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BRIC Spotlight Report

China Real Estate: A Boom or a Bubble?

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While 2009 saw a global meltdown in property markets worldwide, the real estate sector in the Asian dragon painted an entirely different picture. Flush with liquidity from the government's massive \$586 billion stimulus and enthused by favorable policy measures, real estate had almost literally become 'hot property' in China. Property prices raced upwards at a furious pace even as real estate developers and home buyers jumped on the booming sector's bandwagon.

Fast Facts

- Real estate investment in China has more than doubled to \$156.2 billion in 2009, compared to the U.S., which slumped 64% to \$38.3 billion.
- In the past six years, increases in housing prices had exceeded the rise in incomes by 30% in Shanghai and 80% in Beijing (Goldman Sachs).
- Since 1998, real estate investment has contributed to over 10% of Chinese GDP, compared to 3-5% in the U.S.
- More than 70% of real estate investment in China has originated from bank loans.
- In Shanghai alone, banks lent out US\$14.58 billion in new mortgages in 2009, recording a phenomenal increase of 1600% over 2008.
- The residential sector constitutes the biggest chunk in China's real estate market.

Rising investment boosts real estate prices



Source: National Bureau of Statistics

The latter half of 2008 and early 2009 saw a temporary dampening in property prices with the onset of the economic slowdown. But as the economic stimulus seeped into the economy, Chinese banks, under government direction, loosened their purse strings, creating ample liquidity, with a significant portion finding its way into the real estate sector. Prices have climbed

unabated since April 2009, crossing the double digit growth rate mark in February this year. Residential and commercial real estate prices soared 10.7% in February, the fastest pace observed in almost two years. This comes as no surprise, as this sector has been attracting investment at a frenetic pace since last year.

While investment in the real estate sector has more than doubled to a high of \$156.2 billion in 2009, the first two months of this year too saw investment worth 314.4 billion yuan (\$46 billion) pouring in, clocking a handsome 31% growth rate over the previous year.

In fact, Shanghai has been rated as the top investable Asia Pacific city for 2010 in terms of real estate investment prospects according to a study by PriceWaterhouseCoopers and the Urban Land Institute. Capital city Beijing snatched the third position in the Asia-Pacific region, while Guangzhou, Southern China's key trading port as well as transportation hub, ranked 12th according to attractiveness for real estate investment.

Urbanization and economic reforms drive the real estate sector

The development of the Chinese real estate sector has its roots in the process of fast-paced urbanization, set into motion since 1978. With the ushering in of widespread economic reforms in 1985, aimed at creating market institutions, the movement towards urban centers further intensified. This marked a watershed transition from a command economy to a market-oriented economy, where prices would act as the primary signals for economic decision-making. The Chinese economy also opened up to the external world, thereby developing linkages of trade and investment with the global economy.

With economic reforms largely impacting the urban areas, real estate prices zoomed a steep 71% from 1985-87. To cool down the overheated real estate market, the government resorted to

monetary tightening and also relied on its “welfare housing” program, or *fu li fen fang* for state employees. However, as the transition to a market economy gathered momentum, the government started cutting back expenditures to this program. The year 1998 marked a pivotal year when the Chinese perception of personal property changed. Private dwellings became a commodity, giving the purchaser or the developer of property the right to own a newly built house or a newly developed property for a period of 70 years. This ushered in a wave of privatization in the real estate sector, making investment in property a sound financial decision.

Privatization bolsters real estate investment and prices soar

With home ownership becoming a viable as well as a lucrative financial investment, property prices in China began witnessing a phenomenal acceleration. The residential real estate market was booming in the suburban areas, particularly surrounding the first and second-tier Chinese cities. While the first-tier cities experiencing sky-rocketing growth included Shanghai, Beijing, Guangzhou and Shenzhen, provincial capitals as well as coastal ports that constituted the second-tier cities were not far behind. In 2007, China witnessed the highest ascent in residential property prices in the world. In the past six years, the fiery upward pace of housing prices had far exceeded the rise in incomes, by 30% in Shanghai and 80% in Beijing according to a study by Goldman Sachs.

