Urban Land Institute

Mainland China Real Estate Markets 2014

ULI Analysis of City Investment Prospects

城市土地学会

2014年中国大陆主要城市房地产投资前景分析

Kenneth Rhee
Chief Representative, Mainland China, ULI Asia Pacific

Anita Kramer
ULI Center for Capital Markets and Real Estate

Urban Land Institute
Asia Pacific 亚太区

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Cover image: Corporate Avenue and Langham Hotel, Shanghai Xintiandi, by Perry Jacobs

About ULI

The Urban Land Institute is a 501(c)(3) nonprofit research and education organization supported by its members. Founded in 1936, the Institute now has nearly 32,000 members worldwide representing the entire spectrum of land use and real estate development disciplines, working in private enterprise and public service. As the preeminent, multidisciplinary real estate forum, ULI facilitates the open exchange of ideas, information, and experience among local, national, and international industry leaders and policy makers dedicated to creating better places.

The mission of the Urban Land Institute is to provide leadership in the responsible use of land and in creating and sustaining thriving communities worldwide. ULI is committed to bringing together leaders from across the fields of real estate and land use policy to exchange best practices and serve community needs by

- Fostering collaboration within and beyond ULI's membership through mentoring, dialogue, and problem-solving;
- Exploring issues of urbanization, conservation, regeneration, land use, capital formation, and sustainable development;
- Advancing land use policies and design practices that respect the uniqueness of both built and natural environments;
- Sharing knowledge through education, applied research, publishing, and electronic media; and
- Sustaining a diverse global network of local practice and advisory efforts that address current and future challenges.

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The ULI Center for Capital Markets and Real Estate focuses on tracking, analyzing, and exploring real estate investment trends globally. The mission of the Center is to inform, educate, explore issues, create knowledge, and foster communication and networking at the intersection of real estate finance and capital markets and the diverse needs and interests of the ULI membership. The Center also seeks to address members' interests in underlying topics such as market forces affecting property sectors and economic trends.

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ULI Asia Pacific is the acknowledged authority for policy information and best practices in land use in the Asia Pacific region.

Supporting principles:

- Collaboration with universities, government agencies, and like-minded organizations strengthens and disseminates the Institute's expertise.
- Priority initiatives effectively address local land use issues.
- High-quality programs enhance the integrity of the Institute.
- Substantial interdisciplinary membership is engaged throughout the region.

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Executive Summary

Mainland China Real Estate Markets 2014: ULI Analysis of City Investment Prospects—the fourth such annual survey conducted by the Urban Land Institute—reports on real estate development and investment prospects in 36 of the largest cities in Mainland China, as well as issues affecting those prospects, as evaluated by real estate industry leaders active in the country. The survey consists of a written questionnaire answered by 107 participants, plus more than 30 individual interviews and small group discussions held in April and early May 2014.

At the time this report was written, Mainland China's real estate industry was experiencing the initial phase of a sharp downturn. Hampered by the restrictive home-purchase policies and lending policies aimed at reducing speculative real estate investment, real estate sales during the first four months of 2014 dropped 9.9 percent from the same period in 2013, while the gross domestic product (GDP) grew 7.4 percent, the slowest growth rate since 2002, with the exception of the first quarter of 2009 at the start of the Great Recession. A rising number of small and medium-sized developers with projects

largely concentrated in Tier 3 and 4 cities started defaulting on their loans. Developers began cutting prices to stimulate sales and to push out inventory, while buyers waited on the sidelines, unsure how far prices would drop. The interest in investing in overseas markets seemed to grow stronger as the local market conditions worsened. The unexpectedly weak GDP growth rate during the first quarter seemed to be testing the central government's resolve to wean the economy off its dependence on fixed-asset investment for economic growth. How Mainland China's real estate market will perform during the next 12 months will no doubt depend on the central government's policies.

At the same time, other trends that will have long-term effects on the real estate industry can be seen. An oversupply of building stock in a growing number of Tier 2 and 3 cities, fueled by local governments' aggressive land sales, is a real concern. While many provincial capitals and regional economic centers will be able to absorb the excess residential supply during the next few years, it will take much longer for some cities to absorb excess supply of commercial properties. Existing shopping centers are facing serious challenges from a large supply of new centers, as well as e-commerce, and office buildings in many Tier 2 cities will suffer from high vacancy rates for some years to come.

Some bright spots can be found, though. Tier 1 cities—Shanghai, Beijing, Guangzhou, and Shenzhen—are generally viewed as healthy with strong demand. There is little concern about residential prices dropping, especially in the core areas of the Tier 1 cities, given the limited supply of inventory and developable land. At the same time, sizable new areas for development are located on the outskirts—either anchored by major transportation infrastructures, such as airports, high-speed railways, and subways, or supported by the central government's favorable policies. Examples of the former include the Hongqiao Transportation Hub in Shanghai and the area around the second airport in Beijing; the latter include the free trade zones in Shanghai and the Qianhai area of Shenzhen, which will provide many benefits, such as the same tax rate as that in Hong Kong S.A.R. Among Tier 2 and 3 cities, heavy investment in mass transportation infrastructure will create opportunities for profitable development.

Investment and Development Prospects

The 2014 ULI Mainland China cities survey reveals that respondents are more pessimistic about China's real estate market prospects than they were a year ago. Among its findings:

- The average rating for investment prospects of the 36 cities declined to 2.75 from 3.00 (on a scale of 5), and the average rating for development prospects declined to 2.87 from 3.14. Overall, the four Tier 1 cities performed well, either improving on or maintaining ratings similar to those of last year.

- Shanghai retained its top ranking for both investment and development. While its investment rating dropped slightly, it is well ahead of the second-place city. Its development prospects rating improved on the strength of several large-scale development projects, such as the Hongqiao Transportation Hub, free trade zones, and Shanghai Disneyland.

- Shenzhen made a strong showing this year—rising to second place for both investment and development prospects, up from sixth for both last year—no doubt strongly helped by the Qianhai area development.
- Guangzhou retained its number-three ranking for development prospects and improved its ranking for investment prospects to fourth from seventh, reflecting the growing depth of investment-grade assets.
- Beijing maintained its number-three ranking for investment prospects and its number-five ranking for development prospects. On the other hand, it also continued its poor showing in livability, ranking 32nd, one notch below last year's ranking.
- Most improved: along with Shenzhen, Nanjing's rating improved the most. Its investment ranking moved to fifth from ninth and development ranking to fourth from 11th. Its improvement seems to be due to the positive impact of the high-speed railway, its proximity to Shanghai, a healthy local economy, and its relatively more controlled land supply.
- Notable declines: Suzhou, Hangzhou, Chengdu, and Chongqing saw their rankings decline. Suzhou's ranking dropped to seventh from second for both investment and development prospects, while Hangzhou saw its investment ranking drop to tenth from fifth, though its development ranking moved up to 11th from 13th. Chengdu's ranking dropped to 13th from eighth for investment prospects and to 15th from seventh for development prospects due to an oversupply of commercial properties in its downtown and in the Tianfu New Area. Chongqing continued its decline in rankings, dropping to 16th from 12th for investment prospects and to 17th from 14th for development.
- Laggards: Tianjin and Shenyang, both major Tier 2 cities, continued to be ranked near the bottom, with investors and developers worried about the huge oversupply of commercial properties.

Sector Engagement

Respondents were asked whether they will decrease, maintain, or increase involvement in key property sectors. Overall, with the exception of luxury residential and hotels, a clear majority of the respondents indicated plans to maintain or increase involvement in the key sectors.

- Industrial/distribution continues to be the sector most popular among respondents. Fifty-six percent indicated they plan to increase exposure to this sector, while only 4 percent planned to decrease exposure. The growing interest is tied to rapidly growing e-commerce in Mainland China and the severely limited stock of high-grade logistics warehouses.

- Despite the concern about weakening residential sales and an oversupply of office buildings and retail properties, the respondents in general plan to increase exposure in the midmarket residential, retail, and office sectors. The respondents believe the residential market is still strong in Tier 1 cities and a number of Tier 2 cities where the local government had a more controlled land sale policy. Also, continuing urbanization would create more real demand for midmarket residential properties.
- Retail was seen by interviewees as a difficult asset type to develop and invest in, given the growing competition with new shopping centers and e-commerce. It is somewhat surprising that 47 percent of the survey respondents planned to increase exposure, while only 7 percent planned to decrease exposure to the sector.
- The luxury residential sector divided the respondents. Some believe there is strong demand for luxury residential properties from the growing upper middle class and that once the central government relaxes the home-purchase restrictions for second-home buyers, the luxury residential market will recover well.
- The hotel sector was perhaps the least popular among respondents. They said the oversupply was largely created by the local governments' requirement for developers to build five-star hotels in most large-scale projects. Perhaps this desire by cities and districts to have five-star hotels to improve their image explains the high participation rate in the sector—67 percent.

Niche Markets

E-commerce distribution centers again received the highest rating among the niche markets surveyed, reflecting the high level of interest spurred by the explosive growth of e-commerce. Overseas homebuilding was the second-most-popular niche market, following the huge increase in overseas investment, with even local and foreign investors looking at financing overseas homebuilding projects by Chinese developers or to sell to Chinese buyers. With no successful proven business model despite general agreement on the potential for the market, the seniors' housing market saw its rating drop. Resorts were seen as the least popular niche market, probably because of the large supply and the sensitivity of the sector to the overall economy.

Ranking of Cities by Livability

Shanghai, Hangzhou, and Xiamen came out on top among Chinese cities in the rankings of livability, closely followed by Shenzhen, Suzhou, and Chengdu. Shenzhen's ranking shot up to fourth from 11th, possibly reflecting the good job market and improving living conditions there.

In contrast, Beijing continued to be ranked near the bottom, at 32nd, one place lower than last year, largely due to the continuing air pollution problems there. Other major cities that were ranked near the bottom were Shenyang at 27th, Zhengzhou at 28th, and Tianjin at 31st.

Dongguan was the only city in the southern region of China near the bottom, ranked at 30th. Its low ranking, despite its proximity to Shenzhen and Guangzhou and relatively good weather, is likely due to the city's reputation as a manufacturing center with low-value-added factories.

