CHINA'S PROPERTY MARKET IN TRANSITION

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Understanding the impact of China's transition to a service-led economy on the commercial real estate market – the cities most likely to succeed.

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Overview

As China transitions to a service-based economy, this paper looks at the potential implications for commercial real estate and identifies which areas of the market are likely to prosper as a result.

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Key points

- The pace of China's economic slowdown remains in line with official forecasts but downward momentum appears to have increased.
- Recent volatility suggests investors are becoming more concerned over a potential 'hard landing'.
- We think fears of a hard landing in China are exaggerated but acknowledge that downside risks have heightened.
- Our view is that the direct impact on domestic commercial property will be limited if the state manages a controlled slowdown.
- Real estate markets in top-tier cities are best positioned to benefit from China's transition towards a service economy.
- However, rather than picking markets, we emphasize that asset selection will be key to unlocking good performance.

China's slowdown

Chinese growth has trended lower since 2011. The economy grew by 6.9 per cent last year compared with 10.6 per cent in 2010[1] (see figure one, p3). Following a sharp slowdown between 2010 and 2012, the decline has been relatively gradual since. Yet doubts over the reliability of the official data raise questions as to whether the economy is contracting more quickly.

Lower industrial growth and moderated fixed-asset investment has been somewhat balanced by higher consumption (particularly in services) and infrastructure spending. Service-led companies have continued to expand and add jobs with the sector now accounting for about half of the economy.

A faster than expected fall in industrial production has led to increasingly negative sentiment. The spikes in volatility seen since the summer of 2015 suggest investors are taking the risk of a severe slowdown – or hard landing – more seriously.

However, real estate prospects are more closely aligned with developments in the real economy than the stock market. Some cities are better positioned than others to adapt to a consumption-led growth model, and this is where investors should focus their long-term real estate exposure.

[1] Source: Thomson Reuters Datastream, February 2016

Financial markets in flux

Equities

The Chinese market crash of 2015 – share prices tumbled by 40 per cent from mid-June to October before recovering somewhat – made plenty of headlines. When assessing the crash, it is important to bear in mind that prior to the summer downturn a credit-fuelled explosion in margin lending – or using borrowed money to purchase securities – helped propel valuations higher. Indeed, Chinese shares still added 9.6 per cent in 2015.

The impact of equity volatility on the real economy is limited. Given the modest share of households' wealth invested in shares, the stock market is unlikely to be a source of sustained instability. Furthermore, companies are less dependent on public equity finance than is typical in developed economies while market indices remain dominated by state-owned enterprises (SOEs).

Currency

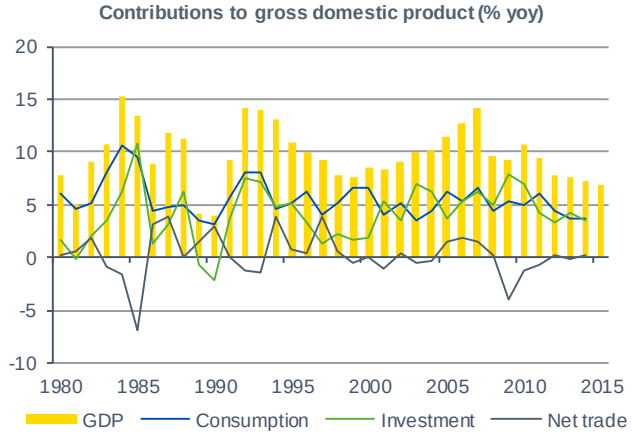
The renminbi has seen significant depreciation in recent times and capital outflows continue to place downward pressure on the currency. An unexpected exchange-rate regime change last August led to speculation regarding the direction of policy. We believe the move towards setting a more market-determined exchange rate is a positive reform and should pave the way for the valuation of the currency to normalise over the medium term.

Nonetheless, risk of aggressive currency depreciation is a concern for investors. Despite the renminbi appearing expensive by most measures, we expect that further adjustment will be gradual and tightly managed by the central bank. We anticipate at least a three to five per cent depreciation of the renminbi (in trade-weighted terms) in 2016. As such, it is crucial that investors adopt appropriate hedging strategies in order to offset currency risk.

