Investment Opportunities in China's Real Estate Market

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Abstract

This paper is a comprehensive introduction to China's real estate market. After briefly reviewing the reforms and macro political and economic environment in China, the paper gives a general overview of the market, and then goes on to discuss the benefits, opportunities, potential problems and risks.

After joining the WTO, China will continue the transition to a free and competitive market. Investors, especially international investors, may soon discover exciting investment opportunities in China's real estate market. For example, the emerging secondary market in real estate financial products and real estate non-performing loans may provide investors lucrative business opportunities. There will be increasing opportunities for investors to benefit from China's vigorous reforms and rapid expansion of the real estate market. Investors may not choose to invest in China now, but should keep an eye on China's growing real estate market because China is where the growth will be!

Keywords

China, international real estate, China real estate market, economy of China, market economics

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Executive Summary

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After joining the WTO, China will continue the transition to a free and competitive market. Investors, especially international investors, may soon discover exciting investment opportunities in China's real estate market. For example, the emerging secondary market in real estate financial products and real estate non-performing loans may provide investors lucrative business opportunities. There will be increasing opportunities for investors to benefit from China's vigorous reforms and rapid expansion of the real estate market. Investors may not choose to invest in China now, but should keep an eye on China's growing real estate market because China is where the growth will be!

Reforms and Macro Political and Economic Environment in China

The People's Republic of China was founded in 1949 by the Chinese Communist Party (CCP), which has been in power ever since. Having adopted an open-door policy and undergone vigorous reforms since 1979, China has been transforming itself from a closed command economy to an open market economy. China's real GDP accomplished an average annual growth rate of 8.6% for 24 years and was 7.3 times greater in 2002 than in 1978. GDP growth averaged 7.5% over the past five years. China's government has set a target of 7% real annual GDP growth for the period 2001 through 2005. This is a reasonable target when compared with the past five years' average GDP growth rate. China's GDP is expected to exceed that of Germany and become the

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world's third largest (following Japan and US) by 2010. With the fast expansion of the financial sector, China's securities market will rank among the top five in the world within ten years. Moreover, China's entry into the World Trade Organization (WTO) has been stimulating foreign direct investment (FDI), which rose by 20% in 2002 and made China the largest host for FDI inflows in the world. China has one of the highest savings rates in the world, and the rapidly growing financial sector should more efficiently channel financial resources to productive investments. China has been gradually relaxing ownership and geographic restrictions on foreign investment in banking, securities, telecom, distribution and logistics, and professional services. China's government has been enforcing structural reforms – including deregulation in most of the previously monopolized sectors, privatization of state-owned enterprises, financial sector reforms, and trade liberalization – to improve the allocation of resources. Of course, there are downside risks. Domestic risks include rising income inequality, persistent urban unemployment, and resistance from currently protected industries to reforms. China's government needs to address these issues by ensuring a more practical pace of structural reforms and an increase in social expenditure. Internationally, escalating tensions tension between the US and China are not beneficial to either country. However, China's government and the US business community, for the benefit of both, will likely continue to co-operate to maintain a sound trade relationship.

Real Estate Market in China

Brief Market Introduction

1949 – 2002 After the People's Republic of China was founded in 1949, land was nationalized and allocated by the government. China's real estate sector was dormant until the 1980s, when the market-oriented system sprouted. In the early 1980s, the lack of supply and growth of FDI drove the vacancy rates to low levels; for example, Beijing's vacancy rate was 4% in 1988. Following the government's order to state-owned enterprises to stop building high-end office to cool down the overheated economy in 1988 and the decrease in FDI due to the political trouble in 1989, the vacancy rates soared in 1989 through 1991. In 1992, the central government summoned local governments to adopt a bold approach to stimulate economic growth. A new preferential policy was initiated to attract FDI. The vacancy rates of prime office space in Shanghai and Beijing dropped to less than 1% in 1993 and 1994. The real estate development and construction industry rebounded very quickly between 1992 and 1995. However, the property market also became overheated swiftly, which caused the government to take radical steps to cool down the market in 1995, including imposition of limits on the approval of new projects. However, it did not affect the projects already in the pipeline and a huge increase in new supply of offices brought about another market downturn. The vacancy rate in Shanghai and Beijing rose above 35% because of the Asian financial crisis in 1998.

In 1999, the "dotcoms" wave and the surge in FDI induced by Chin's impending entry to WTO pushed up the demand for office space. However, the slow-down of the world economy in 2001, the burstng of the technology bubble and the deferral of foreign firms' relocation and expansion plans due to the September 11 terrorist attack in New York City, rocked the real estate market again.

