REAL ESTATE INVESTMENT OPPORTUNITIES IN CHINA: HOW RISKY?

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China's rapid economic growth offers a historic opportunity for global real estate investors. The Chinese economy has been growing more than 12% annually for the last two years and an average of 9% over the last fifteen years. Rich in natural resources and entrepreneurial spirit, China has a literate work force and a $1.40-per-day minimum wage. With a consumer market of 1.2 billion people and rapidly rising per-capital incomes, China offers potential investment returns exceeding those in all First World economies and many emerging markets as well.

Since leader Deng Xiaoping's tour of southern China early in 1992 to promote faster economic growth and reform, China's real estate market has enjoyed a dramatic takeoff. The number of real estate companies increased from several hundred at the end of 1991 to over 10,000 at the end of May 1993. About one-sixth of them have foreign investment. With rapid increase in demand for space driven by the double-digit economic growth, and limited supply of buildings due to past regulations and lack of financing, China's real estate market will be generally tight for the rest of the decade.

Because of the size of both the U.S. and Chinese economies, the two countries have grown almost independently. China's real estate markets are mostly affected by China's own state and local factors. Consequently, there is tremendous diversification benefit from investment across the two countries.

One of the major difficulties in investing in China is lack of information. China is a large and diverse country. Various cities and provinces have different dialects, to say nothing of different investment procedures and regulations. To help global investors develop a clear understanding of the Chinese market, we begin by comparing major dimensions of U.S. and Chinese real estate investment. (See the Exhibit.)

One of the most unique problems of Chinese real estate development is the difficulty of securing effective forward commitments for construction loans from local state banks. The total 'supply of dispersible funds in local banks is controlled by the central bank and determined by state monetary policy. Thus, bank loan officers have little control over the amount of funds they can disperse during the next quarter or the next year.' The central bank can,
Exhibit

A Comparison of U.S. and Chinese Real Estate Markets

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<td>Capital Market</td>
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<td>Development Emphasis</td>
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<td>Regional Development</td>
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<td>Bankruptcy and Foreclosure</td>
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<td>Good Data on Cost of Land and Improvements</td>
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and does, change the loan quota to restrict the funds that banks are allowed to disperse. As a result, if developers relied solely on state bank financing, they could very well find themselves with partially built projects and no funds to complete construction. So Chinese developers often have to arrange alternative sources of financing. This is why the timing of overseas investment is crucial, because by providing financing when their local partners need it the most, global investors can strike the best deals.

Another interesting feature about the Chinese real estate market is that “trophy” properties (located in a prime area in a major city, built to western architectural design and engineering standards, and having international tenants) command much higher premiums over similar but less well-known properties. There appears to be an element of emotional attachment to trophy properties, since they are rarely put up for sale.

It is also worth noting that because of China’s accounting rules and lack of financial training, most internal rate of return estimates provided by Chinese developers are understated due to the fact that leverage is not properly reflected in the figures.

Real Estate Ownership Policies

Sometime in 1994, the Ministry of Construction will send to the People’s Congress a comprehensive real estate law. It will cover land lease, land transfer, land registration, property sales, mortgages, taxation, and almost everything else that has something to do with real estate. The law is well-written and is a modified version of the real estate laws of Hong Kong and Taiwan.

According to China’s constitution, the government owns city land and farmers’ collectives own rural land. Global investors can obtain land rights for development in three ways: negotiate an agreement with the government; submit a sealed bid in an publicly announced request for development; and participate in an open bid public land auction.

The maximum duration of land rights is determined by the structure built on the land. Residential use is seventy years; industrial use is fifty years; commercial, tourist, and recreational use are forty years; and other uses are fifty years.

Land-use rights can be traded on secondary markets and there is a capital gains tax for the transactions. Overseas real estate companies usually pay about 25% of their total investment in various government taxes. Tax items are determined by the central government, while tax rates are usually set by the local government. To attract overseas investment, the central and local governments have set up hundreds of development zones in China, offering various preferential tax incentives to foreign companies.
An Analysis of Various Sectors of the Real Estate Market

The Office Sector

The demand for office space is very strong in major cities. Most Class A office buildings have close to 100% occupancy rate with long tenant waiting lists. The strong demand for office space is driven by the rapid growth of China's financial sector and by the foreign business boom. Because of the government's tight monetary policy of 1989-1990 and its restriction on the construction of office buildings, however, the supply of high-quality office space is very limited. (It is quite striking to see that China's second most powerful real estate agency, the State Land Administration, has to rent most of its office space from a former high school with outdated communication and restroom facilities.) The huge gap between supply and demand has led to a rapid rise in rents and to many companies renting hotel rooms for office use.