Authorities are also incentivised to maintain currency stability for political reasons. Inclusion of the renminbi in the International Monetary Fund's Special Drawing Right (SDR) basket was a major symbolic victory for the ruling party.

Although officially admitted into the basket last November, the decision is set to become effective on 1 October 2016. Currency stability is likely to be a key goal for the Chinese government if it is to maintain confidence in the economy and promote growth in financial services.

Figure 1: Slowing Chinese output



Source: Thomson Reuters Datastream, February 2016

Economic transition

While prospects for Chinese output seem to be worsening, a hard landing scenario is not our base case. Our view is that the authorities will intervene where necessary in order to deliver steady growth. However, further market volatility is expected.

In the short term, we expect growth to stabilise. Continued expansion of the service sector should help consumer demand blunt the impact of manufacturing contraction, while China still has many policy levers it can employ. The authorities' response to the slowdown is likely to come in the form of both fiscal and monetary measures. Looking further ahead, real supply-side reform is required if the country is to unlock its long-term growth potential. This includes privatisation of SOEs and reskilling labour to meet the needs of a service-driven economy.

It seems fiscal reforms (principally relating to local-government finances) have been side-lined in order to focus on the current slowdown. A refocusing of attention on fiscal reforms will be essential to mitigate any sustainability concerns that may emerge further down the road

The biggest risk to our view comes from policy error. Recent heavy handed intervention by the state has cast doubts on the competency of the authorities. While miscommunication can spark episodes of market volatility, more meaningful policy error risks jeopardising developments in the real economy.

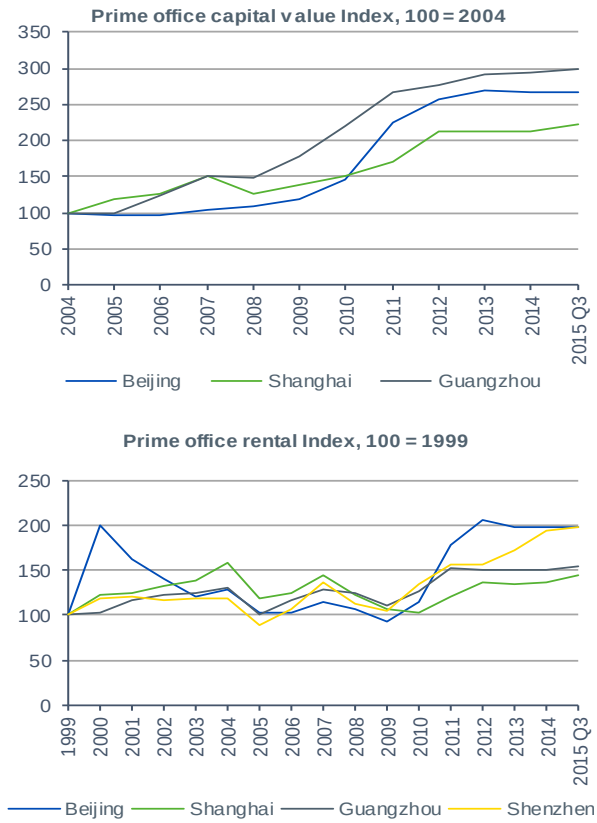
Uncompensated risk makes Chinese property look unattractive

We believe the case for commercial real estate investment in China is currently weak. For a risk-averse investor China looks unappealing based on the following factors:

- Pricing looks expensive: capital growth has levelled off in recent years but values are well above the nadir of the last cycle. Rents are also expensive by historical norms (see figure two).
- Volatility risk is high: the average lease length for commercial property ranges from two years to three depending on sector. So, investment and occupier cycles tend to be short.
- Transparency remains low: China's real estate transparency has seen steady improvement since 2004 (see figure three). But it remains a long distance from other major markets in Asia. China's legal and regulatory system ranks near the bottom among markets in the region, as does its transaction process.
- Currency risk is a concern: an overvalued renminbi poses risk to any non-renminbi investor entering China as devaluation would erode returns.

