

Jing Ulrich
Managing Director, Chairman,
China Equities & Commodities
+852 2800 8635
jing.l.ulrich@jpmorgan.com

Amir Hoosain
+852 2800 8641
amir.h.hoosain@jpmorgan.com

Benjamin Wong, CFA
+852 2800 8932
benjamin.mc.wong@jpmorgan.com

Kelvin Wong
+852 2800 8962
kelvin.x.wong@jpmorgan.com

Have China's Property Curbs Changed Investment Behavior?

With residential property transaction volumes having tapered off and a series of cooling measures and purchase restrictions raising barriers to investment in China's housing sector, an increasingly frequent question being asked is "what are China's would-be property investors doing with their money?" This report examines this question and draws the following conclusions:

- **Property tightening measures should be supportive of a gradual investment rotation into the A-share market.** The "mass-affluent" segment of society has seen its investment options sharply affected by restrictive housing measures, since these households possess sufficient capital to purchase investment property, but do not have the same degree of access to investment vehicles such as private equity funds and retail property available to those in the highest echelons of wealth.

With growth in household deposits moderating, the most obvious expectation is that funds should be channeled towards equity investments. Managed fund subscriptions have risen thus far in 2011 and the creation of new securities accounts has steadily picked up since mid-February (on a 5-week moving average basis: 393,912 accounts during the week ending Apr 1, compared to 159,494 accounts during the week ending Feb 11); the proportion of *active* securities accounts has picked up from 11.3% in early-Feb to 33.7% in early-April – roughly midway in the range observed over the past three years. Inexpensive valuations and relatively strong earnings growth should encourage greater asset allocation into the A-share market, especially if inflation concerns ease towards mid-year. Although the equity position of domestic mutual funds is relatively elevated at ~80%, retail investors account for roughly 60% of the A-share market.

- **China's gold demand has surged.** Demand for physical gold and gold-related investments has been growing at a rapid pace as precious metals represent a good hedge against inflation. Chinese demand for gold jewelry increased 13.5% YoY in 2010, while demand for bars & coins rose 70.5%. Most market participants expect that China's gold demand could grow at a still-stronger pace in 2011. Total consumer demand in 2010 was equivalent to a total value of RMB 150.8 billion, representing between 1.1-3.6% of the increase in household cash holdings during 2010 (depending on whether jewelry purchases are classified as investments).
- **Clear, but limited rotation into commercial property and lower-tier markets.** Local real estate agencies have noted a rotation into commercial property and a heightened willingness to buy residential property in some lower-tier cities where purchase restrictions have not been enacted. More developers are adopting strata-title sales strategies geared towards individuals with liquid funds of RMB 10-20 million who wish to invest in high-end commercial property. For investors with a lower capital base, property agents and consultants in China cite greater interest in investing in retail space (typically linked to residential estates), small offices and serviced apartments. Nevertheless, the rotation from residential to commercial property is of limited scale, due to generally higher capital requirements, greater tax liability and other complexities.

- **Wealth management products in higher demand.** Growth in household deposits moderated to 16.35% in February compared to 24.5% in February 2010. Chinese banks' wealth management product offerings have been gaining popularity as Chinese savers seek relatively low-risk investment alternatives. In recent months, the issuance of RMB-denominated wealth management products has steadily increased, rising from 499 products last October to 1368 in March 2011. Approximately 50-60% of the products issued have maturity terms of less than 3 months, suggesting that investors are using these instruments as replacements for short-term deposits.
- **Surge in popularity of PE funds and real estate trusts among high net-worth investors.** China's ultra-high net worth individuals generally do not invest a sizable proportion of their assets in domestic residential property; therefore, China's recent property restrictions have not materially affected asset allocation decisions among this population. Real estate trust products have gained popularity with the implementation of property tightening, from both a demand and supply perspective as developers seek alternate methods of fund raising, while investors demand financial products that generate higher income streams. Private equity funds have also experienced a surge in popularity among high net worth investors; subscriptions to PE funds now represent approximately half of total new fund subscriptions for wealth management firms such as Noah Holdings (NOAH.US), that cater to high net-worth Chinese individuals.
- **Overseas Property.** Affluent Chinese are acquiring more homes abroad and overseas property exhibitions, as well as overseas buying tours have become common. Purchases of Hong Kong property by Mainland Chinese buyers have been rising rapidly since the second half of 2008 and now account for about a quarter of the Hong Kong market, according to Knight Frank. In Singapore, Mainland Chinese buyers recently bypassed Malaysians to become the leading group of foreign homebuyers in the city-state, having overtaken Indonesians in the last quarter of 2010.

