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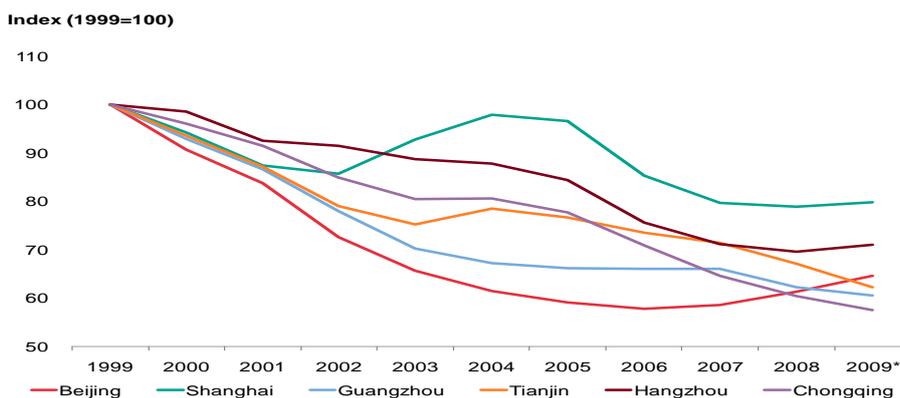
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- Many commentators have expressed concerns about a speculative house price bubble emerging in China. The supporting evidence shows that average nominal house price growth (5.4%) has exceeded inflation (1.9%) over the last decade. This was triggered by mass urbanization and an undersupply of affordable housing. The concern focuses on first tier cities where recent house price growth has been strong, driven by demand from investors, speculating on future increases.
- However, long term affordability trends show that there is no house price bubble in mainland China, not even in first tier cities. The affordability trend across most Chinese cities has improved in the past 10 years (Figure 1), as nominal household income growth has been 11.4% on average annually over the 2000-09 period, more than double the house price growth (5.4%) over the same period. Despite this long term trend, affordability in Beijing and Shanghai has worsened slightly recently. Compared to other countries, the Chinese house price affordability trend has been very favorable over the last decade.
- The market has been driven by a wide range of monetary and other policy initiatives, which have focused on controlling house prices in the past and we expect this to continue going forward. We expect the central government to expedite property tax reform, as they need to diversify their tax revenue base, away from land sales. As a result, we forecast house price growth to remain moderate across most markets.
- The commercial property sector has been largely unaffected by speculative investment and recent government policies.

Figure 1

Affordability trend of housing in selected cities in China, 2000-2009



Source: DTZ Research

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Introduction

Anyone following the Chinese real estate market, especially the residential sector, in the past year will have been struck by the way in which prices and volumes have fluctuated so dramatically within a short period of time.

In this paper we will take a closer look at the elements that are fundamental to these market movements and the drivers and facilitators of these market conditions.

By examining the price, income and economic growth trend over time we will demonstrate how these drivers and facilitators have influenced residential affordability in the past decade.

We will also make the distinction between market movements as a result of owner occupancy demand versus those of a speculative nature, and how the commercial property market performance has differed from the residential market.

The fundamental force behind all these factors is the instrumental role the government plays in attempting to control the property market and its ability to rein in runaway market forces. We will examine the likely policy scenarios and the risks the government faces in attempting to manage the market. We conclude by looking at the outlook for investors in both the residential and commercial property markets.

Market Drivers

The urbanization process

China is undergoing a rapid and massive urbanization process which is expected to last for the next ten to fifteen years. As urban economies grow much faster than those in rural areas more people are moving to the cities in search of better opportunities.

In 2000, there were 40 cities with populations of more than one million in China, this number increased to 122 in 2008. The population in each of the first tier cities (Map 1) has now exceeded 10 million. By the end of 2009, the average urbanization rate (urban vs. total population) in China was 46.6% (Figure 2). The government expects this average to reach 60% in the next ten years which means that, conservatively, 18 million people per year will migrate from rural areas to cities in the next ten years. In the bigger cities, like Shanghai, we have already seen up to 5 million temporary residents at any one time.

