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China's Affordable Housing Program: Picking up Momentum

China's plan to build 36 million units of affordable housing during the 12th Five-year plan has been viewed as an important pillar of economic growth for the next several years, a tool to dampen price increases in the private housing market, as well as a major enhancement to social welfare. Original announcements suggested a front-loading of construction within the 2011-2015 period, with 10 million units to be started in both 2011 and 2012. The rapid increase in construction starts – from just 34% in late-May, to 86.8% of this year's targeted 10 million units by the end of August – has raised many questions about the degree to which this surge in starts is translating into construction activity. It is not necessarily unusual for the statistics to indicate construction starts loaded into the back half of the year, since local governments must first complete preparatory work (such as allocating land and compensating resettled residents). According to the Ministry of Construction, the country aims to finish at least one third of this year's newly-started affordable housing projects nationwide, with the remaining projects having at least started by the end of October. In total, the central government has pledged to complete over 4 million units by the end of the year.

We expect construction activity to pick up in the remainder of the year, however in order for construction targets to be met, considerable changes must occur in the funding aspects of the program. While the contribution from central and local governments is on track to meet the budgeted ~RMB500bn, the contribution from social funding sources is set to fall short of the budgeted ~RMB800bn. The gap must be met through bond issuance from construction companies or local government financing vehicles (LGFV), or greater investment from the likes of insurance funds and housing provident funds.

- **Construction should pick up in the remainder of the year.** In the first eight months of 2011, real estate investment data for economic housing (a category of affordable housing that accounts for 12% of this year's planned construction, and for which funding bottlenecks are less severe) indicates only 5.5% nominal growth compared to Jan-Aug, 2010. Considering that most of this year's starts are being recorded between June and August, the pace of construction should pick up noticeably in the remaining months of 2011.
- **Funding burden must be relieved.** New avenues of funding for affordable housing have been introduced in 2011, however, the pace is still slow and will unlikely be able to ease the funding burden substantially in the near-term. A substantial increase in contributions from insurance funds, the Housing Provident Fund, affordable housing financing vehicles, and/or governmental sources will be needed to meet the full-year budget.

- **12th Five-year plan target unlikely to change, but murky definitions apply.** Considering the political importance of the affordable housing program, we consider any adjustment to the 12th Five-year plan target of 36 million units to be unlikely. That said, there appears to be some leeway for local governments to improve their affordable housing metrics through classification practices. Since the surge in housing starts occurred over a few months, there is reason to suppose that some construction projects may have only started in a very basic sense. The threshold for what degree of progress constitutes a “start” appears to be imprecise, with domestic media reports featuring accounts of school and company dormitories becoming classified as low-rent housing. By the same token, definitional issues might later emerge with the classification of “completed” housing.
- **Central government continues to show resolve.** In its recent statements, the government has shown no softening in its resolve to boost the supply of affordable housing across the nation. MOHURD has emphasized that all affordable housing starts planned for 2011 should commence construction before the end of October, that local governments must step up monitoring of projects to ensure quality, and that the ministry would reward and commend those that finish ahead of schedule. In a recent article, Premier Wen reiterated the government’s pledge to start building 10 million affordable housing units in 2011.

Conflicting accounts have circulated about a potential adjustment to the housing construction target for 2012. At one point, Reuters reported that the government was considering a 20% reduction in next year’s target to 8 million units, but subsequently an official with the Ministry of Housing and Urban-Rural Development (MOHURD) was reported to have denied that such a decision had been made (while indicating that the 2012 target was under review). It has been suggested that the strained financial position of some local governments, as well as concerns about construction quality might be issues underlying a possible revision.

The Ministry of Housing and Urban-Rural Development (MOHURD) has released a breakdown of affordable housing start rates for China’s major provinces and municipalities (as a % of targeted GFA), indicating higher than average rates in some Northern Chinese provinces, but below-average starts recorded in some populous Southern provinces such as Guangdong (66%) and Shanghai (75%). An inspection exercise across 20 provinces, regions and municipalities by the CCP’s Central Commission for Discipline Inspection is currently underway and may help to paint a clearer picture of how the program is proceeding on a nationwide level.