Ever since housing reforms began in the 1990s, the proportion of Chinese households that own their homes has climbed from 17% to 89%. However, it has been well documented that a sizable segment of homebuyers in China, especially in first-tier cities, have been investment buyers rather than owner-occupiers. The most visible symptom of this phenomenon is the elevated number of vacant apartments, which in certain parts of China appears to far exceed what might be expected under normal market conditions. The incredible appetite for physical property in China is easily explained by the limited avenues of investment for ordinary Chinese citizens under a closed capital account regime, coupled with the frequent occurrence of negative real interest rates during times of elevated consumer price inflation.

From 2001-2010, real interest rates (based on 1-year deposit rates) were negative in 51 out of 121 months; a sum of RMB1,000 deposited throughout this period would have appreciated to RMB1,014 on inflation-adjusted terms (at a CAGR of 0.01%). Meanwhile, the domestic stock market has been susceptible to booms and busts triggered by shifts in the policy cycle. From 2001-2010, the Shanghai Composite Index increased at a compound annual rate of 2.9%, while consumer prices expanded at 2.29% CAGR, implying a real rate of return of just 0.08% per annum. Performance was much stronger between 2006-2010, when the real rate of return for the Shanghai Composite Index reached 17.5% per annum, however the period was marked by a dramatic boom and bust from 2006-2008 with the P/E ratio reaching a high of 52x in October 2007 before plummeting to 13x in the span of a year. Newer financial investments such as products under the Qualified Domestic Institutional Investor (QDII) scheme have encountered sluggish demand as retail investors remain unconvinced of potential returns (although domestic fund managers continue to view QDII as an asset class with long-term potential).

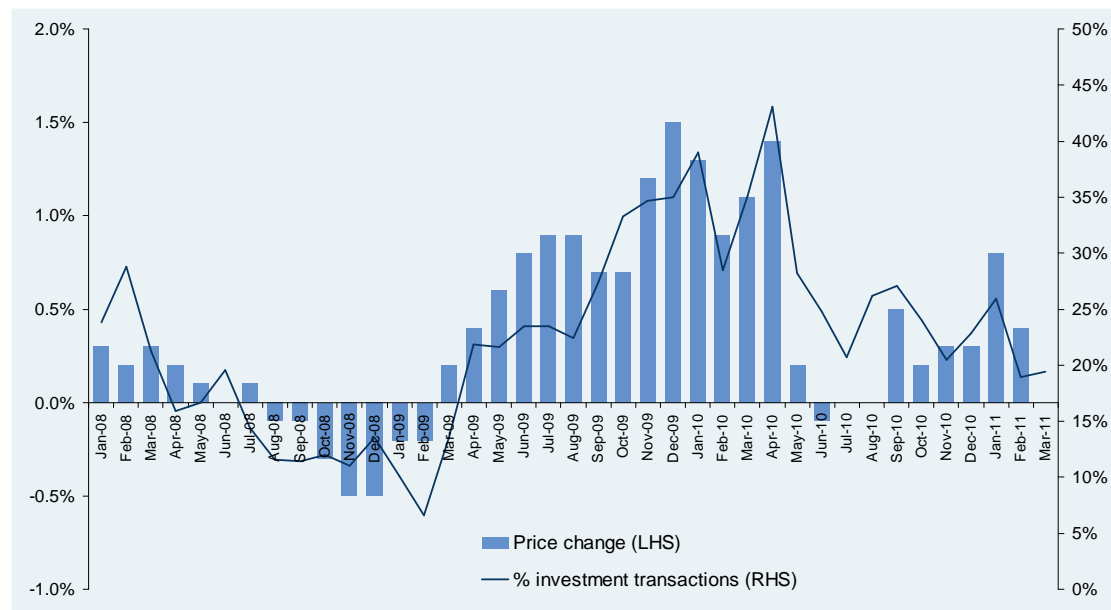
In comparison, the national average residential property price expanded by a CAGR of 8.9% from 2001-2011 (based on official data), registering only one year-over-year decline of 1.9% in 2008. Taking a ten-year historical view, property has been one of the few accessible categories of investment whose gains have soundly beaten inflation.

