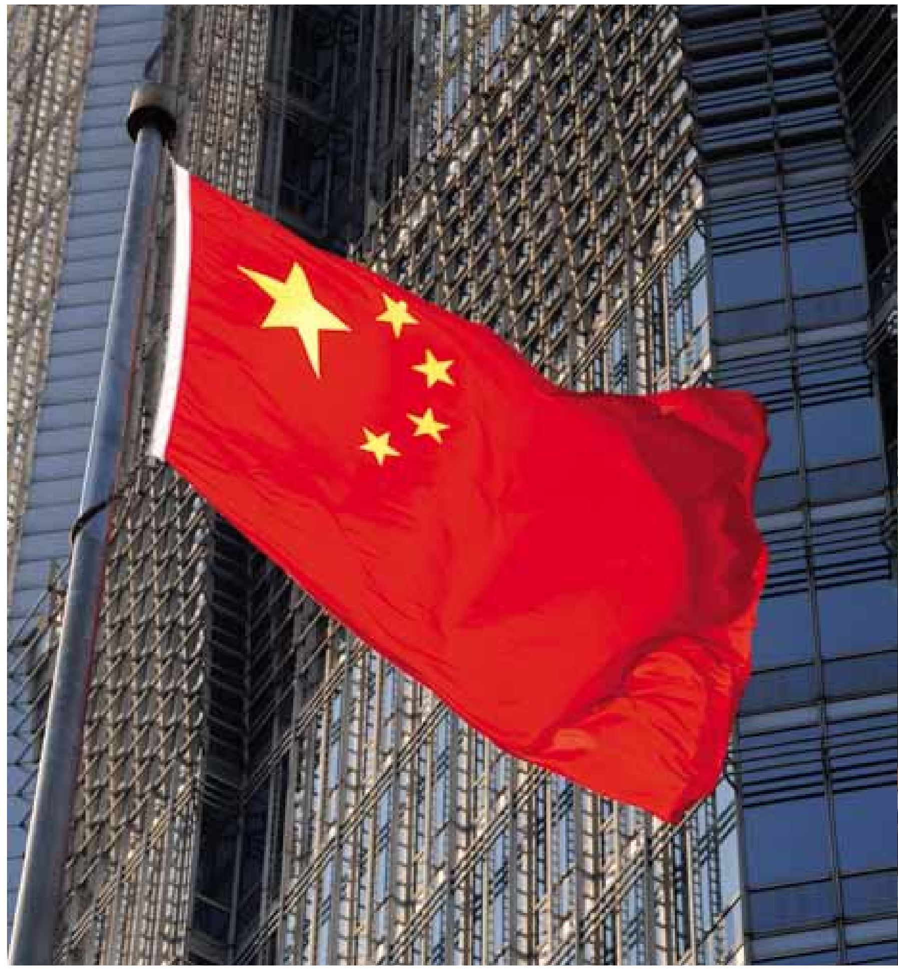

Guangzhou

Shanghai

CHINA: SEEING RED

Claire Malcolm evaluates the highs and lows of investing in the dragon economy

The scale and speed of China's development is a 21st century success story. As one of the world's major economic powers and an emerging market poster child, the momentum of its progress has ignited – and fuelled – investment interest from around the world.

With a population of around 1.3 billion, the roaring Chinese economy may be taking over the world from the inside out, but its own real estate priorities lie in housing and infrastructure, as is the case in several other emerging markets.

In the two decades since the country began to open up there has been a rising middle class, a 30 percent average increase in house prices since 2002 and US$1 trillion of foreign exchange reserves in the bank. This has helped to paint a rosy picture of the People's Republic, but environmental issues, long-term market accessibility, and the largest urbanisation process in human history are key concerns that potentially mar an otherwise attractive investment proposition.

Speaking at last April's Cityscape Asia event in Singapore, Zheng Xiaoping, principal of Shanghai-based BAZO Investments said that the process will see the current tally of 600 big cities increase to 1,500 within the next 15 years, with another six billion square metres of housing required to support this. If current trends hold true, within 20 years China's cities will have added 350 million people, more than the entire population of the US today.

The creation of these urban pressure points, a result of the rural exodus, is significantly boosting real estate development across all asset classes, from commercial and industrial to office and residential, and is upping the ante for development in the country's Tier II and Tier III cities.