Categories of Affordable Housing

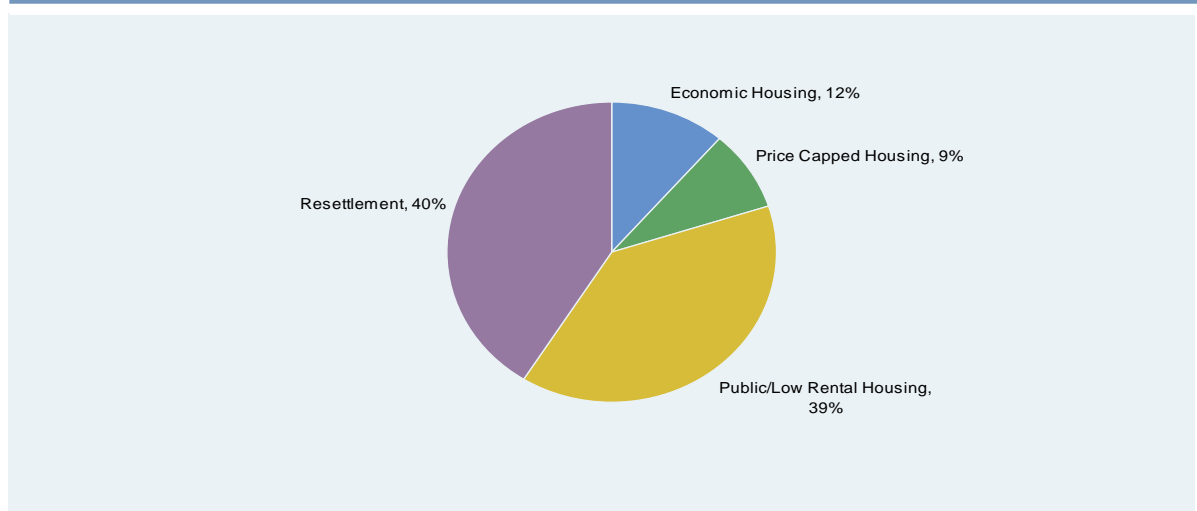
Affordable housing is broadly classified into four categories (this year’s affordable housing targets for each segment are given in Figure 1):

- **Economic Housing:** units are limited to 60 square meters and sold to qualifying families at below market prices, often 20-30% below comparable ordinary housing. Developers’ profit margins are usually capped at of 3-4%.
- **Low-rent housing:** government-owned housing (<50sqm) leased at a low level of rent to the poorest urban residents. Primarily financed from local government budgets, but financial transfers from the central government have become a more important component of overall funding.
- **Price-capped housing:** housing assistance program aimed at urban middle-income families, with units limited to 90 square meters. Prices are capped by local governments when land is sold to a developer, usually at level falling between that of economic housing and ordinary commercial housing.

- **Shanty-town resettlement:** The resettlement of shanty town residents constitutes a major component of China's affordable housing ambitions. A large proportion of China's shanty towns are situated in urban areas. During the process of renovation, displaced families will be offered either economic or price-capped housing, or receive financial compensation.

An emerging issue with the affordable housing program is an imbalance in the housing mix (see *Figure 1*), with major cities Shanghai, Shenzhen, Beijing and Chongqing, reportedly reviewing their plans with a view towards possibly including more low-rent housing, while reducing the ratio of economic housing within the mix. Since 2007, the provision of low-rental housing has emerged as a matter of urgency on the policy agenda, to cater to the large segment of population for whom economic housing is beyond affordability. J.P. Morgan property analyst Lucia Kwong has estimated that the bottom 10% of China's population cannot afford even a typical economic housing unit, and hence low-rent housing remains the only option for this segment of population, unless they are entitled to resettlement compensation. From the standpoint of local government finances, this housing segment also presents the greatest funding challenge. With only the promise of low rental yields over time, local governments must forego land sale proceeds and generally also shoulder construction costs. In comparison, economic and price-capped housing can easily be sold upon completion and can be largely funded by developers' capital and through bank loans.