Livability seemed to have had some impact on respondents' rankings of the cities for investment and development prospects. For example, Beijing's luxury residential market was seen as less favorable than Shanghai's as China's upper middle class, overseas Chinese, and foreigners clearly prefer to live in Shanghai over Beijing, in spite of the capital city's good job and education opportunities. Shijiazhuang, the capital of Hebei province, again was ranked at the bottom due to the city's reputation for heavy pollution and limited attractions.

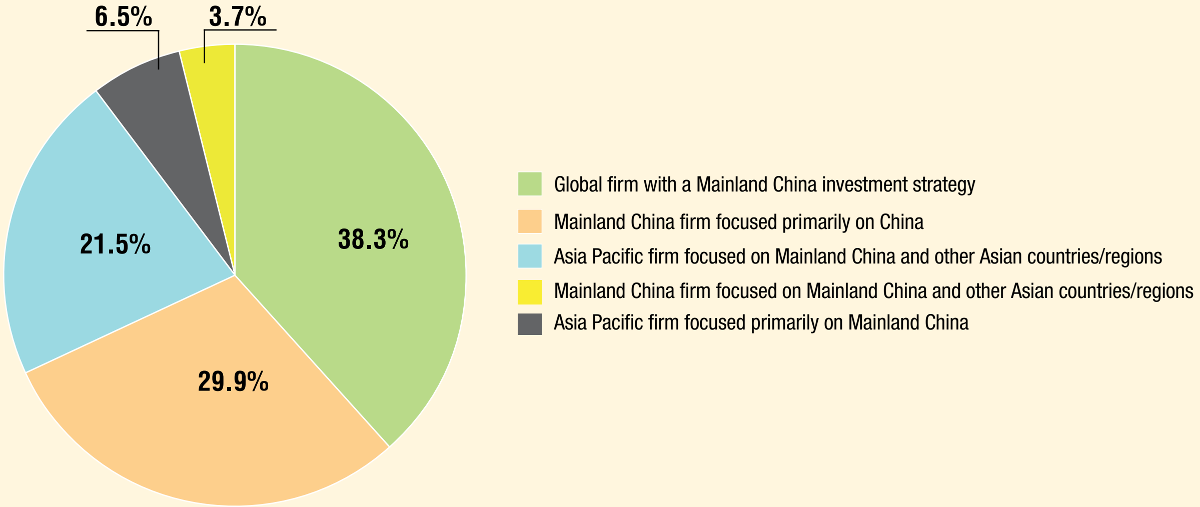
Assessment of Impact of Issues of Concern

The continuing home-purchase restrictions, high cost and difficulty of external financing, and the central government's real estate tax policies were again cited as the factors with the greatest negative impacts on the industry.

Home-purchase restrictions, aimed at deflating home prices and in place for several years, are seen as having seriously affected the residential sector. Both developers and investors—except for large state-owned or listed developers—complained of the difficulty of obtaining bank financing. Many interviewees anticipate a growing number of small players defaulting on their loans and trust products, as well as a long-term consolidation of the industry, with the largest players with access to cheap funding taking up a larger market share. Interviewees also said the land-appreciation tax was being collected more strictly than it was previously, and the property tax, which is being tried in Shanghai and Chongqing, will have a negative impact on the residential market, even though its impact currently is limited.

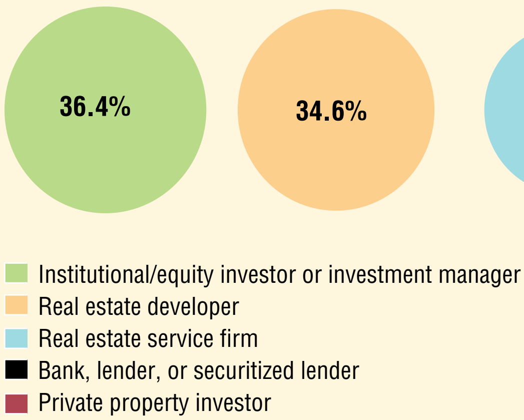
Though land policies by local governments were not seen in the survey results as having a negative impact, many interviewees believe that aggressive land sale and development policies by some local governments have led to an oversupply. Tier 1 cities were seen as being relatively undersupplied with land, while Tier 2 and 3 cities, such as Shenyang, Chongqing, Tianjin, and Chengdu, have been experiencing a huge oversupply of commercial properties due to the development of new districts that have relatively limited demand.

Survey Responses by Geographic Scope of Firm



Source: *Mainland China Real Estate Markets 2014* survey.

Survey Responses by Type of Firm



Source: *Mainland China Real Estate Markets 2014* survey.

Population, 2010–2025 (millions)

			2010–2025 Growth	
	2010	2025[a]	Change	Percentage
Shanghai[b]	19.55	28.40	8.85	45%
Beijing[b]	15.00	22.63	7.63	51%
Guangzhou[c]	10.49	15.47	4.99	48%
Shenzhen	10.22	15.54	5.32	52%
Chongqing[b]	9.73	13.63	3.89	40%
Wuhan[c]	8.90	12.73	3.82	43%
Tianjin[b]	8.54	11.93	3.40	40%
Dongguan	7.16	9.61	2.45	34%
Chengdu[c]	6.40	9.97	3.57	56%
Nanjing[c]	5.66	8.50	2.83	50%
Harbin[c]	5.50	8.21	2.71	49%
Shenyang[c]	5.47	7.43	1.96	36%
Hangzhou[c]	5.19	8.45	3.26	63%
Xi'an[c]	4.85	6.93	2.08	43%
Zhengzhou[c]	3.80	6.02	2.22	59%
Qingdao	3.68	5.44	1.76	48%
Jinan[c]	3.58	5.32	1.74	48%
Taiyuan[c]	3.39	4.99	1.59	47%
Kunming[c]	3.39	4.82	1.43	42%
Dalian	3.31	4.48	1.18	36%
Suzhou	3.25	5.83	2.58	80%
Wuxi	3.22	5.14	1.92	60%
Changsha[c]	3.21	4.94	1.73	54%
Urumqi[d]	2.95	5.06	2.10	71%
Hefei[c]	2.83	5.04	2.21	78%
Fuzhou[c]	2.80	4.24	1.44	51%
Shijiazhuang[c]	2.74	4.19	1.45	53%
Xiamen	2.70	4.87	2.17	80%
Wenzhou	2.64	4.04	1.41	53%
Ningbo	2.63	4.26	1.62	62%
Lanzhou[c]	2.49	3.61	1.13	45%
Nanchang[c]	2.33	3.53	1.20	51%
Nanning[d]	2.10	2.91	0.82	39%
Haikou[c]	1.59	2.28	0.69	43%
Zhuhai	1.36	1.98	0.63	46%
Sanya	<0.75			

Source: United Nations, Department of Economic and Social Affairs, Population Division, Population Estimates and Projections Section, World Urbanization Prospects. The *2011 Revision Data* report, used here, is for urban agglomerations, which refer to the de facto population contained within the contours of a contiguous territory inhabited at urban density levels without regard to administrative boundaries. It usually incorporates the population in a city or town plus that in the suburban areas lying outside of but adjacent to the city boundaries. This source tracks only cities with an urban agglomeration of 750,000 or more.

a. Projections. b. Municipality with provincial status. c. Provincial capital. d. Autonomous region capital.

2012 Gross Regional Product

	RMB (billion)	US$ (billion)
Shanghai	2,018.2	319.9
Beijing	1,787.9	283.4
Guangzhou	1,355.1	214.8
Shenzhen	1,295.0	205.3
Tianjin	1,289.4	204.4
Suzhou	1,201.2	190.4
Chongqing	1,141.0	180.9
Chengdu	813.9	129.0
Wuhan	800.4	126.9
Hangzhou	780.2	123.7
Wuxi	756.8	120.0
Qingdao	730.2	115.7
Nanjing	720.2	114.2
Dalian	700.3	111.0
Shenyang	660.3	104.7
Ningbo	658.2	104.3
Changsha	640.0	101.4
Zhengzhou	555.0	88.0
Dongguan	501.0	79.4
Jinan	480.4	76.1
Harbin	455.0	72.1
Shijiazhuang	450.0	71.3
Xi'an	436.6	69.2
Fuzhou	421.8	66.9
Hefei	416.4	66.0
Wenzhou	365.0	57.9
Kunming	301.1	47.7
Nanchang	300.1	47.6
Xiamen	281.7	44.7
Nanning	250.3	39.7
Taiyuan	231.1	36.6
Urumqi	200.4	31.8
Lanzhou	156.4	24.8
Zhuhai	150.4	23.8
Haikou	81.9	13.0
Sanya	33.1	5.2

Source: National Bureau of Statistics of China.

CHAPTER 1

Investment and Development Prospects

Investment and development ratings (on a 1–5 scale) for the 36 cities in the 2014 survey declined 8.5 percent on average, indicating a more pessimistic outlook overall on prospects compared with last year. All but six of the 36 cities experienced some decline in investment ratings, and all but five saw development ratings slip.

In addition, only four cities' ratings indicate they are "good" or better for investment prospects this year, down from seven cities last year, and 11 cities' ratings indicate they are "poor" or worse for investment prospects, compared with six cities last year. Similarly, on the development side, only four cities' ratings indicate they are "good" or better this year, down from ten last year, and ten cities are rated "poor" or worse, compared with four last year. The balance of the cities are rated "fair" for both investment and development in both years.

Improvement in an individual city's ranking based on this years' ratings compared with last years', as discussed below, in some instances are due to an increase in numerical ratings year-over-year, but in other instances are attributable to the overall decline in numerical ratings: a relatively small decline (about 10 percent or less) typically resulted in a stable or improved ranking among the cities, while somewhat larger declines typically resulted in a drop in ranking.

Top-Ranked Cities: Shanghai (1), Shenzhen (2), Beijing (3), and Guangzhou (4)

For the first time in the four years of this survey, the four Tier 1 cities—Shanghai, Shenzhen, Beijing, and Guangzhou—are the four highest-ranked cities for investment. Shanghai topped the list for the second year in a row and Beijing remained in third place, but Shenzhen and Guangzhou moved up to second and fourth places from sixth and seventh places, respectively. Rankings of both Shenzhen and Guangzhou have shown strong upward movement over the past four years.