RED LIGHT, GREEN LIGHT

In late 2007 the Chinese government introduced new legislative measures in an attempt to curb rampant speculation in the market, which had seen a 29 percent increase in real estate investment in the first eight months of the year against 2006 figures, and valued at US$189.85 billion.

According to Xiaoping, this has reduced the opportunities available to foreign investors. He explains: "In three years time there will be higher entry barriers, so the window of opportunity will be open only for the next two to three years."

The new property law equalised the level of protection available to all property owners, but tightened restrictions for FDI in other areas.

As it stands, at least 70 percent of the land approved by a local government for residential property development must be used for developing low-to-medium cost and small-to-medium size units as well as low-cost rental properties.

Additionally, 70 percent of construction must be for 'small unit space' properties, which increases the down-payment required for larger properties. A resale tax has also been imposed on properties held for less than five years. New rules also ban developers from reserving apartments on speculation.

James Macdonald, head of research for Savills China, says: "A lot of the tightening of legislation is directed squarely at the residential market as this is viewed by the government as being a primary concern in order to keep prices in check and make sure everybody can find suitable housing. This resulted in a slowdown in price rises and, more recently, a fall in transaction volumes, although this is also partly due to the seasonal cycle."

In Shanghai, the municipality will increase mandatory mortgage down-payments this year by 30 percent, in response to enormous price increases on properties.

China also levelled corporate income taxes for foreign companies with that of domestic companies, at a unified 25 percent. Lu Jinyong, a researcher at the University of International Business and Economics, commented: "In the long term, the new corporate income tax law will benefit China in attracting FDI because it creates a level playing field for foreign and domestic investors."

ASSET ANALYSIS

Despite legislative restrictions, investment is still flowing into the country, and Macdonald sees potential across the various asset classes, as he explains: "There is strong growth in all asset classes in all locations at the moment. Demand drivers, while being different for each asset, are present for all property types.

"In the residential segment, strong urbanisation and growing wealth is fuelling demand while the government is pushing for increased supply to help to suppress price growth.

"Despite the stigma of low cost housing there is great potential for its development. The government has time and again reiterated its wish to increase the supply, and developers that are adept at the development of low cost housing will be well-positioned in the future."

Data from the National Reform and Development Commission for 2007 stated that property values across 70 major Chinese cities rose by nearly 10 percent from Q3 2006 to Q3 2007 with middle and high-end properties the highest gainers. Shenzhen demonstrated the highest growth rate, followed by Beijing and Zhengzhou.

Commenting on the retail and commercial markets, Macdonald says: "The retail market is seeing increasing penetration of foreign brands of all types, along with an increasingly sophisticated advertising and marketing industry plus increasing disposable incomes and overall personal wealth which are helping to spur retail sales."

From a purely commercial perspective, the integration of China into the global market is benefiting future growth. "Even though growth on the global platform may be slowing, it is spurring on growth of international company operations in China while also helping to spur on growth of local companies," says Macdonald, adding: "Deregulation of markets in China is also helping to create new opportunities in different industries, there are also a number of industries which have only recently been deregulated."

Recent government policies have also led many real estate developers to switch to commercial and retail facilities which in turn has impacted on new apartment prices and a shift in supply.

The office sector is seeing significant amounts of new stock coming up in major cities like Shanghai, though still not enough to meet current demand, and office rents continue to climb.

INVESTMENT FOCUS

According to China's Ministry of Commerce, the first four months of 2008 have seen the country's FDI increasing steadily, despite a fall in the number of newly approved foreign funded enterprises →

There is also increased demand for leisure – hence development potential for the marine industry – and a national policy to encourage tourism developments

since a raft of new measures were introduced to regulate foreign investment.

Savill's Macdonald says: "A lot of attention is still focused on the first tier cities of Shanghai and Beijing, while the southern cities of Shenzhen and Guangzhou are starting to see a softening of their residential markets.

"Developers, while still looking for opportunities in first tier cities, are finding it increasingly difficult to find suitable development schemes and are being tempted to second and third tier cities by the large opportunities presented to them and the more accommodating local governments.