Investment Demand and China's Home Purchase Curbs

The negative societal impact of worsening housing affordability has become an issue of prime importance for Chinese policymakers in recent years, especially as home prices in major cities surged in 2010. Average home prices in Beijing rose 29.7% last year, 15% in Shanghai, 31.7% in Shenzhen and 34.4% in Hangzhou. As a symptom of speculative excess, much public criticism has been directed at the visible phenomenon of vacant properties. There are no reliable figures to indicate vacancy rates in major cities, or across the nation, however various domestic media reports over the course of 2010 had put the level of home vacancies at as much as 30-40% of residential housing (admittedly based on informal methods of estimation, such as observing the ratio of unlit apartments at housing complexes during evening hours).

World Union Properties Consultancy, a Shenzhen-based national real estate services firm estimates based on its agency transactions that the proportion of investment-driven residential home purchases declined from a recent peak of 34.2% in 1Q2010 to 22.4% in 1Q2011. As Figure 1 shows, from January 2008 to present, the level of investment demand has been highly correlated with average home prices across 70 cities.

Figure 1: 70 cities home price index and investment demand (%)



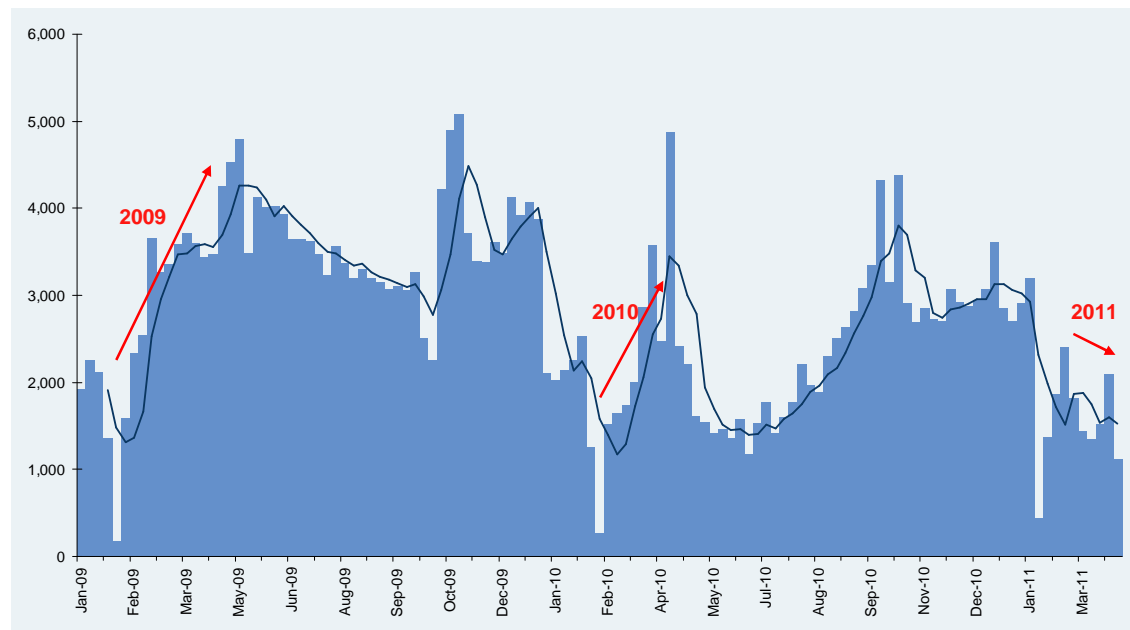
Source: Shenzhen World Union Properties *70 cities price change series was discontinued by the NBS from Dec-10. Data on Jan and Feb 2011 was calculated from the median price change on the 70 individual cities included in the new NBS figures

