THE RESIDENTIAL MARKET – THE FALLING APPLE

13 February, 2001

The observation of a falling apple in his orchard led Isaac Newton into the discovery of universal gravitation and the pulling force for the moon. After 275 years, we are still wondering on the law of gravity for the apple of our life – our home value.

MARKET SUMMARY

- Dismal performance lingered into January, reflected by the low level of property sales and new mortgage loan figures.
- Two rate cuts in less than one month, an aggregate of 100bps, float fresh hopes into the sluggish market as potential buyers will be lured by:
  - A closer yield gap between the mortgage rate and rental yield, which sets mortgage payment more comparable to the rental cost.
  - A much higher affordability ratio than ever, largely due to a precipitous fall in property prices over the past three years.
- Property transactions are poised to surge, possibly up by 50% from January. But this is nothing spectacular since the January's S&P figure 4,591 was the lowest monthly record in six years.
- We still maintain a cautious rating on the outlook of this sector and we don't believe the story of an imminent recovery in property prices, even for 2001.
- Simply the deadweight that has dragged down the market is still there –a looming plethora in 2001: new supply from developers 23,000 units, existing unsold stocks 10,000 units, HOS supply 19,000 units. An improved market sentiment will attract even more new supply as developers are rushing to cut their huge stockpiles. Competitive price incentives still rule.
- Sales in secondary market continue to lose market share as small owners lack the financial clout to undercut developers. The demise of the secondary market is deterrent to a full-blown market recovery.
- Housing policy is to be blamed. At this stage we lose the interest to join the chorus of opposition, instead, we urge the government to consider policies to lift the secondary market.
- We look for parallels from the recovery story of office sector and find containing the supply factor is the most effective way to buck the downward trend.
- Property market performance in 2001 is unlikely to mirror the rally in property counters that saw prices jump by 40% since last November. As such, they will not hold at this level when the interest rate play recedes.

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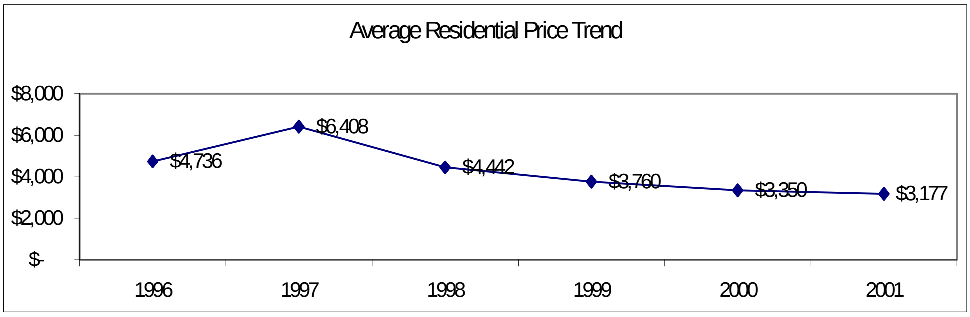
THE NEVER ENDING TUG-OF–WAR

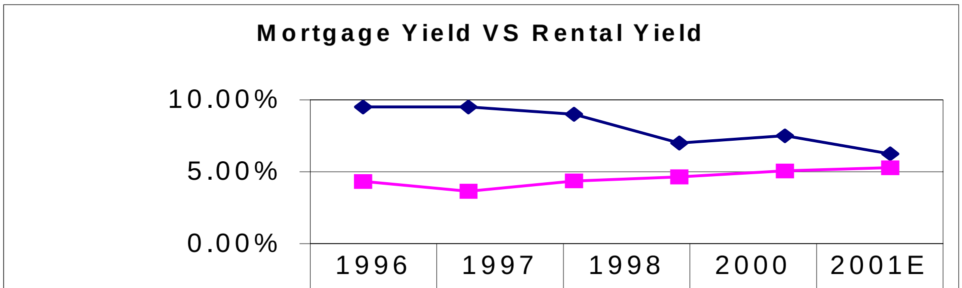
Hope, got beaten, another hope, dashed again.... this is the ongoing tug-of-war in residential market. Over the past three years the residential market soldiered on the many hope and lost cycles. Our honorable opponent seems to be an invincible sumo wrestler who has inexhaustible reserve of sucking power. Would this time the two straight interest rate strikes deal a body blow to this awesome foe?