Figure 1: 2011 Affordable Housing breakdown for 2011

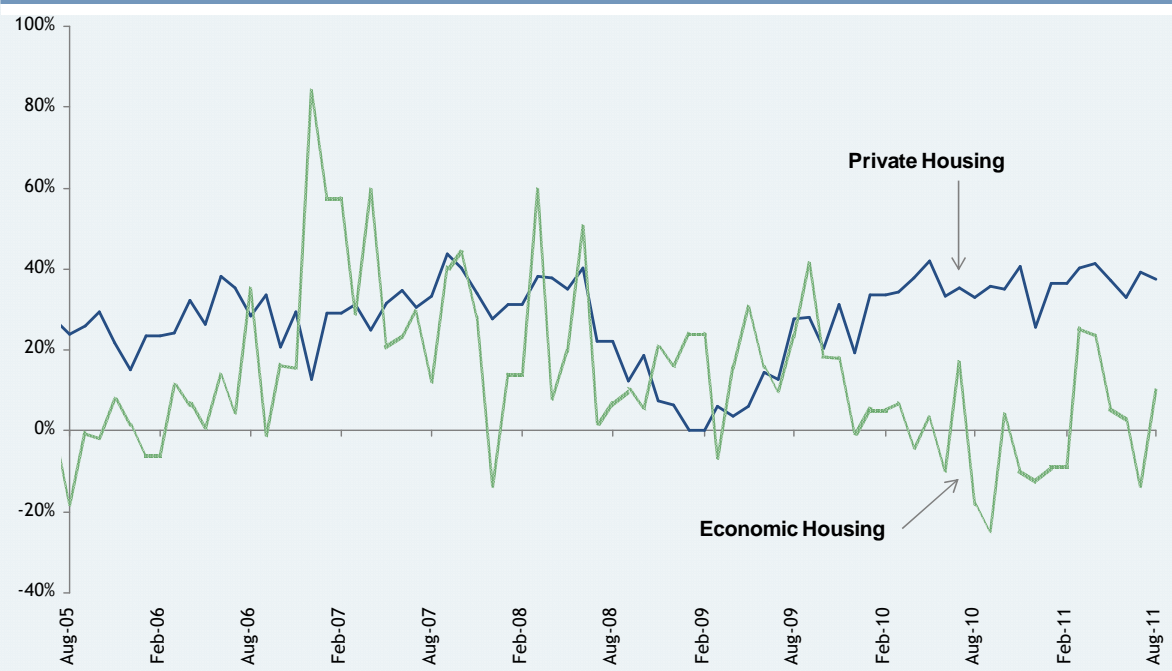


Source: MOHURD

Interplay Between Affordable Housing and Private Housing Market

Considering the magnitude of official plans for affordable housing and the fact that construction material requirements for both private housing and affordable housing are similar, the expectation has been that affordable housing construction might shore up real estate investment in the event of a slowdown in the private housing market. In fact, Chinese real estate investment has grown strongly in the first seven months of the year, but this has been driven by strong levels of investment in the private housing market (see *Figure 2*), while data for economic housing (the only segment of affordable housing for which monthly data are available) shows only 5.7% YoY nominal growth in 8M2011.

Figure 2: Real Estate Investment Growth – Private Housing vs. Economic Housing



Source: CEIC

The expectation is that developers will slow their pace of expansion going forward, as incentives to invest are dampened by slack sales and the challenging credit environment. On a nationwide basis, residential property prices rose slightly by 0.07% in August from a month earlier, however 44 cities reported price declines compared to 56 cities with month-on-month price increases. It is also expected that China's housing ministry will extend home purchase restrictions to certain second- and third-tier cities. Property sales are expected to pick up again as residential developers increase supply and show more flexibility in pricing. However the gap between residential floor space started and sold has widened to 485mn sqm in 8M2011 vs. 364mn sqm in 2010 and 71mn sqm in 2009, suggesting that developers will have considerable inventory to work through. The level of housing inventory in seven major cities has been on a general uptrend this year, with J.P. Morgan's property research team finding on average 6-15 months of supply in the seven cities in August.

Our China property analyst Lucia Kwong believes the government's policy support for affordable housing could crowd out both land and credit supply and lead to more intense competition in the low-end segment of the housing market. As such, the industry's earnings growth appears likely to slow from the buoyant level of recent years as companies cope with higher onshore borrowing costs, as well as higher capital requirements to meet stringent requirements on construction starts and land premium payments. In this new climate, Lucia Kwong remains cautious on highly-leveraged developers, preferring COLI (688 HK), Country Garden (2007 HK), Longfor (960 HK) and Evergrande (3333 HK) as likely outperformers with a track record in execution and the ability to sustain positive cash flow. At the same time, several domestically-listed developers such as Beijing Capital Development and Cinda Real Estate have recently raised funds for the purpose of developing affordable housing. Considering that fewer fundraising restrictions exist for this purpose, some developers with funding constraints might be attracted to affordable housing projects, despite much lower margins.