Map 1

First tier and major second tier cities in China

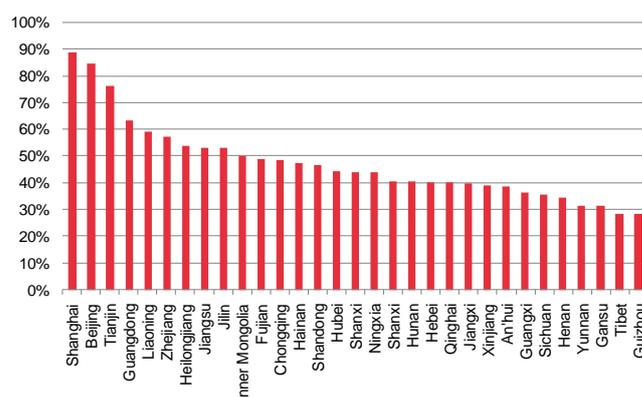


Source: DTZ Research

This movement of people is being made easier by the spread of inter and intra city transportation networks¹. As a result more people will move into cities in even the remote provinces in central and western China.

Figure 2

Urbanization rate by province, 2007



Source: National Bureau of Statistic of China

Strong owner occupancy demand vs. speculation

Partly due to this urbanization process, there has been a tremendous increase in demand for housing in the past five years, which the construction industry has not been able to keep up with (Figure 3). In order to address this situation, since the end of 2009, the government has

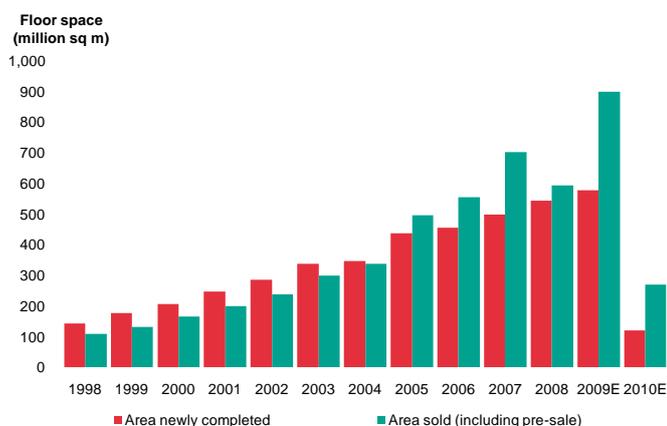
¹ China's 11th Five Year Plan, DTZ Research, September 2006 and Shanghai EXPO 2010, DTZ Research, 12 March 2010.

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been increasing the land supply for affordable housing, and compelling developers to speed up the construction of housing by imposing heavy fines on land that is left idle.

Figure 3

Annual new completion and sale of private residential buildings (including pre-sales), 1998-2010



E = Estimate; The estimate for 2010 is as of April 2010

Source: National Bureau of Statistics of China, DTZ Research

In addition, China has yet to develop a significantly strong second hand sales market given the short development history of its housing market. This has reduced the ability for the second hand supply to address any first hand market shortages.

Culturally for the Chinese renting is not a stable long term option, especially for married couples. The lack of tenant protection in the current legal framework is also partially to blame. This lack of a rental market is also not conducive to alleviating the burden on housing supply in the short term.

These owner occupation demand factors have inevitably driven up nominal housing prices. However, the circumstances under which the price hike occurred during the second half of 2009 were unusual as the government released a RMB 4 trillion stimulus package to fend off the global financial crisis, which included demands to the banks to increase mortgage lending.

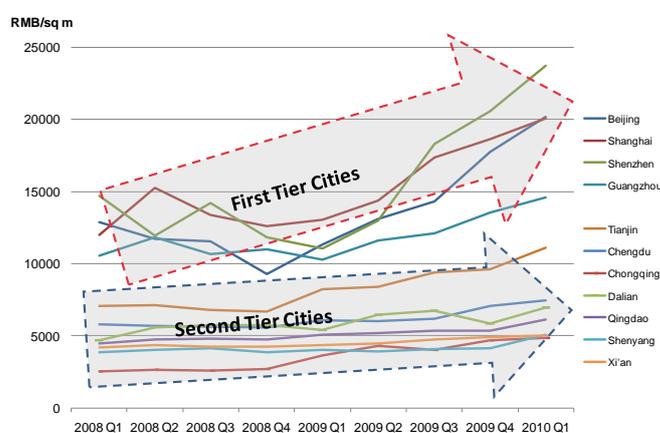
First tier versus second tier cities

Geographically, our data shows that residential prices in the first tier cities have in general grown much faster than those in the second tier cities (Figure 4), partly due to speculative activity. Major metropolises often face bigger housing pressure than smaller cities thanks to a larger migratory population. As the economies in these cities grow ever faster, wealth is often channeled into real

estate thanks to the lack of alternative investment channels and the lack of market transparency. Additionally, first tier cities tend to attract international investment buyers drawn by the possibility of rapid price growth, which adds to the overall demand for housing in these cities.

