



J.P. Morgan's
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Impact of China's New Property Tax and Latest Round of Tightening –Views from Shanghai

After years of anticipation, China introduced its first property tax trials for homebuyers on January 28, only one day after the State Council announced a fresh round of national measures to restrain home prices. The anticipation of the new tax inspired unseasonably elevated market activity in the luxury segment since mid-December, but will now likely push Chinese homebuyers into a wait-and-see mode in the coming weeks. As had been rumored, the property tax is based on an assessment that takes into account home size, number of occupants, and number of properties owned. In recent days, we met with several property developers in Shanghai including Shui On Land, Capitaland China, Shimao and Shanghai Forte Land, and toured their respective residential projects. Since Shanghai is one of only two cities that has started levying property tax (along with Chongqing in southwestern China), we were eager to gauge their impressions and outlook for the market.

Reaction to the latest measures

- Companies we met with were unperturbed by the property tax trial, since its implementation was considered inevitable, while the removal of a major source of policy uncertainty allows them to better plan construction volumes. Although most contacts felt that the new property tax was milder than expected, the cumulative cooling impact of recent measures (especially the earlier announced home price restrictions and increases to second-home down-payment requirements) should not be underestimated.
- Given the government's focus on curbing speculation and the trend towards luxury property, developers with portfolios that emphasize such residences in the two affected markets (e.g. Shui On Land and C C Land) have underperformed their peers in recent trading. J.P. Morgan property analyst Lucia Kwong finds sector valuations attractive at 10.8x 2011P/E and thinks that the correction may create buying opportunities for quality developers such as China Vanke (000002.CH), Longfor (960.HK) and KWG (1814.HK).
- Although the new measures will clearly dampen transaction volumes, it will take some time to gauge the true impact on the physical market as we have entered the traditional Chinese New Year low-season. Following strong sales last year, developers are sitting on strong balance sheets. In addition, fund-raising at the beginning of 2011 has been much stronger than the first quarter of 2010. As a result, many developers are not under immediate pressure to cut prices.
- Following the recent measures, physical property prices in first-tier cities have limited upside, but the price outlook is more promising in lower-tier

cities experiencing fast growth, infrastructure improvements and strong owner-occupier demand for housing. Although the expansion of the property tax to other cities is an eventual likelihood, this will entail substantial groundwork at each locality, including preparation of the land registry and integrated systems for tracking property sales. Moreover, the government will be inclined to take a wait-and-see approach to better understand the efficacy of the Shanghai and Chongqing measures.

In the long-term, the property tax may provide an important new source of funding for local governments. Municipalities have traditionally depended on land sales for a significant portion of their income. Last year, despite strict measures to tighten the property market, land transactions generated RMB 2.7 trillion in revenue for local governments (+70.4% YoY). In comparison, RMB 55.1 billion in central government financing was extended for affordable housing in 2009 and local governments spent only RMB17.5 billion.

A Third Round of Property Tightening

The State Council's January 26 announcement of eight measures to curb property prices and the January 28 introduction of property tax trials in Shanghai and Chongqing have been collectively characterized as a third round of property tightening. The eight new measures (see *Appendix 1*) were, for the most part, a reiteration of existing policies; however three measures stood out as significant escalations in the government's campaign to control property prices:

- I. An increase in the minimum down-payment requirement for second-home mortgages to 60% from 50%
- II. A decree that city governments must establish a real-estate price target for 2011, with the caution that city leaders will be summoned by the Ministry of Housing and Urban-Rural Development if they fail to realize the limits. The Shanghai government recently announced that its price target for the year would be announced by the end of March.
- III. The extension of home-purchase restrictions to more cities with overheated housing markets.

More generally, the State Council's notice mandated the strict collection of business tax (unified at 5.5% of the total sales amount) on properties sold within five years of purchase, and required 70% of this year's new land supply to be allocated to policy housing and smaller-sized commercial housing.