The government has released progressively stricter measures to rein in the property market over the last twelve months. After increases in down-payment requirements and interest rates, much more aggressive directives emerged from late-January, as various cities announced restrictions on the purchase of second and third homes, as well as purchases of any kind by non-residents. Notably, Shanghai and Chongqing launched property tax trials, which although relatively mild, constituted the first tax levied on existing homeowners in China. Some 35 cities now have purchase restrictions in place. New measures in Beijing have been the most stringent – as of mid-February, the city banned property sales to non-local households that cannot demonstrate at least five years' worth of social security or income tax payments. The immediate impact of the ban was reflected in a 70% MoM drop in Beijing home sales in February; when other cities introduced their own restrictions in subsequent weeks, similar drops in transaction volume have been observed.

The dampening in property transaction volumes has been most notable since Chinese New Year. Property transactions historically climb after the holiday period, building up towards peak home-buying

season in May. However, with restrictive policies implemented in numerous cities, transaction volumes have begun to defy seasonal patterns and declined (see Figure 2). Reflecting this trend, most residential property developers saw a slowdown in the volume of sales during the first quarter. China Vanke, the country's largest property developer saw its sales growth slow sharply in March to 47.8% YoY, as compared with more than 100% YoY growth in the first two months of 2011.

Figure 2: Average daily property transaction in 8 major cities (units, 4 week moving average)



Source: Centaline, City real estate trading centres, J.P. Morgan property research

There is some leeway for resolute homebuyers to circumvent restrictions – by registering home purchases in relatives' names for instance, or by trading-up to higher-valued properties. While such options may exist, initial signs of declining residential prices are surely dampening investment appetite and prompting many would-be property investors to wait on the sidelines or explore other options. According to February home price data from NBS, primary residential prices in 9 lower-tier cities have begun to decline, by an average of 0.36%, compared to just 3 cities in January (see Figure 3). Anecdotally, many developers and homebuyers alike expect less stringent policies to come out within one or two years to substitute the restrictions, meaning that a more favorable property investment climate may materialize in the medium-term.

Figure 3: Growth in primary home price – February (MoM %)



Source: NBS

What are the Investment Alternatives?

Although China has a fast-growing population of high net worth individuals – many of whom already own multiple properties – the vast majority of investment-driven property purchases in China are conducted by the “mass affluent” – a class whose members may not have access to direct investments, alternative investment products and opportunities to allocate assets offshore. According to Bain Consulting, the popularity of property-related trust products and private equity funds has seen a recent increase among high net worth individuals (minimum RMB 10 million in investable assets). But for the typical “mass affluent” investor, such products are generally considered too risky since the minimum investments would equate to a large proportion of household assets, with typical lock-up periods amounting to 2-3 years. At the highest echelons of wealth, China’s ultra-high net worth individuals generally do not invest a sizable proportion of their assets in domestic residential property; therefore, China’s recent property restrictions have not materially affected asset allocation decisions among this population.

