Zeppelin's Real Estate Tech

3Q 2009: A Real Estate Newsletter by Zeppelin Real Estate Analysis Limited

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Boom, Bounce, or Bust? The Hong Kong residential real estate market has picked up in sales and prices with some recovering their lost grounds since the global crisis in 2008. Here we seek to investigate some of the investment prospects via 3 simple articles.

Lower Return to Risk Ratio: China real estate has shown signs of recoveries too. Nonetheless, we would maintain our line of caution as the overall return to risk ratio might have actually decreased i.e. return becomes fewer relative to risk given that prices have not really adjusted by much and that some of the macro issues which existed before the global tsunami are still there.

In this Issue, Hong Kong Residential ABCDE:

- **D-NT and E-NT are Relative Bargains**
- **1st and 2nd hand Luxurious Sectors Go Their Own Ways**
- **2008 Supply = 1/4 of 1999! But E Bucks the Trend...**

We would also like to hear from prospective readers / writers who wish to share their real estate experience with us.

This quarterly (generally published in January, April, July and October) newsletter is circulated freely via email to over thousands of readers comprising real estate developers, investors, fund managers, financiers, owners, users, top executives, senior managers, prominent academics and related professionals from Hong Kong and abroad. Our content is / has also been published in newspapers and web portals such as the **South China Morning Post, China Daily**, **Hong Kong Economic Journal** (a Chinese daily), **21st Century Business Herald** (China), **The Standard** (a Hong Kong English Daily), **MITCRE Alumni Newsletter**, the **Surveying Newsletter** of the Hong Kong Institute of Surveyors, **Centanet.com, Netvigator.com, Hongkong.com, E-finet.com, Red-dots.com, PacificProperties.net**, **Soufun.com** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal** and interviewed by **Radio Hong Kong** and **Commercial Radio**. We also publish monthly articles and analyses in the months in between. This newsletter is now into its **13th year** and **52nd** issue.

We also operate a website www.real-estate-tech.com through which we intend to share some of our real estate knowledge and ideas with interested parties. There are close to 1,000 content items, in English or Chinese, including analyses, articles, charts, and tables, plus spreadsheets, tutorials, e-books, and the like, the majority of which is free with some requiring a token fee. The website is regularly visited by thousands from all over the world and focuses on China real estate markets.

Zeppelin Real Estate Analysis Limited is involved in real estate development, investment, and management with a focus on **independent real estate analysis**. Together with Zeppelin Property Development Consultants Limited, we offer services related to real estate asset management [analysis, investment strategy, and portfolio allocation], project management [architectural design, cost control, and contract administration], and facility management [facility utility assessment, facility strategy, and building maintenance. We are part of the Zeppelin Group headquartered in Hong Kong with office operations in Mainland China and we also have access to networks covering Asia, North America, and Europe.

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- **In Real Estate Investment:** you encounter challenges in 1) Selecting which markets (cities), sectors (residential, office, retail etc), and properties-projects to invest; 2) Striving for the best possible risk-adjusted portfolio return; or 3) Sensing the volatility of a market or sector…you need an independent real estate analyst like us

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For details: please download our group introduction at http://www.real-estate-tech.com/ZPG-Group%20Introduction-sOct07.pdf

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Hong Kong Residential ABCDE: D-NT and E-NT are Relative Bargains

Real Estate Tech, 3Q 2009

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Due to the low (practically nil) savings deposit rate and easier credit flow, the private residential real estate sector appears to have recovered lost grounds in both sales and prices. At the same time, some clients and investors are having a tough time trying to figure out which (smaller sized units, larger sized units etc) and where (Hong Kong Island, Kowloon, or New Territories) of the residential properties to acquire.

Your humble author wishes to help throw a light on the issue using data abstracted from the website of the Rating and Valuation Department (RVD) of the Government:

1) **First, know your ABCDE** = these first 5 characters in the alphabet refer to the categorization used by the Rating and Valuation Department of the Government of private residential properties by floor size with category A being the smallest and E being the largest. Here is how the categories are defined by floor size.

Unit Categories:	A	B	C	D	E
Floor size from, m2	Less than 39.9	40.0	70.0	100.0	160.0
To, m2	39.9	69.9	99.9	159.9	More than 160.0

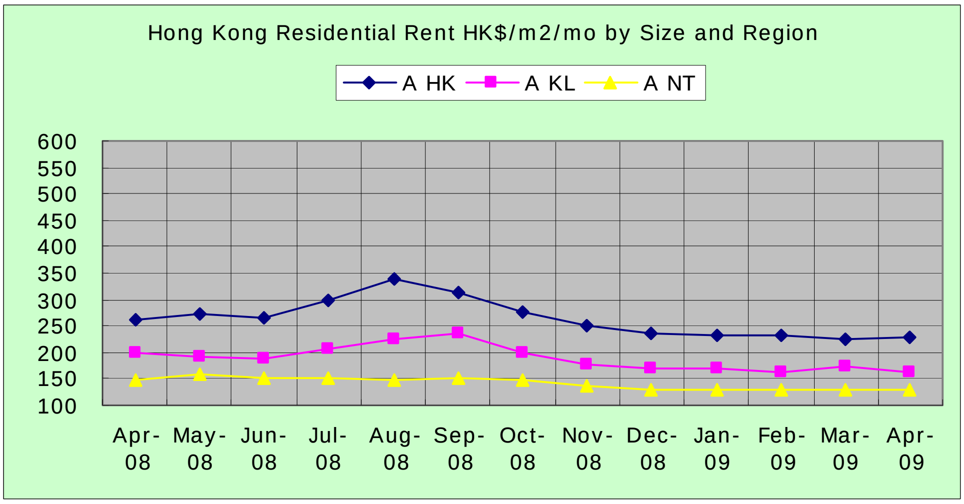
2) **Rental rates HK$ / m2 / month** = in addition to the floor size categories, the rental rates are also divided into the 3 main regions of Hong Kong, namely Hong Kong Island [HK], Kowloon Peninsula [KL], and New Territories [NT]. For readers used to the American system, 1 m2 (square meter) is equal to 10.76 ft2 (square feet).