City Investment Prospect Ranking in the Asia-Pacific			
City	2010	2009	2008
Shanghai	1	5	1
Hong Kong	2	3	5
Beijing	3	12	6
Seoul	4	6	7
Singapore	5	2	2
Sydney	6	14	15
Tokyo	7	1	3
Mumbai	8	7	10
Melbourne	9	11	17
New Delhi	10	9	13
Taipei	11	8	16
Guangzhou	12	16	9
Ho Chi Minh City	13	13	8
Bangalore	14	4	12
Kuala Lumpur	15	10	11

Source: Emerging Trends in Real Estate Asia-Pacific 2010, PriceWaterhouseCoopers & Urban Land Institute

The global financial crisis triggers another round of price escalation

Property bubble concerns in 2007 led the government to introduce stricter housing policies, including new property taxes and tighter lending. These measures, along with the global economic slump, first led to a slowdown in house prices in the first half of 2008 followed by falling residential real estate prices in the second half of 2008. To combat the economic crisis, which hit China's export-oriented economy hard, and to stoke up domestic demand, the government reversed its tighter housing policies. The massive \$586 billion stimulus package also had specific allocations for housing and infrastructure.

The favorable policy framework for encouraging the real estate sector included measures such as:

- Reduction in property taxes for first time buyers, while stamp duty and land value-added tax was waived for purchasers of residential property between January-December 2009.
- A provision stating that if residential property was held for more than two years, the seller was exempted from the 5.5% business tax.
- Home loan rates, which were benchmarked to the key lending rate, also came down with monetary easing.
- Banks were given a directive by the government to boost lending and thereby stimulate investment and demand.

These encouraging measures, along with the ample liquidity dose, whetted the appetite of home buyers as well as property developers alike. With property demand revitalized, Chinese property prices witnessed another upward spiral in 2009.

Curbing speculation

The newest round of rising property prices in the aftermath of the global financial crisis prompted the government to yet again outline policies to rein in the escalating prices and prevent a speculative housing bubble.

- The government re-imposed a sales tax on homes sold within five years of their purchase from January this year. In January 2009, this period was cut back to two years to stimulate demand.
- To curtail indiscriminate lending, especially to speculators, bank reserve requirements have already been increased twice this year, while the total amount of loans is to be scaled down by 22% to 7.5 trillion yuan (\$1.09 trillion) in 2010.

- China's central bank, The People's Bank of China, has introduced new measures wherein banks are only allowed to extend loans to property developers with ongoing commercial or residential properties as collateral, instead of a mere "stretch of land".
- The central bank is also encouraging banks to carry out field inspections before sanctioning loans.
- The Ministry of Land and Resources has introduced a stipulation, which requires a down payment from developers for land purchases equal to 50% of a plot's price. This down payment must be made within a month of signing a contract for the land purchase.
- When participating in land auctions, buyers are also required to pay a deposit amounting to 20% of the minimum price of the land.
- In a bid to make housing more affordable to the common populace, the ministry also directed developers to utilize at least 70% of the new land supply for affordable housing and smaller apartments, putting a restraint on villa construction.
- Developers also have to submit the dates pertaining to the start and completion of housing projects to the ministry, providing explanations for any delays. Any failure to comply with this will result in the exclusion from land auctions for at least a year.

Pockets of prosperity

Real estate has been thriving in Chinese urban cities and towns, largely concentrated in the Eastern coastal areas, and some pockets in Northern as well as Central Western China. The typical real estate hubs in the country, which have seen prices surging at a rapid pace include:

Yangtze River Delta: Shanghai, Suzhou, Nanjing, Ningbo, Nanchang, Hangzhou, Zhengjiang, Wuxi, Hefei

Pearl River Delta: Shenzhen, Guangzhou, Zhongshan, Foshan, Zhuhai, Changsha, Xiamen, Foshan, Dongguan

Bohai-Rim: Beijing, Tianjin, Jinan, Shenyang, Dalian, Qingdao, Changchun

Western Region: Xian, Chengdu, Chongqing

Northern Region: Changchun, Shenyang, Dalian, Qingdao

Market structure: Key players in a snapshot

The Chinese real estate market remains highly fragmented with an estimated 50,000 property developers. While the property market is still evolving, several of its key players have been lapping up the opportunities brought about through economic development and reforms. Needless to say, there is considerable scope for consolidation, with larger entities seeking to scoop up small-scale developers starved of capital.