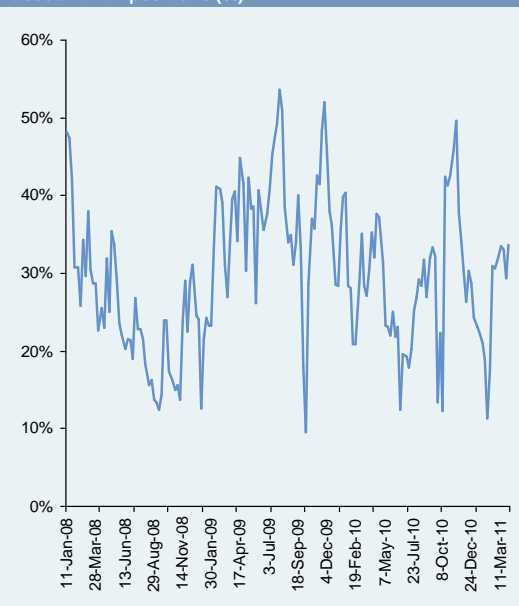
With conduits for capital deployment still rather constricted, the recent downturn in housing sales volume in China has led to much speculation of where investment funds have been channeled:

- Property tightening measures should be supportive of a gradual investment rotation into the A-share market.** Since the beginning of the year, China’s CSI 300 index has gained 6.3%, outperforming the MSCI Emerging Markets index by 4.1ppts. The total trading value on the Shanghai and Shenzhen exchanges has increased by 40-50% YoY, but the average trailing A-share P/E level is still below the November 2010 level and below the average level for the post-financial crisis period. The proportion of active securities accounts has picked up from 11.3% in early-Feb to 33.7% in early-April – roughly midway in the range observed over the past three years (see Figure 4b). Inexpensive valuations and relatively strong earnings growth should be supportive of greater asset allocation into the A-share market over the course of 2011, especially with real estate investment remaining constricted.

Figure 4a: CSI300 PE multiple (times)



Figure 4b: Active A-share accounts as a percentage of all account with positions (%) *

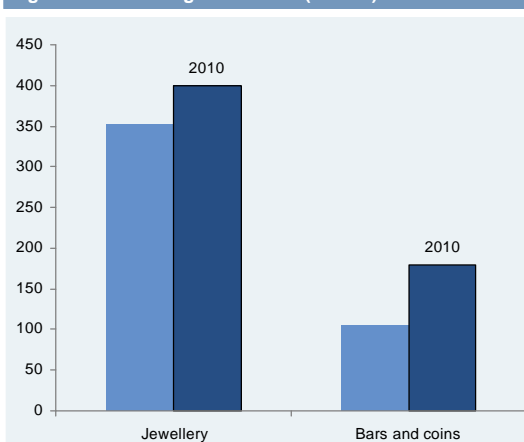


Source: CEIC * Defined as accounts with trading activity in the secondary market during the week

Managed fund subscriptions across asset classes have risen thus far in 2011. We estimate that the net-increase in managed fund subscriptions amounted to ~RMB 36 billion in 1Q11 compared to ~RMB 3 billion in 4Q10. In particular, fund flows reversed in the equity category, showing an increase of RMB 22 billion compared to net outflows of RMB19 billion in 4Q10. Bond funds in the meantime have experienced steady inflows over the last 5 quarters, recording ~RMB10 billion in inflows so far in 2011.

