China Watch

A China Business Report prepared by David Mahon,
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S U M M E R 2 0 1 4

Managing a big country
is like cooking small fish.
The more your stir them,
the less their shape can be maintained.

Laozi, fifth century BCE

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'For a few square metres'

2015 will be a difficult year for China as the government continues to restrain property speculation while avoiding damaging genuine demand and confidence in the wider housing sector. The government is trying to rebalance an economy that for decades has been overly focused on top-line growth and the accrual of fixed assets, paying too little attention to fair competition and value.

The liberally used term 'property bubble' does not pertain to the majority of home owners in China. A survey of 70 large- and medium-sized Chinese cities shows prices have lost momentum with a slight decline month on month, but also reflect a small but significant increase compared with the same period last year. Individual home owners are seldom overleveraged, but new buyers are unsure if prices may fall, and speculators are finding it harder to secure reasonably priced credit. Property companies are the Achilles' heel of many second- and third-tier cities' economies, as they teeter between shadow (informal)-banking interest rates of 15% per annum or higher (as opposed to state-owned bank lending rates of 7% to 8%) and slowing sales. The more dramatic corrections are likely to take place in the third- and fourth-tier cities where the economies tend to be less developed and diverse, and where present real estate demand is relatively weak.

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City governments have been following logical policies of relocating people to newly built suburbs, supporting construction, furnishing an array of services, and expanding transport and utility infrastructure. But property companies and local governments lost sight of the true nature of real estate demand over the last five years, creating an oversupply of apartments. The property sector loves a boom, and the prime source of tax revenue for local governments in China is derived from real estate transactions. A key factor influencing the perception of the real estate market is that it is coming off a rate of increase in recent years that was unsustainable. Urbanisation, however, continues to be a genuine source of demand for new housing, as rural demand for apartments in second-, third- and lower-tier cities remains steady.

> *Property companies are facing big challenges here. Speculators that made up a significant proportion of apartment buyers have dropped to just 20% of the market. City residents may be waiting in case prices fall, but farmers are still buying houses for their children when they marry. It is virtually impossible for wealthier farmers in Hebei to find a wife if they cannot provide a house in a nearby town. Couples buying their first apartments now qualify for mortgages of 70%. We have a strong industrial base which will continue to attract workers who need housing, but we need to diversify the sources of income as real estate currently accounts for 40% of our GDP. Our property companies have more flexibility than their counterparts in first-tier cities, which can only sell completed apartments; ours can be sold once the foundations are completed. But they do not pay contractors and material suppliers until apartments are sold and so the contractors also rely on shadow banks for bridging finance. The government may step in to stop these chains of debts collapsing by delaying their requirements to be paid for land and even relaxing mortgage restraints. I am not concerned now, but the government must be careful not to restrict the market too much. It must let the pressure off from time to time to ensure that growth is sustained.*
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> City official in third-tier city in Hebei

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Local governments in China can source up to 60% of their revenues from land sales. The conversion of rural land also exacerbates wealth disparity. The top 10% of Chinese households own 85% of the country's total assets and account for 57% of total income. The government will not be able to balance the property sector until it has created alternative revenue sources for local governments. Power and water are underpriced, environmental and residential property taxes and congestion charges have yet to be explored, and incentives could be introduced for higher-density urban developments to maximise land use and avoid the propensity for expensive urban sprawl. The current situation will create a flux of tightening and easing over the coming 12 months as the Chinese Government attempts to relax the clinch in which the property and shadow-banking sectors find themselves. Premier Li Keqiang has been quietly easing real estate sector restrictions over the last few months in all major cities but Beijing and Shanghai.

The stability of the market will be improved as more small property companies, which are legion in second- and third-tier cities, are pushed out of the market altogether. A national crisis of confidence is not out of the question, but the chances are remote. China's senior leadership is strong enough to allow some regions of China to endure a degree of economic pain for the sake of national stability. It may take until the middle of 2015 for the government to rebalance the property sector, discipline shadow banks and establish alternative sources of credit for private businesses, and this will be reflected in lower GDP growth somewhere in the range of 7% next year.

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In the spring of 2015, four new private banks are expected to start business. This could be no more than a political gesture but could also be the birth of a new, privately owned banking and finance sector as other institutions become licensed across China. Middle-class expectations of government are much higher for Chinese than for Westerners in often less efficient and more restrained democratic systems. They should be, for China is a one-party state and, while the power of its central government is not absolute, its mandate is extensive. Despite regional resistance and inefficiencies in the wider Chinese administration, President Xi Jinping has the means — and eight unchallenged years of his ten-year term left — to force change and facilitate a vigorous, innovative and stable economy. Premier Li Keqiang, who is responsible for management of the economy, and Xi are aligned in recognising the need for an increasingly greater role for the market. The next 12 months will be a test of the quality of the government's understanding and the strength of its will.

While China's policy direction is correct — with the aim of restructuring economic growth to depend fundamentally on internal trade and investment, combined with a relatively closed financial system — the success in rebalancing the domestic economy relies, in part, on global trends. External factors may assist China in the coming 12 months, as global growth is forecast by the World Bank to increase by 3.4%, and in developed countries in excess of 5%, in 2015. As long as the United States and Europe make reasonable efforts to use the currently benign credit environment to implement structural reforms aimed at avoiding the instability that led to the Global Financial Crisis, these positive external factors should prevail into 2016. A worsening crisis in the Ukraine — which is threatening business confidence in Europe — and the United States' re-entry into Iraq could undermine this growth. Improved exports, incoming foreign investment and increased investment abroad will help deepen and diversify the Chinese domestic economy.