Leading Chinese Real Estate Players (in terms of sales revenue for the first three quarters of 2009)			
Company	Regions	Market Capitalization (\$ Billions)	Stock Exchange Listing
China Vanke	Pearl River Delta, Yangtze River Delta, Bohai-Rim Region, Central & Western Region	1.4	Shenzhen A & B shares
China Overseas Land & Investment	Pearl River Delta, Yangtze River Delta, Bohai-Rim Region, Northern & Western Region	16.6	Hong Kong Red Chip
Greentown Group	Hangzhou, Zhejiang, Beijing and Shanghai	2.2	Hong Kong
Evergrande Real Estate	Guangzhou, Tianjin, Chongqing, Shenyang, Wuhan, Chengdu, Nanjing, Xian, Changsha, Taiyuan, Kunming, and Hefei	6.4	Hong Kong
Guangzhou R & F Properties	Beijing, Shanghai, Tianjin, Xian, Chongqing, Chengdu, Taiyuan, Hainan, Jiangsu, Shenyang, Huizhou and Foshan	1.5	Hong Kong H Share
Shimao Property	Shanghai, Beijing, Harbin, Wuhan, Nanjing, Fuzhou, Kunshan, Changsha, Shaoxing, Wuhu, Yantai, Jiaxing, Changzhou, Shenyang, Suzhou, Xuzhou, Hangzhou, Xianyang, Taizhou, Mudanjiang, Dalian, Ningbo, Qingdao, Xiamen, Wuxi, Chengdu and Tianjin	5.9	Hong Kong
China Resources Land	Beijing, Shanghai, Shenzhen, Chengdu, Dalian, Ningbo, Wuhan, Hefei, Hangzhou, Changsha, Suzhou, Chongqing, Shenyang	10.5	Hong Kong Red Chip

Market capitalization data based on full capitalization as on February 26, 2010

CHINA VANKE - The topmost real estate player in the country, China Vanke, has been voted the world's leading developer in residential property for 2009 by Euromoney. Almost 90% of its revenues were derived from the prosperous Pearl River Delta, Yangtze River Delta and the Bohai-Rim region. The core cities of Shenzhen, Guangzhou, Shanghai, Beijing and Tianjin accounted for over 44% of revenue and net profit. With housing prices rising steeply in many of China's prime cities in 2009, the company adopted a cautious approach, locating most of its 44 newly launched projects in second and third tier cities.

CHINA OVERSEAS LAND & INVESTMENT- The only Hong Kong Blue Chip Company in the Chinese real estate industry, China Overseas Land & Investment (COLI), is the subsidiary of China State Construction Engineering Corporation, the largest construction conglomerate in China. A constituent of the Hang Seng Index as well as the Standard & Poor's Global Property 40 Index, the firm is involved in the sales of home and office property projects in 22 Chinese cities, including Beijing, Shanghai, Guangzhou, Shenzhen, Chengdu, as well as Hong Kong and Macau. A major strategic move by China Overseas Land was the acquisition of a 23.08% stake in Shell Electric. This gives the company access to the quality assets and land reserves owned by Shell Electric-controlled China Everbright Real Estate. COLI intends to focus on high-end, large-scale projects in tier-one cities, while Shell Electric would concentrate on small-scale residential and mixed use projects in second and third tier cities. As its key investment strategy for 2010, COLI would gradually like to increase its commercial (office and retailing) investment portfolio.

Earnings Growth			
	2007	2008	2009
China Vanke	110%	-16.7%	19.2%
China Overseas Land & Investment	76.29%	20.78%	48%
Greentown Group	-27.2%	-41.49%	-4.32% (H1 2009)
Evergrande Real Estate	233%	-51%	95%
Guangzhou R & F	148%	-40.9%	-7.1%
China Resources Land	66.7%	42.4%	121%

GREENTOWN GROUP - Deriving 80% of its revenues from the core areas of Hangzhou, Zhejiang, Beijing and Shanghai, Greentown Group has 51 on-sale projects across 25 cities. The group expects to continue with its expansion plans, focusing on Shanghai and the surrounding Zhejiang, and Yangtze River Delta area, as well as Beijing and the Bohai Rim Region. Sales of villas, which constituted 65.3% of total property sales in the first half of 2008, decreased to 29.1% in the same period in 2009, with the proportion of apartments recording a significant increase.