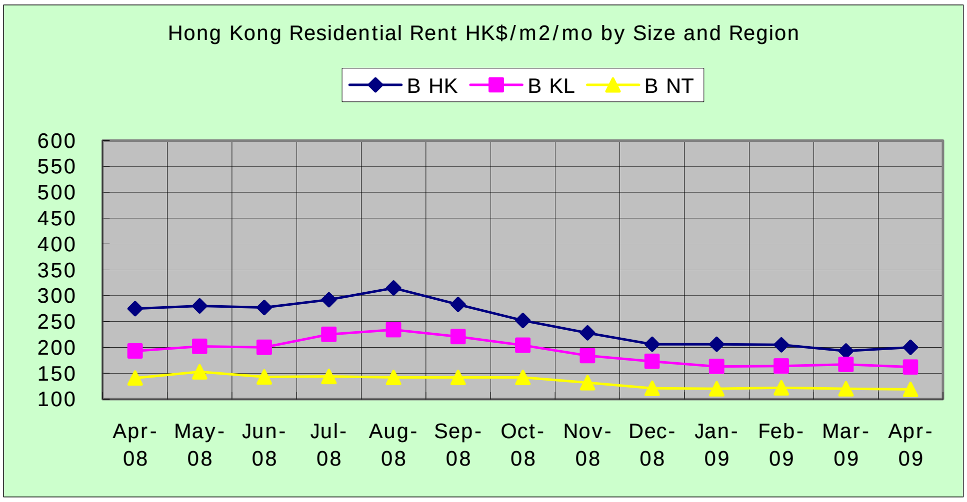
Note we have used the same vertical scale for all 5 charts hereunder in order to give a sense of the rental rate levels for each of the 5 categories in each of the 3 regions.

a) **In general, the smaller categories e.g. A and B command lower rental rates** while the higher categories e.g. E could get much higher rental rates.

b) **With a category, usually the Hong Kong rental rates would be higher** than their Kowloon counterparts which in turn would be higher than their New Territories counterparts.

c) **A and B are quite similar;** C starts to lift up; D continues the trend set by C; and E epitomizes noting though the erratic pattern of E-KL.




Hong Kong Residential Rent HK$/m2/mo by Size and Region
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B KL
B NT
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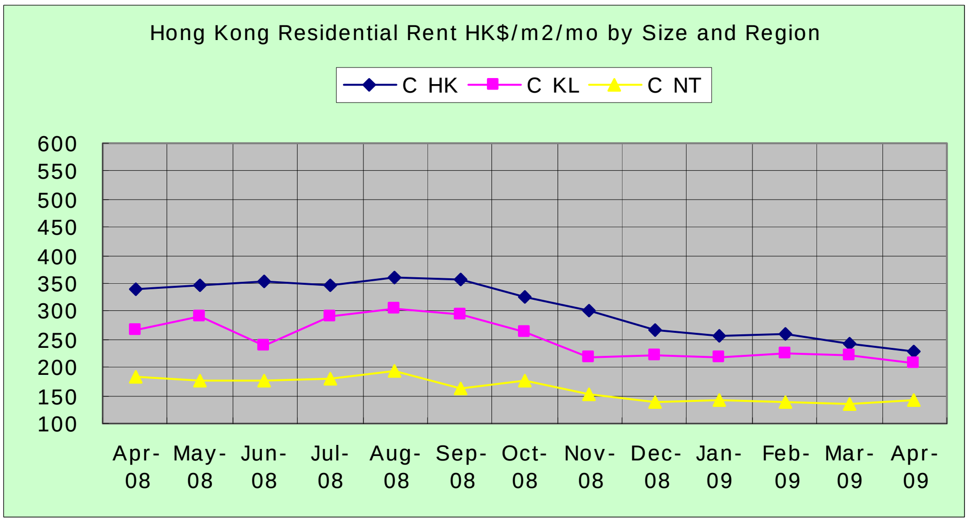
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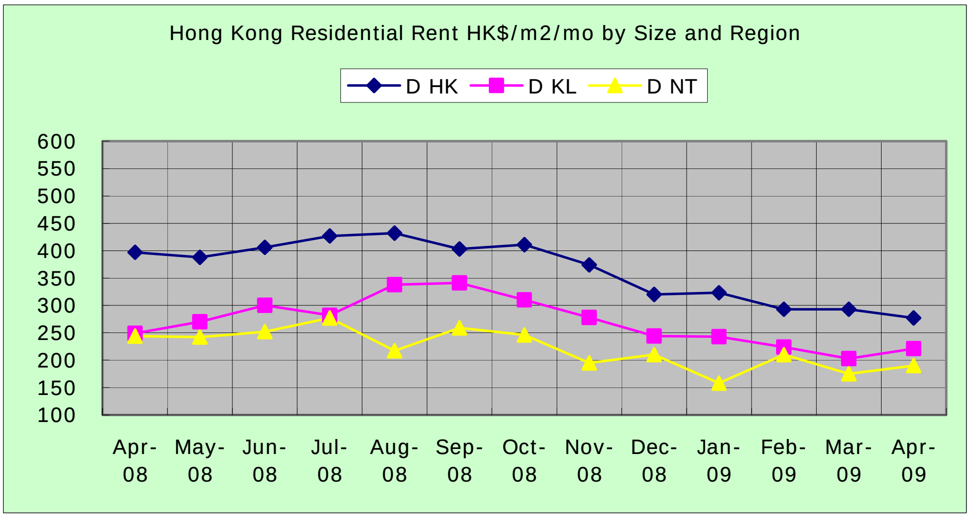
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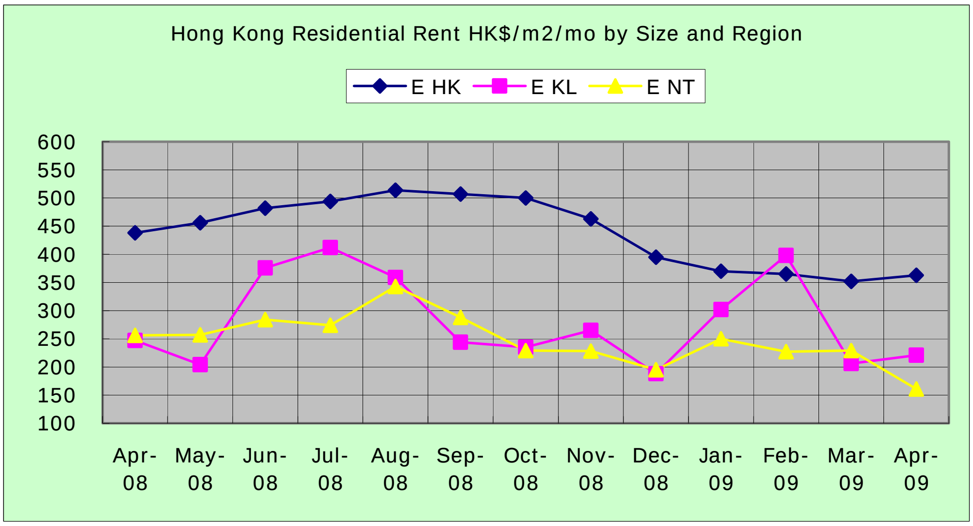