In contrast, the much-anticipated property tax trial was milder than most observers had anticipated. In Shanghai, the levy primarily targets buyers of luxury residences and those who have accumulated investment property, since the tax is only applied on any property above 60sqm per person in the family (defined as husband, wife and children under the age of 18). The tax is only applicable to new purchases of second homes or above for local residents, and any new purchases for non-Shanghai residents. The tax base is established as 70% of the transaction price, with a rate of 0.4% for properties less than twice the average cost of new properties in Shanghai in the previous year and 0.6% otherwise. Importantly, property purchased prior to January 28 will be exempt from the tax, unless subsequent purchases cause a household's total property ownership to exceed its allowance.

This means that the effective tax rate is 0.28% for homes less than twice the average cost of new properties in the preceding year, and 0.42% otherwise. Based on an average ASP of RMB 21,827/sqm in 2010, Figure 1 shows the annual amount of taxes payable for a family of three for various price/size combinations.

Figure 1: Payable taxes for various property sizes and prices for a family of three (RMB)

	150 m ²	200 m ²	250 m ²	300 m ²	350 m ²	400 m ²	450 m ²	500 m ²
30,000 RMB/sqm	0	1,680	5,880	10,080	14,280	18,480	22,680	26,880
40,000	0	2,240	7,840	13,440	19,040	24,640	30,240	35,840
50,000	0	4,200	14,700	25,200	35,700	46,200	56,700	67,200
60,000	0	5,040	17,640	30,240	42,840	55,440	68,040	80,640
90,000	0	7,560	26,460	45,360	64,260	83,160	102,060	120,960
120,000	0	10,080	35,280	60,480	85,680	110,880	136,080	161,280
170,000	0	14,280	49,980	85,680	121,380	157,080	192,780	228,480

Source: J.P.Morgan

The tax amounts in the above table amount to between 0.028% - 0.269% of property value, exceeding 0.2% only for properties above 350 sqm and 50,000 RMB/sqm.

The Shanghai government's announcement made reference to further tax exemptions that imply an even-thinner tax base than one might assume and point to very complicated implementation:

- Families who sell their previous home within a year of buying a new property will get the tax refunded if the previous home was their sole.
- Newly purchased properties for the purpose of marriage will be exempt.
- A legitimate non-local professional may receive a tax waiver if the property purchased is their only residence.
- A tax waiver may also apply to non-local people with Shanghai residence permits who have been living in the city for over three years and wish to purchase a first-home. For non-locals with residence permits, who have lived in Shanghai for less than three years, tax will be collected but will be refunded three years later.

Reactions to Property Tax

Our contacts in Shanghai's real estate sector considered the terms of the new property tax to be milder than expected and suggested that the earlier-announced home price restrictions and increases to second-home down-payment requirements were more aggressive in comparison.

Considering that the introduction of property tax had been anticipated for over a year, its launch has removed a major overhang and now allows developers to adapt their product and target marketing to the new situation. Major listed developers' properties tend to sell at pricing levels above the city-wide average ASP, but even so, the applicable property tax can be relatively low, except in the case of very large high-end luxury units (relative to the average home size in Shanghai of approximately 80 square meters). Taking for example a first-time home purchase at various developments that we visited:

- Family of two purchasing a 79sqm 1 bedroom apartment in Shanghai Forte Land's Glorious Times project located in Zhabei (70% of units already sold, primarily to second-time buyers):

*Average price ~RMB 42,000/sqm, **No property tax***

- Family of three purchasing a 200sqm apartment at CapitaLand China's Paragon development at Shanghai Luwan:

Average Price ~RMB100,000/sqm x ((200-180) x 0.42%) = **RMB 8,400/year**

- Family of three purchasing a 142 sqm apartment at Shui On Land's Rainbow City Phase III development in Hong Kou district (90% sold out on first day of launch, almost 60% of buyers were existing residents of the district, 90% were Shanghai-based):

*Average Price ~RMB 40,000/sqm, **No property tax***

- Family of three purchasing a 320sqm villa at Shui On's *Manor at Casa Lakeville* adjacent to Xintiandi:

Average Price ~RMB160,000 (per sqm) x ((320-180) x 0.42%) = **RMB 94,080/year**

Although it can be assumed that high-end developers will be most directly affected by the new property tax, a representative of Shui On Land posited the counter-argument that the increased cost associated with upgrading one's residence or purchasing additional homes meant that quality properties in prime locations might see greater demand.

