth will decrease. More recent trends further explain China's sharper than expected slowdown. According to many, the single most detrimental economic

[1] In 2005 - constant international prices

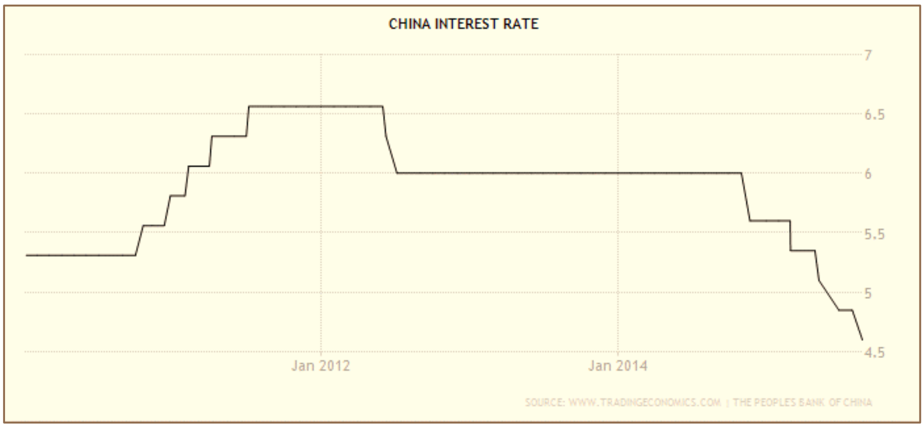
factor has been China’s credit binge. Total debt (including government, household and corporate) has climbed to approximately 250% of GDP, double the level seen in 2008. Although high levels of borrowing allowed China to ride out the global financial crisis, it also lumbered the nation with a heavy repayment burden. Much of the credit flowed to property developers and as a result, China’s inventory of unsold homes currently sits at a record high. August witnessed the People’s Bank of China (PBoC) devalue the Yuan against the Dollar by 4% and interest rates cut for the 5th time since November 2014, decreasing from 6% to 4.6%. Furthermore, “Black Monday” saw the Shanghai Stock Exchange record its biggest slump in eight years with the index dropping almost 30% since its peak in June. Quite incredibly….

- Share values are still 60-70% above their level a year ago (August 2014).
- 67% of new investors in China’s stock market have not finished high school and only 12% have a college education according to Southwestern University of Finance and Economics.
- Data produced by Chinese-language media and cited by Foreign Policy highlights that over a third of China's 100 million investors are aged 30 or below.
- The Shanghai Composite Index climbed from 2,063 points on July 3, 2014 to as high as 5,166 points on June 12, 2015. A 150% increase in less than 12 months.

As the second largest global economy and the largest country in the world by population with over 1.3bn inhabitants, the news that approximately $3.7 trillion had been wiped off the value of Chinese stocks so suddenly, sent shock waves throughout global financial markets.

Even though China’s subdued growth rate is still the envy of most nations, its recent economic slowdown has revived questions about the quality of its economic data. Many have suggested that Chinese authorities may have overstated the economy’s growth and understated inflation and in fact the nation’s economy could be worse than authorities in Beijing wish to declare. The recent complaints followed a long period of questioning whether China, as a developing country and authoritarian state, has the institutional ability and political desire to publish accurate and credible economic statistics. As the second largest global economy and a nation currently amidst economic volatility, the debate carries more weight than in the past.

Structurally, China's economy faces strong headwinds and must undergo significant changes in order to stabilise its stock and property market, without undermining economic growth. Looking ahead, the nation needs to be driven less by manufacturing and construction and more so by consumer spending and services. The challenge is to make the transformation smoothly, however a highly state-controlled economy is well suited to delivering the investment required to develop manufacturing and undertake large construction projects. It is not so well suited to a more services and consumer-orientated economy where there needs to be increased accessibility for innovation and enterprise.



Capital Movement?