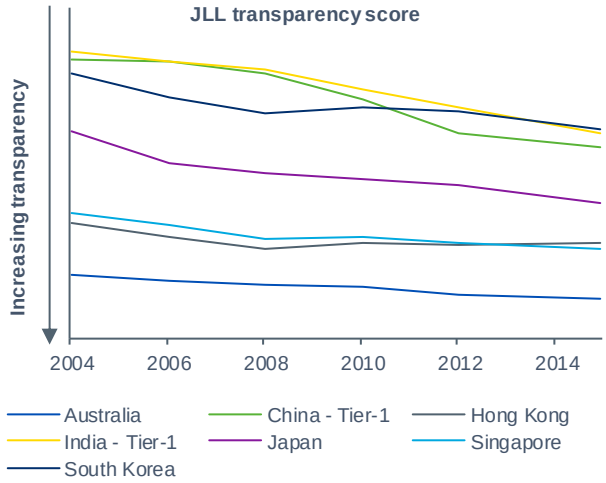
As a result, the hurdle rate for Chinese real estate investment is relatively high. But not all cities are the same. Individual market prospects are likely to evolve in line with the economy's transition. In the next section we evaluate which markets will be more resilient to slower growth.

Figure 2: Office valuations look expensive



Source: Property Market Analysis, Q3 2015, October 2015

Figure 3: Real estate transparency remains weak



Source: JLL, Global Real Estate Transparency Index, February 2016

The winning and losing cities from China's transition

Moving up the value chain from a production to consumer-driven economy will have profound consequences for China's real estate markets.

In order to differentiate between the winners and losers of economic rebalancing the diversity of China's cities must be taken into account. In the past, foreign investors have commonly turned to a 'tiered' classification system when analysing China's property markets. Emphasis is often placed on a centre's political, military or logistical importance rather than being focused purely on economic prospects.

Grouping cities based on shared socio-economic characteristics provides a better framework for understanding which property markets are best placed to benefit from China's transition. Recent work by independent US think-tank The Demand Institute (TDI)[2] offers an alternative categorisation method, based on a city's capacity to grow and adapt in a consumption-led economy.

Winners – 'Super cities'

Cities with diversified industries and an established service sector are likely to propel China's economy into the next phase of economic development. These markets, branded "super cities" by US think-tank The Demand Institute (TDI), have the means to drive and sustain a consumer economy which will ensure strong demand for commercial real estate.

Beijing, Chongqing, Guangzhou, Shanghai, Shenzhen, and **Tianjin** fall into this category. They are more advanced and

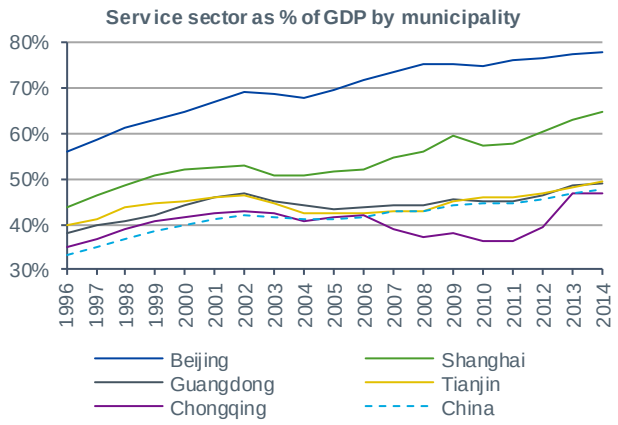
[2] Source: The Demand Institute, No More Tiers: Navigating the Future of Consumer Demand across China's Cities, November 2015

have less room for growth than smaller cities; yet a blend of the following characteristics means that these commercial property markets are likely to be more resilient to a slowdown.

Relatively strong and/or growing service sector

The six super cities highlighted possess the advantage of already having an established and growing tertiary sector. That **Shanghai** and **Beijing** have the most developed service sectors and the most mature commercial property markets is no coincidence. In the medium term, demand for retail and office space should track growth of the service industry.