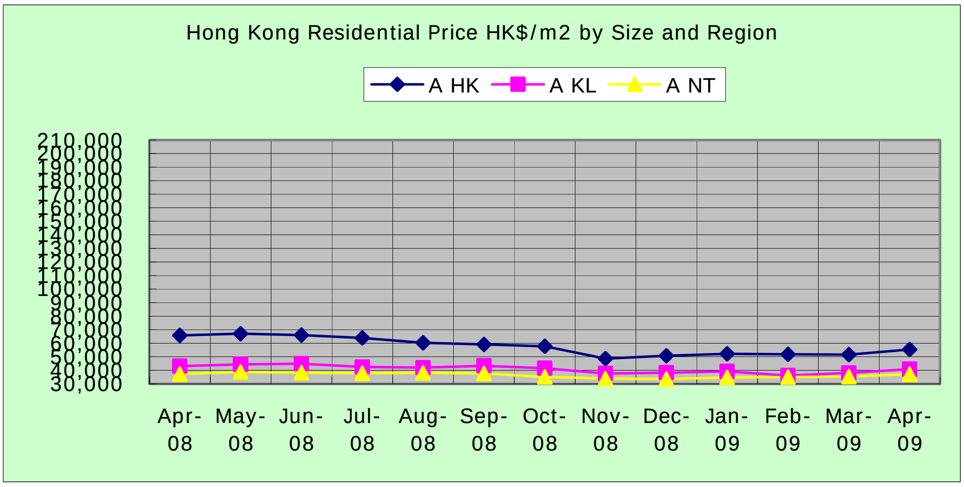
3) **Prices HK$ / m2** = similar presentation to rental rates above with the scale being the same for all 5 charts.

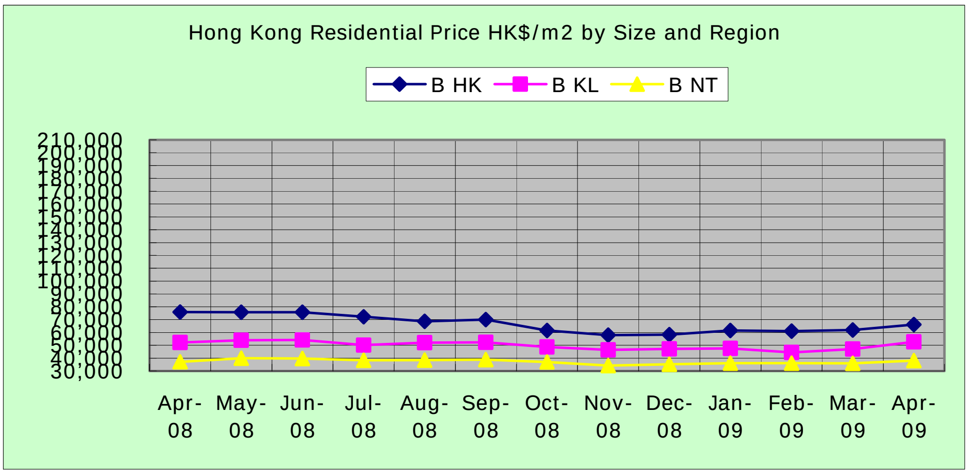
a) **As in the rental rates, the larger floor size categories command higher prices** per floor area than the smaller categories.

b) **Again, within the same category, prices in Hong Kong are > than Kowloon** which in turn are > than New Territories.

c) **While category A and B look quite similar, the Hong Kong and Kowloon prices are pronouncedly higher** than their New Territories counterparts in category C, D, and E.

d) **Furthermore, in category E, while the Hong Kong prices are still generally higher than the Kowloon prices, there were occasional cross-over between the two,** albeit noting the number of transactions could be less than 20 in such larger floor size categories in any month. That is to say, the averages in the larger floor size categories could have been (not a must, but possible) skewed by exceptionally pricier transactions.




Hong Kong Residential Price HK$/m2 by Size and Region
B HK
B KL
B NT
210,000
30,000
Apr-08
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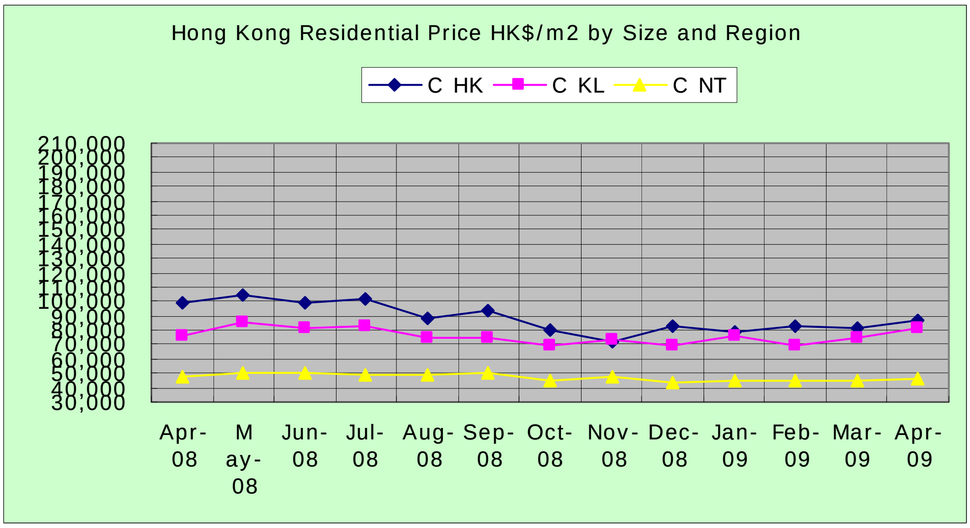
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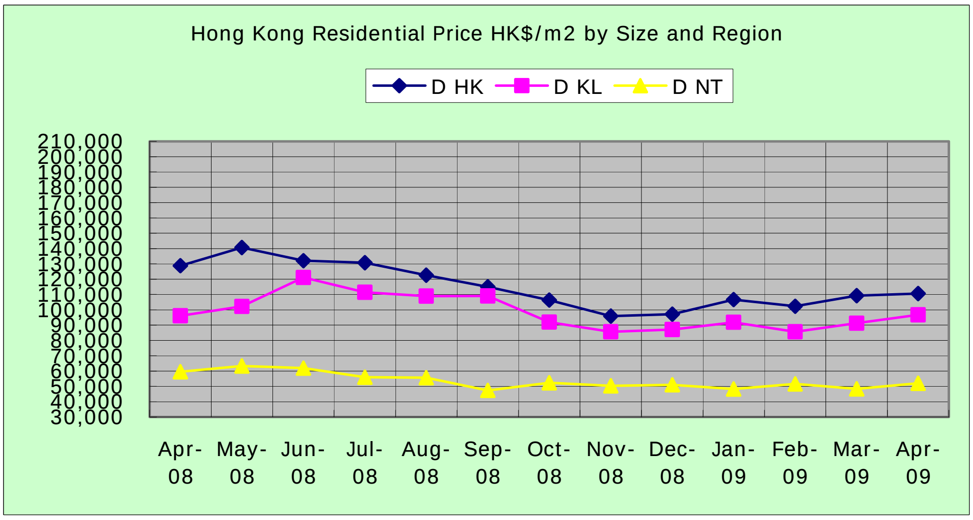
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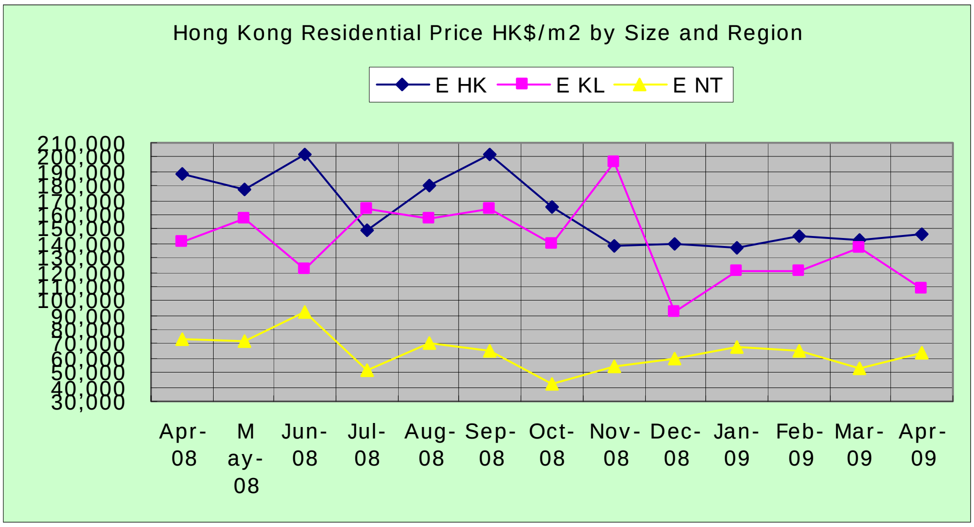