The cities' ratings for investment indicate that survey respondents consider all four cities to have "good" prospects. Though the numerical ratings for Shenzhen and Guangzhou inched up and the two other cities experienced a slight downward shift from last year, all four cities stayed in the same rating category as last year.

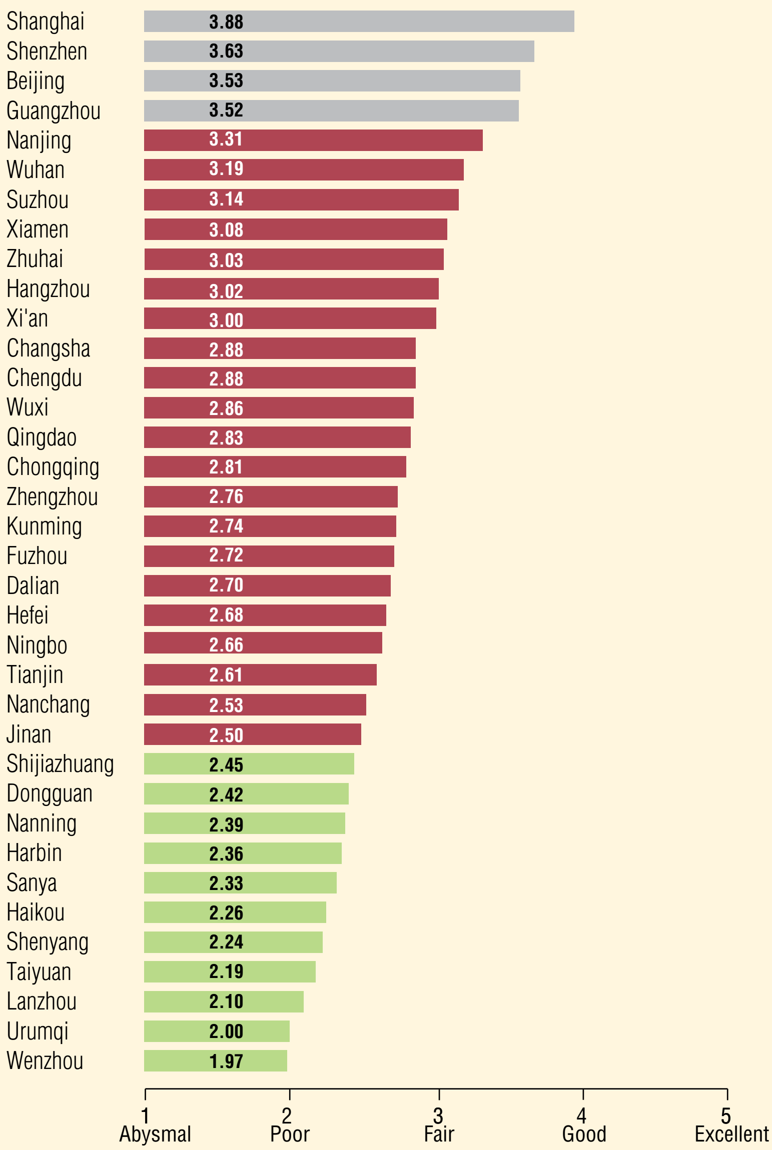
And for the first time in four years, three of the Tier 1 cities—Shanghai, Shenzhen, and Guangzhou—are the three highest-ranked cities for development prospects. Beijing is ranked fifth. The rankings of Shanghai, Guangzhou, and Beijing for development prospects remain unchanged from last year, but Shenzhen moved up from sixth place to second. As is the case with investment prospects, Shenzhen has shown strong upward movement in its ranking over the past four years.

The ratings for Shanghai, Shenzhen, and Guangzhou for development indicate that survey respondents consider these three cities to have "good" development prospects, the same rating category as last year. A slight decline in numerical ratings changed Beijing's rating category from "good" last year to "fair."

Chairman Wang Shi of China Vanke cited the key reasons for the relative stability of the Tier 1 cities in his speech on June 6, 2013, at the ULI Asia Pacific Summit in Shanghai. "There is a bubble in China's real estate markets; it is unlikely the bubble will burst in the near term, especially in big cities like Beijing and Shanghai," he said. "Beijing, Shanghai, Guangzhou, and Shenzhen are not only the centers for politics, economy, and employment, but also have high concentrations of top education and health care resources. At the same time, these cities have relatively transparent and open environments, attracting strong demand and a reasonable increase in housing prices."

Exhibit 1-1

City Investment Prospects

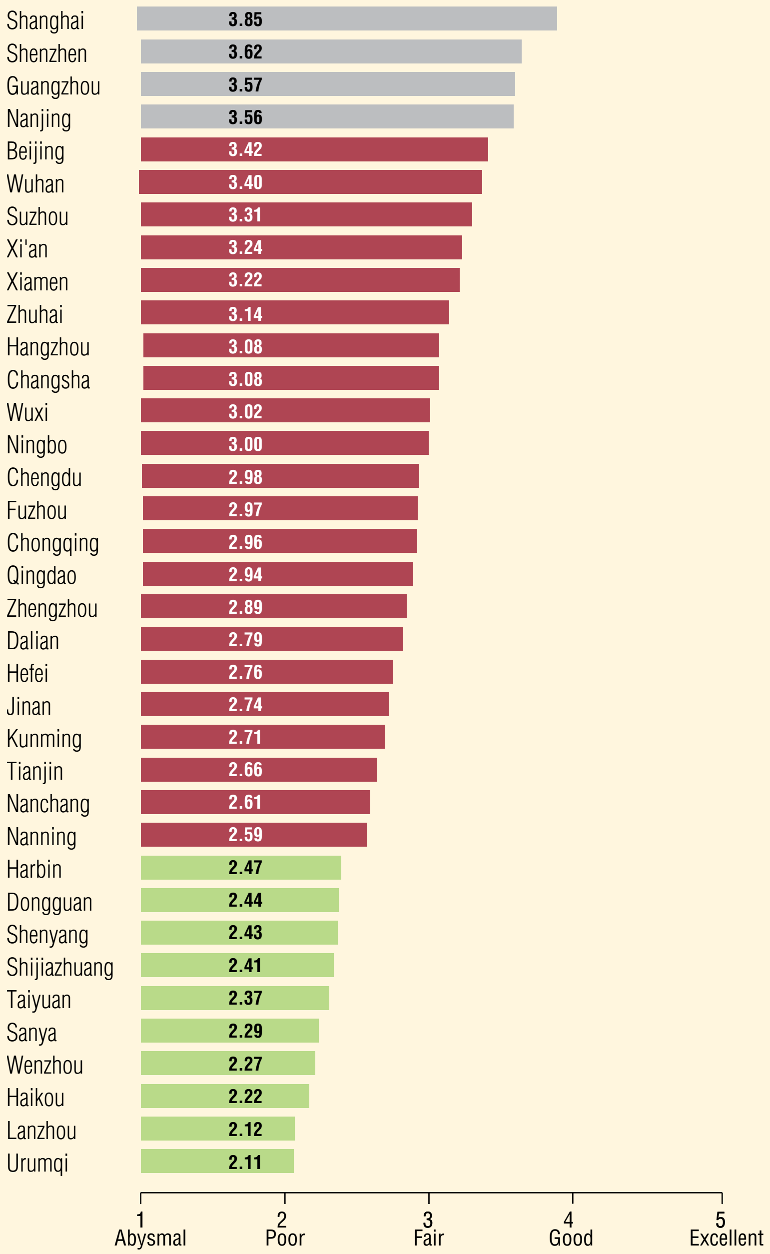


Source: *Mainland China Real Estate Markets 2014* survey.

He noted that though Beijing and Shanghai have about 2 percent of the country's population, they have almost one-third of the nation's 211 universities, 11 percent of the top hospitals, and 43 percent of the subway lines. "However, some of the third- and fourth-tier cities do not have high-quality public resources," he said, "and due too aggressive city planning and development, there is a risk of a bubble."

EXHIBIT 1-2

City Development Prospects



Source: *Mainland China Real Estate Markets 2014* survey.

Shanghai. It is not surprising that Shanghai has retained its top ranking for both investment and development prospects. In Mainland China, the city has the deepest pool of investment-grade assets of all the major asset types: office, retail, hotels, logistics warehouses, and business parks, and some specific investment-grade assets have been traded more than twice in the past ten years. The city is widely considered the most transparent and easiest for foreign investors and developers to operate in given the relative abundance of local and foreign talent. Foreign funds started investing in earnest about a decade ago and have since successfully exited from many of their earlier investments and reinvested in new projects. Said one foreign fund manager, "We like everything in Shanghai, but it is a matter of pricing." This view is consistent in Shanghai's top or near-the-top ranking in all the major asset categories. Shanghai ranked first in office, retail, industrial/distribution, and luxury residential; second in hotel; and third in midmarket residential.

Shanghai has three well-defined business districts—Lujiazui, and districts along Huahuai Road and Nanjing Road. There is little doubt that Lujiazui will become one of the premier financial centers of the world, and its new position will perhaps be heralded by completion of the iconic 632-meter Shanghai Tower in 2015. The Huaihai Road business district in the former Luwan District has been expanding westward with the recent completion of a major mixed-use project by the Hong Kong developer Sun Hung Kai Properties (SHKP) on the site previously occupied by Xiangyang Market. In particular, a number of buildings have gone through substantial repositioning and retrofitting to cater to higher-income and often younger segments of the market. Similarly, the Nanjing Road business district, which started with Shanghai Center and Plaza 66 in the late 1990s, have welcomed the opening of the repositioned and expanded Kerry Center. Wheelock Square and Eco City, completed in the past few years, have further expanded and vitalized the western end of the district.

Whereas many of the earlier investments by foreign institutional investors were concentrated in these three districts, decentralized locations have seen a substantial increase in investment. The expansion of the subway system and business parks with a focus on high tech and biomedicine has created an increasing number of pockets of investment-grade assets, such as Zhangjiang High-Tech Park and Yangpu Knowledge and Innovation Community (KIC).

While the initial investments were dominated in the office sector by opportunistic funds, the number and types of investors have increased substantially, including local insurance companies and even foreign sovereign funds investing in suburban office parks and retail shopping centers.