Land and Housing Policy Milestones

Before the 1980s, most of the properties were national assets (in other words, the government retained ownership of the property). There was no consumer housing market in the country. The government-controlled distribution system was the only channel to allocate houses to a typical family. After the economic reforms in 1978, China's government started separating the ownership and land use rights, and legal private ownership of real estate emerged. Real estate appeared as a consumer product in the market.

Significant reform has occurred in the last decade. The introduction of housing reform in the early 1990s has greatly changed the landscape of China's real estate sector and has further motivated residents to buy properties and to participate in the public market. The policy was first tried in metropolitan areas of China such as Beijing, Shanghai and Guangzhou, which are big cities with large populations, high density and above-average household income levels. Residents in those areas were allowed to buy the properties that had been "allocated" to them by the government. The reform policy propelled the development of a secondary market by permitting owners to sell the property they had acquired from the government after a 5-year' "freeze" period. Since the purchase price was usually considerably lower than the market value of a property (though the property could be extremely small for most families), people could make high profits when they sold their first property in the public market, and then use the lump sum money as the equity to invest in their second property. This imbalance helped to stimulate real estate sales in China in late 1990s.

Another milestone in the Chinese real estate market was the termination of restrictions on foreign ownership of real estate in China. Previously, there were two classes of housing: the first was for local sale, which was open to domestic residents only; the second was for "overseas" sales, and foreigners were only eligible to buy this class of properties. Developers who wanted to build a community open to overseas buyers were required to pay an extra cost for the land to convert the land to non-domestic usage. Therefore, the prices in the "overseas" sales market were generally two to three times higher than that in the local sales market. This demarcation between 'local' and 'overseas' markets was removed in 2001 when the government changed the policy and made all the properties in the market equally accessible to all developers and buyers, thus escalating the competition among developers, providing buyers with a wider variety of choices, and consequently increasing real estate prices.

Under the present system the government retains the title of ownership, but sells the marketable and renewable land use rights to developers under a long lease, which lasts for between 40 to 70 years. Unless the lease is renewed, the land use rights and the superstructure thereon revert to the government when the lease expires. In the past, land was mainly acquired through private negotiation. Consequently, those developers with strong relationships with local government entities could secure prime sites at cheap prices, which made it very difficult for government to control land supply and therefore, housing supply. However, big cities such as Guangzhou, Shenzhen, and Shanghai have adopted the practice of selling state owned land in a single open market through auction or tender. These actions help to ensure that competition is based on investor quality rather than networks or connections. In the new land grant system, it is difficult for developers without solid financial backing to gain access to land, gradually leading to a more efficient market.

Housing Reform

In 2001, most cities completed their housing reform programs to commercialize property transactions and allow individuals to purchase homes for themselves rather than relying on the government or state-owned enterprises to assign apartments. For example, China's government provided its employees with housing subsidies, increased the salaries and raised rents of staff quarters to market levels, so as to encourage individual home ownership. As a result of the reform, the sales of residential units increased swiftly, and individuals – rather than the government or state-owned enterprises – became main buyers. In 2002, approximately 98% of residential properties sold were purchased by individuals, compared with 61% in 1998. Keeping abreast of economic development, other major cities in China are also eager to modernize their urban landscape.

Liberalization of Mortgage Financing

Mortgage financing is a critical factor in stimulating residential demand growth since it provides the necessary financing for homebuyers. Urban residents purchase homes primarily with two types of financing schemes: through mortgage loans from commercial banks and through loans from the housing provident fund, which was established by the government to provide financing to homebuyers at an interest rate lower than that offered by banks. For mortgage loans provided by commercial banks, the maximum mortgage terms have been increased to 30 years from 20 years and the ceiling of loan-to-value (LTV) ratio on mortgage has been increased to 80% of the property value. The increase in mortgage terms and LTV, accompanied with the continuous decrease in mortgage interest rates in the recent years, has enhanced homebuyers' ability to buy apartments.

Developers and Investors

China's real estate sector has approximately 25,000 real estate developers. Even the largest developer does not command a market share of more than 10% in major cities. Many local developers come from non-real estate industry backgrounds such as manufacturing or heavy industry. This is a result of those companies' strong accessibility to land and to banks/ funding. Due to the low-urbanization in most cities 20 years ago, many highly labor intensive factories and plants were located at prime locations within the cities. With the development of the real estate markets in China, people realized that moving the plants out of the city and converting the land to commercial or residential use would help to create more value to the land-user, and in most cases be a good way to help state-owned enterprises get out of financial crises and generate cash in the short term. Consequently developers, often unprofessional and immature, have rushed into the market to capitalize on the opportunities.