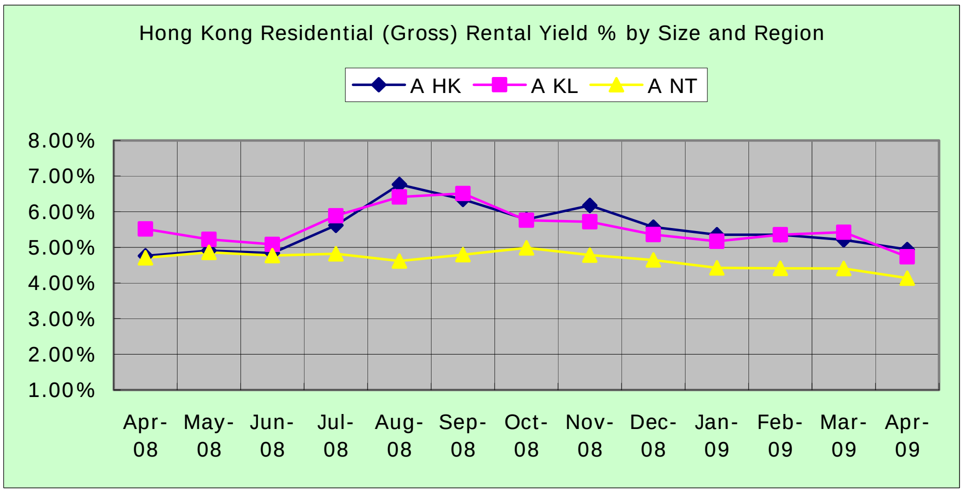
4) Gross rental yield rates % = we have taken the rental rates above, multiplied them by 12 to bring them to annual figures, and divided them by the respective prices, thus obtaining rough gross rental yield rates in %.

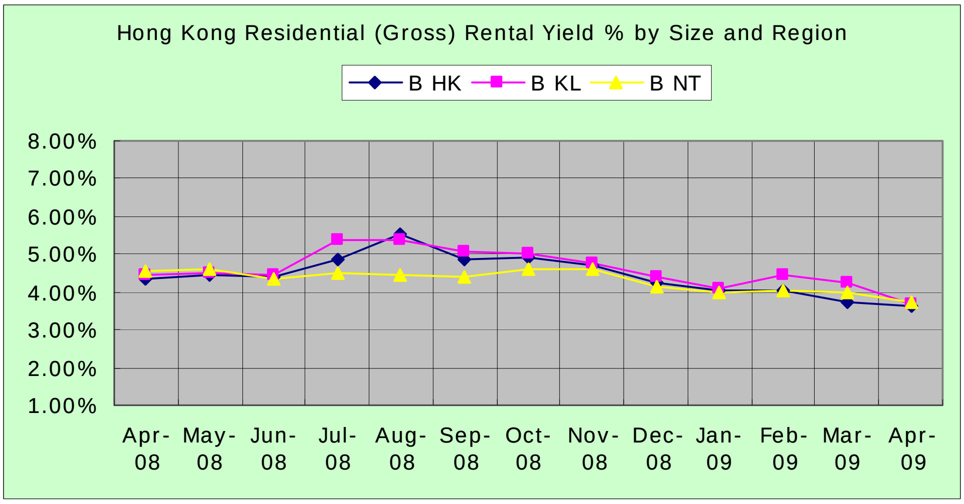
Here things get a bit interesting:

a) **Overall, the smaller categories e.g. A and B offer higher rental yields** than the larger categories e.g. D and E. <u>HOWEVER, this only applies when ONLY the HK [Hong Kong Island] and KL [Kowloon] residences in each category are considered</u>.

b) **The NT [New Territories] exhibits a different pattern** in that the larger categories offer higher rental yields than the smaller categories.

c) **The larger categories also exhibit higher fluctuations or volatilities over time** [note this may be in some cases induced by its relatively fewer transactions]