Figure 4

Residential price trend in first tier and major second tier cities, Q1 2008-Q1 2010



Source: DTZ Research

Unlike first tier cities the rate of price increases for second tier cities remained mild. Demand in these cities is often localized with a smaller population pool in the surrounding areas. Owner occupancy demand serves as a major driver of the price movement in second tier cities.

We should recognize that in spite of the speculation that is evident particularly in the luxury sector of some first tier cities, fundamental demand from the growing urban population for housing will more than counterbalance the effect of short term spikes.

Due to the sharp price rises in some cities in the past 12 months, there are concerns that income growth will not be able to match the house price increases and this has led to fears of an asset price bubble. In our opinion this fear is unsubstantiated. As Figure 5 demonstrates, over the long term and across China, household income growth has outstripped overall home price growth in every year apart from 2004. Since 2000 household income growth has averaged 9.5% while home price growth has averaged 5.4%. Over the period incomes have risen 1.5 times faster than home prices.

Although statistics for 2009 are not yet finalized and home price growth in the last few months of the year may increase the overall growth, from a longer term standpoint and looking at the nation as a whole, the

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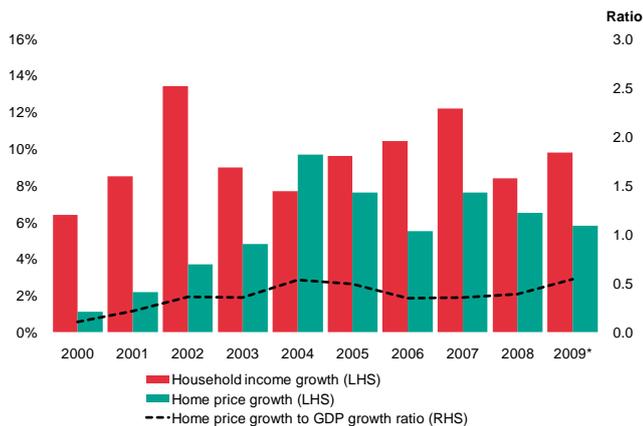
growth in incomes is able to sustain a healthy demand for housing.

A closer look at affordability

In Figure 5 we have also illustrated the ratio of home price growth to GDP growth. The nearer the ratio to 1, the closer is the correlation between home price growth and GDP growth. Also the flatter the line, the less volatile this correlation becomes. As we can see over the past decade, despite fears of a housing market meltdown, home prices in China have grown consistently below half the rate of the overall economy.

Figure 5

Overall Chinese nominal income growth, home price growth & ratio to GDP growth, 2000-2009



*Figure for 2009 is provisional figure.

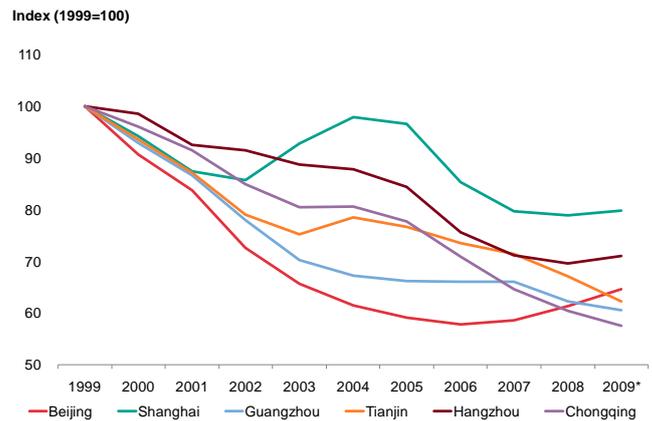
Source: Oxford Economics, CEIC

To further examine the growth in home prices in China we have constructed an affordability trend index. We measure affordability by indexing the ratio of household income growth to home price growth and comparing the two. For the purpose of this exercise we have not included interest rate levels or mortgage payments.