In recognition of the inexorable trajectory of housing policy, some developers are committing to grow their business in the more affordable segments of the residential market. CapitaLand has established a residential business unit, CapitaValue Homes, to cater to homebuyers whose monthly mortgage payment capacity is pegged to ~40% of the household income level in a particular city. These homes are expected to be about 90sqm in size and will conform to a more standardized design with a different set of specifications compared to mid-to high-end homes. CapitaValue's maiden project in China is a 200,000 GFA development situated 20km from the city center of Wuhan in Hubei province.

China's largest national developer Vanke has in recent years heightened its focus on developing mid-priced properties, with 90% of its apartments less than 140sqm, and 70% smaller than 90sqm.

Shanghai's property market: a testing ground for national policies

Shanghai's real estate market is arguably the most significant testing ground for government policies designed to dampen non-occupier demand (ie, speculative or investment-driven demand) for housing on one hand, while boosting the supply of affordable housing on the other. For many years, the city's housing market has attracted intense speculation, with many foreign and non-local investors actively participating. Although the Shanghai government first introduced restrictions on foreign property investors in 2006, the existence of loopholes and the abundance of cash-rich local buyers prompted housing prices to surge 310% since then.

In response to last year's two rounds of property tightening, the total primary sales volume in Shanghai dropped to the lowest level since 2002 (a decline of 41% YoY), while in value terms sales dropped 33% YoY. Even so, the ASP for primary residential property rose 36% (excluding policy housing). In part, this was due to the continued boom in supply of luxury residential property in Shanghai. In 2010, there were 60 residential projects priced at an average more than RMB 50,000/sqm, up from 33 such projects in 2009. In the closing weeks of 2010 and in early-2011, luxury sales in the primary residential market exhibited a sharp pick-up as some buyers rushed to purchase property ahead of the anticipated introduction of property tax.

In the judgment of Shanghai mayor Han Zheng, the issue of housing affordability has become elemental to his city's aspiration to become a global center for finance, trade and shipping, since

prohibitive home prices threaten to drive away talent. Although the government has vowed to ramp up the supply of affordable housing in the years ahead, there remains a large sandwich class of households whose members earn above the RMB 2,900/month income ceiling (increased last August from RMB 2,300/month) to qualify for economic housing – but for whom a 70sqm commercial property (priced at last year's city-wide ASP of RMB 21,827/sqm) represents 32 years' of an individual's total pre-tax income. As an indication of the burden imposed on homebuyers, the colloquial term "mortgage slave" has come to be used in reference to people who pay over half their disposable income toward home loans. In recognition of the plight of this sandwich class, a new category of policy housing – "price-capped housing" – was initiated last year, whereby prices are capped by local governments when land is sold to a developer (usually at level falling between that of economic and ordinary commercial housing).

Affordable Housing

A crucial corollary to the government's campaign to curb speculation is its commitment to boost the supply of affordable housing. Last year, local governments largely met the national policy housing target, achieving starts of 5.9 million units and completions of 3.7 million units. Although 2010 was already a record year for policy housing construction for most provincial governments, the 2011 campaign is set to be still more aggressive with a target of 10 million units. Affordable housing starts are expected to represent more than 35% of construction starts in 2011. In particular, Shanghai aims to start 220,000 and complete 170,000 units in 2011. The city government has promised that 5% of all new homes to be built this year must be affordable and is targeting 1.2 million units of affordable housing supply over the next five years.



Sanlin Affordable Housing Development, developed by Shanghai Construction Group

According to domestic media, Shanghai's first batch of economic housing, consisting of 48,000 units in 20 developments across six districts, will be ready for occupancy this year. The housing will fall into three price brackets of approximately RMB5,000-6,000/sqm; RMB6,000-7,000/sqm and RMB7,000-8,000/sqm. Affordable housing developments are generally situated in non-prime locations on the outskirts of the city. We visited one such development in Pudong New District, which at ~20km from downtown Puxi was one of the better-situated economic housing developments in Shanghai (low-rent housing developments, which cater to the poorest urban residents are generally situated further still in city outskirts). Our guide, a recent university graduate, pointed out that an average salary of

RMB3000-4000/month for the city's fresh university graduates would instantly put them above the income ceiling to qualify for one of the units.