Source: Asia Financial (Research)

PULL FACTORS

A. RENTAL YIELD ECLIPSES THE MORTGAGE INTEREST RATE – BUY OR RENT NO LONGER A DILEMMA



	1996	1997	1998	2000	2001E
Mortgage Yield	9.50%	9.50%	9.00%	7.50%	6.25%
Rental Yield	4.33%	3.65%	4.37%	5.06%	5.29%

Source: Asia Financial (Research)

The spread between the mortgage rate and the interest rate is narrowing, due to the rate cuts at the beginning of the year and intensive competition amongst banks in the home loan market. As at least another 25bps cut is widely expected in this year, we believe the spread of the two would be very insignificant.

Even at this current mortgage yield level, the lowest record in a decade, it makes more sense to buy a flat than rent for owner occupation purpose, as the mortgage payment is more or less comparable to the rental cost.

RENTAL AND MORTGAGE COST COMPARISON FOR A 400SQ.FT. FLAT

	1996	1997	1998	1999	2000	2001E
Monthly Mortgage	$12,360	$16,725	$11,192	$ 8,163	$7,556	$ 6,502
Rental	$6,839	$7,791	$6,478	$5,822	$5,653	$5,600
Diff.	$5,521	$8,934	$4,714	$2,341	$1,903	$902

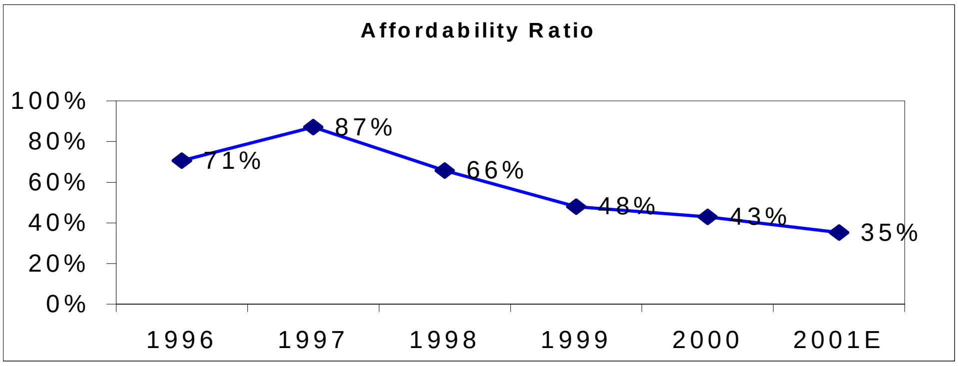
Source: Asia Financial (Research)

Thanks to the steep decline of price and rent in residential market after the Asia Crisis, the 50% difference between mortgage and rent we saw in 1997 now comes down to less than 15%. In some estates, the current rents are even higher than the mortgage payment.

Given the keen aspiration for home ownership amongst the Chinese, we expect that more buyers will be drawn into home markets by this magic yield reversal.

B. AFFORDABILITY RATIO AT HISTORICALLY RECORD HIGH – FLEX A STRONGER ARM TO EMBRACE THE MARKET

Based on the median household income of HK$18,480 p.m. and the assumption of purchasing a 400 sq.ft. flat with 70% financing and 20 years pay-back terms, the current affordability ratio (Monthly Mortgage / Household Income) is 35%, another lowest record in a decade alongside with the mortgage yield.



Source: Asia Financial (Research)

The effect of higher affordability has two folds. First it means the acquisition cost for new flat is lower, much easier for people to buy. Second, the burden of mortgage is also lower, more families are willing to shoulder the mortgage payment which is only 35% of the total household incomes. After the mortgage, they can still live quite comfortably, in contrast to those who had bought houses in 1997 and had less than 20% of their incomes to make ends meet.

SINK FACTORS

A. SUPPLY FROM DEVELOPERS IN 2001 IS STILL VERY LARGE – COMPETITIVE PRICING TO UNDERCUT EACH OTHER

According to our research, a total of 23,000 units will be offered to sell by developers in 2001. Plus the 10,000 unsold units carried forward from the previous year, there will be 33,000 units on sale in this year, the figure is more than the supply in the past five years.

HOW MANY UNITS SOLD BY PRIVATE DEVELOPERS

	1996	1997	1998	1999	2000	2001E
Developers' Units	22,851	20,629	31,424	21,557	16,279	23,000

Source: Asia Financial (Research)

What worries us most from the supply analysis is that the large overlapping of new developments in the same area, this inevitably will not rule out the possibility of fierce price-cutting strategies. We see heavy battles amongst developers in Tung Chung, Sham Tseng, Yuen Long ,Tseung Kwan O and in New Kowloon Reclamation Areas.