A city-level analysis of affordability in China further confirms our findings (Figure 6); homes in China's first and second tier cities are more affordable now than they were in 2000. The effect of rising home prices in 2009 is evident in Beijing, Shanghai and Hangzhou (southwest of Shanghai), where affordability has worsened, particularly in Beijing. Affordability in these cities appears to have now plateaued. In the smaller second tier cities affordability continues to improve.

Figure 6

Affordability trend of housing in selected cities in China, 2000-2009

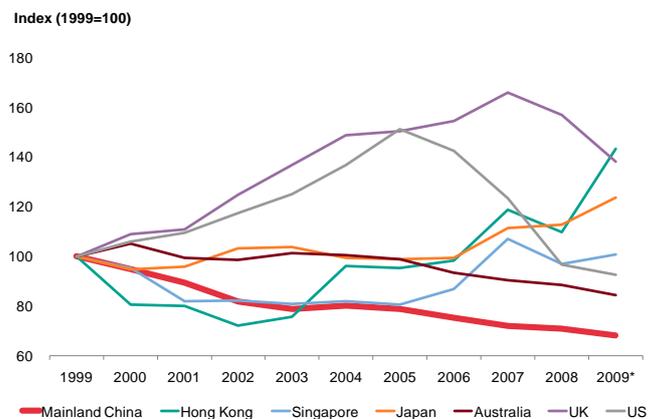


Source: DTZ Research

From this measure we see that not only has China's affordability level improved over the last 10 years, but there is better affordability in China than in many of the more mature, developed economies such as the UK and the US (Figure 7). Moreover, in contrast with the more volatile relationships in almost all the other countries we surveyed, apart from Australia, affordability in China has been improving steadily since the beginning of the decade on the back of rising income levels.

Figure 7

Affordability trend of housing in selected economies, 2000-2009



Source: DTZ Research

Looking at the housing market in general, the situation differs from city to city. However, this comparison reinforces our belief that overall China's residential development is supported by its economic growth and rising income levels.

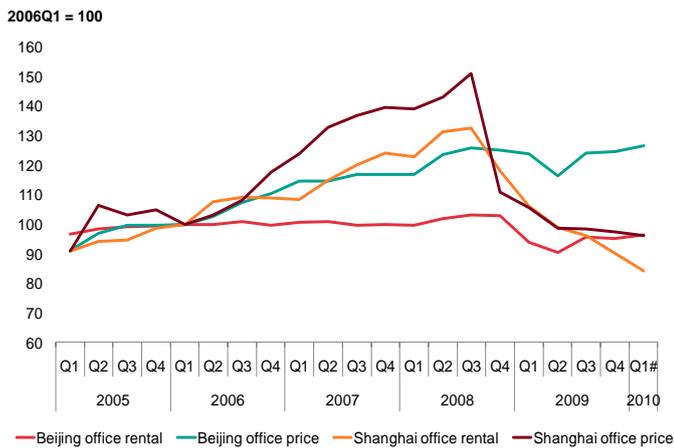
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Impact on the commercial market is limited

It should be pointed out that despite all the turmoil in the residential market we have not seen similar characteristics emerging in the commercial markets. Office rents and prices in first tier cities have largely been influenced by demand and supply (Figure 8). This supply and demand mix is in turn coupled with the ups and downs of the economy. Given the large potential supply in these cities, the office market is unlikely to see the sort of speculation seen in the residential market, which was partly driven by the lack of supply.

Figure 8

DTZ office rental and price index, Q1 2005–Q1 2010

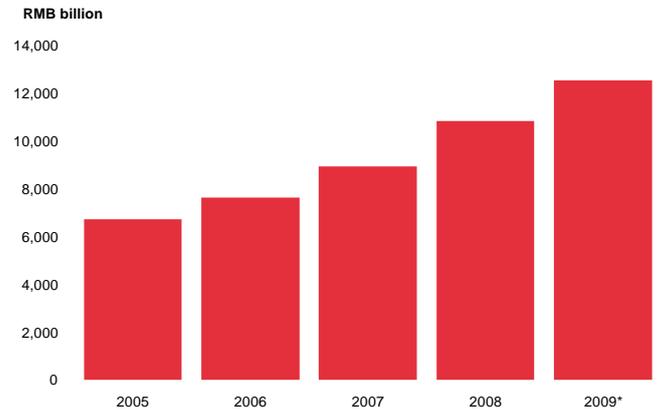


Note: # Provisional figures
Source: DTZ Research

In the retail market, the fast growing economy and rising urban disposable incomes has helped drive up the country's retail sales (Figure 9), which in turn has translated into demand for more retail space. In major cities like Shanghai, prime retail land has almost run out while in second tier cities the appetite for shopping malls remains strong.