"Restrictions on foreign investment have meant that there has been a slowdown in investment as investors reassess their standing and their options. However many investors still view China as an enticing market."

Lu Jinyong, from the University of International Business and Economics, said: "China is also attracting more foreign investors by further easing restrictions on mergers and acquisitions as well as improving the investment environment in the service sector."

For Savill's, the hot topics right now are funding and the softening of some residential markets especially in the south of China.

"Developers, especially smaller local ones, are finding it very difficult to get funding at the moment as the government tries to cool down the property market by removing developers' access to easy cheap money. At the same time they are encouraging developers to increase the rate at which they develop their land banks. It is expected and we are stating to see some of the smaller developers being swallowed up by larger companies and more medium to large developers looking for cash injections from foreign and domestic investment banks/insurance companies," says Macdonald.

"Property players are paying close attention to the southern cities, speculating what were the causes of the softening of their markets and whether it has the potential to spread to other parts of China, and how long those markets will remain in the doldrums," he adds.

DUE DILIGENCE

For Zheng Xiaoping of BAZO Investments, investing into China has a number of obstacles, not least the cultural differences as well as government control over land banking, cross-border capital flow and local lending issues. He says that due diligence and the establishment of multi-layered project control, from local to central government, is the key to success for any foreign investor.

Savill's Macdonald agrees: "The major problem is trying to communicate differences in opinion between different parties with different cultural and linguistic backgrounds as well as work modes.

The cultural minefield aside, Xiaoping is confident that the market is still an exciting proposition. "Central government wants to cool down the market and the regional governments want to boost investment.

"Everyone is very bullish about China investment, for at least the next 15 years, and I think it will move to become more transparent."

Macdonald however, urges caution, and says: "As with anywhere in the world, when a sector or an area grows so fast for so long, there is always potential for overshooting demand and 'oversubscribing'.

"This also holds true in China as developers and investors believe that they have managed to 'break the cycle'. Nevertheless, while there may be pockets of oversubscribing in China, demand in most sectors is such that a relatively brief period of correction would be necessary to redress the situation."

ONES TO WATCH

In his conference presentation at Cityscape Asia, Xiaoping highlighted nine areas of potential investment interest for the future.

Aside from the obvious market segments, he also believes in the investment potential of marina-related real estate, quality housing for an ageing population (China has more than 120 million senior citizens) and heritage-related projects.

"The focus traditionally has been inland, not coastal. But a growing number of people want a second home on the sea shore. There is also increased demand for leisure – hence development potential for the marine industry – and a national policy to encourage tourism developments," he says.

Macdonald supports the need for retiree housing, saying: "The rapidly ageing population, and increasingly wealthy but busy offspring with little time to spare, feel indebted to their parents/grandparents and there is filial responsibility.

"They are willing to pay increasingly large sums to ensure quality of life for their older family members and especially when the government →

China stats

11.4 percent GDP growth in 2007 was the country's highest in 13 years

Inflation reached an 11-year high of 8.7 percent in February 2008

China is now the world's second largest economy in purchasing power parity terms

China's economic growth, which has averaged 9.5 percent over the past two decades, has been the single largest contributor to global growth over the past five years and in 2005 accounted for around one quarter of world economic growth

According to the Asian Development Bank (ADB) estimates, the economy is expected to slow down in 2008, with a forecasted growth rate of 10 percent

Real estate-related IPOs may garner nearly US$7 billion this year, close to the US$8.4 billion total amassed between 1999 and 2006

China has 3.48 million kilometres of roads and a rail network covering 77,000 kilometres

China has more than 2,000 ports

Shenzhen

Beijing National Stadium

as yet has only a very minimal support structure for the elderly. Nevertheless, culturally it may take some time to accept the concept of elderly care facilities."

According to Xiaoping, industrial real estate and the strengthening of the investor sector class is another opportunity, along with the growth potential in land value. "We see a huge potential in land appreciation, and this is the gain, rather than project development," he says.

Macdonald disagrees. "There is a lot of uncertainty as to the strength of China's industrial market to weather the current slowdown in international trade which could see a reduction in the volume of demand for industrial properties. R&D centres on the other hand have strong potential for future growth."