The government, on its part, has begun to impose stricter scrutiny on the qualifications of domestic developers in recent years in hopes of increasing the quality of properties and limiting supply to maximize long-term benefits to both buyers and sellers. Stricter entry criteria have also led to higher start-up costs. Since 1992, China has permitted foreign investors as well as wholly foreign-owned real estate developers to enter the real estate sector through equity and contractual joint ventures. Foreign real estate enterprises (mainly with equity participation from areas such as Hong Kong, Taiwan, Singapore, Japan & South Asian countries) account for 17% of the total real estate companies in China. Major developers in Hong Kong such as Cheung Kong Holdings Limited, Kerry Properties Limited, and Sun Hung Kai Properties Limited have proactively expanded their real estate business into China, developing a number of high-end residential and commercial projects in major cities such as Beijing, Shanghai, Guangzhou, and Shenzhen.

As the number of foreign real estate companies entering into the China's real estate market, especially from developed countries, continues to increase, the competition for high-end office and residential markets is expected to become more intense. Hines Interests, which bought an office building and completed a high-end apartment building in 2001 and 2002 respectively, and is developing a residential project targeting the middle class in Beijing, is one of the few American real estate developers in China so far.

Social and Cultural Changes in Home Buyers

The housing reform program implemented over the past ten years has fundamentally changed Chinese urban residents' consumption behavior. Unlike a decade ago, when home buying was not part of most households' spending plan; today a home is the single most important asset that most families dream to own.

In the past, it was typical for four generations of a family to live together in a tiny apartment assigned by the government. The living conditions were usually unsatisfactory, often lacking independent sanitary facilities. However, in recent years, the average size of a household has decreased rapidly and the average per capita living space has increased significantly. Most importantly, the purchasing power of a household has increased considerably during the past ten years. Younger generations prefer a "western lifestyle" and are eager to upgrade their quality of life by living independently in housing with convenient access and sufficient recreational and sporting facilities.

By the year 2000, after decades of efforts, the Chinese government had successfully increased the average living space per capita to 100 square feet in major cities. However, this number is still far below the world average of 350 – 370 square feet per capita. Consequently, there is much room for China to catch up with the rest of the world. The average selling price of a medium-sized apartment is about 6 times the annual income of an urban household. In addition, the consumption behavior has changed significantly in recent years. Now, most of the existing homeowners are first-time buyers. With the increase in income, more and more people purchase more than one property for investment purposes, from residential assets to commercial and retail, even industrial properties. The rising income levels, the beneficial tax policy, and expanded availability of mortgage financing have contributed to the improvement of living standards and demand growth for residential properties.

Benefits and Opportunities

Benefits

Investors, especially international investors, may soon discover exciting investment opportunities in China's real estate market. By investing in the Chinese real estate market, investors may secure the following benefits: higher returns, portfolio diversification, matching assets and liabilities, and inflation hedge.

Higher Returns

The huge demand combined with low labor and construction material costs in China's real estate market may provide investors with higher returns than most countries. Following China's entry into the World Trade Organization (WTO) on December 11, 2001, there has been an increase in the number of foreign companies opening branches and representative offices in China. Foreign companies already in China are expanding and there has been an increase in the number of expatriates living in China. This has translated into an increase in demand for high-grade office and residential buildings. Rapid economic growth and completion of the housing reform program in major cities in 2001 (which allows individuals to purchase homes for themselves) have boosted the demand for residential units, as evidenced by the 239% increase in the balance of residential mortgages from US$28 billion in 2000 to US$67 billion in 2001.

The gradual change in the Chinese concept of purchasing real estate for personal use to purchasing it for investment purposes is another impetus for increased demand for real estate in China. The strong demand provides real estate developers with returns between 40% and as high as 100% according to a major developer in China. International investors have a comparative advantage in China due to their knowledge of more sophisticated real estate management and investment practices. Because the capital markets in China are underdeveloped, foreign investors with access to international capital markets can make investments in China that domestic investors, with no comparable access, are unable to execute.

Portfolio Diversification

Most international investors seek to invest in investment-grade real estate, which is in limited supply in China. With a real GDP growth of 7% per annum and the implementation of WTO-related liberalization measures, demand for new investment-grade real estate to meet the needs of China's expanding economy will be strong. China will continue to provide more investment-grade real estate suitable to international investors, allowing them to diversify their portfolios.

Matching Assets and Liabilities. Inflation Hedge

International companies had invested US$73 billion in China by 2001. Pension plans have become exposed to liabilities that are denominated in China's currency, Renminbi (RMB). Pension plans need to have assets in RMB as beneficiaries live in China. When pension funds invest in China in order to match their liabilities, they require a tool to hedge against inflation in China. Empirical results demonstrate that real estate investment is an effective hedge against inflation during extended periods of low inflation. China's inflation has been low for several years. Real estate investment in China offers two advantages – asset-liability matching and inflation hedging.