Figure 9

Total sales of consumer goods in China, 2005-2009

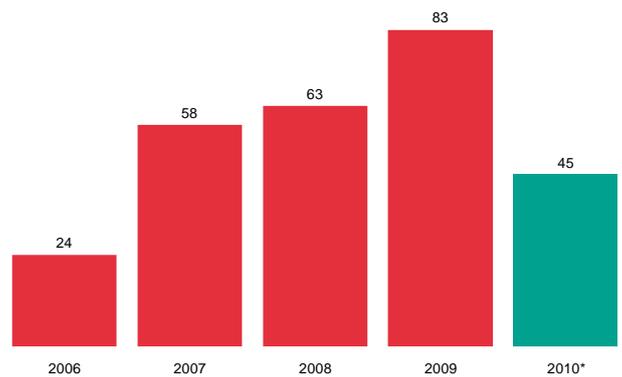


* Provisional figure
Source: National Bureau of Statistics of China

There has been a steady increase in the number of transactions in retail properties and land sites zoned for retail (Figure 10). This will lead to an increase in good quality retail buildings coming to the market in the next few years, which in turn will provide additional investment grade stock.

Figure 10

Major retail transactions, 2006–2010*



Transactions with value equal to or over US\$10m are taken into account
* As of April 2010
Source: DTZ Research

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Government Policies

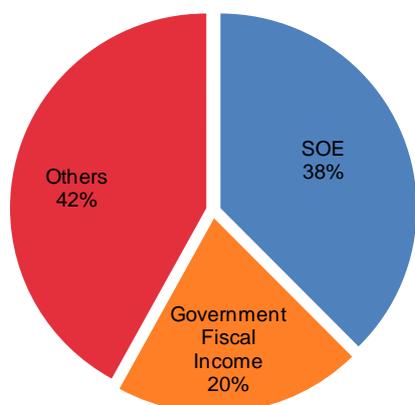
The role of the government

We cannot comment on the drivers of the residential market without examining the fundamental role the Chinese government has played in shaping the country's economic landscape.

After two decades of developing a market economy, China is still managed by the central government. The government runs almost every aspect of economic life, including housing. This is reflected in the fact that government fiscal income and revenue generated by the state owned enterprises (SOEs) still make up nearly 60% of the country's GDP (Figure 11).

Figure 11

Share of GDP, income measure, 2009



Source: National Bureau of Statistics of China

All land is owned by the government, and income from selling land forms a major part of its income. Real estate is one of the pillar industries of the Chinese economy, contributing more than 10% to China's GDP in 2009. Land conveyance fees have become one of the most important revenue sources for local governments. In cities like Beijing, Shanghai and Tianjin, income from land sales reached close to 30% of government income in 2009 (Table 1), while in smaller cities such as Hangzhou and Foshan over half of their annual income comes from this source. Local government relies on land sales to generate revenues to fuel economic growth, to launch urban renewal projects, and to provide services.

Table 1

Selected first and second tier cities land conveyance income, 2009

	2009 RMB billion	Year on year increase	% of Government Revenue
<i>1st tier:</i>			
Beijing	92.8	85%	29%
Shanghai	104.3	172%	29%
Guangzhou	48.9	301%	41%
<i>2nd tier:</i>			
Tianjin	73.2	67%	29%
Hangzhou	105.4	238%	51%
Ningbo	48.8	617%	34%
Chongqing	44	276%	27%
Wuhan	36.1	345%	26%
Foshan	33.2	390%	57%