Hong Kong Residential (Gross) Rental Yield % by Size and Region
B HK
B KL
B NT
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
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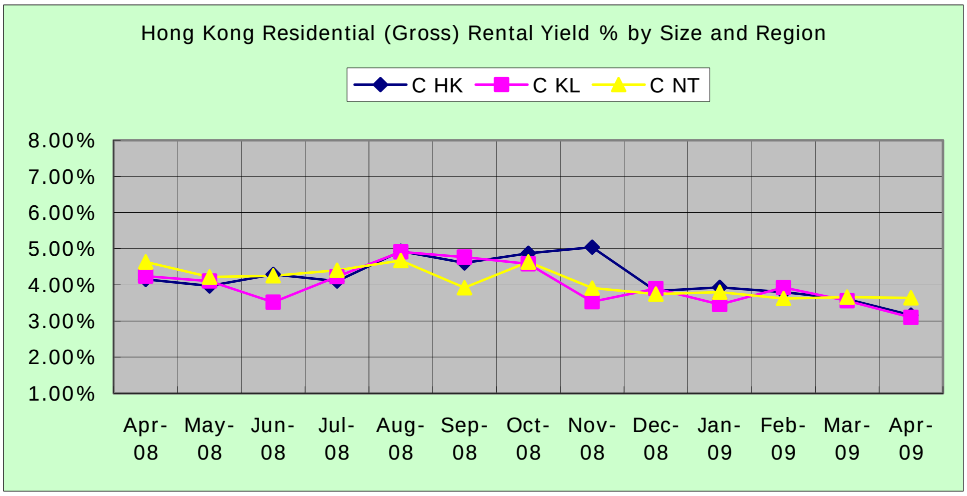
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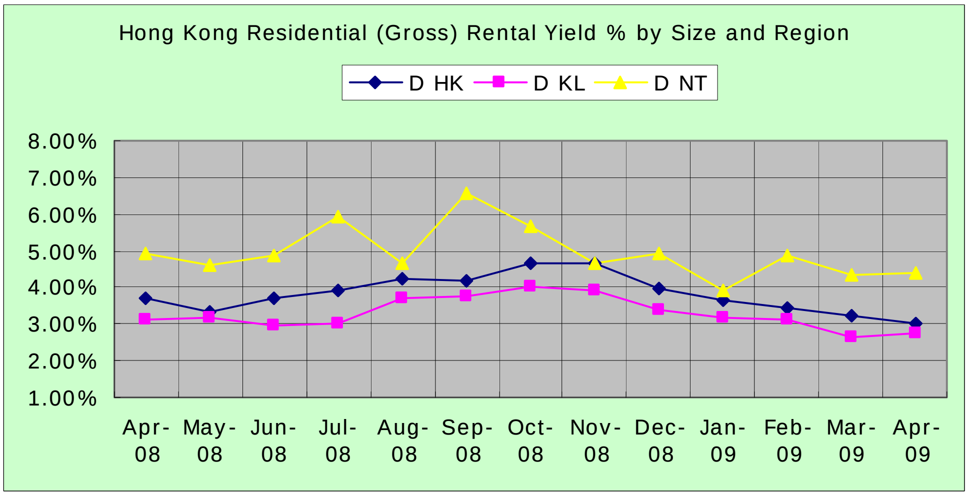
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4.00%
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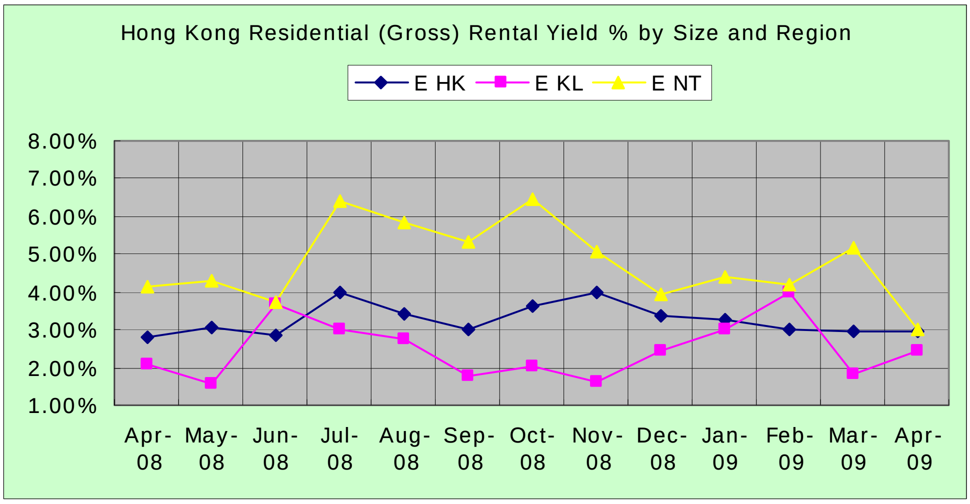

5) Category D units and Category E units in the New Territories [D-NT and E-NT] are <u>relative</u> bargains = and here are the <u>reasons</u>:

a) **Unit Price [HK$ / m2]** = from a homeowner-self-use angle, and assuming one has no specific location need or preference, D-NT and E-NT are, on average during the period studied [April 2008 to April 2009], priced at less than half the unit price per floor area required for a similar unit on Hong Kong Island, or around half the unit price per floor area for a similar unit in Kowloon. Given that recent residential real estate developments have taken place in the New Territories, probably a newer unit too.

b) **Gross Rental Yields [%]** = from a investment-rental yield angle, and assuming an investor does not wish to acquire the smallest sized units, D-NT and E-NT offer very competitive rental yields, beating not only their HK and KL counterparts, but also some of the B and C categories.

As for which category and / or location would offer the better price appreciation prospects, <u>IF ANY</u>, we would bet on the more 'urban' ones; e.g. parts of HK and New Kowloon, and focus either on the smaller or the larger units, and avoid the middle ones.

Yet, <u>a word of caution</u>: the current upbeat market sentiment appears to be a result of relaxed credit environment and pumped up liquidity. Add this to the still worsening fundamentals, it means risk is increasing faster relative to return or <u>deteriorating return to risk ratios</u>.

Note: Read our previous quarterly newsletter too for a more comprehensive study = http://www.real-estate-tech.com/articles/RET2Q09.pdf

Hong Kong Residential ABCDE: 1st and 2nd hand Luxurious Sectors Go Their Own Ways