Opportunities

Secondary Market and Finance Products

A thin secondary market is a barrier to the development of a strong real estate market. On the other hand, a vibrant secondary market providing a channel for investors to buy and sell properties fairly easily is very important when they need liquidity. Reforms such as simplifying the sales and purchase registration procedure and lowering transaction costs have been instituted by China's government to facilitate the development of an active secondary real estate market. However, currently this secondary market in China is considered mainly a second-hand property exchange market. The major participants in China's real estate market are buyers (borrowers), sellers (both developers and borrowers), and state-owned banks (lenders). So far, there have been no refinancing operations such as second mortgages, no investment institutions such as syndication or Real Estate Investment Trusts (REIT) or mortgage securitization products such as commercial mortgage backed securities (CMBS). The whole market is quite simple in terms of structure, which means the real estate financial products have enormous potential to grow. China's neighbors, South Korea and Japan already have already initiated real estate mortgage securitization. Other areas outside of Mainland China, such as Hong Kong and Taiwan have recently begun discussing the introduction of REIT and CMBS as well. While some leading stock traders in Shanghai introduced the concept of issuing bonds against high yielding commercial buildings into the bond market a year ago, results are so far limited.

Non-Performing Loans in Real Estate

It is not a secret that all the state-owned commercial banks have huge non-performing loan portfolios owed by the local enterprises borrowers. With the commercial banks' trend of going public, one of their key requirements is to eliminate bad debt and get as much as money back as they can. For example, Bank of China (BOC), the leading commercial bank of the country, has as high as a 20% non-performing loan ratio on its books. All state-owned commercial banks are under the pressure to deal with non-performing loans. Among its the non-performing loans, BOC would prefer to start with real estate loans such as hotels and commercial buildings. The recent auction (in March, 2003) of the Beijing Olympic Hotel was a sign of BOC's intention and efforts to dispose of bad assets.

Investors now have opportunities to buy valuable properties at below-market prices. However, due to the complicated relationship between the state-owned banks (the lenders) and their clients – state-owned enterprises (the borrowers) – in some deals, the ownership of the problem property is not clear, or the banks may have limited claims to ownership. Therefore, it would be difficult for the bank itself to clear the deal with prospective buyers without the cooperation of the borrowers or special authorization from the government.

Special Purpose Properties

Affordable Housing

There are two types of residential asset classes worth noting – affordable housing and seniors housing. Most developers in China tend to build high-density luxury units and target white-collar buyers, who have higher income levels and work and live in metropolitan areas. However, there is actually strong demand for affordable housing.

China has huge population concentrations in both the northern and western regions where most of the households have an annual income of one-half or one-third of those living in eastern cities. In these less developed areas, affordable housing, which is called "Economic Units", is in high demand. In order to get the chance to buy an Economic Unit, people do not hesitate to wait in lines outside the sales office in freezing winter. Having noticed that products currently in the market are over-priced in some big cities, China's government has recently enforced new policies designed to limit the development of high-end properties. These new policies include forbidding new development of luxury properties, applying high taxes on the rental income of properties with a value exceeding a threshold amount, and implementing high transaction fees for expensive properties.

Even though the concept of affordable housing is not very common, the demand for affordable housing is definitely immense and there are no leading developers currently supplying affordable housing.

Seniors Housing

Another type of property with very high growth potential is seniors housing, which is still a nascent concept in China. This is largely due to culture and affordability. The traditional Chinese culture of family and household structure goes against the basic concept of senior housing. The elderly tend to live with their children instead of living independently – the family relationship is close in a typical Chinese family. However, with social and cultural changes, and most importantly the increase of the income level, young people have begun to live alone, while the elderly are encouraged to participate in the community or social activities rather than spend all of their retirement time taking care of grand-generations. Those aged between 50 and 60 have started to accept the idea of living with the same age group, and participating in group activities.

An unavoidable problem is the household structure of the Chinese families. Because of the "one child policy", which has been executed over 25 years, most families in urban areas consist of a father, mother and one child. The resulting "upside-down pyramid" structure requires the child take care of six people – parents and grandparents. Consequently, seniors housing is a way to reduce the burden on children. With the increase in urbanization and the average age of the population, we can expect a large demand for seniors housing in the future. However, seniors housing developers may face two major problems when they look into China's market: how to present the seniors housing concept in the way that can work well with the traditional Chinese household culture and second, the timing: when will the market be ready to absorb the products?