Source: National Bureau of Statistics of China

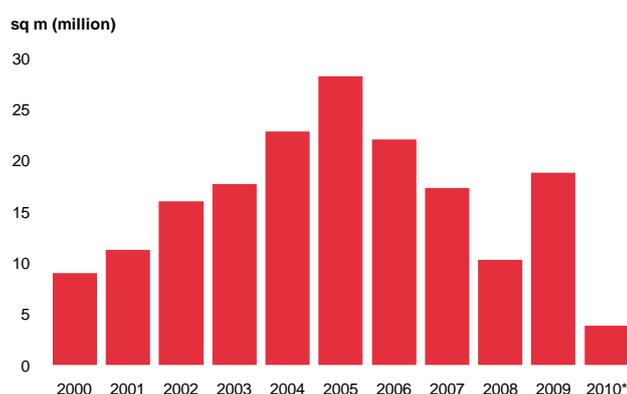
Through direct intervention, the government also acts as the real estate regulator, especially in the residential market. It has now become apparent that the price increases seen last year were in part a result of the government's RMB 4 trillion stimulus package including both fiscal and monetary relaxation. The package was released after the start of the global financial crisis in order to maintain GDP growth after a dramatic drop in export demand. However, a large part of the money earmarked for development went into the residential property market, which in turn drove up prices.

A city which often serves as a test bed of government measures, Beijing has seen its fair share of policy induced market fluctuations. In 2007, at the height of the last market peak, the benchmark interest rate was raised six times in one year to rein in rampant credit issuance. As a result, by the end of the year residential transactions in Beijing dropped 21% year on year (y-o-y) (Figure 12). During the global downturn in 2008 the same benchmark interest rate was reduced five times in order to encourage borrowing. On top of that, administrative measures including discounts on mortgage rates and reduction of taxes directly lifted transaction volumes.

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Figure 12

Residential floor space sold in Beijing, 2000-2010

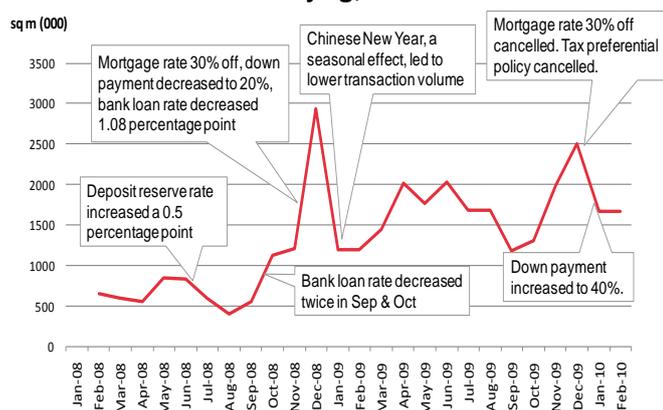


* Data as of April 2010
Source: National Bureau of Statistics, Beijing Statistics Bureau

The effect of government policies on real estate has become even more pronounced in the past year.. By the end of 2009, Beijing's residential transactions had increased 77% y-o-y (Figure 13).

Figure 13

Impact of government policies on housing transaction volume in Beijing, 2008-2010



Source: DTZ Research

This heavy-handed involvement in the residential market demonstrates the government's determination as well as its ability to manipulate transactions and pricing.

Government measures against speculation

In an effort to put a brake on residential price rises nationwide, from January to April this year there were no less than 10 occasions when the central government announced new rules or monetary measures aimed specifically at the residential market.

Monetary policies

On the monetary side, managing liquidity has been the core task of China's central bank, the People's Bank of China (PBOC); increased liquidity has been partly blamed for price rises in many major cities. In January, February and May this year, the central bank raised the deposit Reserve Requirement Ratio (RRR, or the proportion of banks' deposits that they must keep on reserve at the central bank) for most financial institutions three times, each time by 50 basis points. As a result, a huge amount of liquidity was drained from the market (some estimates put the amount at RMB 300bn each time); greatly reducing the market's purchasing power for housing.

The PBOC has so far refrained from raising interest rates as they are concerned about hampering economic development. However, they have not ruled out doing so in the future.

Non-monetary policies

Most of the recent government policies have come in the form of directives. In April 2010 the government ruled on mortgage requirements which stipulate that people should put down at least a 50% deposit for their second homes. Meanwhile people buying any unit larger than 90 sq m should put down at least a 30% deposit. It also banned non-residents of a city from obtaining mortgages unless they can prove that they have paid taxes in that city for at least one year.

The central government also imposed a sales tax of 5.5% on homes sold within 2 years (last year it was relaxed to 5 years).

On the supply side, the government forbade all centrally controlled non-property companies from engaging in property development. So far, 78 such firms have withdrawn from the property market.

For developers, those who fail to develop one year after bidding will face fines of up to 20% of the bids. If the land is still idle after two years, it will be taken back by the local government.