Shanghai's number-one ranking for development is most likely due to the substantial volume of new development opportunities in decentralized locations supported by significant infrastructure investment and the central government's favorable policies. Arguably the most significant development project in Shanghai's suburbs is the Hongqiao Transportation Hub (HTH). By 2020, the HTH will have 4 million square meters of commercial area completed. This area is supported by the Hongqiao International Airport, two subway lines, and a high-speed railway station with direct links to many of the major cities in China, including Beijing, Nanjing, Hangzhou, and Wuhan. One subway stop away, the Hongqiao Convention and Exhibition Center building—about 400,000 square meters of gross floor area (GFA), three times the size of the city's main convention center—is under construction, scheduled to be completed this year.

The recently announced Shanghai Free Trade Zone (FTZ), made up of four bonded zones located in the Pudong District, is also expected to have a substantial impact, with a large number of local and foreign companies setting up new businesses there, attracted by the favorable policies. In the Shanghai FTZ, the government has allowed foreign investment in a variety of sectors, including finance, shipping, and trade, as well as professional, cultural, and social services. The FTZ also will provide a more comprehensive range of tax-friendly facilities than bonded zones and is expected to offer foreign-denominated offshore banking, financial leasing, cross-border financing, and international trade settlements.

Other major development opportunities are around Shanghai Disneyland, which will open in 2015; the Expo site; and the Western Bund in the Xuhui District along the Huangpu River.

Some survey respondents voiced concern about the impact the large supply of office buildings in decentralized locations will have on the rent and occupancy rate of the existing buildings in core areas. There also has been grumbling about the city government's recent policy change that would reduce the lease period for industrial land from 50 years to 20 years, posing a serious challenge to logistics developers. For some, the FTZ's impact is unclear, and housing prices remain unreasonably high compared with the income level of residents. A senior research analyst in an international real estate agency said, "There are too many things being built in Hongqiao, and the market there is already under pressure."

Nonetheless, Shanghai is the most advanced city with the most mature real estate market in Mainland China. Moreover, compared with most cities, Shanghai has carefully controlled its new land supply. Also, with the economy seeing further upgrading and transportation infrastructure improving, the overall view is that Shanghai will be able to accommodate the new supply relatively well.

Moreover, Shanghai's growing economy is expected to have a positive influence in the Yangtze River Delta. "Shanghai will help small cities like Wuxi, Jinhua, and Changzhou in the regional urban cluster grow," one research analyst in an investment bank noted. "Shanghai is well connected with surrounding cities through good infrastructure."

Shenzhen. Shenzhen's strong performance this year appears to be largely due to the central government's designation of the Qianhai area as a special economic zone, providing the companies registered there with a wide range of preferential policies. The Qianhai Shenzhen–Hong Kong Modern Service Industry Cooperation Zone covers

15 square kilometers in the Nanshan District and focuses on the development of finance, modern logistics, information services, science, technology, and other professional service industries. Already, a large number of Mainland Chinese financial institutions have registered new businesses in the Qianhai area, attracted by the preferential policies, including the ease of setting up businesses and tax rates that are essentially the same as those in Hong Kong SAR. Earlier this year, Silverstein Properties of New York, in partnership with a local investor, won a waterfront site in the heart of Qianhai with total GFA of more than 400,000 square meters. "In the past, companies set up their regional headquarters in either Guangzhou or Shenzhen," a foreign fund manager said. "But with the Qianhai policy, some companies may move out of Guangzhou to Shenzhen."

While Qianhai is expected to provide a huge boost, Shenzhen's economy already has very strong foundations. Having Mainland China's second-most-important stock exchange and located next to Hong Kong, Shenzhen possesses a strong financial sector. Shenzhen is considered the center for China's private-equity industry: there are more private-equity companies in the city than in any other Mainland Chinese city. It is also the home of a number of global high-tech companies such as Huawei. With its largely migrant population, the city continues to be a magnet for local Chinese talent.

Two other positive factors are its relatively limited supply of land available for development and its close integration with Hong Kong, Guangzhou, and nearby cities in Guangdong, to which it already is or soon will be connected by high-speed rail. Especially in the Guannei area of the city, the inventory of greenfield land is limited, and new projects will increasingly require redevelopment of previously developed areas, which generally takes much longer and is costlier than greenfield development. "There is a huge lack of supply. Land prices and rents are going up," said a developer familiar with the city. This view was echoed by a research analyst at an investment bank: "There is a shortage of land supply in Shenzhen and Guangzhou. Urban renewal is the only way out. There is a lot of short-term supply coming from redevelopment of old factory buildings."

Historically, Shenzhen's real estate market has been dominated by strong local players, and there has been a limited pool of investment-grade assets, with many office building strata sold rather than being retained en bloc. So, unlike Shanghai, Shenzhen has a limited pool of investment-grade assets, and foreign investment in the city has been limited. Development of the Qianhai area may help the local real estate industry mature.

However, the sudden increase in office supply may be disruptive. One research analyst at a real estate agency cautioned, "The Shenzhen office market is less attractive as a lot of office supply is coming in 2015–2016 in Houhai and a lot more supply in 2018–2020 in Qianhai. Developers and investors are betting on Shenzhen and think it will become a mini–Hong Kong."

Beijing. Along with Shanghai, Beijing has the deepest pool of investment-grade assets in Mainland China. As the nation's capital and the home of many of the nation's most prestigious universities, Beijing has a strong economy based on government services, high tech, and the professional service industry. Many multinational corporations have set up their China or even Asia Pacific regional offices in the city.

During the past several years, Beijing has surprised many investors who fretted about the seemingly massive oversupply of office buildings released after the 2008 Olympics. With strong demand for Grade A office buildings by local companies, the new supply has been fully digested, and now Beijing has the highest average office rents in Mainland China. Top office buildings in the central business district (CBD) and Finance Street command a daily rate of about RMB 15 per square meter of GFA, while comparable buildings in Shanghai, the city with the second-highest office rents, command around RMB 12 per square meter.

For many, the expansion of the CBD, which will release over 1 million square meters of GFA during the next few years, is not a real threat given the strong demand for office buildings from local companies. The increase in rent is tied to the relatively limited new supply in recent years. As one developer with a project in the city noted, "You cannot add density. There are height restrictions in the city core."

Like last year, Beijing ranks near the bottom in terms of livability, which is seen as hurting the market, especially in the luxury residential market. Wealthy Chinese and expats prefer to live in Shanghai; as such, luxury residential units command around 70 percent of the price that can be achieved in Shanghai. Said one developer, "'What if Beijing's air pollution gets worse?' This question may be asked by the investment committee, especially for core investors whose investments are more on a long-term basis. If expatriates leave the city, there will be at least 10 to 20 percent less demand for international schools, luxury apartments, retail sales, high-end groceries, and restaurants."

In terms of development, Beijing is expected to have a large volume of projects near the second international airport, to be located in the Daxing District in the southern part of the city. The plan calls for the airport to have eight runways for civilian use and become the world's busiest airport, handling 130 million passengers per year when completed. Construction is scheduled to start this year, with Phase I scheduled to be completed by the end of 2018. Also, a new 37-kilometer high-speed rail line is planned to connect the airport and the Beijing South Railway Station. The area is expected to have a large business district, but its impact will not be felt for the next several years.

Guangzhou. Guangzhou's high ranking for investment probably results from the maturing of the Pearl River New Town and the improving infrastructure of the city following the 2012 Asian Games. Said a developer familiar with the city, "Because of the Asian Olympic Games, Guangzhou built a lot of modern buildings in the Pearl River New Town."

Some survey respondents complained that the city government continues to develop new areas without providing sufficient time for recently completed areas to mature. One foreign investor, whose firm has invested in Guangzhou, said, "Guangzhou has a new financial center, the Guangzhou International Financial Town [GIFT]. It is having negative impact on the Pearl River New Town, which is barely stabilized." Added the investor, "Retail rents in the Pearl River New Town are not doing well. There are too many retail new openings in the area. Retailers want to protect their brand and are very choosy in terms of site selection." GIFT is adjacent to the Pearl River New Town and covers 7.5 square kilometers. GIFT will largely consist of office and residential towers.

Nonetheless, like the other Tier 1 cities, Guangzhou is running out of developable land in the city core. Said an experienced analyst, "Shenzhen and Guangzhou are good. There is a shortage of land supply in those two cities. Urban renewal is the only way out. There is a lot of short-term supply coming from redevelopment of old factory buildings."

Also, while the additional office supply in GIFT is expected to keep office rents from rising, high-end residential units have clearly benefited from the maturation of the Pearl River New Town, which includes a large public open space at its center and a host of world-class cultural facilities, including a Zara Hadid–designed opera house. Residential units that traded at about RMB 20,000 per square meter several years ago are now trading at over RMB 50,000 per square meter.

Nanjing (5)

Nanjing's ranking for investment prospects jumped to fifth from ninth last year. Its rating for investment prospects remains "fair." With a slight increase in its numerical rating for development prospects, Nanjing's development ranking also jumped, to fourth place from 11th; its rating category improved to "good" from "fair."

For a long time, Nanjing received little attention from institutional investors. Despite being the provincial capital of Jiangsu province, it was often left in Suzhou's shadow. However, the opening of the high-speed railway connecting Nanjing to Shanghai and Beijing has made the city very accessible. "Nanjing is an important transportation hub in China," said the head of investment for a local developer with a nationwide footprint. "The history of the city is long and there are many universities. The high-speed railway has a large positive impact on the city."

Said another local developer, "The Nanjing market is very healthy. It has only five months of housing inventory. There are 35 months of office building inventory, but this level has been the case for some years—so, generally stable. Though supply is big, demand has been strong as well. Nanjing used to be among the five or so most important cities until the '60s, but has declined over the years in relative importance. However, this may change as the Yangtze River Delta continues to grow and expand, with Nanjing emerging as a key city in the region."