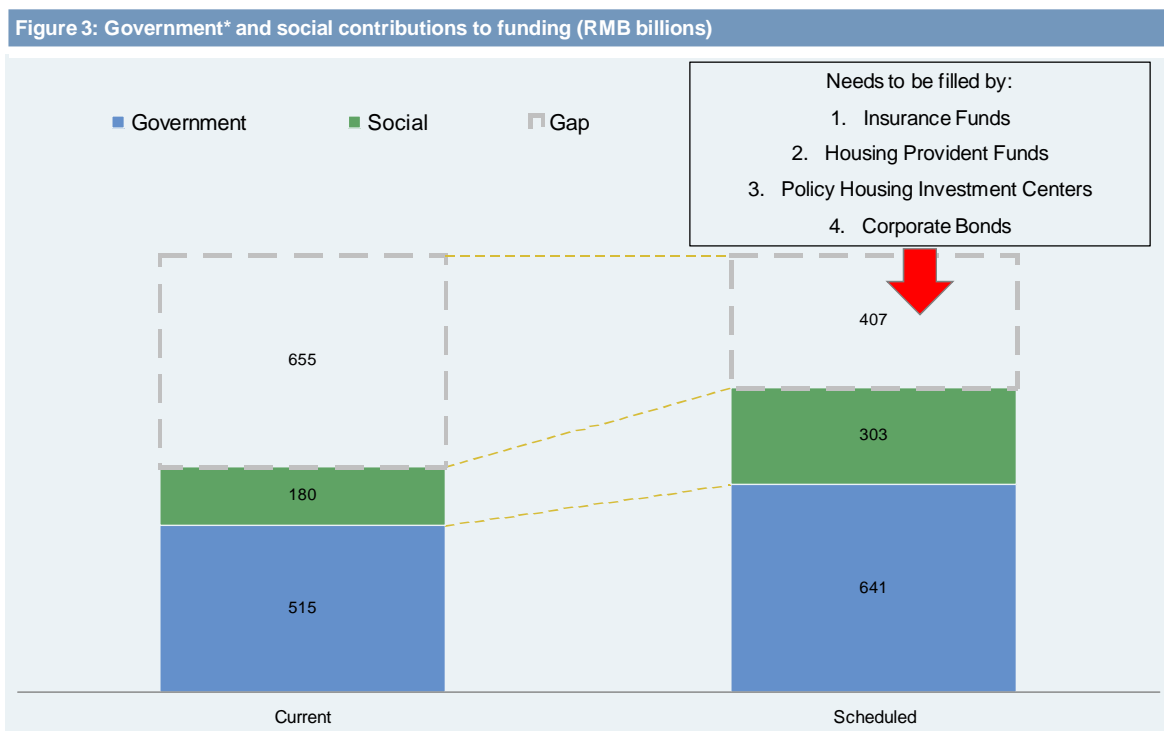
The central government has projected that the construction of 36 million affordable housing units will raise the proportion of affordable housing to 20% of the nation's formal housing stock by the end of the 12th Five-year plan, from around 11% at present (according to the Lincoln Institute at Peking University).

- Assuming an average size of 60 sqm per unit and construction costs of RMB2,200 per sqm GFA (according to China State Construction estimates), 10 million units of affordable housing would contribute RMB1.32 trillion towards real estate investment. By way of comparison, total real estate investment across all categories of property in China amounted to RMB4.8 trillion in 2010.
- According to the government, construction of 5.9 million affordable housing units began in 2010, with 3.7 million units finished. This implies that last year's affordable housing starts were equivalent to 37.6% of the nation's total private housing starts by floor space. The proportion can only rise this year, considering that the government's target of starting 10 million units of affordable housing is roughly on par with last year's total private housing construction (~10.5 million units).