China's development laggard has always been the financial sector, where the state controls banks too tightly to service a genuine market, or for political reasons pushes them to obey state diktats and to make unwise credit decisions. The other drag on China's development is the lack of management sophistication and a broad enough base of stable, well capitalised and private small- and medium-sized enterprises. ☯

Stubborn pioneers

In some of China's highest-performing provinces… previously booming second-tier cities face multiple manufacturing bankruptcies.

Over the last 25 years Chinese entrepreneurs, with farming and engineering skills and considerable courage, threw together factories using second-hand or copied equipment, securing state bank loans and local tax breaks due not so much to their creditworthiness but relationships in local government. Such entrepreneurs could also draw from an army of low-cost employees from an impoverished countryside. Towns and cities across the country grew as these highly speculative businesses met the explosion of demand in China and abroad for a wide range of inexpensive products. A number of companies evolved to become solid businesses, enjoying significant shares of the domestic market and commanding stable export terms. Many of the smaller, more opportunistic factories are now exposed to the sluggish and uneven export sector, in which foreign buyers extend receivables to over 100 or even 200 days. In some of China's highest-performing provinces such as Zhejiang, previously booming second-tier cities face multiple manufacturing bankruptcies. Some firms have borrowed more than 80% of their asset values, forcing banks to discard the limbo that previously passed for bankruptcy in China (a form of suspension without defining obligations to creditors or even a timeframe) and force the weakest into real bankruptcy, closer to the United States' model.

> *My father's company has become very successful over the years. But it all centres around him. He has the networks and the trust of local government officials, having moved from property to construction and now retail. Although he and his close associates have become rich, the firm is not always stable, and he is responsible for the fortunes of many suppliers, contractors and employees. I have worked for an American investment firm for five years since returning from studying and working in the United States, and have seen how global companies calculate risk and become strong. I want him to focus on one sector and consolidate all that he has achieved. I respect what he has done, but worry that he finds it hard to change.*
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> Shanghai fund manager

Millions who as children had struggled to piece together an education and survive the chaos of the Cultural Revolution went on to establish successful businesses. As China became more politically stable, the economy began to change, only to produce another kind of tumult: the transition from a command to a market-forces economy. In the 1990s Chinese enterprises grew in an uncertain environment as state-owned interests vied with the new private companies; officials, who could not accept that China had moved away from Communist ideology to a new economic model, blocked and frustrated the efforts of China's emerging entrepreneurs. Many entrepreneurs already had the skills to navigate relative chaos, work outside unjust taxation and regulatory systems, and avoid the demands of rent-seeking officials. It was once quite justified, and even a virtue, to live outside the law. In the more sophisticated economy of today, it is less justifiable and seldom a virtue.

> *In Taiwan in the 1980s I saw how bold entrepreneurs can transform an economy. It is all very well to expect emerging markets to balance strong growth by developing international business practices, but many would not have become successful without their large appetites for risk, opportunism, willingness to expand despite meagre capital resources, and bravery in dodging unreasonably restrictive regulations. By necessity China has followed a similar pattern. The danger with attempts to stabilise companies in developing countries is that you risk suffocating the very forces that made them successful. The Chinese Government has been heavy handed in the past but usually managed to compensate in time. Such corrections are much harder to undertake now.*
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> British banker in Hong Kong

The first generation of entrepreneurs and private industrialists are beginning to retire and, in the process of succession, their company cultures are changing. The growth of domestic private equity investment and an increased number of these private companies listing is forcing management and governance changes at an accelerating rate. As hard as it may be for individual towns and cities, this trend is requiring banks to work harder to assess private-sector borrowers and to play a greater stabilising role; this should result in stronger companies to meet global demand (as it recovers) as well as measurably growing domestic demand. In order to soften the transition the Chinese Government is also giving broader mandates to the four state-owned asset management companies established in 1999 to acquire weak businesses with residual value, invest in private companies with

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growth potential and to play a crucial role in helping local governments move burdensome projects from their books.

The Chinese Government is under greater pressure than ever to develop the private manufacturing and service sectors, support job creation and income growth, improve China's social safety net and clear impediments to the supply of consumer goods and services that are holding back growth in consumption.

THE KEY

Development of the private sector is the key to China's future economic development. The very loose and entrepreneurial nature of many Chinese enterprises will change as the market becomes better regulated and more transparent. In the next few years China will become, by sheer critical mass, the largest economy in the world, but it will be many years before the market is rational and most sectors largely stable. Foreign investors need to look at each sector objectively and avoid applying the broad assumptions about growth and development in the Chinese economy that have led many into trouble.

Sectors such as the food and beverage, electronics, and logistics sectors, which enjoy considerable long-term demand, have also become some of the most competitive. By the time foreign firms identify opportunities they are often too late, as faster-moving domestic companies have already responded to the degree that margins have been whittled untenably thin. Foreign investors need to find a balance between adhering to universal commercial and management principles and adopting the Chinese pace of doing deals (including consideration of some unique Chinese practices). More than ever, foreign firms need to make their own judgements of the market for their products in China, come up with their own strategies, and then find means to respond to the market swiftly enough without losing sight of their long-term opportunities.

China's trading partners risk forming the mistaken impression that China's slower GDP growth will result in the economy stalling, undermining their economies and global economic recovery. Although the challenges of managing the Chinese economy grow more complex each year, the underlying drivers and the medium-term trends of development remain firm. While growth of 9.2% in 2009 represented an increase of RMB 2.7 trillion (USD 395 billion) in the economy, 2013's 7.7% growth reflected a much larger absolute increase – some RMB 5 trillion (USD 806 billion).

The heady days of fast growth and quick profits in China's raw experiments with market forces may be over for now, but the opportunity that China has presented to global businesses over the last 20 years remains, even in these days of relative uncertainty. ☯