Real Estate Tech, 3Q 2009

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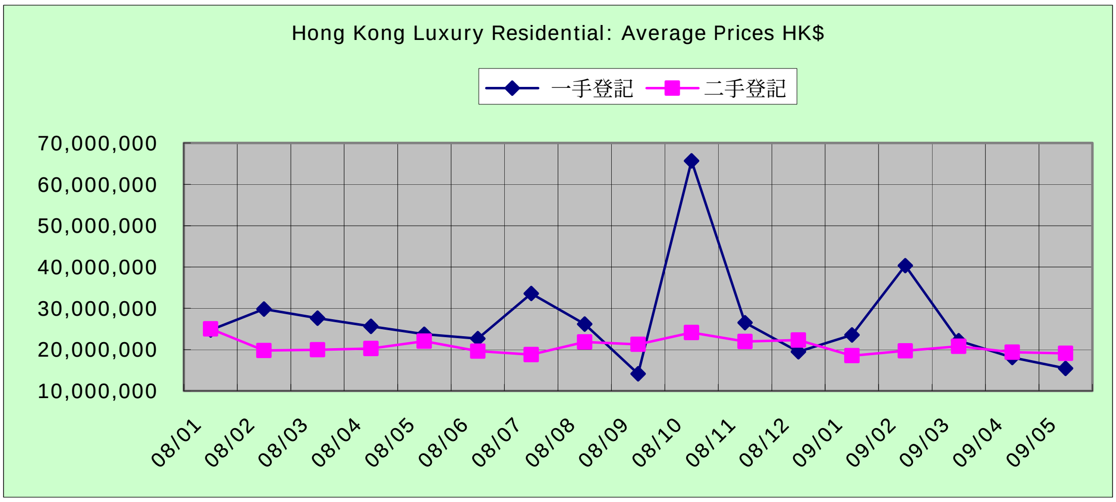
The term 'luxurious residences' is probably one of the most abused terms in the Hong Kong real estate market. It seems having shiny and expensive granite or marble lobbies or a price tag of over HK$10M would be sufficient qualification.

In fact, some of the luxury residences would be better described as 'expensive' residences and expensive is not the same as luxurious. Anyhow, this article is not about English usage.

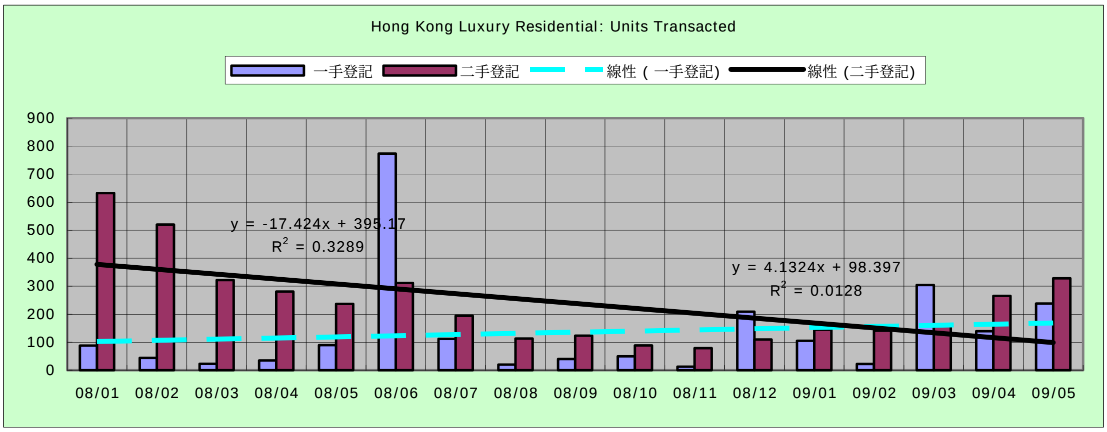
But the article is about this: the 1st and 2nd hand luxurious residential sectors are two different markets with each going their own way. Here are the details:

a) **Data sources** = mainly from www.centanet.com of Centaline (Real Estate) Agency, one of the largest Hong Kong real estate agencies.

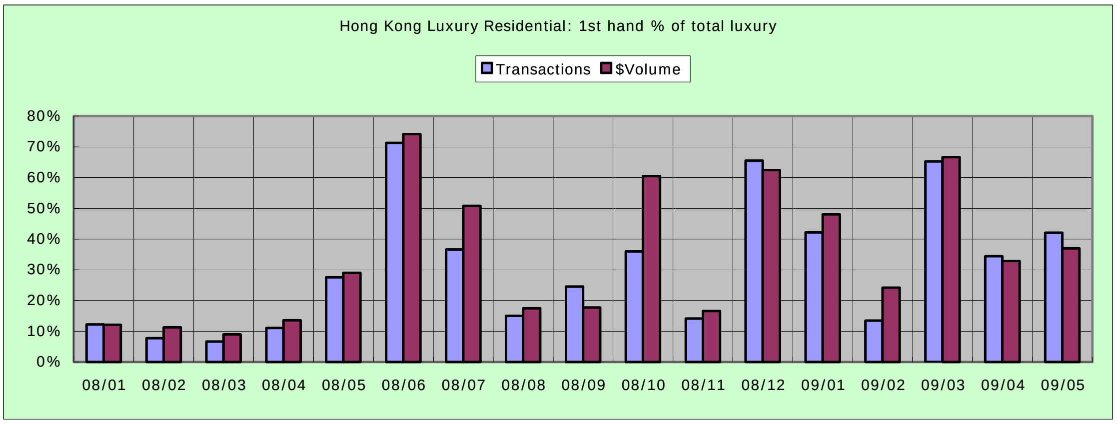
b) **1st hand erratic, 2nd hand steady** = and this applies whether in terms of average prices, total transaction dollar volumes, or number of transactions per month. For instance, 1st hand averages range from HK$15M to HK$70M while the 2nd hand ones range between HK$18M to HK$24M. Nonetheless, this is not entirely surprising as 1st hand sales could have been skewed by exceptionally expensive (or inexpensive) properties in any particular month although this may also signify the newly developed properties are getting more and more 'luxurious' and thus expensive.



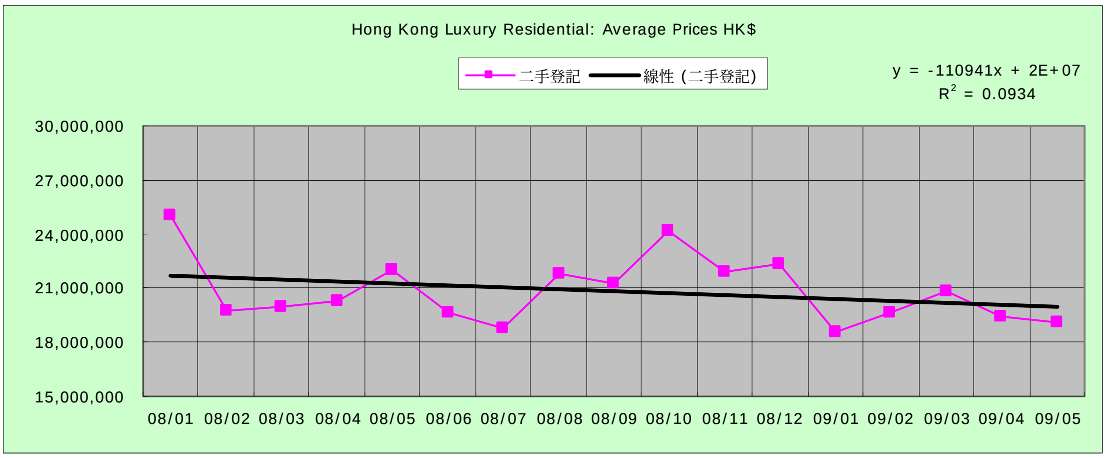
c) **1st hand enjoys a slightly upward transaction trend** while the 2nd hand has a slightly downward one = although the former exhibits higher volatilities in both transactions and volumes, in part a reflection of the flexible muscle which most real estate developers enjoy i.e. selling only when the market sentiment and timing are favorable.