Funding the Affordable Housing Program

Funding has always been the biggest hurdle to meeting affordable housing targets. Of the estimated RMB1.3 trillion - RMB1.4 trillion in funding needed in 2011 (*MOHURD estimate*), only RMB500 billion in contributions are slated to come from various levels of government. The large funding gap has prompted provincial and municipal governments to tap a comprehensive set of social funding sources.

Since the expansion of the affordable housing program last year and the first announcement of this year's target, various supportive policies have emerged, intending to expand funding channels for the construction of affordable housing. Nevertheless, the pace of new funding has been slow and is unlikely to substantially ease the funding burden in the near-term. Assuming that all scheduled funding will come through, governmental funding will exceed the target of RMB500 billion by RMB140.5 billion, while social sources of funding fall short of the target by RMB497 billion. A substantial increase in contributions from insurance funds, the Housing Provident Fund, Policy Housing Investment Centers, and/or governmental sources will be needed to meet the full-year budget (see *Figure 3*).



Source: Factiva, J.P.Morgan *does not include local government financing vehicle contributions

Currently the main funding options are as follows:

- **Bank Lending**

According to the mid-year report by the PBoC, new loans to real estate development amounted to RMB 209.8 billion in 1H2011, while the balance rose 13.7% YoY. New loans for affordable housing construction amounted to RMB90.8 billion, from RMB65.1 billion in the first quarter. New loans tend to be front-loaded in the year, and historically, first quarter real estate development loans are about twice as much as in the second quarter, falling progressively until the end of the year. Assuming such a schedule, bank loans to affordable housing for the full year would amount to ~RMB100 billion.

- **National Council for Social Security Fund**

The first affordable housing project that utilized social security funding from NSSF was signed as a trust loan of RMB3 billion on February 26 for the construction of 4 affordable housing projects in Nanjing. The term of the loan was 2 years and 11 months, while the interest rate was 6.05% (social security interest of 5.45% seasonally adjusted, trust fee of 0.18%, and a guarantee fee of 0.42%). The loan was issued by Jiangsu International Trust Corporation Ltd. and guaranteed by Minsheng Bank. According to the director of NSSF, funding support for affordable housing from this source could reach RMB50 billion in 2011. Investments in other projects include RMB10 billion in Chongqing, RMB3 billion in Nanjing, and RMB3 billion in Tianjin.

- **Insurance Funds**

On September 3 last year, insurance companies were granted permission to invest up to 10% of their assets in real estate. This represents a theoretical maximum of ~RMB 540 billion of potential investment into the property sector, based on total insurance assets of RMB5.4 trillion at the end of the first quarter, according to the China Insurance Regulatory Commission.

One of the most significant developments in this area of funding is the signing of contracts by the Beijing Land Reserve Center with 7 insurance companies to secure funding for the construction of affordable housing in the city. Led by China Pacific Insurance Co., the insurers will lend between RMB7 to RMB8 billion to the Center, with the funds managed by the Beijing municipal government, and the city's land reserve used as collateral. The interest rate offered by insurance companies is typically at a discount to the base rate for bank lending, with reports placing the discount at 10-15%. Other examples of insurance funds financing affordable housing construction include a RMB5 billion investment by China Pacific Insurance in Beijing, following a RMB4 billion investment in Shanghai. Ping An Insurance also invested RMB3 billion in Shanghai affordable housing projects. In addition, the mayor of Chongqing stated earlier in the year that The People's Insurance Company of China and China Life have each pledged RMB10 billion to projects in the city.

On May 17, the Deputy Director of China Insurance Regulatory Commission's General Office Cai Jipu stated that the CIRC is in the process of developing policies to better regulate insurance capital investment in affordable housing, on the basis of experience gained in the initial projects. If the investment process is streamlined, insurance capital can potentially play a significant role in closing the funding gap in the long run. In the short term, however, contributions from insurance funds will have to ramp up very rapidly to be able to reduce the size of the funding gap significantly.