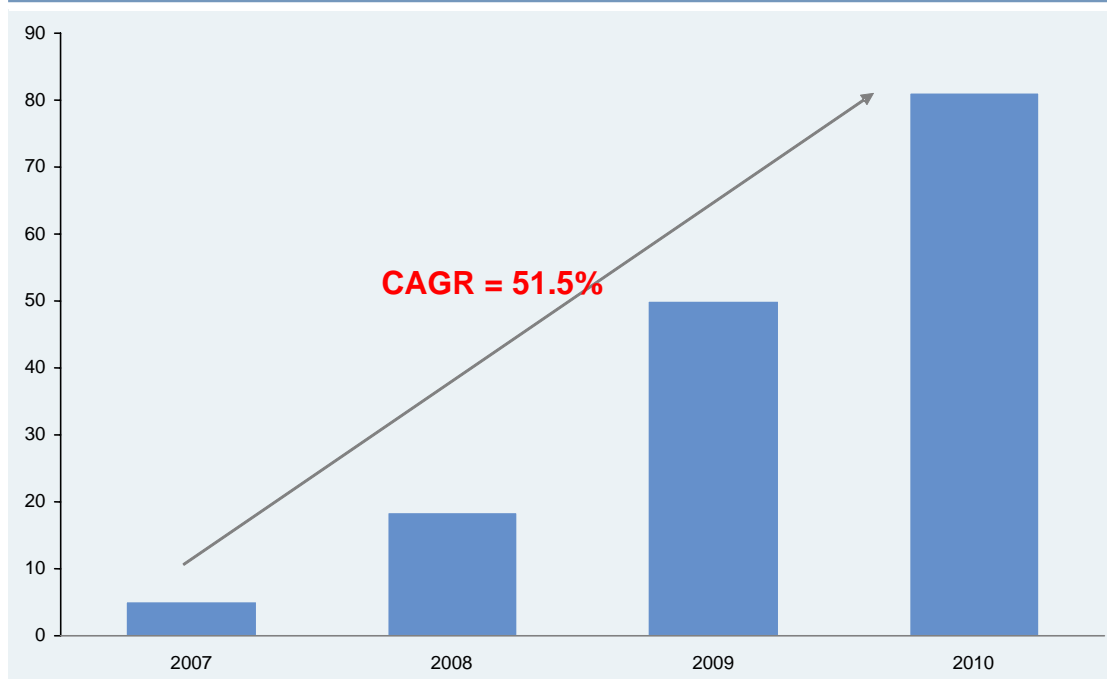
An Update on Funding

With 10 million units of affordable housing starts targeted in 2011, the necessary funding is estimated to have grown 62% to RMB 1.3 trillion, according to the Ministry of Housing and Urban-Rural Development (MoHURD).

It has been reported in domestic media that Chinese banks and other lenders extended RMB 2 trn in new loans to real estate last year, of which RMB 591 bn were to developers and the rest were home loans. Nationwide, total real estate investment was RMB 3.4 trillion.

Meanwhile, central government subsidies in 2010 reached RMB 81.1 billion, increasing at a 3-year CAGR of 51.5% since 2007 (see Figure 2). In early-2011 China Development Bank pledged RMB 100 bn of loans to support policy housing development, an amount that exceeds its entire outstanding loan balance of RMB 87.8 bn.