Figure 4: Rising importance of service industry



Source: Thomson Reuters Datastream, February 2016

Relatively high income per capita

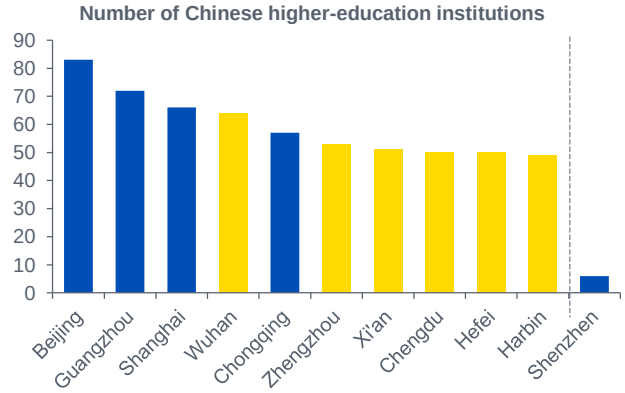
According to TDI, income per capita across the super cities averaged $6,528 in 2014 and is expected to grow 24 per cent to $8,124 by 2025[2]. This strong rise in income combined with an expected decline in saving rates should result in much higher consumption power. As discretionary spending rises and consumer trends become more westernised, mass market retail is likely to be a beneficiary.

Deep labour pools

With an average population size of 19 million, these cities offer a deep pool of both skilled and unskilled labour.

Along with financial services, knowledge-based industries have become a key driver of real estate demand in these cities. Super cities have a high concentration of elite universities, and companies benefit from a relatively well educated workforce. Unsurprisingly, the information technology (IT) sector is emerging as an engine of growth in several of these cities. Beijing in particular has seen strong demand for office space from IT businesses. Despite having a low number of higher-education institutions, **Shenzhen** has a large pool of skilled tech workers and is already home to IT giants such as Huawei Technologies Company.

Figure 5: Tertiary education establishments by city

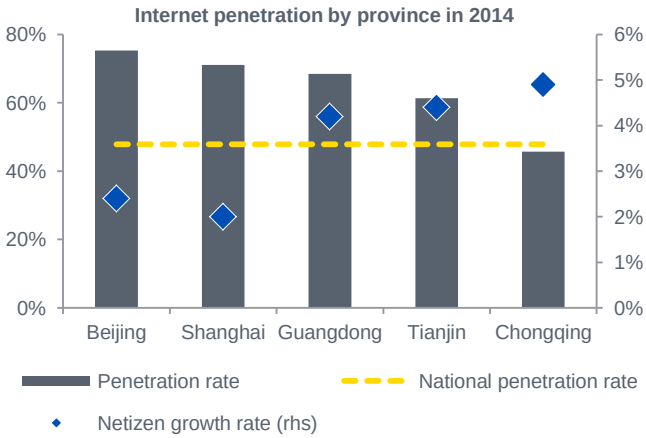


Source: Ministry of Education, China, July 2014

High internet penetration

Reliable internet infrastructure as well as a high level of connected users lends super cities a major advantage in the age of 'big data', the 'internet of things' and e-commerce. **Chongqing** is the only province with an internet penetration rate below the national average, but notably the area saw the fastest growth in users in 2014. Consumer studies suggest a slower economy is unlikely to significantly affect growth in online shopping[2]. Burgeoning demand for e-commerce poses a challenge to traditional retail assets, but simultaneously presents opportunities for logistics facilities located close to end users.

Figure 6: Internet usage on the rise



Source: China Internet Network Information Center, January 2015

International appeal

Most super cities, particularly **Beijing** and **Shanghai**, already have an international feel. Overseas companies and retailers are a significant proportion of the tenant base. Both cities rank strongly by presence of international retailers[3]. Greater covenant strength from multinational businesses provides a higher degree of income security relative to many domestic-oriented markets. **Shenzhen** and **Guangzhou** have a more domestic bias, partly due to their proximity to Hong Kong.

Losers – Integrated industrial, inland core, and resource-exhausted cities

If real estate markets with the best medium-term prospects are found in cities geared towards services, the least favourable markets are those with a high dependence on manufacturing.