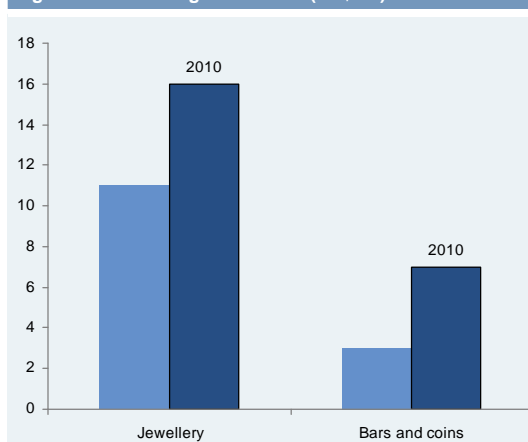
- China's gold demand has surged.** In the context of inflation concerns and heightened geopolitical risk, gold investment has increased in popularity in China, although the scale of investment relative to other asset classes remains small. According to the World Gold Council, Chinese demand for gold jewelry increased 13.5% YoY in 2010, while demand for bars & coins rose 70.5% (by tonnage, see Figure 5); total consumer demand was equivalent to a total value of RMB 150.8 billion at current exchange rates. This represents between 1.1-3.6% of the increase in household cash holdings during 2010, depending on whether jewelry purchases are classified as investments.

Figure 5a: Chinese gold demand (tonnes)



Source: GFMS, LBMA, WGC

Figure 5b: Chinese gold demand (US\$ bn)



Gold investment activity remained elevated in recent weeks, with data on average trading volumes from the Shanghai gold exchange showing a six-fold increase in the first 3 weeks in March, compared to the same period last year.

Reflecting the healthy appetite for gold exposure on the part of China's retail investors, Shenzhen-based Lion Fund Management Co raised more than RMB3.2 billion (US\$483 million) for its gold exchange-traded fund (ETF) under the Qualified Domestic Institutional Investor (QDII) scheme in December. This amount was the highest raised by a new QDII product since 2008. The product is China's first ETF to offer exposure to physical gold and mainly invests in overseas ETFs that track international gold prices.

- **Clear, but limited rotation into commercial property and lower-tier markets.** With the expansion of home purchase restrictions, residential property investors have been increasingly inclined to seek investment opportunities in nearby cities where restrictions have not yet been enacted. Although this phenomenon is in its infancy (and thus not fully apparent in transaction data), local real estate agents we spoke to observed increased interest in lower-tier residential properties in certain locales during February (normally a low season for property purchases). This was said to be evident in Foshan, for instance, which is a 30-minute commute from Guangzhou (where home purchase restrictions were enacted on February 24).

Interest in commercial property investment has also picked up, since this segment is not subject to the many purchase restrictions now imposed on residential property. More developers are reportedly adopting strata-title sales strategies geared towards individuals with liquid funds of RMB 10-20 million who wish to invest in high-end commercial property. For investors with a lower capital base, property agents and consultants in China cite greater interest in investing in retail space (typically linked to residential estates), small offices and serviced apartments. According to our discussion with a major real estate agency in Shanghai, both the supply and demand of these smaller commercial properties has increased in 1Q2011. Serviced apartments and 40-50 sqm offices offer higher rental yields (~3-5%), with typical investment requirements comparable to a higher-end residential property.

On the whole, we believe the rotation from residential to commercial property is of limited scale, in light of generally higher capital requirements, greater tax liability and complexities in property selection. Some real estate agents casually estimated that 10-20% of residential property investors might rotate into commercial property. Nevertheless, the redirection of capital into commercial property as well as residential property in lower-tier cities may explain the greater emphasis that developers are placing on developing commercial projects and housing in second and third-tier cities. Media reports also suggest that more developers are adapting to restrictions by developing so-called "SoHo" apartments – offices equipped with private bathrooms and kitchens.

- **Wealth management products in higher demand.** With the real deposit rate for 1-year term deposits standing at negative 1.95%, cash is a relatively unattractive asset class for Chinese retail investors. Growth in household deposits moderated to 16.35% in February compared to 24.5% in February 2010, when the real deposit rate was -0.5% (see Figure 6).