FORECASTED NEW PROJECTS FOR SELL IN NEW KOWLOON RECLAMATION AREA BETWEEN 2001 TO 2003

Land Lot	Estimated GFA (sq.ft.)	Estimated New Units	Developer
The Waterfront Phase 1 Kowloon Station	1,590,000	1,500	Wing Tai
Phase 2 Kowloon Station	2,260,000	2,100	Wharf
Phase 3 Kowloon Station	1,080,000	1,000	SHK
Phase 4 Kowloon Station	1,390,000	1,200	Amoy
Phase 5 – 7 Kowloon Station	1,000,000	800	SHK
KIL11086	870,000	988	Cheung Kong
Island Harbourview Phase 1 Olympic Station	1,830,000	2,314	Consortium led by Sino
Park Avenue Phase 2 Olympic Station	2,370,000	2,936	Consortium led by Sino
Phase 3 Olympic Station	1,110,000	1,500	SHK
NKIL11107	485,769	659	Cheung Kong
NKIL 11152	1,413,315	1,663	Amoy
NKIL 6338	1,042,495	1,600	Amoy & Hyundai
Yau Ma Tei Ferry Redevelopment	2,057,336	3,520	Henderson
Cheung Sha Wan Shipyard Redevelopment	3,094,273	4,900	Cheung Kong/SHK/Shun Tak & others
	21,593,188	**26,680**	

Source: Asia Financial (Research)

B. THE COMPETITION FROM HOS MARKET MAKES THE PIE EVEN SMALLER

HOS SUPPLY FROM 1998 - 2003

1998	12,135
1999	14,516
2000	10,293
2001E	19,000
2002E	16,000
2003E	17,000

Source: Asia Financial (Research)

In 1997 before the property crash, a typical HOS unit in New Territories was sold for around HK$1mn – HK$ 1.5mn while a brand new private unit was sold for HK$2mn – HK$3mn. HOS was not considered as a competitor by the developers back then because they catered for buyers from different segments.

In 2000, in a same district a HOS unit was sold for around HK$0.7mn – HK$1mn and developer's unit for HK$1.2mn - HK$1.5mn. But this time they were competing against each other for the same group of buyers i.e. namely: the first-time buyers.

No wonder developers have thrown their furies on the HOS policy, as it now becomes a serious threat to the sale of developers' units. Despite the mounting pressure, we estimate the Housing Authority (HA) would have an even more aggressive sales plan in the coming three years.

HA, however, in its recent announcement, agreed to cut supply, but only after FY2004. This isn't addressed to what the market concerns.

Unless there is another housing policy U-turn by Tung's government in this year, we believe the new supply in 2001, both from the HOS and private sector, is too large and would dampen the positive effects triggered by the lower interest rates.

C. DEMANDS ARE MOSTLY FROM FIRST-TIME BUYERS, TRANSACTIONS ARE TILTED TOWARDS DEVELOPERS' MARKET

In our view we think a healthy property market must consist of balanced housing demands, i.e. from first-time buyers and from trade-up owners, and balanced transaction spread in developers' market and in secondary market.

But this is not the case right now in our residential market. Buyers's profiles are mostly first-time buyers and they rely on the Government's subsidized Home Starter Loan Scheme to realize their dreams of becoming proud owners. We estimate each year the demand from first-time buyer is only 30,000 units.

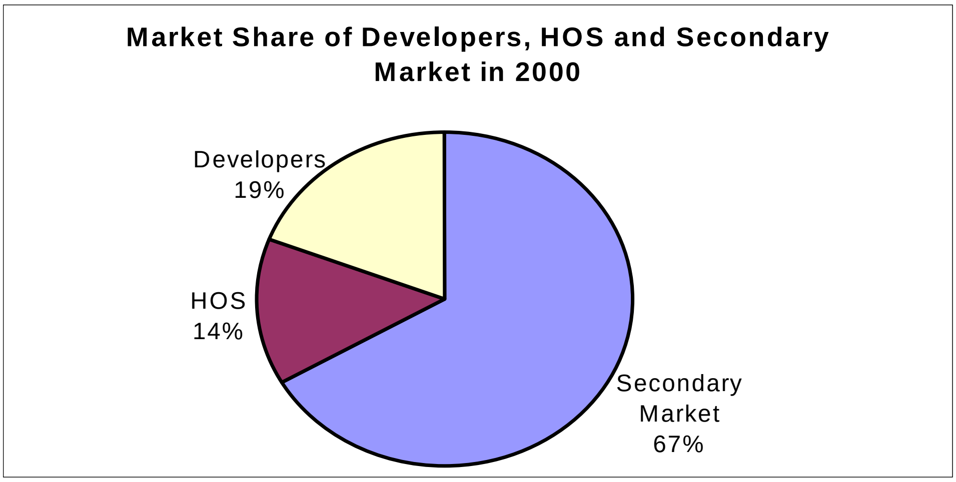
On the other hand, existing home owners are not that lucky, they have no access to the Government subsidized housing loan. Worst, they face depreciation in home values and make it harder for them to sell and trade up for a new property. The flight of demand from existing homeowners largely accounts for the fall in transaction volume in recent years.