The outlook for cities with mining and heavy industrial bases has turned bleak in recent years due to severe overcapacity and softening domestic demand. These cities predominantly lie inland and in the north-eastern 'rustbelt' provinces. It is telling that of the top 20 ranked growth cities in 2010, only six remain five years later as prospects for heavy industry have worsened[4]. Industrial centres such as **Shenyang** and **Changchun** are likely to be among the biggest losers of structural change, as government support shifts away from manufacturing towards the service sector.

Consumption growth in lower-tier cities is still likely to outpace that of the top tier, however. Research by management consultants McKinsey suggests inland China's share of the urban middle class could reach 39 per cent in 2022, compared with 13 per cent in 2002. While these trends are supportive of real estate demand, we believe investment prospects remain unappealing in the short-to-medium term. The lack of transparency and maturity compared to China's super cities generally makes them unappealing for foreign investors. Supply is also elevated in many markets due to previous overdevelopment.

Somewhere in the middle – Affluent and satellite cities

So-called "affluent cities" (as defined by TDI) have relatively high levels of wealth and are growing at a fast pace. Many are export-oriented with strong links to global trade so any slowdown in global trade leaves these cities vulnerable.

Markets that show more promise are those such as **Hangzhou** and **Nanjing** that are investing more in hi-tech industries and education. Overall, however, issues such as overdevelopment and a lack of maturity make the case for real estate investment less compelling. Similarly, migrant-fuelled 'satellite' cities possess strong growth potential, but lack transparency.

Asset selection is key to success

Having outlined which markets are likely to fare better in the process of economic transformation, we emphasize that asset selection is paramount to unlocking outperformance in China. For instance, even in cities that have been highlighted as having strong demand dynamics, a significant expansion of stock in recent years has led to excess supply; **Tianjin** and **Chongqing** being good examples of this. So, asset selection should be prioritised when assessing opportunities.

Retail

Although e-commerce has been marked as a threat to parts of the retail sector, an oversupply of poorly managed shopping centres is compounding the problem. Well located malls which offer experiential environments are likely to outperform, demanding higher rents and capital values than weaker alternatives. This presents opportunities for experienced managers who understand the preferences of local consumers. There has also been a recent spate of conversions to office space as developers seek to capitalise on rising demand.

Logistics

Internet retailing will also impact the build specification and location choices for logistics assets. The need for instant gratification means that such assets need to be near purchasers. Consumers in tier-one cities place higher importance on delivery times than in other markets[5]. A general dearth of modern units presents opportunities but the level of scale required for efficiency makes it difficult to compete against the large players.

Offices

Office vacancy rates in China's top-tier cities are very low by historical standards. This is expected to change dramatically in the near term as the supply pipeline is high for the next few years. Investors should be aware of emerging trends such as co-working, which can protect against rising void risk through offering users greater flexibility. This niche sector has gained significant traction recently in 'gateway cities'. WeWork, the

[3] Source: CBRE Research, How Global is the Business of Retail?, May 2015

[4] Source: The Economist Intelligence Unit , Rising stars, fading comets: China emerging city rankings, 2015, January 2015

[5] Source: Mizuho Securities Asia, China Internet: Chinese online shoppers – what we know and what we didn't know, January 2016. The survey suggests product selection is the most important factor for tier-1 cities, followed by price then delivery time. Around an eighth of tier-1 respondents claim delivery time is the most important factor compared to nine per cent in rest of cities.

company that has pioneered co-working in the US, has now set its eyes on China. Home-grown developers such as SOHO China are also looking to capitalise.

Distressed assets

Despite signs of a housing recovery, indebted developers with insufficient cash flow may need to dispose of assets. Around two-thirds of listed Chinese developers are operating at a level where equity is exceeded by current liabilities[5]. The emergence of distressed assets may create buying opportunities, ones that are most likely to come from smaller developers as larger listed companies remain liquid and are able to tap into capital markets. Providing rescue capital for projects could be an option, but entity-level deals come with a high level of risk due to the relatively weak legal environment.

[5] Source: Bloomberg, 18 February 2016, based on 124 out of 183 Chinese-domiciled real estate holding and development companies