d) **1st hand sector can still dominate the overall luxurious sector in terms of sales** = sometimes up to 70%. Given that 1st hand residential sales of ALL grades do not go above 20% of total residential transactions in any one year, this 70% is comparatively high reflecting the smaller scale of the luxurious sector.



e) **2nd hand sector prices are still on a downward trend despite the recent upbeat sentiment** = in early 2008, the average price was around HK$25M and this dropped to around HK$18M in May 2009, representing close to 25%.



We have also looked at the correlations between the 1st and 2nd hand luxurious market sectors and found that there is practically no relationship between them in terms of price trends or transaction activities.

That is to say, the performance of one gives no useful clue to the performance of the other.

Hong Kong Residential ABCDE: 2008 Supply = 1/4 of 1999! But E Bucks the Trend…

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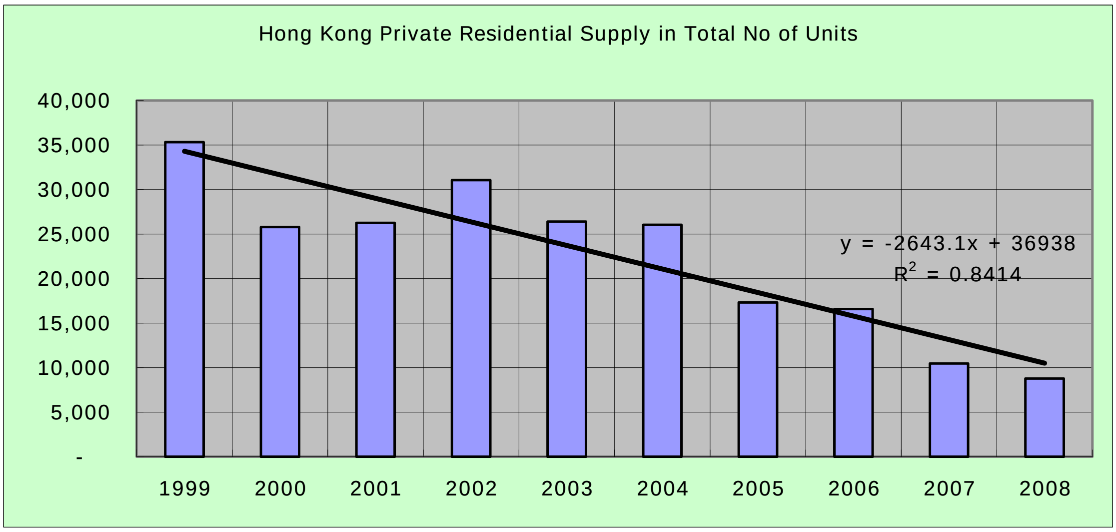
ABCDE refers to the categorization used by the Rating and Valuation Department of the Government of private residential properties by floor size with category A being the smallest and E being the largest. Here is how the categories are defined by floor size:

Unit Categories:	A	B	C	D	E
Floor size from, m2	Less than 39.9	40.0	70.0	100.0	160.0
To, m2	39.9	69.9	99.9	159.9	More than 160.0

And the overall 2008 supply of 8776 units, all categories included, is only around 25% of what it was in 1999! Then the figure was 35322 units. The drop sounds steep and indeed it was and is probably still is. Here is a chart showing the declining supply trend (data source: Rating and Valuation Department, HKSAR Government):



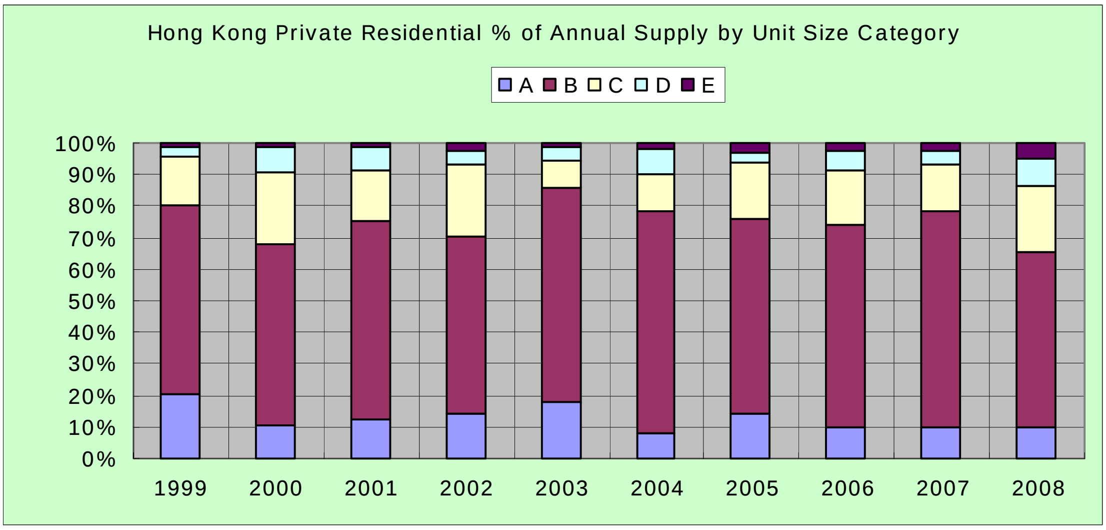
Now, perhaps anyone with a slightest hint of the Hong Kong residential real estate market would have sensed the above. There are a variety of reasons for this with population demographics being one of them. Baby-boomers are getting old and most of those who could and had wanted to purchase a home have already done so and there are relatively fewer people in the X or Y generations. No wonder the real estate developers have been seeking other markets (cities) and diversifying their operations, else they may have problems enhancing revenues or even keeping them.