EVERGRANDE REAL ESTATE - Possessing the largest land reserves among all mainland property developers, Evergrande Real Estate was listed on the Hong Kong Stock Exchange main board in November 2009, raising \$722 million in its initial public offering. The bulk (97%) of Evergrande's land reserves are in second and third tier cities, with the company involved in developing residential and commercial property in 24 major cities including Guangzhou, Tianjin, Chongqing, Shenyang, Wuhan, Chengdu, Nanjing, Xian, Changsha, Taiyuan, Kunming, and Hefei. It is a pioneer in large real estate projects, with standardized operations applied to project selection, planning and design, use of materials, bidding, project management as well as marketing.

GUANGZHOU R & F PROPERTIES - The first mainland real estate enterprise to enter the Hang Seng China Enterprise Index, Guangzhou R & F Properties owns 70 residential as well as commercial property projects spread across Beijing, Shanghai, Tianjin, Xian, Chongqing,

Chengdu, Taiyuan, Hainan, Jiangsu, Shenyang, Huizhou and Foshan. In Guangzhou, the company became the first to develop commercial property in over 10 property sites.

CHINA RESOURCES LAND – China Resources Land is involved in the development and management of residential and investment properties in China spanning 21 tier-one and tier-two cities like Shanghai, Shenzhen, Chengdu, Wuhan and Hefei. Property investment also continues to be the firm's core business, with its revenue from property leasing and management increasing by 10.5% in 2009, year-on-year. The company is uniquely focused on commercial properties, which include metropolitan commercial complexes, residential plus regional commercial centers and residential plus district commercial centers. The Shenzhen MIXC, a metropolitan commercial complex developed by China Resources, was met with grand success. The company has been included on the Hang Seng Index commencing on March 8, 2010.

Restricted role of foreign investment

International participation in the Chinese real estate market remains limited due to government restrictions on foreign investment in this sector. Only foreign institutions setting up branches or representative offices in China, and individuals working or studying in China for more than one year can purchase apartments for their own use. To stem speculative investment, the government instituted a policy in July 2006 that raised the ratio of registered capital to a property developers' overall investment.

The revised *Catalogue for the Guidance of Foreign Investment Industries*, brought out jointly by the Ministry of Commerce and the National Development and Reform Commission in 2007, continued to adopt a restrictive stance towards the inflow of foreign capital in Chinese real estate. Restrictions were continued on foreign investment in land development, and in the construction and operation of high-end hotels, villas, high-class office buildings and international exhibition centers. Only joint venture operations were allowed for land development, and new restrictions were imposed on foreign investment in secondary real estate markets, such as real estate brokerage firms.

Despite these restrictions, according to the estimates of the State Administration of Foreign Exchange (SAFE), foreign direct investment (FDI) accounts for 15% of the Chinese real estate market, typically the most speculative money flows. This continues to be an area of discomfort for the government, which has been battling speculation in this sector.

Real Estate Investment Trusts (REITs): New financing option on the block?

The overt dependence on bank finance by real estate developers, accompanied by aggressive lending last year, imposes risks on Chinese banks in terms of potential bad loans or Non-

performing assets (NPAs). In order to mitigate this risk, the Chinese government is considering real estate investment trusts (REITs), as an alternative source of finance for the often cash-strapped real estate developers. These REITs could also prove to be an attractive investment option for foreign investors eager to participate in the Chinese real estate market. The government is in the process of developing a legal and institutional framework for the governance of REITs in China, and is likely to launch a pilot program soon for foreign participation in Chinese REITs.

Irrational exuberance or an outcome of real economic growth?

To some, the fears of a Chinese real estate bubble are unfounded, as the exuberant growth observed in this sector is backed by robust rising incomes, a rapid pace of urbanization, and a modest debt-to-gross domestic product ratio of 20%. The economy clocked an enviable 8.7% growth rate last year, even as the world economy limped back towards recovery. But the unprecedented property price escalation, especially in the residential housing sector, highlights the critical issue of affordability of housing for common Chinese citizens. Not surprisingly, the Chinese government is trying to temper this increase so that the fruits of its economic growth are rightfully enjoyed by the very people who made it possible. How far these measures succeed in curbing speculation and sustaining real demand remains to be seen. 🌐

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