Empty Buildings and NPLs

By Michael Hart

I have been struck recently by just how much empty real estate there is in the city. Some of it you can't easily see, because it's not at street level; empty floors in office buildings high up, hotel rooms not being used, apartments in prime locations that sit empty. However, some of it is on full display. Empty units in shopping malls, vacant store fronts on the ground level of residential towers, whole office buildings at major intersections with no one coming in or out. And this empty space indicates we have a challenge, a challenge in the real estate market itself and probably also a challenge in the debt market.

Real Estate and Debt

It is extremely expensive and time consuming to build commercial real estate. A 50-story office building could easily take four or five years from architectural drawings, through construction to opening the building for office tenants. Shopping malls can also take years to bring to market. And then even once they've opened, the income generated will take years to pay back the cost of these investments, so developers almost always turn to the debt market to finance their construction. And while debt sounds like a negative thing to individual consumers, it is an important part of the overall property market and when used well, allows projects to be financed which often boost the local economy. Once a building has been leased and has steady income, it is often referred to as a stabilized asset, meaning it generates regular and dependable income streams. This stabilized asset is very valuable to investors and or banks who financed the developers. A bank who has loaned money to finance a successful real estate project can expect to receive a steady stream of income for years as the loan is paid off. And although the original loan was given to a single developer, if an office building is leased to hundreds of tenants, they collectively help repay the loan when they pay their rent, thus diversifying the repayment risk some for the original lender. However, when the project isn't generating income because the building is sitting empty, this creates a problem for the developer and for the bank who made the loan.

NPLs and AMCs

If for some reason the project doesn't generate the income it is supposed to, and can't make its regular loan repayments, the debt associated with the real estate project becomes known as an NPL (Non-Performing Loan). And banks don't like NPLs because loans that don't get repaid stop the bank from repaying their depositors, making new loans or undertaking other profitable activities. Most banks aim to keep their NPLs at 4% or less of all loans.

An additional challenge with real estate is that it is an illiquid asset, meaning it isn't easy to buy and sell, and sometimes it isn't even easy to understand what the current value of an asset should actually be. So once a bank realizes that it has too many property NPLs, it may decide to try and sell them. But who would buy a loan linked to a real estate project that isn't currently repaying its loans and whose current market value is hard to determine? Enter the AMCs or Asset Management Companies. There are many kinds of AMCs, but in this case we are focused on those that buy real estate related NPLs. Since China has gone through several cycles of bank debt restructuring, they set up a unique system of state-backed AMCs whose job it is to take over bad loans from banks, pay them for these bad loans thus recapitalizing the banks and letting them get back to lending on new projects. Often referred to as the big four, (China Orient, Cinda, Great Wall, Huarong) these four large AMCs dominate the market for buying or taking over bad loans from Chinese banks. Although there are other AMCs in China, the structure of the Chinese NPL market currently makes these firms key to solving NPL issues.

Working out NPLs

In order to discourage the banks from making loans to developers who won't be able to repay them, if a bank is forced to sell an NPL or bad loan to the AMC, they must do so at a big discount meaning they will recognize a loss on that specific loan. So for instance if the loan was originally valued at RMB 100 million, but the borrower hasn't made any payments for a year, the AMC may only be willing to pay RMB 30 million, or even less for that loan. The steep discount punishes the bank for making a bad loan, but at least gives them back some capital to start lending again. The original borrower may get nothing back and have lost their asset in the process, but at least they have their debts erased. The low price paid for the NPL also gives the AMC a lower cost basis to start repositioning the asset. Maybe the problem was that asking rents were too high and so no one was willing to rent space. At a lower cost basis the new owner can accept tenants paying lower rents and maybe even still turn a profit.

The implication is that the value of the asset or building has now declined, but the building can be re-leased and thus can now start to generate income. The original developer lost most or all of their initial investment on the project, the bank made no profit and maybe even a loss on their loan, but now the AMC has gotten a low price on buying the building and if they can lease it out and then over time increase those rents, they will eventually be able to sell it for more than they paid and thus generate additional profits.

Foreign Participation

There have been a number of announcements recently stating the Chinese financial markets are opening up wider for foreign participation. One foreign firm, has even registered interest in setting up an AMC. Since foreign AMCs actively buy real estate related NPLs across the world, there is some expectation that if they could play a role in the mainland real estate NPL market, this might make the market more efficient and more international, but active foreign participation in a major real estate AMC is probably still a few years off. For now, the big four local players will continue to dominate this space.

Regaining Balance

As I noted earlier, large amounts of empty real estate space is an indicator that the market has gotten out of balance. Either developers built faster than occupiers needed the space, the wrong type of space was built or the pricing for the real estate isn't consistent with the returns it can generate. It appears we are headed towards a point in the cycle where debt is getting harder for developers to get and new construction will stop. Developers who can't repay their debt will need to sell their property and take a loss. Banks with NPLs will need to find a buyer for these loans by discounting them significantly. It isn't the end of the world when some developers lose their projects and banks write off losses and sell the loans at discounted prices. It is important that companies like AMCs exist to help clear out the NPLs that banks hold. This will help reset the prices, improve banks balance sheets and then hopefully get the property back into active use and generating income again. So expect over the next year or so to hear about some bad property loans and to see property changing hands. Once this has happened the properties can be put back on the market and be leased again. Once NPLs have been sold and AMCs have sold on or re-leased or repositioned these projects and rents and prices will start to rise. At this point, we will see fewer empty buildings and developers will start to approach banks for new loans and we'll be headed into a new development cycle.

This article was published in ***Business Tianjin Magazine*** in August 2020.

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