What is not so obvious is that the drop in supply is NOT evenly distributed among the 5 different residential categories = the smaller the floor size category, the bigger the drop during the period from 1999 to 2008 and vice versa. In fact, category E, the largest units, has even increased a bit. This table shows the yearly supply by floor size category A to E:

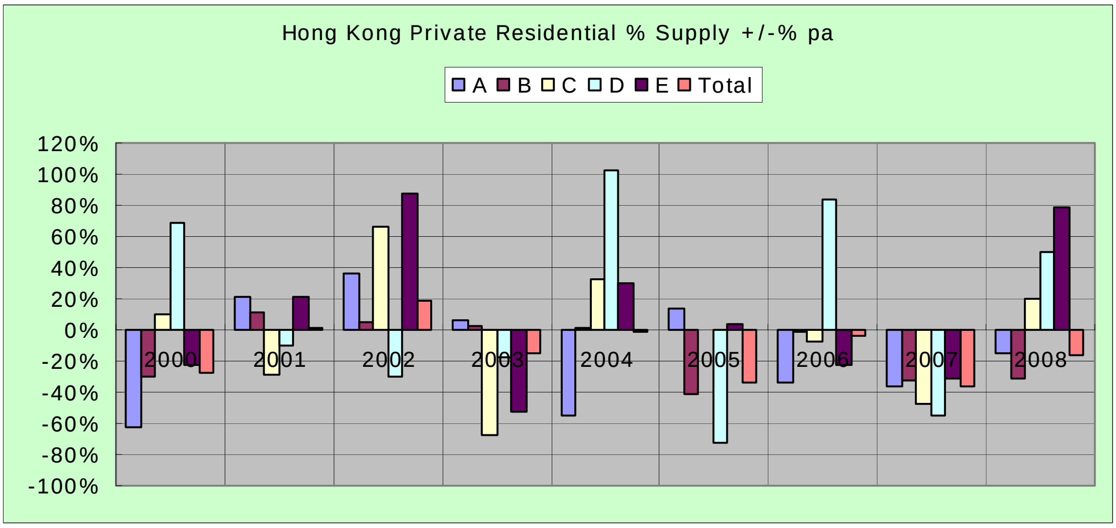
Year	A	B	C	D	E	Total
1999	7,271	20,982	5,451	1,188	430	**35,322**
2000	2,683	14,753	6,025	1,998	331	**25,790**
2001	3,257	16,475	4,320	1,810	400	**26,262**
2002	4,456	17,370	7,204	1,270	752	**31,052**
2003	4,738	17,908	2,349	1,043	359	**26,397**

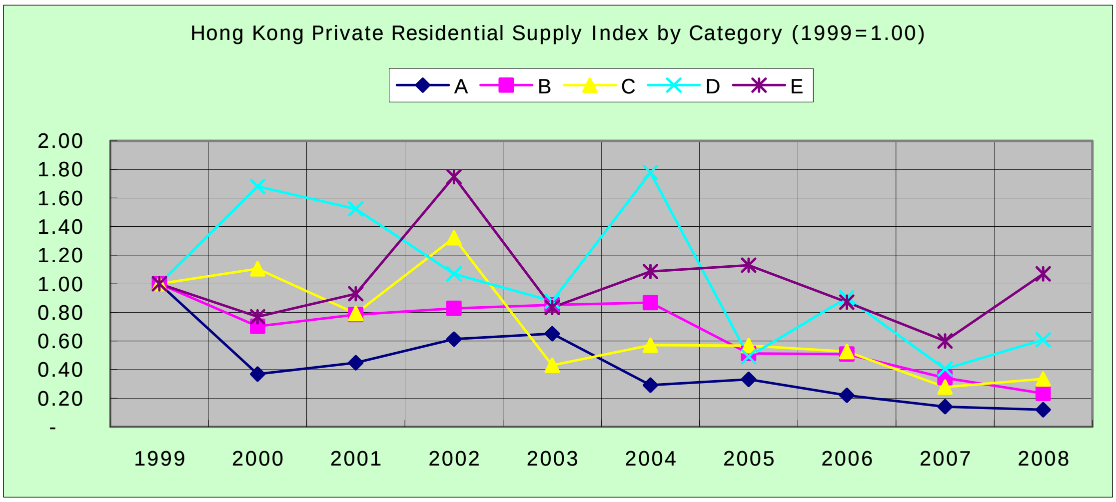
2004	2,122	18,225	3,110	2,112	467	**26,036**
2005	2,408	10,754	3,091	582	486	**17,321**
2006	1,601	10,664	2,867	1,072	375	**16,579**
2007	1,029	7,188	1,516	480	258	**10,471**
2008	871	4,897	1,825	723	460	**8,776**
Total	**30,436**	**139,216**	**37,758**	**12,278**	**4,318**	**224,006**
2008/1999	**12%**	**23%**	**33%**	**61%**	**107%**	**25%**

Put simply, there has been a supply shift from the lower floor size categories of A and B to the higher floor size categories C to E on a market share (by number of units) basis. Here is a simple chart showing the effect:



Despite the overall supply down trend, the actual supply for each category A to E could fluctuate wildly from year to year and from one another. Except for category A and B (the 2 smallest floor size categories) which have some correlation in supply between them, i.e. their supply patterns more or less match one another, there is no way to tell the supply of the other categories via looking at A or B, or for that matter, vice versa i.e. guessing A or B via looking at C, D, or E. Here are 2 charts showing what we mean:





What to make of all these? A couple of observations:

1) **The residential market theme has gone from satisfying basic homeownership to satisfying upgrading households** = the developers are building proportionately more of the larger floor size units and this reflects in part the changed / changing economic structure since the late 1990s. There are now fewer new household formations but many existing households are seeking to upgrade thus leading to not just overall higher prices in the larger units, but also higher prices per floor area in the larger units.

In 1999, category C to E (70m2 or above) units accounted for no more than 20% of overall supply. In 2008, these occupy 1/3 of market supply.

This also jives with our earlier analytical article titled "Hong Kong Residential: 1^{st} hand and 2^{nd} hand are Different Markets" = http://www.real-estate-tech.com/articles/SRS060901.htm.

2) **The wide and occasionally wild supply fluctuations seen in some of the categories during some of the time may add to investment return…and risks too!** = additional return may result when market goes hot and supply is relatively few yet additional risk may be in the cards too when the other way round applies.

Supply fluctuation is normal in real estate development (production) as there is always a time lag between market sentiment and market supply plus the fact that supply can never 100% match the (estimated, guessed) market demand. For instance, a developer may see a potential to sell 1,000 E-sized residential units yet his search for a site (or sites) may be able to meet 800 units of that guessed potential.

For investors, supply is only part of the equation and other aspects need to be considered too e.g. demand potential which is even harder to gauge and can evaporate overnight compared to supply.

Nonetheless, the current residential supply trend, where continued (and even taking into account the higher supply in 2009 and 2010), is unlikely to lead to any major long term supply glut anytime soon.

But then again, never bet on a market simply and only because supply is low.