An important element of Nanjing's emergence as a key business center is the development of the Hexi central business district, located in the Jianye District. Hexi CBD covers two square kilometers and stretches four kilometers south to north. The Nanjing government started the planning and construction of the CBD in 2002. According to the plan, the Hexi CBD has total planned GFA of 6 million square meters and is to become a cluster of modern services industries, exhibitions, culture, and sports, as well as trading in Jiangsu province. So far, Phase I, covering one square kilometer with total GFA of 2.6 million square meters, has been completed. With the Youth Olympic Games being held in the Jianye District of Nanjing this year, the government has accelerated development of Hexi CBD Phase II.

Wuhan (6) and Suzhou (7)

Wuhan. Wuhan's ranking for investment prospects slipped to sixth place this year from fourth last year and its rating declined to "fair" from "good." But Wuhan's ranking for development prospects moved up to sixth place from eighth; even though Wuhan's numerical rating for development slipped a bit, it experienced one of the smaller declines of all cities, pushing its ranking upward. Its rating category for development prospects is "fair."

Wuhan's relatively high ranking for the past three years shows the wide recognition of the city as an important economic center. Wuhan's economy is anchored by its transportation hub, growing high-tech industry, and universities. "The city is one of the key transportation hubs in China, with mature infrastructure, including high-speed rail," said one foreign investor familiar with the city. "The city has a strong industry support, including 'Silicon Valley' in Wuchang." Said a local developer with a project in the city, "The high-speed railway has a great impact on the overall property market in Wuhan. In the first half of this year, the Wuhan–Shanghai high-speed railway will be operational. Wuhan–Guangzhou/Shenzhen has been operational since 2008. Wuhan is a key transportation hub. Enterprises recognize this and set up regional headquarters in the city."

In the inner part of China, Wuhan is the only city that sees high-end residential projects selling at a price above RMB 30,000 per square meter. Said a local investor, "Wuhan is okay. There is an oversupply in the city at the moment. However, when the transportation infrastructure, especially more metro lines, is in place, the city can accommodate more people and thus the take-up of inventory will accelerate." Regarding the positive impact of transit expansion, another local developer said, "Wuhan has opened three metro lines already. In the next few years, the city will open a new metro line each year. The impact from the current subway system is relatively limited. The metro system has not expanded to new areas. Projects at the intersection of two or three lines are selling really well."

Another local investor was more upbeat about Wuhan's residential market. "It is wrong to say there is too much supply in Wuhan," the investor said. "The current inventory of residential units is about ten months of sales, substantially down from 22 months in 2012." This sentiment regarding the residential market was echoed by another developer, who said, "There is a divergence among projects. Some projects are doing really well while others are performing badly. Overall, sales volume has decreased by 10 percent y-o-y, which is still okay compared to other Tier 2 cities in China. Part of the reason why sales volume decreased is because there is less new supply in the first half of the year."

Some complained about the lack of a clear central business district. Said the head of a foreign investment fund, "To some extent, jobs locate to cities with good higher education resources. Wuhan is one of those cities. The problem with Wuhan is that the city has too many satellite areas and does not have a center." A developer noted the negative impact this has on the city's economy: "The city lacks a focal point for business. Office and retail suffer but residential is good. People are leaving again as there are not enough services-sector jobs available in the city. It's critical to attract more major corporations to the city."

The city seems to have recognized the need for a CBD to bring in service-sector companies. One interviewee said the local government plans to build a main CBD in Hankou District near the confluence of the Yangtze and the Han rivers. This project, however, will take many years to realize because it involves redevelopment.

Suzhou. After a one-year spike to second place last year, Suzhou's ranking for investment prospects fell to seventh place, with a decline in ratings to "fair" from "good." This matches Suzhou's ranking and rating for development prospects.

Suzhou is seen as suffering from an oversupply of office buildings. Said one investor, "Our team recently visited Suzhou Industrial Park [SIP]. Our host joked that we were welcome to use office space in the same office building for free if we set up a company in Suzhou. There are so many empty office units in the building." The office oversupply is not expected to improve much in the near term: over 2 million square meters of GFA of office buildings are scheduled for completion in the next two years, mostly in SIP.

Another investor voiced similar sentiments: "Residential sales price has been flat during the last two years. Overall, there is oversupply of office space in Tier 2 cities in China. For office market in Suzhou, there is no real demand."

Xiamen (8) and Zhuhai (9)

Both Xiamen and Zhuhai experienced a marked jump in their investment rankings, in part boosted by relatively small declines in numerical ratings. Their rankings for development prospects remained unchanged.

Xiamen. Xiamen's ranking for investment prospects jumped to eighth place from 13th last year though its rating category remains "fair." Xiamen's ranking for development remained the same both years, ninth, while its rating category shifted down to "fair" from "good." Said a developer, "Xiamen's real estate market is very healthy. It is a key economic center for Fujian and nearby provinces of Zhejiang, Jiangxi, and Guangdong; similar to Qingdao in positioning." Xiamen also benefits from its high livability, despite its very high housing prices, attracting a large number of wealthy families both from Fujian and nearby provinces, as well as Taiwan. Xiamen is ranked third this year in livability, close behind Shanghai and Hangzhou.

Xiamen is generally regarded more favorably than its nearby rival, Fuzhou. Said an executive with a developer, “Xiamen’s property market performs even better than Fuzhou as the city benefits more from the Taiwan Straits. Xiamen is closer to Taiwan and there are more Taiwanese enterprises in the city than in Fuzhou. As a result, home prices in Xiamen are higher than Fuzhou.”

Zhuhai. Zhuhai’s investment ranking jumped to ninth place from 18th last year, while its development ranking was unchanged at tenth. Its rating category remains “fair” for investment while it slipped to “fair” from “good” for development prospects.

The sharp rise in Zhuhai’s ranking seems to be attributable to the soon-to-be-completed bridge that will link the city to Hong Kong. Said a foreign investor familiar with the city, “Zhuhai is promising mainly because of the bridge. Zhuhai is a better place for retirement than Sanya. Zhuhai appeals to people from surrounding cities in Guangdong province and Hong Kong. Living in Zhuhai is so much cheaper.” Those thoughts on the bridge’s impact were echoed by a developer: “Zhuhai is not doing well at the moment, as the population is small. However, market fundamentals will improve after the Zhuhai–Macau–Hong Kong Bridge is operational.”

In addition, Hengqin Island, in the southern part of Zhuhai adjacent to Macau, is the site of a large-scale development. Said a Hong Kong–based developer, “There are lots of things happening in Hengqin Island. Hengqin Island is for cross-border experimental financial reforms. There are good communities in Zhuhai and the city is leisurely paced. Eventually, the city will be linked with Macau and Hong Kong by bridges. The city will benefit from Hong Kong. Living in Zhuhai is like living in a suburb of Hong Kong. The city is also linked with Zhongshan and Guangzhou by a high-speed train.”

Hangzhou (10) and Xi’an (11)

Hangzhou. Hangzhou’s investment ranking fell to tenth place from fifth last year as its rating category changed from “good” to “fair.” Hangzhou’s development ranking shifted up a bit to 11th place from 13th last year, even as its numerical rating declined slightly; its prospects remain “fair.”

The drop in Hangzhou’s investment ranking is not surprising given the recent media reports of substantial residential price-cutting by developers to boost stalled sales. “As quoted by the media that Hangzhou witnessed a sharp decline in housing prices, this is because in the past three years, the government put up as much as six times the average land supply per annum,” said one local developer. “In terms of the existing residential inventory alone, it will take 18 months for the city to take up. As a result, developers chose to sell as quickly as possible and cared less about the selling prices they could achieve. In addition, the private sector in Zhejiang province is experiencing problems, while the overall domestic economy is slowing down.”

Said a developer with residential projects in the city, “Hangzhou’s residential market will continue to be weak unless there is a change in government policies. Stock is too much. There is a lot of land to be developed that was sold over the past several years at very expensive prices. If sold to the basic demand market, margin would be low or developers may even lose money.” However, the same developer said the price decline for projects in good locations is limited to 5 to 10 percent.

Still, Hangzhou’s status as the economic, political, and educational center of the prosperous Zhejiang province will prevent the city from slipping into a long-term lull. “Hangzhou receives great recognition from people in Zhejiang province,” said a developer. “Short-term supply is huge; however, this will not become a problem in the long run.” An investor who invested in Hangzhou was more upbeat about the positive impact from the expanding metro system: “Once you have a second or third subway line, that forms a web of subway lines. It creates a critical mass, and projects can really benefit from the infrastructure.”

Xi’an. Xi’an’s investment ranking was fairly stable at 11th this year, compared with tenth place last year, and its rating category remains “fair.” But Xi’an’s development ranking fell to eighth from fourth last year, and its rating fell to “fair” from “good.”

Xi’an is one of the two inland cities whose investment ranking has remained in the top quartile; the other is Wuhan. With a large number of universities and high-tech businesses, including foreign companies, expanding their investment in the city, the interviewees had generally positive views on the city. “Xi’an is positive in investment,” said one investor. “The rezoning of the city is helping get more things constructed around the city core. Besides, the residential units are currently sold at RMB 8,000 per square meter, even in downtown. Investments there are pretty safe.” Said another investor familiar with the city, “I absolutely like Xi’an. Prices in Xi’an have not gone up. The market fundamentals there are good. Xi’an has a massive skilled labor force. If you don’t have jobs, you don’t have rooftops.”

One big contributor to Xi’an’s real estate market is the establishment of Samsung’s research and development center in the New High-Tech Zone. Samsung has already committed US$7 billion to build its largest R&D center outside Korea, and the next two phases will see another US$14 billion of investment in the city. “Samsung’s R&D center project is expected to bring in a large Korean community. Residential units there sell for around RMB 12,000 to 13,000 per square meter. But other parts, including the city core, have much lower prices,” said a developer with projects in the city. “Xi’an is interesting in the sense that there is not much difference in land price between the core and the outside core.”

Though Xi’an received mostly positive comments during the interviews, one investor cautioned that it is not an easy place for foreigners to operate in because of limited transparency.

Changsha (12), Chengdu (13), and Wuxi (14)

Changsha. Changsha's investment ranking rose to 12th place from 17th last year, in part boosted by a relatively small decline in its numerical ratings, which indicate that respondents continue to consider Changsha to have "fair" prospects for investment. Similarly, its development ranking improved, rising to 12th place from 16th, while its ratings show respondents continue to consider its development prospects "fair."