- **Housing Provident Fund**

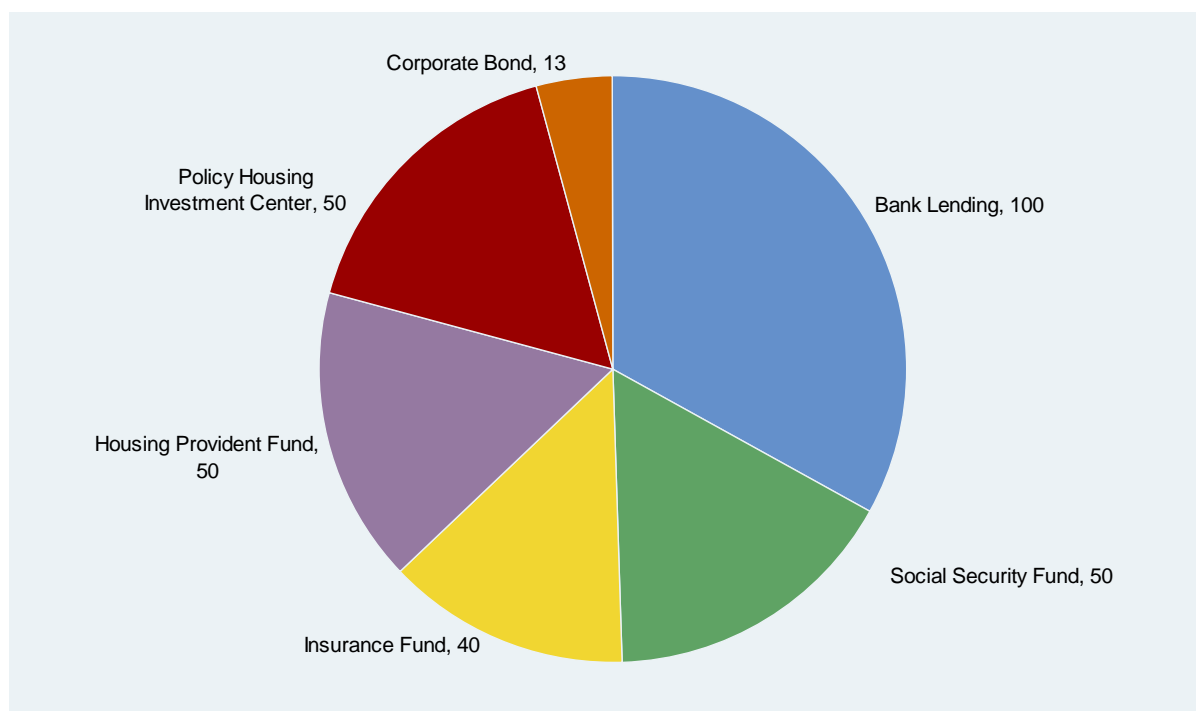
Established in 1994, the Housing Provident Fund is a compulsory housing savings plan designed to assist ordinary wage earners by providing subsidized mortgage loans from the fund. A pilot program utilizing HPF funds for construction of affordable housing has been planned for 28 cities, with total

loan approvals estimated at RMB50 billion. As of June 30, RMB5.93 billion has been committed. Shanghai received RMB1.5 billion, Xi'an received RMB3.53 billion, while Jiangsu received RMB0.9 billion. Surplus HPF capital was reported by the MOHURD to be RMB319.3 billion at the end of 2008. With a large amount of idle funds within the HPF, the surplus capital could be utilized more effectively to finance policy housing construction, as well as provide additional returns in the form of interest payments from the loan arrangement.

- **Affordable Housing Financing Vehicles**

On July 27, the China Banking Regulatory Commission stated in its mid-year work report that it supports the establishment of provincial level and municipal level affordable housing financing vehicles. It will also promote lending by banks and financial institutions to affordable housing projects in light of this year's goal. The vehicles are platforms for public rental housing financing, construction, and operational management. The first investment by a policy housing investment center was made in the Haidian area of Beijing two months after the center was established. The agreement is for the acquisition of 3 public rental projects, and the construction of 1 public rental project, for a total of 5,200 units at an investment of RMB1.7 billion. This marks a new development in resolving the funding issue as it is the first agreement between the municipal and district level governments and can potentially allow more efficient capital deployment of capital within a municipality by distributing funds to districts in need. The investment center has thus far raised RMB20 billion and aims to raise RMB50 billion from various channels.