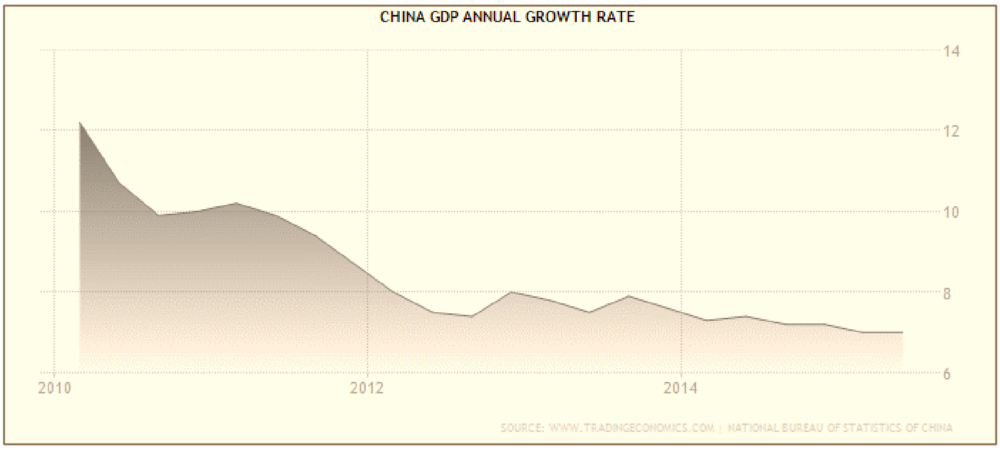
China's decline and uncertainty regarding future economic movements has raised a number of concerns for the nation's wealthy individuals with substantial interests in the Chinese economy.

- According to Bank of America Merrill Lynch, major shareholders in Chinese securities sold 360bn Yuan (US$56bn) in the first five months of 2015 alone, compared with 190bn Yuan (US$29bn) in all of 2014 and an average of 100bn Yuan (US$15bn) in prior years.

In an effort to preserve individual wealth, much of this money is expected to be relocated in countervailing investments that include more liquid assets such as bonds, treasury securities and stable currencies. The Wealth-X Ultra Wealth Report identified that the Chinese UHNW population increased at a rate of 5% over the past five years, almost entirely a result of the nation's superlative economic expansion rates. However, irrespective of their growing population, this community has faced significant economic challenges over recent years.

Real estate, a well acquainted asset for wealthy Chinese individuals, has frequently been compared with gold due to its defensive investment characteristics, often providing protection against more volatile alternative investments. Therefore, current uncertainty in the Chinese economy is expected to continue to drive the appetite for real estate situated in safe jurisdictions. Such desire to preserve individual wealth amidst economic and political dislocation has fueled growth in luxury real estate markets worldwide and according to Wealth-X's leading indicator, the UHNW Luxury Real Estate Index, growth is up 8.3% year on year.

- There is also some speculation that the proposed launch of a new scheme, the Qualified Domestic Individual Investor Programme, will see more Chinese investors seek foreign real estate investment. The pilot programme will permit individuals from six cities, including Shanghai, to invest directly in overseas markets.



London's Attraction

Of all the global cities, London is considered to retain the most established luxury real estate market. The UK capital is home to the most UHNWIs with over 4,000 (2.5% of global total UHNWIs) retaining in excess of US$30m. Located halfway between Shanghai and New York, London attracts luxury real estate investment due to its easy access to global financial markets, preferred time zone, politically stable environment, mature property market and excellent education on offer.

For such reasons, since 2000, London has been the largest European recipient of Chinese investment. A currency equivalent of £10bn was received, compared with £5bn in Germany and France, £4b in Portugal and £3.5b in Italy. Furthermore, Chinese investors last year found real estate situated in the UK and in particular London's 'golden postcodes' particularly attractive, investing approximately £1.5bn in the sector. According to PrimeResi, with capital markets facing uncertainty, Bond yields low and interest on cash deposits at an all-time low, there currently may be no better investment than UK residential property.