Said an executive of a large Hong Kong–based developer, "Home prices in Changsha have been quite stable in the past few years. Compared with other Tier 2 cites, prices in Changsha are not high. Supply and demand in the city are balanced. Changsha has relatively high transaction volume compared with other Tier 2 cities. However, investors and developers shall be cautious as the city auctioned off a very large amount of land in the past few years," which will translate into a huge supply in the coming years. This view was echoed by an executive of another large nationwide developer, who said, "Changsha is not the worst among Tier 2 cities. There is a large inventory in Changsha, and a lot of builders are already there. The future supply will be high."

Chengdu. Chengdu was the top-ranked city for investment prospects in the first two years of the survey, 2011 and 2012, but its ranking has declined steeply the past two years, slipping to 13th place this year from eighth last year. During the first two years, survey respondents rated Chengdu's investment prospects "good"; this year and last, survey respondents lowered that assessment to "fair." Likewise, Chengdu's ranking for development prospects has fallen from number one for the first two years—to seventh place last year and 15th place this year. Ratings for development have fallen from "good" for the first three years to "fair" this year.

Though not as worrisome as the oversupply of commercial properties in Shenyang and Tianjin, oversupply is considerable in downtown as well as in the Tianfu New City to the south. Said one market watcher, summarizing Chengdu's real estate market, "Some developers in Chengdu are discounting prices as developers were previously overly optimistic about housing prices. There is too much supply of office in Chengdu; however, it still has good long-term potential for long-term investments given the number of workforce in the market."

Regarding the luxury residential market, a developer familiar with Chengdu said, "Chengdu's residential market is better compared to Chongqing as there is no property tax levy in Chengdu. The overall average selling price in Chengdu is similar to Chongqing's. However, high-end products in Chengdu are selling for RMB 25,000 per square meter, which is much higher than in Chongqing due to the property-tax levy in Chongqing." High-end residential properties in Chengdu can command high prices largely because of the strong high-end job market and livability. Though its livability ranking fell to sixth from third, Chengdu still ranked highest among inland cities; nearby Chongqing was ranked 19th and Xi'an 20th.

Wuxi. Wuxi's investment ranking remained unchanged this year at 14th, and its rating remains "fair". But its development ranking shot up to 13th place from 19th, boosted by a relatively slight decline in its numerical rating; it remains in the "fair" category. Wuxi is seen as having an oversupply of land and sellable inventory. Said one developer, "We bought a land parcel in Wuxi three years ago. Today, the city is so overbuilt. The government gives high plot ratio and makes us build tall towers. Construction cost is expensive."

Nonetheless, the proximity to Shanghai appears to be benefiting Wuxi. Despite the widely shared concern about oversupply in the city, Wuxi ranks 11th in retail and industrial/distribution, 14th in midmarket residential, and 17th in office.

Qingdao (15) and Chongqing (16)

Both Qingdao and Chongqing saw their rankings slip for investment and development prospects; even with a decline in numerical ratings, the two cities are still considered to have "fair" prospects for both investment and development.

Qingdao. Qingdao ranks 15th for investment, down from 11th last year, and its development ranking is 18th, down from 15th.

Much like Dalian, Qingdao is somewhat geographically isolated and has not received much attention from foreign investors. One developer who plans to invest in Qingdao soon likes the city for its strong local economy, which is anchored by several large local companies, such as Tsingtao beer and white-goods manufacturing giants Haier and Hi-Sense. He also noted the strong marine industry and the large shipping sector with its deep seaport, which positions Qingdao better than Xiamen, which lacks a deep seaport. The same developer is also enthusiastic about the impact of the eight subway lines under construction and scheduled for completion in the next three to five years.

One Hong Kong–based developer was optimistic about the city, citing the city's good planning. "Qingdao is another city in Mainland China that has done good urban planning," the investor said. "Qingdao has been quite successful in the new CBD, and it has a very good harbor. The city is building a subway system, and I see potential in Qingdao."

Chongqing. Similar to Chengdu, Chongqing saw its ranking slip as excitement about the city only a few years ago has evaporated. Chongqing, 16th in investment ranking, is down from 12th last year, and its development ranking is 17th, down from 14th.

"There is an oversupply of retail and office in Chongqing," said a developer with a project in the city. "The vacancy is expected to increase. Future new supply in Jiangbeizui, Yuzhong, and Daping will be several hundred thousand square meters each in the next year. Usually, occupancy of office buildings reaches 70 percent during the first year after completion. Given the large supply in the city, the occupancy can only reach 20–30 percent in the first year after completion." The oversupply is largely the result of the push by district governments in the core area of Chongqing for more high-grade office buildings to attract businesses. However, the same developer said that with many office buildings strata sold, the rent level for high-grade office buildings is "quite stable" because big tenants, especially multinational corporations, do not want to be in strata-owned buildings.

Regarding housing, the same developers said, "Residential in Chongqing is relatively stable compared with other cities. Per capita GDP in the city is ranked relatively higher. But the housing price is low ranked in the nation. The average selling price is around RMB 7,000 per square meter. The supply-and-demand ratio is close to 1."

However, for the high-end residential sector, the property tax is seen to be taking a toll. Together with Shanghai, Chongqing has been implementing a trial property tax before the central government rolls out the tax to other cities. Currently, the tax is only applied to those residential units with transaction prices that are double the city's average sales price in the past two years. The same developer noted that sales of high-end products have fallen substantially, and the price gap between suburban midmarket units and high-end units in the downtown areas is limited compared with that in other cities like Shanghai, Beijing, and Chengdu.

Zhengzhou (17)

Zhengzhou experienced the largest change in investment ranking, shooting up to 17th place from 31st last year in part due to its improved numerical rating. Still, survey respondents place the city's investment prospects in the "fair" category. Zhengzhou's ranking for development prospects also improved, rising to 19th place from 27th; but with a somewhat stable numerical rating, its development prospects remain "fair."

The provincial capital of Henan province receives little attention from developers and investors. "People have ignored this city for many years," said one developer who is considering entering this market. This makes it relatively easy for outside developers to initiate work in Zhengzhou, he said, and he thinks opportunities exist. Another developer familiar with the city said a key is the city's large population. In his view, while it has limited high-tech and service sector jobs, Zhengzhou, with a population of around 9 million, plus over 80 million in other parts of Henan province, has huge demand for midmarket residential units.

The big jump in Zhengzhou's ranking may be due to the development of a new central business district named Zhengdong CBD, which has a planning area of about 3.5 square kilometers in two rings of 60 high rises. The local government reportedly is worried about the leasing of the office buildings planned in the CBD and has rezoned some office buildings for residential use.

Kunming (18), Fuzhou (19), Dalian (20), and Hefei (21)

Results for this group of lower-ranked cities for investment prospects changed little from last year. Rankings changed only slightly, and although each experienced some decline in numerical ratings, their investment prospects remain "fair."

Development prospects followed a similar pattern, with only slight changes in rankings and development prospects remaining "fair" despite a decline in numerical ratings. The exception was Kunming's marked decline in ranking to 23rd place from 12th, although its development prospects also remained "fair."

Kunming. Kunming, the capital of Yunan province, is seen by some of the interviewees as having an oversupply of residential space, reflected in its ranking at 27th for the midmarket residential sector. According to an investor with an investment in a residential development in the city, there are pockets in the city's core area where demand is strong. "We have an infill development project within the Second Ring Road of Kunming in a well-established neighborhood," he said. "Four hundred units were sold out on a weekend."

Fuzhou. The provincial capital of the prosperous Fujian province, Fuzhou lags behind its nearby rival Xiamen in rankings for all property categories with the exception of industrial/distribution. In livability, it ranks 18th while Xiamen ranks third. Still, a research analyst said, "Xiamen and Fuzhou are good for residential investment and development. Also, there is not much oversupply in the commercial sector." An executive of a developer said, "Real estate market in Fuzhou develops rapidly. The city has attracted many domestic developers, and the market performs pretty well." An executive of another developer sounded a more cautious note: "Inventory there is high as people in Fujian don't stick to their own province and tend to go abroad. There is some bubble in Fuzhou as there is strong speculative demand. However, the market is not as bad as Wenzhou."

Dalian. Considered the most popular place to live in the northeast region, Dalian suffers from its lack of an urban cluster and the fact that the nearest large city, Shenyang, is nearly 400 kilometers away. "Dalian is with difficulties," a commercial lender commented. "There is too much retail and office supply in Dalian. But the primary residential market is doing well. Wanda's project in Donggang is selling well. The majority of the buyers are people from the northeast provinces who prefer to own properties in Dalian." The geographic isolation and limited population base makes logistics investment less profitable. Said one developer, "We have a logistics park in Dalian. We are not going to do new logistics projects in the city."

Hefei. The capital of Anhui province, Hefei benefits from its proximity to Shanghai and other cities in the Yangtze River Delta region. "Hefei benefits from its booming industrial development and its status as an important transportation hub," said a local developer. "Many manufacturers are relocating from Shanghai and Suzhou to this city." Said another interviewee, "Though the infrastructure there is not very advanced, the supply-and-demand fundamentals are healthy. There is limited supply of commercial development projects, especially hotels."

Ningbo (22), Tianjin (23), Nanchang (24), and Jinan (25)

This other group of lower-ranked cities also saw little change from last year for investment prospects. Rankings moved only slightly from last year, and although each experienced some decline in numerical ratings, their investment prospects remained in the "fair" category. The exception is Ningbo, which registered a more marked decline in its ranking.

Development prospects followed a similar pattern, with only slight changes in rankings, and although their numerical ratings declined, their development prospects remain "fair."

Ningbo. Ningbo's sharp decline in ranking for investment prospects is due to the oversupply of sellable properties and land, caused by the local government's aggressive land sales during the past several years. Moreover, unlike Hangzhou, its nearby rival, Ningbo has limited demand from out-of-town buyers. A local developer predicted that residential prices in Ningbo would drop more than those in Hangzhou. Said an executive of another developer, "Ningbo is the city where we see a lot of troubles. The inventory is extremely high. There are way too many developers in the city." However, he also noted that Ningbo's economic fundamentals are "not bad."