According to industry statistics, Shanghai's prime office space now sells for $1,800 to $3,000 per square meter, with rents varying from $12 to $60 per square meters a month. The average initial yields are about 9%. Development costs, depending on the location, range from $1,000-$2,200 per square meter, including land costs. The largest component of cost in most developments is the cost of land rights, typically accounting for 30% to 50% of the total development cost. Moreover, the price of land rights on the secondary market has been rising rapidly. As a result, office real estate has been a good investment for most developers because of high capital appreciation. A survey of a large sample of properties shows that in 1991, for example, price appreciation was 32% (measured in dollars) for office buildings designated for foreign companies in the city of Shenzhen.

Office and residential mixed-use buildings are very popular in China. Because of traffic jams and lack of communication, many company executives prefer to live close to their offices. They also like to entertain their guests in nearby restaurants. That is why many office buildings in China are built near shopping centers where there are a number of good restaurants. Many office buildings even have their own five-star restaurants.

The Retail Sector

The dream of many foreign retailers is to sell directly to China's 1.2 billion people. This dream has been made possible by a recent Chinese government decision to widen China's doors to foreign retailers. According to the new policy, joint ventures can own and operate stores in six large cities and several special economic zones. To encourage foreign investment, other cities have announced similar policies.

Until recently, the work schedule for most people — factory workers, salespersons, doctors, and other white-collar professionals — has been eight-hour days and six-day weeks in all cities. Most factory workers take Sunday off, but the retail sector takes rolling rest days. Because of a recent reduction of workdays from six to five-and-a-half days in many southern cities, people have more leisure time to go shopping. As domestic and foreign retailers expand, more shopping centers will need to be built and existing ones will need to be renovated. This is a huge market, and the Chinese could certainly use some of America's excess development capacities and talents.

The Hotel Sector

In the Pearl River Delta and in Shanghai, hotel supply has been growing faster than demand for the past few years. This is especially true at the high end of the market: Occupancy rates for most four- and five-star hotels are below 60%. Most hotels are doing fairly well, however, because of their booming restaurant and entertainment business. Room rates have more than doubled this year. A standard room in Shanghai's Jingan Hilton Hotel costs as much as $110 a night. Thus, despite their low occupancy rate, most hotels are still profitable. Moreover, the low occupancy could change quickly if China's rapid economic growth brings in more foreign business travelers.

Despite the excess capacity among upscale hotels, there appears to be plenty of room for "Econo-Lodge" style facilities, whose occupancy rates are much higher. These type of rooms are used mostly by Chinese tourists and business travelers. Domestic travel has been growing at over 10% annually for the last five years.

The Single-Family and Townhouse Sector

Single-family houses and townhouses are still beyond the reach of most Chinese families because of their low incomes. Consequently, the demand in
this sector comes almost exclusively from overseas Chinese and representatives of foreign firms. The market has been somewhat overbuilt in recent years. As a result, the price of some units has declined in recent months, especially in the presale market. It is estimated that 15,000 units of single-family houses or townhouses have been built in Shanghai in the last two years, with an average price of $1,400 per square meter and rising to as high as $2,500 per square meter. A typical three-bedroom, two-bath townhouse unit would cost as much as $210,000, which is more than a similar unit in most major U.S. markets.

With the recent slowdown in sales to foreigners, the house and townhouse sector needs to target the domestic market. In most major cities an average Chinese family of four typically lives in a small shabby apartment of less than 400 square feet. As their incomes rise, these families would definitely like to have more living space. It is reported by the Chinese press that there are five million Chinese millionaires (in local currency), These are people who are each worth nearly $170,000. Most of them live in the Pearl River Delta or in major coastal cities. If U.S. investors could develop townhouses that cost between 4,000 and 5,000 yuan per square meter ($65 to $81 per square foot), that is within reach of the Chinese upper income class. Preliminary calculations suggest the profit margin could be as high as 50%.

The Apartment Sector

An average Shanghai family of four lives in a 240-square-foot apartment.* Populations in China are so large that if the living space is increased by ten square feet per person in the city of Shanghai alone that accounts for 120 million square feet of development. If new regulations permit foreign developers to enter the domestic apartment market, medium-priced high-rise apartments should be in very strong demand in the next ten years. A careful analysis shows that the payback period for apartment development can be as short as two years.