Over the last 12 months, prime London pricing figures have been relatively weak and thus Chinese investors, amidst current domestic economic uncertainty, may begin to see increasing value in these well acquainted locations. While the recent Stamp Duty reform introduced in December 2014 presents a new threshold for luxury residential property buyers to overcome, the 'best in class' properties are poised to continue to sell. History also tells us that although the Stamp Duty reform may be at present the single largest hindrance for those looking to purchase luxury residential property, arguably within a year or two the tax increase will be considered an accepted transactional cost. Research obtained during the financial crash in 2007-08 may offer an insight into future Chinese investor property interests within London. PrimeResi identified that enquiries evaporated for residences priced above £10m. However, at the same time they witnessed an increase at the less expensive end of the market, which encompassed properties valued at £2m and below, as investors sought assets that were weakly correlated with global stock markets.

An Increased Interest

Chinese investment into the UK currently remains stable, despite reports of a surge from Chinese investors seeking to escape domestic stock market turmoil. However, several London luxury residential estate agents are at present witnessing an increase from wealthy Chinese individuals interested in purchasing properties at the top of the London market. While such interests within London real estate are certainly not considered an uncommon phenomenon, a number of irregularities have been highlighted that disregard typical Chinese real estate investment trends.

Sources at one agency indicate that they have two Chinese individuals in prime London currently looking to purchase entire blocks of flats as opposed to the more traditional investments in single apartments or townhouses. This uncharacteristic interest may signify a capital movement rather than just individuals looking to park money or obtain quick returns. However, many suggest that it is too early to say whether China's current economic instability will have a major impact on the prime London real estate market, as much depends on the length and depth of China's economic decline and its broader economic performance.

This being said, a number of alternative global real estate markets have identified a substantial increase in Chinese investment. According to Brian Ward, the president of capital markets and investment services at Colliers International, Chinese investors have invested roughly US$5bn into US real estate in the first six months of 2015, more than the US$4bn invested in the whole of 2014. Further commenting, Chinese investors are attracted to the US due to its perceived stability, low interest rates and moderate economic growth during a time of domestic economic uncertainty.

Within the US, Chinese buyers are strongly focused on the West Coast, which provides geographical proximity and opportunities in education, business and trade. About 35% of reported sales to Chinese buyers during the 12 month period ending in March 2015 were in California. Key real estate investment cities include San Francisco, Los Angeles, Seattle, New York and Houston.

In Summary

- After years of remarkable growth, China's economy has lost significant pace and at present is witnessing its slowest growth in more than two decades.
- Although the nation's economic slowdown was globally anticipated, China's decline is far worse than many had predicted.
- According to many, the single most detrimental economic factor has been the nation's credit binge.
- Recent events saw the People's Bank of China (PBoC) devalue the Yuan against the Dollar by 4% and approximately $3.7 trillion wiped off the value of Chinese stocks.
- Uncertainty regarding China's future economic movements has raised a number of concerns for the nation's wealthy individuals with substantial interests in the Chinese economy.
- Much of this money has and is expected to continue to be transferred out of China's immature and volatile stock markets and into countervailing investments such as real estate.
- London, home to the most UHNWI globally, is considered to retain the most established real estate market and since 2000, has been the largest European recipient of Chinese Investment.
- Many London real estate agents have documented a surge in luxury property interests from Chinese investors.
- However, alternative global property markets have seen a recent increase in Chinese investment.
- Wealthy Chinese have invested approximately US$5bn into US real estate in the first six months of 2015, more than the US$4bn invested in the whole of 2014.

Conclusion

Despite reports of a projected increase from those looking to escape China's volatile stock market, at present Chinese investment into UK and in particular prime London real estate remains stable. It may be too early to say whether the ongoing economic instability in China will have a major impact on the UK and prime London real estate market. Much will depend on the length and depth of China's economic decline and its broader economic performance. This being said, Soane strongly believe that frailty in the Chinese economy will extend beyond the next three quarters despite intensified government stimulus measures. As a result, Soane predict that continued Chinese economic volatility will accelerate capital movement and enhance the attraction for countervailing investments such as luxury real estate situated in safe jurisdictions.

The next Soane Speaks article will review the first six months of Conservative government and its impact on UK real estate.