NUMBER OF S&P AGREEMENTS

1995	1996	1997	1998	1999	2000	AVG
97,649	147,423	205,461	111,489	98,436	85,744	124,367

Source: Asia Financial (Research)

In a market that many sellers chasing a few buyers, the winners are those who fork out handsome bargains. Small individual owners, without sleek marketing campaign or strong financial muscles, have been undercut by developers and Housing Authority's HOS market and lost out in the sales market.



Source: Asia Financial (Research)

THE WINNER IS....

After weighing in the Pull and Sink factors, we see there will be a growth in transaction in wake of downward rate cycle, however, the rise in market activities will not bless the market a price recovery in 2001 because of looming oversupply in this year and the continued depressed state in the secondary market which, in our view, suffocates a large source of potential housing demand. Developers are the winners in 2001, but at a cost - generous pricing terms and lower profit margins to pit against each other.

WHEN WE CAN REVERSE OUR VERDICT

Only when we see

- Sharp reduction in developers' inventories.
- HOS units, in terms of price and supply, no longer pose a threat to private market.
- Revival of interests in the secondary market.

We think that the recovery of the secondary market is a crucial stake towards a full recovery of the market because more liquidity in this sector will free up more potential homebuyers. Owners who are able to sell off their old homes will be prone to trade up in the home market. These, in return, will pump up new buying powers into the market and eventually spur a faster and stronger momentum to pull the market out of the depression.

Currently we see the majority of housing demand comes from first-time buyers who tend to buy smaller and cheaper new flats. The absence of trade-up owners has posed difficulties for developers to sell more expensive stocks. Evidence are found in projects like The Waterfront in Kowloon Station, the large-sized flats in Laguna Verde Phase 3, Hunghom and The Belcher's in Kennedy Town.

If the government has any sincere intention to prop up the property market, as we expect there would possibly be yet another major housing policy overhaul in this year from the government, we urge them to deliver measures to lift the secondary market. The revival of the secondary market will also bode well for the developers.

A TALE OF TWO SECTORS

Newton wondered why that apple tumbled down toward the ground while the pale August moon continued to sail contentedly overhead.

Equally, the trend in our office market is polar opposite to that of residential market. The soaring office rent is in stark contrast to the ailing residential prices. But back in one or two years' time, a similar supply overhang has wrecked this sector and rents in Central Grade A office buildings fell below $30 p.s.f , against $65 p.s.f at its peak.

In our view, the recovery of office sector is attributed to its success in containing the supply factor. There has not been any significant new office supply in Central since the completion of Cheung Kong Center, The Center and the IFC South West Tower in 1999. Office sector performance will remain robust in 2001.

However, we don't think that the strong rebound of office market could resonate into the residential market in 2001 because these two sectors share different market fundamentals:

- Recovery in office sector is uneven, only concentrates on Grade A office buildings largely owned by a single owner. HK Land, Swire Pacific, Great Eagle and Cheung Kong, with major office portfolios in Central and Island East, are the only few beneficiaries. In home market, ownership is much fragmented and there is no dominant voice in price setting. It is unlikely recovery only confines to certain areas in HK residential market.

- Office sector recovery is only seen in rental market, not the sales market. For the home market, eyes are on the growth in prices and nothing else. This is much harder than achieving a rental increase.

INVESTMENT STRATEGY

We think the share prices of some property stocks namely, Cheung Kong, SHK and Henderson Land are bit expensive and have already well priced in the rate cuts. We expect no surprise in property prices in 2001. Once the interest rate story runs out of steam and sales pitch returns lackluster results, selling pressure would be mounted on these stocks. We, therefore, recommend SELL on those over-valued stocks.

Developer	Share Price HK$ on 8th Feb.	Estimated NAV HK$ per share	Discount (%)	Recommendation
Cheung Kong	102.50	110.70	-7.41%	Sell
Hang Lung	7.80	9.50	-17.89%	Hold
Amoy	8.80	12.10	-27.27%	Buy
New World	12.05	17.00	-29.12%	Speculative Buy
Sino Land	4.30	5.79	-25.73%	Hold
Henderson Land	42.30	46.00	-8.04%	Sell
SHK	79.00	78.90	0.13%	Sell
Hysan	14.25	21.00	-32.14%	Buy
		Avg	**-18.44%**	

Source: Asia Financial (Research)