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Local issues

As part of the effort to curb house price rises, the central government plans to:

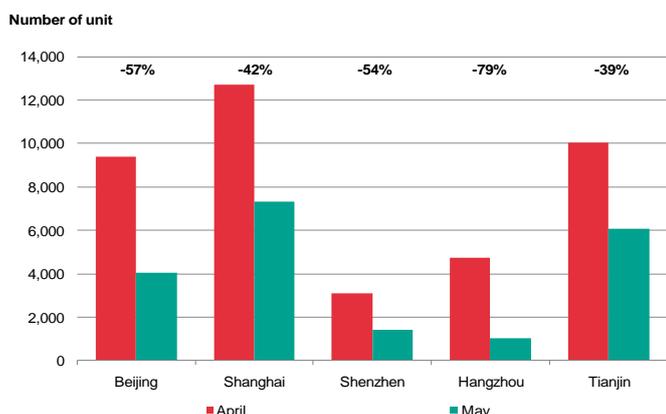
- Increase the supply of smaller houses
- Continue to support residential consumption
- Curb speculation
- Expand construction of housing projects for low-income families
- Increase spending in rebuilding poorly-constructed houses
- Strengthen real estate project loan risk management and market supervision

Whilst such measures are to be expected, they may further hamper local governments' ability to sell land at higher prices to boost local finances. Recent directives and guidelines will work towards cooling the market as local authorities have no alternative but to comply, although local authorities are also allowed to fine tune the policies to suit local situations. A balance has to be reached in how much control both the central and local governments will exert on the residential market. In the long run, a reform of the overall fiscal system is vital.

Nevertheless, the effect of these monetary and non-monetary policies is already apparent. After the latest policy announcements in mid April, residential transactions in many cities took a major hit. For example, government data has shown that residential transactions in Beijing in May were down 57% from April. In Hangzhou, transactions fell by 79% over the same period (Figure 14). With the government tightening its grip, much of the speculative activity has all but vanished in recent months.

Figure 14

Residential transactions, April & May 2010



Source: Bureau of Statistics Beijing & Shenzhen, DTZ Research

Policy outlook and risks

Meeting the supply shortage of affordable housing

The fundamental problem with the Chinese property market is that home buyers are finding it increasingly difficult to afford mass residential housing thanks to the short supply.

The key way for the government to tackle this issue is to significantly raise the supply of affordable housing units. In its 11th Five Year Plan, the government planned to improve the living conditions of urban households by constructing more transportation projects. In the next Five Year Plan, due to be tabled in the second half of this year, building more mass residential housing is likely to be called for.

The government will also likely undertake measures to revitalize the second hand market and rationalize the rental market in order to provide more alternatives to potential home buyers.

The risk to this is that it will take several years for any tangible results to materialize. In the meantime, the supply demand mismatch will continue to cause sporadic price hikes.

A continued control on speculation

Real estate investors tend to treat housing as a source of major capital gains. History shows that without any improved market transparency and alternative investment channels, investors will continue to invest in residential housing which will in turn continue to drive up prices and consequently lead to another crack down. Part of this is due to the lack of alternative asset classes to invest in.

In recent years, there have been several occasions where drastic governmental policies have been introduced to cool an overheated market. However, once prices have stabilized the government measures were reversed and prices rose again quickly. The danger is that as the housing market is still viewed as the primary way to generate income, investors will simply wait for the policy storm to pass.

In the light of this, the government is now deploying more drastic monetary and administrative measures, such as disallowing mortgage lending for third homes and forcing down land sale prices to suppress speculation and prevent overheating, at the same time increasing the supply of affordable housing.

A report released by the Chinese Academy of Social Sciences, a major official think tank, has recommended

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that the government make the current anti-speculation measures long term, especially the lending and administrative policies targeting second and third house purchases².

Structural reform – A sustainable property tax system

However effective the government's control policies have been so far, it is clear that it is keen to avoid recurrent situations where it has to drastically intervene in the residential market.

As governments of all levels currently depend on land sales to boost their revenue, a reform is urgently needed to diversify this revenue base. The purpose is to provide a sustainable and sizable revenue source at the local level, in the mean time providing a better tool for the central government to manage the system and boost the country's overall fiscal income through a more balanced tax mechanism. Therefore it is no surprise that the government will now actively look into reforming the property taxation system.