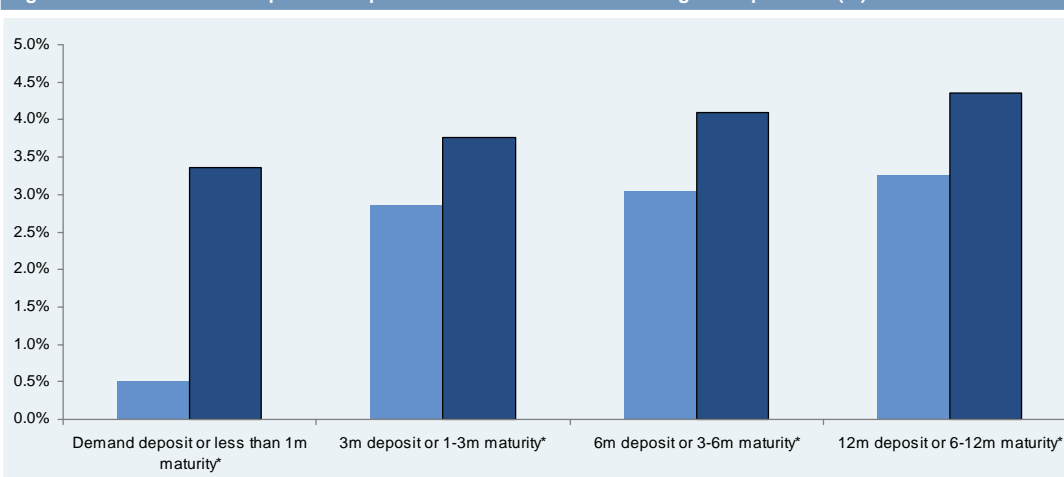
Figure 6: Total household deposit growth and 1-yr real deposit rates (%)



Source: PBOC, CEIC

Chinese banks' wealth management products have been gaining popularity as savers seek relatively low-risk investment alternatives. With the CBRC strictly regulating off-balance sheet trust loans, the number of trust loan-related products declined during 2H10, replaced by bond and currency-related wealth management products that mainly invest in sovereign, policy bank and corporate bonds domestically and overseas. According to data from *bankrate.com.cn*, wealth management products are paying annualized interest rates that are on average ~1% higher than official deposit rates (see Figure 7). In recent months, the issuance of RMB-denominated wealth management products has steadily increased, rising from 499 products last October to 1368 in March 2011. Approximately 50-60% of the products issued have maturity terms of less than 3 months, suggesting that investors are using these instruments as replacements for short-term deposits. Domestic wealth management data provider *Chengdu Benefit* estimates that total issuance in 2010 reached ~RMB 7 trillion (compared to RMB ~5 trillion in 2009, and compared to household bank deposits of ~RMB 32 trillion).

Figure 7: Interest rates on deposits compared to bank issued wealth management products (%)



Source: Bankrate.com.cn *Labels refer to terms of bank deposit or maturity on wealth management products

- **Surge in popularity of PE funds and real estate trusts among high net-worth investors.** PE funds have experienced a surge in popularity among high net worth investors. Noah Holdings (NOAH US), a leading Chinese investment advisory firm for high net-worth individuals noted that subscriptions to PE funds represented approximately half of total new fund subscriptions in 2010, up from approximately 30% in 2009. Data from Simuwang, an online PE fund database suggests that PE fund launches grew to 60 funds launched per month in November – January, compared to an average of 40 launches per month in 10M10. Activity in the PE space has increased as China's economic rebalancing and new Five-year development plan is expected to provide a burst of growth opportunities for smaller private companies in emerging industries. Fund launches in February however fell to 25, potentially due to a combination of factors such as the Chinese New Year effect and natural moderation in demand, following several months of strong issuance.

Noah Holdings indicated that there did not seem to be any notable up-tick in the growth of fund inflows in recent months; however, the business had been expanding rapidly even before the latest round of housing measures, so it was difficult to discern the intention behind new fund inflows.

Although traditional private equity funds in China requires minimum investments of ~RMB 1 million, several banks including China Merchants and China Everbright have repackaged traditional private equity funds into structured trust products. Investors may gain direct private equity exposure through these products, or receive a fixed income stream, with their investment effectively taking the form of a high-yield bond issuance by the fund. With lower minimum investment levels of RMB 100-300K, these products are gaining popularity among "mass-affluent" investors.