Potential Problems and Risks

Information and Services

The lack of in-depth market statistics and research has made market analysis and feasibility studies difficult. For example, geographical information systems in China are still underdeveloped. China's real estate intermediary agency services industry is still in its infancy and is characterized by small scale and poor service quality. The inadequacy of experienced building professionals results in an inferior standard of property management. In the post-WTO period, the increased competition brought by foreign companies in this area is likely to result in consolidation of services companies and improvement of service quality.

Guanxi

Networking, which is called guanxi, still plays an important role in doing business in China. Since sites for office development were generally acquired by private treaty with the local governments, people with good networks and power acquired prime sites at very low costs. The continuing promotion of rule of law, the fight against official corruption and malfeasance, changes of personnel policy and promotional criteria for officials are examples of the central government's effort to stop officials supporting unlawful vested interests and abusing their power for their personal benefit. The new personnel policy favors officials with better education and training, who are more competent and experienced and less involved in localized networks. Non-performing officials are dismissed and non-local officials are appointed. The entry into the WTO gives the central government an opportunity to press for reforms.

Finance

Two reasons for the Asian financial storm in 1998 were non-performing loans and the excessive reliance on short-term loans. Unfortunately, many projects in China depend heavily on short-term borrowings. Some cities claim to have attracted billions of FDI, but in most cases they are contract values only. The real capital sources behind many development projects actually come from local banks, directly or indirectly. The non-performing loan problem is a significant issue in China. The transfer of non-performing loans to four asset management companies and the reform of the banking system help to deal with the non-performing loans. In the past, banks did not usually evaluate a real estate project based on its financial soundness, but issued loans because of political reasons or networking. In order to compete with foreign banks, the Chinese commercial banks now employ a more complete and reliable credit analysis to assess credit risk and evaluate projects based on borrowers' repayment capacities, collateral, and overall customer relationships.

Risks

Doing businesses in China involves a combination of economic, political, exchange rate, and business risks for investors.

Economic Risk

China's economic risk, which can be quantified by factors such as GDP, inflation, and current account balances, has continuously decreased due to China's healthy economic growth – sustained GDP growth of 7% per annum, inflation of 0.7% per annum, and a current account balance surplus of US$22.5 billion. China's cultural value and consequent investment in education should continue to supply the required human resources for sustained growth. Structural reforms – including deregulation in most of the previously monopolized sectors, privatization of state-owned enterprises, financial sector reforms, trade liberalization, and settlement of the non-performing loans – will improve the efficiency of resource allocation and enhance the economic outlook.

Political Risk

The main concern of investors may be political risk. With continued implementation of the open-door policy and WTO-related liberalization measures, China has progressed to maintaining a more open and stable political environment than it had one or two decades ago. Consequently it has convinced increasing numbers of international corporations to invest in China. China's government has adopted a pragmatic approach to reform and to promote economic development and has gradually become a devoted supporter of the open market economy. The economic success since 1979 has also produced a consensus on the necessity of reform. The smooth transition of power from Jiang Zemin to Hu Jintao should maitain political stability in China.

Exchange Rate Risk

With sound monetary policy, low currency volatility, and an exchange reserve of US$212 billion to support the RMB, China has managed to limit international investors' exchange rate risk on the RMB. Some international investors in China reduce their exchange rate risk by investing in dollar-denominated real estate leases. Investors need to be aware that methods of hedging the RMB such as currency swaps are rather limited.

Business Risk

Dealing with local practices and procedures involving business risk may concern investors. Though China has been undergoing a wide variety of structural reforms to allow international companies to compete on more equal terms with state-owned enterprises and domestic companies, networking still plays an important role in doing business in China. To reduce this risk, international investors may choose to invest in the Chinese market in the form of equity participation with local partners. Such joint ventures can make use of local knowledge to mitigate the operating risks associated with investing in China's real estate market. Thus, it is advisable for an international investor to find the right local partner with the necessary network, and good understanding of cultural and market insight. In addition to the complexity of the legal system and the lack of in-depth market statistics and research, there are differences in infrastructure, tax incentives, price of property, and income levels among different provinces or cities, which means that the selection of a city in which to start business is critical. Therefore, it is advisable for an international company to hire a consulting firm with extensive experience in setting up businesses in China.

Conclusion

With vigorous reforms and rapid growth, investors may soon discover exciting investment opportunities in China's real estate market. After joining the WTO, China will continue the transition to a free and competitive market. Investors, especially international investors, may not choose to invest in China now, but should keep an eye on China's growing real estate market. They may then choose to steadily increase their investment as their understanding of China's real estate market improves. China is where the growth will be!

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