China continues to see demand for high-end hotel products, and the government has identified this as a key area of development for the country, but Macdonald takes an opposing view. "The hotel market has been expanding rapidly for the last five years and is starting to see pockets of oversupply especially at the higher end of the market.

"In the resort market there is still some potential for resort developments, especially in areas renowned for their natural beauty. Budget hotels still have some room for expansion – providing clean and cheap accommodation."

Xiaoping also touches on the redevelopment of urban centres as a niche market with huge potential. Macdonald concurs, and says: "Now that China is looking at revising its policy of growth, at any cost, to one that looks at the sustainable growth and preservation of China's rich history, there is most definitely a potential for the redevelopment of urban centres including retail clusters, alternative office space, exhibition centres, etc.

"There is also a significant metropolitan rail expansion which is facilitating the construction of urban centres at metro interchanges, and there will be good potential for developers that communicate with the government planning bureaus on these schemes."

INFRASTRUCTURE FIRST

China's infrastructure is struggling to keep up with the urban migration movement which is a key concern in almost every emerging market.

According to research analyst Business Monitor International, China's infrastructure development plan up to 2010 focuses primarily on developing major projects, which include port-related construction, road and transport infrastructure, oil utilities and development of water infrastructure.

Special emphasis is being placed on airport development and China plans to continue to invest large sums in its airport infrastructure. Between now and 2010, US$17.4 billion is earmarked for expansion with 42 new airports in the pipeline as well as extensive upgrading scheduled for existing facilities.

However, despite the rapid rate of construction, infrastructure development suffers from poor labour conditions and long overdue environmental and regulatory reforms.

Xiaoping pleads the case for FDI into this crucial sector, and says: "Every year China needs to invest US$170 billion in infrastructure. The government cannot sustain this.

"FDI into infrastructure has a social stablising effect and offers a long-term stable return for investors."

ENVIRONMENTAL WOES

China's poor environmental track record has led to recent government initiatives designed to encourage green investment, but this is in the very early stages.

The country's major environmental concerns are air pollution (greenhouse gases and sulphur dioxide particulates) from over-reliance on coal, which produces acid rain; water shortages, particularly in the north; water pollution from untreated waste; deforestation and desertification.

Deforestation has been a major contributor to China's most significant natural disaster – flooding. China's national carbon dioxide emissions are also among the highest in the world and increasing annually.

The government isn't ignoring global concerns, and through initiatives such as Dongtan Eco-City (see green feature on page 60), is taking baby steps towards effecting change in the mid to long-term.

It has also published a new catalogue to encourage overseas investors to invest more in high-tech or environment-friendly projects. Says Xiaoping: "China has a budget allocated for environmental development and we will see a lot more legislation coming out."

Savill's Macdonald adds: "While it has been slow to take off, there are now a number of projects, typically office projects, that are looking at integrating energy-efficient systems into new builds, especially in the first tier cities of Beijing and Shanghai, although there are also some in the southern cities of Guangzhou and Shenzhen.

"There is increasing interest from developers as the government shifts its policy to more sustainable development and identifies the real estate industry as one of most important sectors to target. Some developers are also using sustainability as a selling point in the increasingly competitive market. This is especially important when trying to attract MNCs who are coming under pressure from their home countries to monitor the carbon footprint of their global operations."

LET THE GAMES BEGIN

With all eyes on China this summer and the Beijing Olympic Games, the dragon economy is definitely under the international investor spotlight.

So, what is the long-term prognosis for this emerging market? Says Macdonald: "As the global economy slows and as the Chinese government changes its development mode to one that it is more sustainable, the Chinese economy will undoubtedly slow somewhat from the red hot pace it currently maintains.

"Nevertheless, while this may result in a slowdown of the property market this is probably a good thing for the health of the economy and the real estate market, which has been supercharged for such a long time that it needs to slow down in order to maintain its integrity."

He concludes: "While there may be an 'Olympics hangover', it is likely to be reactionary and short-lived, rather than a longer more drawn-out slowdown as the fundamentals underpinning the expansion of markets are linked much closer to the economy and salary growth which will remain after Olympics."

Investors and developers will obviously be 'seeing red' for some time to come, and while slower economic growth is on the cards, the long-term demand across the major asset classes could make 2008 an auspicious year for market-savvy investors. ●