Tianjin. Tianjin's real estate market continues to suffer from a huge oversupply in the Yujiapu Financial District in Binhai New District. "There is no need to build an additional one square meter of office buildings for the next ten years," said a local developer familiar with the city "However, the old Tianjin area is relatively healthy, especially in the core area." The same developer said new office buildings in the old downtown of Tianjin could charge daily rent as high as RMB 6 per square meter of GFA. Regarding the residential market, he noted undersupply within the inner ring and a huge oversupply outside it.

The midmarket residential sector in the city is considered relatively safe, though some respondents were negative regarding the luxury residential sector. One said wealthy people in Tianjin go to nearby Beijing to purchase high-end homes. "Rich people go to Beijng to buy luxury goods," said a Beijing-based investor familiar with Tianjin. A recently opened retail shopping center in Tianjin has limited foot traffic, the investor said, and travel to Beijing has been made all that much easier by the high-speed railway that cuts the trip to a half hour.

A developer familiar with Tianjin best summarized the situation: "Wherever you can get cheaper land is okay. However, you shall avoid Binhai New Area."

Nanchang. The capital of Jiangxi province moved very little in ranking from last year. Comparing Nanchang's real estate market with that of nearby Changsha, an executive at a developer said, “Supply and demand fundamentals are better than Changsha. The transaction volume in Nanchang is smaller. The demand is mainly from within Jiangxi province. The residential market in Nanchang is less attractive to people outside the province.” Said another executive at a large nationwide developer, “There is not a large inventory in Nanchang compared to the current demand.”

Jinan. Jinan’s ranking has changed little from last year’s for both investment and development prospects. The capital of Shandong province is generally viewed as less attractive compared with Qingdao, the other economic center in the province. “Jinan’s property market developed slowly before the National Games, which were held in the city in 2009,” said an executive of a developer. “After the Nationals Games, real estate development in the city has all of a sudden accelerated. The area surrounding the Olympic Sports Center in the city is quite hot for real estate development.” Added the developer, “I prefer Qingdao to Jinan as Qingdao attracts more nonlocals.”

Lowest-Rated Cities (25 to 36)

The remaining 11 cities—Shijiazhuang, Dongguan, Nanning, Harbin, Sanya, Haikou, Shenyang, Taiyuan, Lanzhou, Urumqi, and Wenzhou—were all rated 2.49 or below, representing “poor” prospects for investment. Last year, six of these cities were rated as having “fair” prospects for investment: Dongguan, Harbin, Sanya, Haikou, Shenyang, and Taiyuan.

Ten of the 11 cities are also rated this year as having “poor” development prospects; the exception, Nanning, is rated as having “fair” prospects. Last year, seven of these cities were rated as having “fair” prospects: Dongguan, Nanning, Harbin, Sanya, Haikou, Shenyang, and Taiyuan.

Shijiazhuang. Shijiazhuang’s ratings for both investment and development prospects improved the most among the 36 cities surveyed. Its rating for investment prospects increased to 2.45 from 2.00 and the rating for development prospects rose to 2.41 from 2.06. As a result, the capital of Hebei province is ranked 26th for investment and 30th for development, compared with 35th and 36th, respectively, last year.

The significant improvement in ratings and rankings appears to be directly linked to the central government’s recent policy announcement to integrate and coordinate economic development of Beijing, Tianjin, and Hebei provinces. The policy’s main objective is to ease pressure on Beijing in terms of population and to improve its polluted environment. The plan calls for moving low-value-added industries from Beijing to the nearby Hebei province and improving social and transportation infrastructure in cities around Beijing.

While acknowledging some potential impact of the new policy on Shijiazhuang, an executive of a developer did not think the new policy will benefit Shijiazhuang significantly. “I don’t like Shijiazhuang,” he said. “The positioning of the city is awkward. The city has no other advantages besides the status as the capital of Hebei province.

Shijiazhuang is not close to Beijing or Tianjin geographically. It is not attractive to people outside of the city. The city has been quite polluted. Air quality in Shijiazhuang is worse than in Beijing. The concept of Beijing/Tianjin/Hebei integration may have some positive impact on Shijiazhuang. However, other cities within Hebei province will benefit more than Shijiazhuang. For instance, Langfang and Yanjiao, which are closer to Beijing, will benefit more from the development of Beijing's number-two airport in the south. It takes one hour from Shijiazhuang to Beijing by high-speed train. Commuting is not realistic in terms of both time and monetary cost."

Furthermore, the executive downplayed the potential impact on the housing market from the planned relocation of enterprises and factories to Shijiazhuang. "The relocation will focus on those industries which are not in line with the economic development plan of Beijing, especially polluting enterprises and labor-intensive industries," he said. "More low-salary job opportunities don't form effective housing demand."

In contrast, an executive of another large nationwide developer was more optimistic. "Beijing has certain impact on Shijiazhuang for sure," he said. "Home-price increase is happening in Shijiazhuang as the price in Shijiazhuang is still low and affordable." He added, "The integration of Beijing/Tianjin/Hebei will have a larger impact on more remote areas as the traffic system will become more efficient, some polluting enterprises will be moved or renovated, and smart city programs will happen in certain areas in the region."

Shenyang. Shenyang continues to scare away many developers and investors with its massive supply of commercial property. One investor offered the following analysis of the situation: "You cannot strata-title sell commercial properties along Qingnian Street in Shenyang. The government regulates that only 20 to 30 percent of commercial products in each mixed-use project can be strata-title sold. Residential products in those mixed-use projects are actually apartments built on commercial-use land. They have been counted as commercial products that are allowed for strata-title sale." In the long run, the large pool of Grade A office and retail buildings that are owned en bloc could position the city well compared with many second- and third-tier cities that take a more liberal approach to strata sale of buildings.

A residential developer who is considering entering the Shenyang market said he likes the areas between the airport and downtown because the city is growing in that direction. As for the retail sector, one investor familiar with the city said his firm would be willing to invest in some parts of Shenyang where there are limited retail shopping amenities relative to the residential population.

Dongguan. Dongguan received unusually low numerical ratings this year. Compared with its more famous neighbor Shenzhen, Dongguan is considered a low-end manufacturing center. In recent months, the city has received unwanted media attention for massive raids on certain entertainment establishments and the arrests of some senior government officials suspected of corruption.

A senior executive of a local developer with projects in Dongguan said his projects in Dongguan could be more profitable than those in other cities. With the continuing integration of the Pearl River Delta with expanding transportation infrastructure and the further upgrading of the local economy, Dongguan may move up in the rankings in the coming years.

Sanya. "Sanya is perhaps the most sensitive to the overall economic conditions of the country, given its tourism-dependent economy," said a developer with a development project in the city. Another developer with a villa project in Sanya said his company's sales have been surprisingly good, citing as possible reasons the relatively small scale of his project and better design and positioning than the competition.

For the hospitality sector, the recent opening of many new five-star hotels in Sanya's Haitang Bay are believed to have had a negative impact on the hotels in the high-end Yalong Bay. According to a hotel industry consultant, Sanya's hotel sector has been hurt by relatively poor access to the island by air for tourists, as well as the large supply of new hotels. Hainan Island's two main airports have reached capacity, unable to accommodate more visitors. Because it often costs more to fly to Sanya than to other resort destinations such as Phuket, Thailand, Sanya is not as competitive. Some interviewees noted that the city infrastructure is not keeping up with the development of other high-end resorts.

One interesting result from the survey is that Sanya's office sector moved up significantly from the bottom to 26th place. While the city has primarily focused on developing its resorts, it lacks high-grade modern office buildings for leasing.

Harbin. A local developer with projects in Harbin, the capital of Heilongjiang province, expressed pessimism regarding the city's real estate markets. A number of large-scale developers such as Evergrande started coming in several years ago and took up large sites, primarily in new areas, he said. "We've started to see bankruptcies happening to smaller developers. Large players can restructure their debts when facing potential default as they have more assets to work with," he said. Not all is bad in Harbin. According to a hotel consultant, the city's two five-star hotels enjoy a high occupancy rate and a high average daily rate due to a limited supply of such hotels in the city center. A banker who financed a new shopping center in the city by a large national developer said the business is doing well. Even the generally pessimistic aforementioned developer noted that a high-end residential development in the city center by another national developer is selling well, even at prices significantly higher than those of other nearby projects.

CHAPTER 2

Trends in Sector Engagement

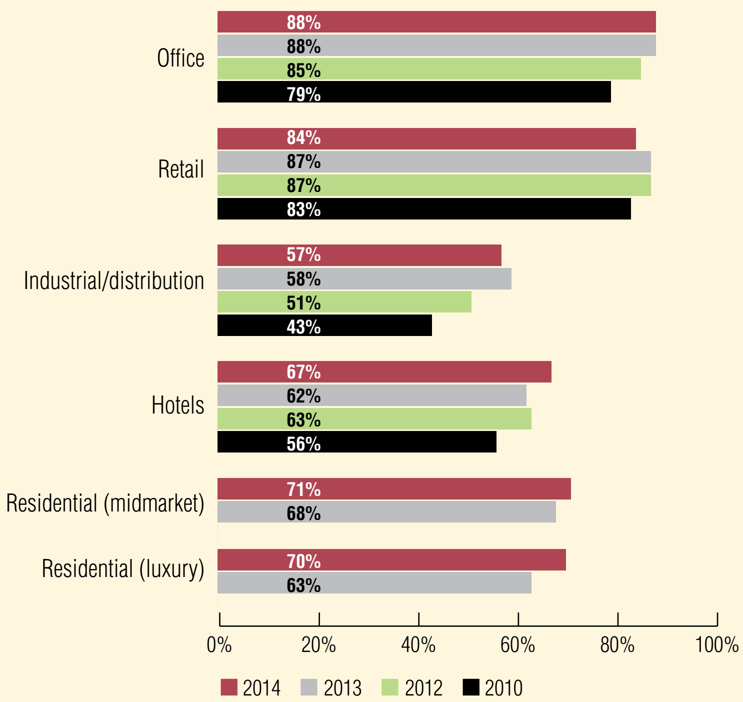
Office and retail are the sectors of choice for the vast majority of survey respondents, with 88 percent currently in the office sector and 84 percent in the retail sector. Participation in the office sector has increased since 2010, up from 79 percent, and has remained steady the past two years; participation in the retail sector is back near its 2010 level of 83 percent after a slight intervening increase.