Figure 4: Scheduled non-governmental contributions to affordable housing funding (RMB billions)



Source: Factiva, J.P.Morgan

- **Local Government Bonds**

On July 11, the first issuance of local government bonds for 11 provinces was tendered. The issue had two tranches, RMB25.4 billion worth of 5-year notes and RMB25 billion worth of 3-year notes. On August 23, the Ministry of Finance announced the issuance of 5-year notes for an additional 6 provinces: Hebei (RMB3.7 billion), Jiangxi (3.5), Guangxi (3.0), Sichuan (6.8), Guizhou (2.7), Gansu

(3.0), as well as Tianjin (1.3), for a total of RMB24 billion. Reports citing the Hebei Ministry of Finance stated that the funds will primarily be used for affordable housing construction. For example, Guangxi tendered a total of RMB6 billion worth of bonds, RMB3 billion of 3-year notes at 4.01% and RMB3 billion of 5-year notes at 4.3%. Notes issued at the municipal level (RMB3 billion) will be prioritized for infrastructure supporting affordable housing construction, while those at the provincial level (RMB3 billion) will mostly be used for the same purpose (RMB2.6 billion) as well as for railway infrastructure (RMB0.4 billion). According to the MOF, it is anticipated that issuances for the year will amount to a total of RMB200 billion, which can make a substantial impact to affordable housing funding.

- **Corporate Bonds**

In June, the National Development and Reform Commission (NDRC) authorized local government financing vehicles and construction companies to issue corporate bonds to fund affordable housing projects. On June 28, the NDRC issued a document that mandated local government financing vehicles to give funding priority to affordable housing projects. In particular, corporate bonds for other projects are only allowed to be issued by LGFVs after local affordable housing needs have been fully met. According to the NDRC, such corporate bonds have the advantages of low interest rates and long tenors, which are suitable for fund raising for affordable housing projects.

Since late July, 4 A-share listed developers – Poly Real Estate (600048.SH), Beijing Capital Development (600376.SH), Chixia Development (600533.SH), and Cinda Real Estate (600657.SH) separately announced that they will raise up to RMB13 billion in aggregate for development of affordable housing. According to the J.P.Morgan's property research team, restrictions on money raising for affordable housing is much less stringent than that for private housing, and more developers with funding shortages may raise money via this route in the future.

- **Central Government Allocation**

Earlier in the year, the central government pledged RMB103 billion to aid affordable housing construction. At this point, the planned amount has been completely deployed; an additional RMB39.4 billion was allocated, as well as RMB28 billion was carried over from the balance of 2010. This implies a total of RMB170.5 billion in contributions from the central government.

- **Proceeds from Land Sales**

10% of proceeds from land sales are invested into construction of affordable housing. While the area of land sold this year has been comparable to that of 2010, prices have dropped dramatically. Certain major cities have reported severe declines, e.g., Beijing in the first half of 2011 saw a year-over-year drop of 48.2% in land sales proceeds. In 2010, a total of RMB2,700 billion was collected for land sales, which implies a cap of RMB270 billion in contributions to affordable housing construction, given the weaker real estate climate.

Closing the Funding Gap

At this point, with the assumption that bank loans will amount to roughly RMB100 billion, funding from non-government sources has amounted to RMB179.6 billion. An additional RMB31 billion may come from the Social Security Fund, an additional RMB44.07 billion is due to be released from the Housing Provident Fund, and an additional RMB48.3 billion can be deployed from the Policy Housing Investment Center, bringing the total to RMB303 billion. In the absence of newly created and substantial funding sources, the balance of RMB497 billion will need to be met by contributions from some of the following:

- Insurance funds that can be invested in real estate

- Additional capital from the Housing Provident Fund
- Corporate Bonds
- Affordable Housing Financing Vehicles in municipalities other than Beijing
- Overflow from government contributions beyond RMB500 billion

If land sales proceeds for 2011 were to match last year's figure (an unlikely proposition, considering that land sales in major cities have been down in the year-to-date), government contributions would amount to RMB514.9 billion, exceeding the target of RMB500 billion and could reach RMB640.5 billion if local government bonds reach the target of RMB200 billion (as stated by the Ministry of Finance for 2011). If the full RMB1.3 – 1.4 trillion budget for affordable housing is to be met, it seems likely that governmental contributions must eventually play a bigger role than previously planned.