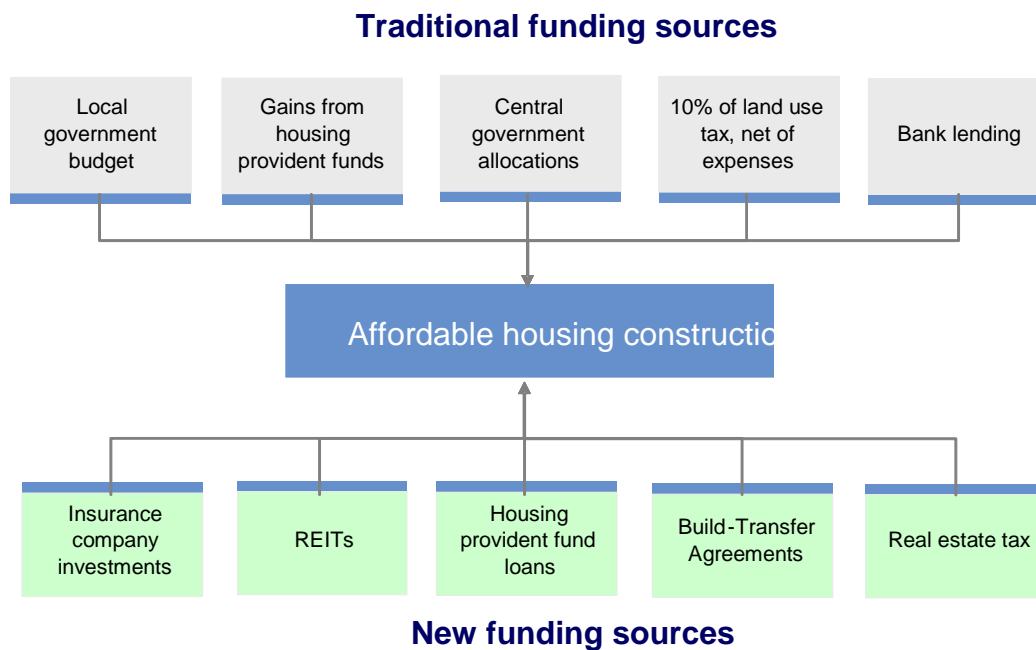
Figure 2: Central government subsidies for affordable housing (RMB bn)



Source: Ministry of Finance

The problem of misaligned incentives and insufficient local government funding is gradually being addressed through new financing arrangements, including build-transfer agreements between construction companies and local governments, REIT financing, the investment of insurance funds and the use of Housing Provident Funds (see Figure 3). Both the Shanghai and Chongqing governments have emphasized that proceeds from the new property tax will be applied towards their respective affordable housing programs.

Figure 3: Sources of funding for affordable housing program



Source: J.P. Morgan

Appendix I: The State Council's Eight New Measures (announced on January 26)

1. Local governments are responsible for keeping housing prices in check. For 2011, each municipal government must set a target price level for properties, aligned with the economic development goals of the city, disposable income growth rates, and housing affordability.
2. The government will increase the supply of affordable housing by building new units, converting existing residential space, repurchasing real estate, and committing to long-term rentals. It will also expand the coverage of affordable housing and improve governance, creating a truly transparent and fair system.
3. At the retail level, transaction of properties held for less than 5 years will be taxed, using the entire transaction value as tax base. Governance over taxation will be strengthened. At the developer level, the government will investigate projects that were priced substantially higher than neighboring properties.
4. To further strengthen the current differentiated mortgage scheme, for second homes, down payments have to exceed 60%, while the mortgage rate must be at least 1.1 times of the benchmark rate.
5. Further enforce the amount of residential land allotted to affordable housing to be over 70%. Suppress land hoarding by rescinding land use rights of land unused for over two years, and imposing fines for land left idle for over a year.
6. Limit purchases to one property for local families already with a residence, and for non-local buyers who can produce proof of residence for at least one year. The following groups are not allowed to purchase homes:
 - a. Local residents with two or more homes
 - b. Non-local residents with one or more homes
 - c. Non-local residents without proof of residence
7. Local governments will be questioned on:
 - a. The timeliness and transparency of goals stated in 1.
 - b. Housing prices that exceeded said goals by the end of 2011
 - c. Affordable housing construction if annual targets were not met
8. Greater governance over the media to put a stop to the dissemination of false information that may mislead the participants of the property market.

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