The demand for apartments is so strong that the price index for Shenzhen’s apartments rose 40% in 1990 and another 47% in 1991, measured in dollars. Similarly, apartment prices in Shanghai jumped from about 1,000 yuan per square meter at the end of 1991 to 2,000 yuan at the end of 1992. Now, the price is approaching 3,500 yuan. These dramatic increases are due not only to rising relocation costs and inflation of construction materials, but also to a large and growing gap between supply and demand. The housing shortage has been exacerbated recently in Shanghai because infrastructure construction caused many old houses to be demolished and a tremendous amount of residential relocation. The traditional large Chinese family of five to six people is also moving toward smaller families, further adding to the growth in demand for housing. According to government statistics, family size in the Pearl River Delta has dropped from 4.83 in 1982 to 3.61 in 1990.

The Industrial Property Sector

This sector has very strong growth potential because both the Pearl River Delta and Shanghai are enjoying industrial growth rates of over 20%. Foreign corporations are flocking to these two areas to set up manufacturing firms, and demand for industrial space is very strong. Because many foreign manufacturers prefer new buildings, recently built properties that satisfy international standards are in especially strong demand. Since most Chinese real estate developers have limited experience in designing and building this type of property, they would be very willing to work with outside interests. In 1991, Shenzhen’s industrial property index for foreign firms appreciated 19%, as measured in dollars.

Investment Strategies for Global Real Estate Investors

The scale of today’s real estate investment opportunity in China is huge, but so are the risks. Consequently, we do not recommend direct property investment by institutional investors. Rather, we prefer a more management-intensive approach. Considering the need for an exit strategy, we think global institutional investors should enter China’s real estate market in the following ways:

1. Buy shares in a publicly traded Hong Kong real estate company,

Many Hong Kong developers, such as Cheung Kong, Hopewell Holdings Ltd., and New World Ltd., have poured capital into southern China real estate. These shares are traded on the Hong Kong
stock exchange and are fairly liquid. Many other Hong Kong-listed companies have real estate subsidiaries that are not separately listed.

2. Buy B shares in China's real estate companies. So-called “B” shares are securities of Chinese companies that are designed to be tradable in Chinese stock exchanges by overseas investors. While B shares, such as Shenzhen Properties, allow global investors a direct play in the Chinese real estate market, these shares are more appropriate as long-term investments because transaction costs tend to be higher and liquidity lower than in most Western stock markets. Also, B share prices will be affected by Chinese currency fluctuations, as their dividends are dependent on Chinese companies' profits earned in yuan.

3. Provide financing for established overseas developers in their joint ventures with local partners.

This can be done in two ways. First, through equity positions in large investor/developer companies. Global investors could bring more to the party than capital. Americans are perceived to build the most modern and functional buildings in China. Global investors could also contribute by bringing their ability to source tenants globally. A building is perceived to be prestigious in China if it has overseas tenants.

Second, through subordinated corporate debt in large investor/developer companies. The current yields on real estate in Guangzhou and Shanghai are much higher than those available in the United States. Because of the tight credit policy, interest rates on real estate loans tend to be nearly double the world market rates even after adjustment for currency devaluation.

When investing in a large emerging market like China, one can never underestimate the importance of local partners. They play important roles in dealing with government bureaucracy, obtaining local financing, and handling changing market conditions.

Conclusion

Although we believe China will continue its economic development in the 1990s, global investors need to be aware of some of the major political and economic risks that may affect their returns in the short run: 1) the transfer of power from Deng Xiaoping to the next generation may cause political instability; 2) the growing economic disparity between Chinese farmers and city dwellers may cause peasant unrest; and 3) China's currency devaluation due to high inflation could eat into global investors' profits. We believe, however, that the political risk is much smaller than some people think and we feel that the potential returns justify the risk taken.

As the world's fastest growing economy, China offers real estate investment opportunities that should help investors beat conventional return-risk benchmarks. To prepare for the buying opportunities in the next few years, institutional investors should begin now to learn about the Chinese market and to establish relationships with those domestic developers and investors who have the right contacts and investment experience. While collecting data and building relationships to find optimal investment vehicles won't be easy, the opportunity to participate in the world's biggest economic boom since the Industrial Revolution should justify the cost.

Endnotes

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According to Chinese government statistics, the average living space is 6.7 square meters per person in Shanghai, 8.3 square meters in Guangzhou, and 11.5 square meters in Shenzhen. Because of their relatively low per capita incomes, compared with the prices of single-family houses, most people live in government-subsidized apartments.