Views from Construction and Real Estate Executives

Understandably, uncertainty about the progress of affordable housing construction has raised concerns about the outlook for real estate investment growth, and demand for cement, glass, other building materials and construction equipment. We recently spoke to management from CNBM, China State Construction and CRIC to gauge their views:

- **Cao Jianglin, President, China National Building Materials (3323 HK)**

The property sector accounts for 20% of CNBM's revenue, out of which 9% of demand is associated with affordable housing projects – i.e., 1.8% of total revenue. Cement and other building materials are not supplied directly to affordable housing projects, but through distributors. Mr. Cao personally did not expect any reduction in this year or next year's affordable housing target. For the broader property sector, he believed the property investment growth rate of 32% in the 1H2011 would be maintained in the second half. On the outlook for nationwide cement demand, he projected growth of 9% for at least the next 3 years, (Mr. Cao believed that demand in the second half might exceed 19% in 1H2011). The long-term outlook for cement in China is underpinned by the fact that building life-spans in China are merely 50 years according to current construction standards, compared to 100 years in Western countries. This means that in 10-20 years, approximately two-thirds of buildings in China will need to be replaced.

- **Zhou Yong, CEO of China State Construction International Holdings (3311 HK)**

China State Construction has 2.2 million sqm of affordable housing currently under construction, and targets 3 million m² in the full year.

Although it isn't yet clear if next year's affordable housing target will be reduced to 8 million units, Mr. Zhou believed that the 12th Five-year plan target of 36 million units will remain unchanged. In the event of a 20% reduction in starts in 2012, the balance of 2 million units would be applied towards the targets for the subsequent three years (i.e. 6 million units in each of 2013, 2014 and 2015). This is actually a preferable scenario to having an extremely high number of units front-loaded in the first two years. Considering that affordable housing projects are typically completed in 24 months, Mr. Zhou expects peak construction to arrive in the year 2013 (>20 million units under construction).

LGFVs, banks and CBRC policy will provide support for affordable housing construction, however, local governments under financial strain may be compelled to eliminate some "image projects" in order to deploy capital to affordable housing projects. Some municipalities are also in the process of issuing local government bonds to finance affordable housing projects (e.g. Tianjin and Chongqing). Ultimately, Mr. Zhou believes the 12th Five-year plan target will be met, although some local governments will experience financial problems. The cost of construction 8 million units of affordable housing amounts to approximately 3% of GDP.

- **Mr. Ding Zuyu, CEO, China Real Estate Information**

Mr. Ding believed that the 12th Five-year plan target of 36 million units would be met, as would this year's target of 10 million starts (with approximately one-third completed in 2011). He also noted the current trial in Shanghai, whereby capital from the public housing accumulation fund is being used for affordable housing project financing, to supplement local government and bank financing.

Mr. Ding did not expect any pick-up in the broader property market in 2H2011, relative to the first half. The best-case scenario for developers would be to maintain transaction levels seen in May and June. On the pricing front, he believed that more developers would offer discounts, as more projects are launched in the second half. Moreover, he expected that ~10 more second and third-tier cities would be subject to home purchase restrictions on the new list, to be published in early-September. In contrast to Cao Jianglin's view, he believed that property investment growth would decelerate to within the 20-30% range in 2H2011.

- **Li Wenjie, Head of North China Research, Centaline**

Mr. Li believed that the scale of affordable housing construction would be reduced in 2012, and that even if this year's targeted 10 million starts were achieved, the contribution to GDP would be less than expected. He noted considerable challenges surrounding the allocation of affordable housing, with some projects now ready to sell but awaiting government direction. Such delays are eroding developers' profits, increasing perceptions of political risk and deterring their future involvement in affordable housing. Mr. Li was skeptical towards reported data on affordable housing starts and believed that only 70-80% of the 36 million units targeted during the 12th Five-year plan would be achieved.

- **Jiang Deyi, President, BBMG**

Mr. Jiang believed the 12th Five-year plan target could be achieved if the central government exerts sufficient pressure. At the moment, different interest groups are attempting to shape policy surrounding affordable housing. BBMG has achieved unusually high gross profit margin for affordable housing construction of 19% compared to an industry average between 3% and 5%. This has been due to the lower cost associated with converting industrial land into a site for affordable housing as opposed to acquiring land in the open market. He believed that prosperous first-tier city governments would not face difficulty in achieving their affordable housing targets.

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