One possibility is refocusing the tax away from transactions and more towards holding the property as well as the rental income from the property. The closest example to follow is the Hong Kong model in which taxation is targeted more on rental generating properties and less at transactions. In the long run, local governments will be able to reduce their over dependence on selling land to raise revenue.

However, for a system that is as complex as China's, taxation reform will encounter many administrative and legal obstacles. It would take at least 3-5 years for a comprehensive but simple and enforceable tax system to come into play.

What It Means for Investors

Residential

Due to the government's recent policies on curbing residential overheating, in the next two years prices in many cities are now forecast to grow at a much slower pace than previously predicted. Some city sectors will even see negative price growth (Figure 15).

In Beijing's luxury market, where last quarter we predicted over 10% growth for the next two years, we are now forecasting only limited growth. A similar picture can

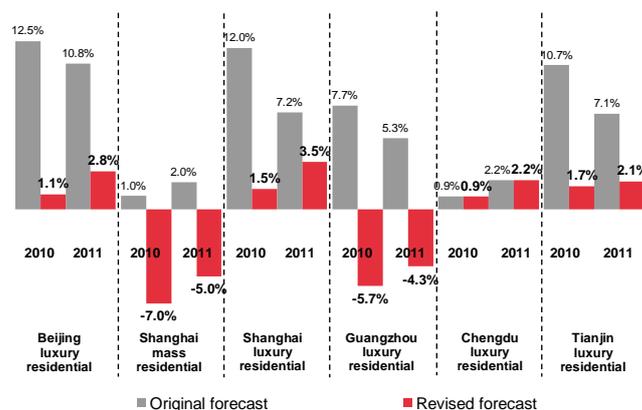
be seen in another first tier city, Shanghai, where we are now predicting much lower price growth in the luxury sector than previously anticipated.

Luxury prices in Guangzhou (another first tier city) are now forecast to see a drop instead of the 5-7% growth previously forecast. This change is influenced by the fact that in the past month, since the policy announcements, we have seen unusual investor activity, with investors rushing to sell-off the luxury units they were holding.

In the second tier city of Tianjin, close to Beijing, luxury prices are expected to mirror those of the capital. In Chengdu, the other second tier city in our coverage, the forecast for luxury prices remains unchanged, reflecting the fact that there has been much less speculative activity here than in the other locations.

Figure 15

Home price forecasts for selected cities, 2010-2011



Source: DTZ Research

The only mass residential market in our forecast coverage is Shanghai. Here we predict large price drops of 5-7%. What we see from the forecast is the effect that the tightening of mortgage lending and the increase in the supply of land for mass residential development will have on home prices.

Commercial

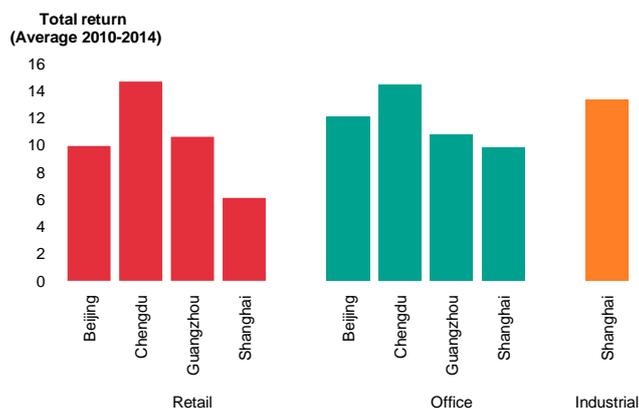
The office market will continue to grow provided that strong economic growth continues. Prime grade A office space, however, will still be clustered in Beijing and Shanghai. Both prices and rents will see stable growth as the market is less speculative and there is a steady stream of future supply. Total returns for these two cities are forecast at over 9% per annum in the next 5 years (Figure 16).

² Blue Paper on China's Real Estate Market 2010, Chinese Academy of Social Sciences, 5th May 2010

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Figure 16

Total return by sector, annual average 2010-2014



Source: DTZ Research

A sector that will also see strong growth is retail. Given the strong growth of average disposable income and national retail sales, demand for retail space will continue to push up prices and rents, especially in prime locations in Beijing and Shanghai. In the second tier cities, where a retail revolution is developing, space in shopping malls and large modern shops will be highly sought after. We expect to see the current trend of a steady increase in investment in retail properties and land to continue in the next few years.

As future government efforts to contain overheating will continue to focus on the residential side, commercial markets present a less regulated investment alternative.

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