The Korea Economic Slice on KBC (Vol. 1.9)

An Exclusive Report from Korea Business Central and DS - Financial Market Analysis

By: ***Robert Eberenz*** August 5, 2010

Korea is a land of limited space and high population. It's borders surround just under one-hundred-thousand square kilometers, making the land mass a bit larger than the U.S. state of Indiana, with a population of approximately 48,000,000; over seven times that of Indiana. It's safe to say that the result of these basic observations has for years been a high demand for real estate in Korea. This week we'll discuss the state of the South Korea real estate market by investigating the Korean "Jeonse" (key money) lease process, deciphering the implications of economic downturns on the industry, and looking for answers to the looming supply of unfilled apartment skyscrapers in years to come.

Making Sense of "Jeonse"

"Joense" (Jeon-say) is a real estate financing agreement that is unique to Korea. Many who have lived in Korea have a working knowledge of this concept from personal experiences of leasing apartments, but here we'll peer through a wider lens.

In a traditional Korean lease agreement the Lessee (renter) is required to provide a lump sum of capital between 40% and 80% of the market value of the property. This lump sum of cash, or "Jeonse", is then required to be returned in full by the Lessor (landlord) at the end of the lease term.

At first glance the Jeonse system seems quite unreasonable from the renter's standpoint. If someone is able to pay half of the value of an apartment in cash, then why wouldn't they just buy it and finance the rest? Furthermore, why would the landlord not opt to offer a western style system, so that the cash flow from the investment would be definitively positive?

Western renters and landlords may be drawn to mental fits over the major commitment of capital and means of income, but the Jeonse system is very popular in Korea. Why?

First, Jeonse can be financed with a loan from a bank, much like a mortgage; making the down payment and interest on a fraction of the home's value much more manageable.

In fact, the Jeonse system feels nearly identical to a mortgage for many tenants. Monthly payments build equity and pay interest simultaneously, akin to a mortgage. The only difference is that tenants cannot realize gains from the increasing value of the unit, because they don't actually own anything other than their pile of cash.

This way, the only net loss at the end of the lease term is equal to the interest paid on the loan; a sum much lower than the combined twelve monthly rents under the American system.

From a landlord's point of view, the costs and benefits of Jeonse can differ dramatically. In a high interest rate environment, the capital held by the landlord during the lease period can be invested in safe fixed income products (bonds or CDs) at higher rates. Conversely, low interest rate environments are less profitable for Jeonse landlords.

As you might expect, the percentage of rental agreements operating on the Jeonse system fluctuate with economic cycles and interest rates.

When the Economy Soured

In February, 2010, the Korea Times reported that,

The number of "jeonse" units offered for less than 100 million won ($87,000) in Seoul sank to 126,609 in February, with more than 35,000 such properties vanishing over the past year [2009].

The data shows a 20% drop in supply of these units during the height of the recession, which may be attributable to heightened risk and decreased reward for landlords, mixed with spiking demand from consumers for Jeonse units.

Recent research, conducted by the European Real Estate Society (ERES) on deposit based real estate rental systems, made some interesting conclusions concerning the Jeonse system and its effects in different economic climates.

Returning to our initial observation of Korea's high population density, the success of the Jeonse system is easier to grasp. The ERES data shows the vacancy rate in Seoul, near 1%, far below all other major Asian cities. The closest second is Singapore's 4.5%, with the upper range held by Shanghai, where vacancy rates are over 13%. The vacancy rates tell us that the negotiation of the contract terms are controlled by landlords, while renters have relatively little leverage.

When economic activity is contracting people begin to lose jobs and earn less on average, forcing owners to sell and enter the Jeonse demand pool. During the same period of time something else interesting happens to the risk profile of Jeonse landlords… it goes up.

The beauty of the Jeonse system is that it nearly eliminates default risk of any property under lease, because after "key money" has been handed over to the landlord there are no payments to miss until the Jeonse contract's conclusion and the commencement of the next tenant's contract. The leverage of the landlord in Korea, especially in Seoul, is attributed to high population density and low vacancy rates.

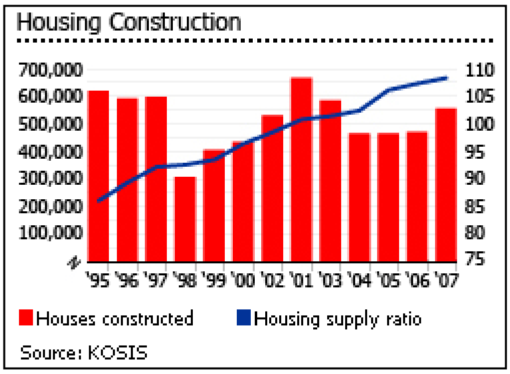
Demand… Meet Supply

Korea does face significant challenges in the real estate arena from time to time. During periods of economic expansion it can be difficult for regulators to control speculation in the real estate market. As such there are stiff loan-to-value requirements when it comes to owning property in Korea.

During last year's economic recovery, Korean regulators set mandatory loan-to-value caps on mortgages at 50%, down from 60%, to stem a modest 2.1% rise in prices from April to October 2009. In addition Korea imposes heavy capital gains taxes on real estate that is deemed "investment property", all to keep the market stable and contained.

The recent drop in Jeonse properties corresponds to a spike in housing supply. There are several ways to explain this coincidence, but off hand a drop in Jeonse supply would seem more appropriate if it corresponded to tight housing supply.

See the chart below, compliments of Global Property Guide…



In 1990, Korea's housing supply ratio was only 72.4%, but now the level is near 110% and is expected to grow to 116% by 2012. Could this glut of new home supply be crowding the Jeonse market, where potential home buyers with spare capital can afford the same quality home as buying a new unit, but are immune from price declines.

In a country as dense as any, one would think it impossible for there to be an over-supply of real estate; particularly given Korea's reliance on domestic agriculture and it's mountainous terrain. Yet it seems the old supply and demand curve needs a bit of finesse to account for the various breeds of home ownership and financing in Korea. The Jeonse market continues to tell the story of low vacancy and landlord dominance in existing units, but half empty towers with fresh paint and shimmering windows could change the face of Korean real estate. The supply of housing in Korea has finally outpaced the demand, perhaps foreshadowing an end to the landlord's reign and the beginning of more flexible payment options for tenants willing to fill those cozy new boxes stacked twenty high.