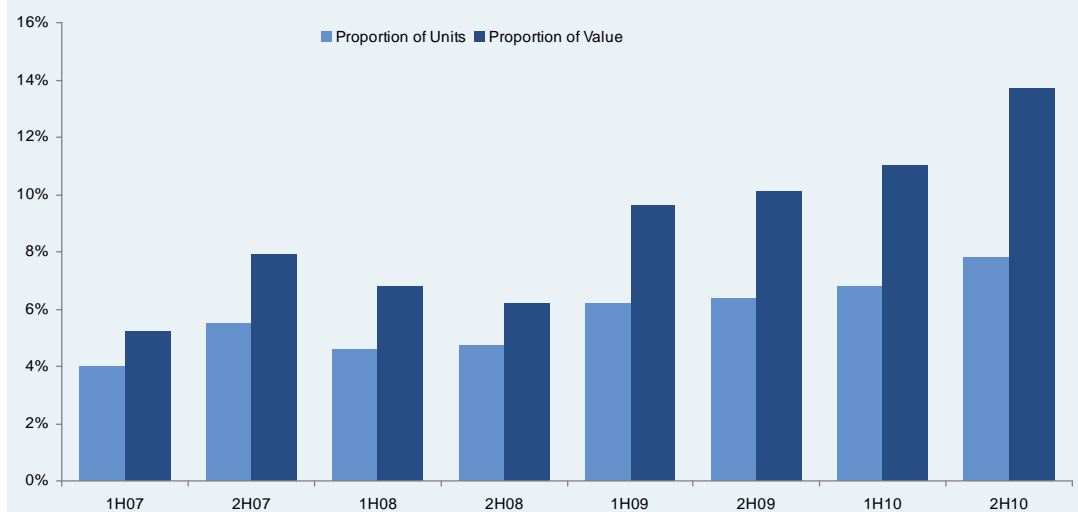
Property trust products.

Trust products have gained popularity with the implementation of property tightening, from both a demand and supply perspective as developers seek alternate methods of fund raising and investors demand financial products that generate higher income streams. According to data from the Chinese managed fund consultancy *Howbuy*, real estate trust issuance averaged ~50 products per month between July and November 2010. However the rapidly ballooning trust product industry has attracted caution from regulators. In late-February, CBRC disallowed trust companies from making loans for the purpose of land banking and more restrictions are anticipated. As a result, real estate trust product launches for the first 2.5 months this year reportedly attracted just RMB 24.7 billion in subscriptions, equivalent to just one month's value in 2010.

- **Overseas Property.** Affluent Chinese are acquiring more homes abroad and overseas property exhibitions, as well as overseas buying tours have become common. Purchases of Hong Kong property by Mainland Chinese buyers have been rising rapidly since the second half of 2008 and now account for about a quarter of the Hong Kong market, according to Knight Frank. The growth in purchases of new property has far outstripped that of units on the secondary market. The value of mainland housing purchases in Hong Kong as a percentage of total value shows that the rise in value is quicker than the rise in units as a proportion of total purchases. This implies that the willingness of mainlanders to invest money into the Hong Kong real estate market has been much stronger than the local population (see Figure 8). This likely reflects the fact that Chinese citizens are still facing a dire shortage of investment avenues. However, in our conversations with the largest Hong Kong real estate agencies, they have indicated that there was no up-tick in purchases by mainland buyers since the latest round of housing purchase restrictions.

In Singapore, Mainland Chinese buyers recently bypassed Malaysians to become the leading group of foreign homebuyers in the city-state, having overtaken Indonesians in the last quarter of 2010.

Figure 8: Mainland purchase units and value as a proportion of total purchases in Hong Kong (%)



Source: Research department at Centaline Properties

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