The midmarket and luxury residential sectors follow in participation with about 70 percent of respondents involved in each. Whereas the previous years' surveys asked only about the residential sector overall, it is illustrative of the increasingly less attractive residential sector that overall participation has declined from 82 percent in 2010 to 70 percent for both types of housing now. And only 23 percent of respondents expect to expand their involvement in luxury housing next year, one of the lowest percentages found in the survey, while 44 percent plan to expand involvement in midmarket residential.

The hotel sector is not far behind the residential sector with 67 percent of respondents involved, up from 56 percent in 2010. But only 19 percent expect to expand their involvement in the sector next year, the lowest number in the survey.

Exhibit 2-1

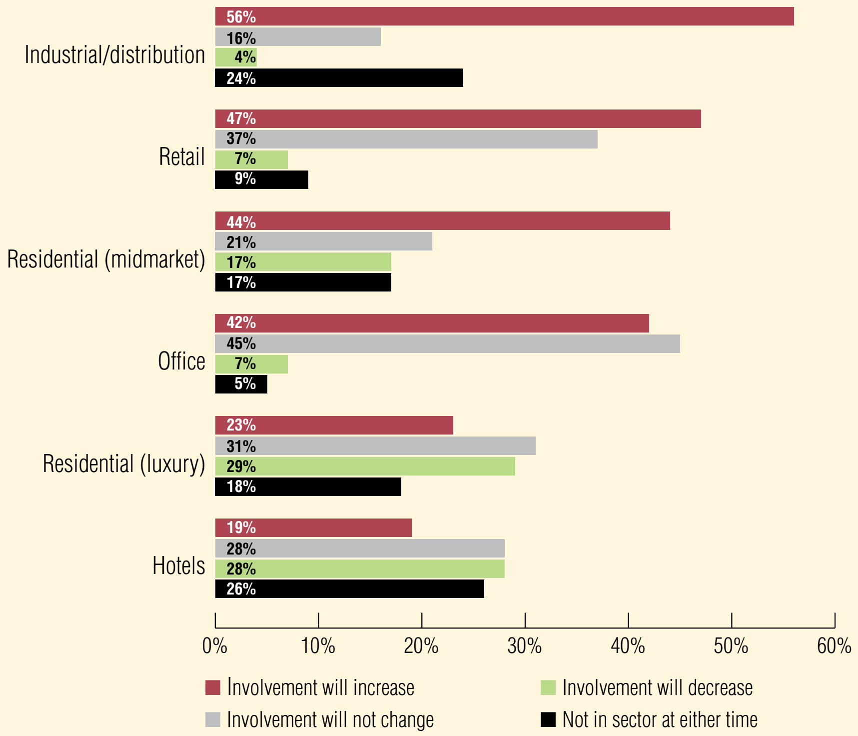
Sector Involvement by Percentage of Respondents



Source: *Mainland China Real Estate Markets 2014* survey.

Exhibit 2–2

Expected Change in Sector Involvement from 2014 to 2015, by Percentage of Respondents



Source: *Mainland China Real Estate Markets 2014* survey.

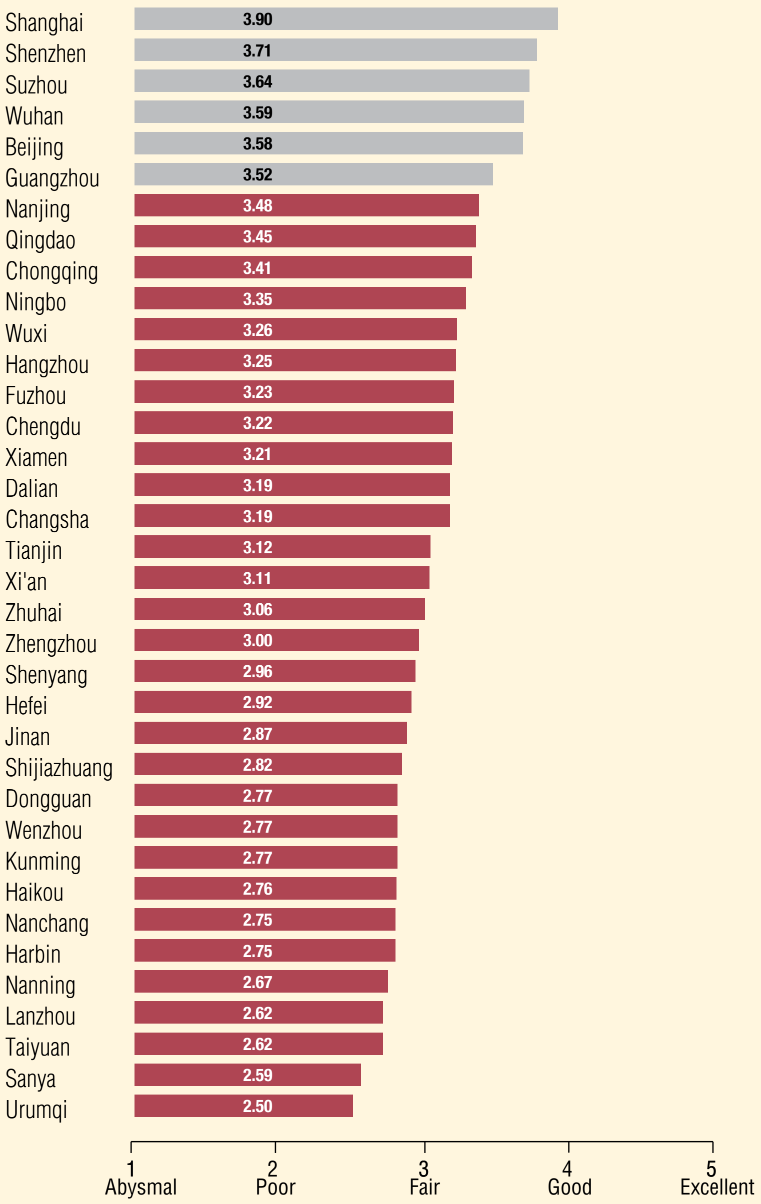
The industrial sector has the lowest rate of participation at 57 percent, but this is up from 43 percent in 2010. Fifty-six percent of the respondents expect to expand their involvement next year, the highest percentage in the survey, and significantly higher than the 31 percent who were planning expansion in the sector last year.

Industrial/Distribution

The key reason for the high level of interest in the industrial/distribution sector continues to be the severe shortage of high-quality warehousing and distribution facilities in China. According to the China Electronic Commerce Research Center (CECRC), per capita warehousing and distribution space in China is equivalent to only one-14th of the level in the United States. Moreover, of the warehousing and distribution facilities in China, more than 70 percent were built before 1990 and fail to meet modern logistics needs. Said a global logistics property developer with operations in China, "China has much potential in the logistics property sector. So far, there is only 20 million square meters of GFA of Grade A logistics facilities in Mainland China. In Boston alone, the GFA of logistics facilities is higher than this number."

Exhibit 2-3

Sector Prospects: Industrial/Distribution



Source: *Mainland China Real Estate Markets 2014* survey.

The demand for logistics facilities, especially high-grade ones, will continue to grow in line with rising domestic consumption, urbanization, and e-commerce. Retail sales grew at a double-digit rate during the past ten years, a trend very likely to continue as China's economy evolves from an investment-driven model to one driven by consumption. Many interviewees think the proliferation of e-commerce will have a huge positive impact on warehousing and the distribution sector. One senior executive at a logistics property developer noted that about 20 percent of his company's business is from e-commerce. iResearch projects that online shopping, which represented 7.9 percent of retail consumption in 2013, will register compound annual growth of 27.2 percent for the next three years as more consumers shop online and e-commerce spending per buyer increases.

Recognizing the critical shortage of high-quality logistics facilities—paired with China's commitment to a structural shift to a more consumption-driven economy—the central government has placed the logistics sector among the top ten items in the past two five-year economic plans. However, local governments are seen as reluctant to provide more land for logistics use because logistics properties generate limited direct employment and tax revenue but require a lot of land. In addition, "getting land quotas for logistics is very time-consuming, and sometimes developers have to make guarantees on tax contribution," the senior logistics executive said. Given the limited supply of land dedicated to logistics use or that can be used for logistics and growing demand for logistics facilities, developers have started to adopt the "go-up" strategy—building vertically rather than horizontally. However, use of concrete for multistory facilities involves a substantial increase in construction costs for developers.

In the recent months, developers and investors in the logistics sector were surprised by an unexpected reduction of the land-use period for new industrial land to be sold in Shanghai. In April, Shanghai announced a policy to shorten the tenure of industrial-use land from 50 years to 20. According to the same logistics property developer, the policy will help give local governments strict control over who gets the land and eliminate low-value-added manufacturers. "This policy may make investors and manufacturers stop investment," he added. "No investors or manufacturers will underwrite a deal for 20 years." Said another investor with logistics investments, "It will shut out people like us if the government shortens the tenure of industrial land from 50 years to 20 years. We do not know how to justify that."

However, another foreign industrial property developer with operations in China thinks the new policy may have limited impact: "For built-to-suit projects, the lease term is usually ten years, plus ten years for renewal. Such manufacturing facilities will become very old and outdated after 20 years." He also noted that the newly announced policy is not much different from Singapore's land use policy for industrial land, which includes a 30-year land lease for industrial use.

An executive at a Chinese investment company said her firm could accept the shortened land use tenure if the numbers work. "Net yield from the industrial/distribution sector is usually above 10 percent," she said. "This helps balance the yield of money from our insurance arm. For hard assets, investors could consider capital appreciation. While understanding that capital appreciation from industrial/distribution sector is usually well below that from office assets, it's possible that land can be rezoned in Shanghai one day and the construction together with the land underneath can be sold to the market at a high premium."

While the majority of interviewees are optimistic about the industrial/distribution sector, one private equity investor expressed concern: "There is too much liquidity in the space, and Shanghai has changed the tenure for industrial-use land to 20 years, which is likely to be expanded to elsewhere. At the same time, land cost is going up. We don't know how to make it attractive."

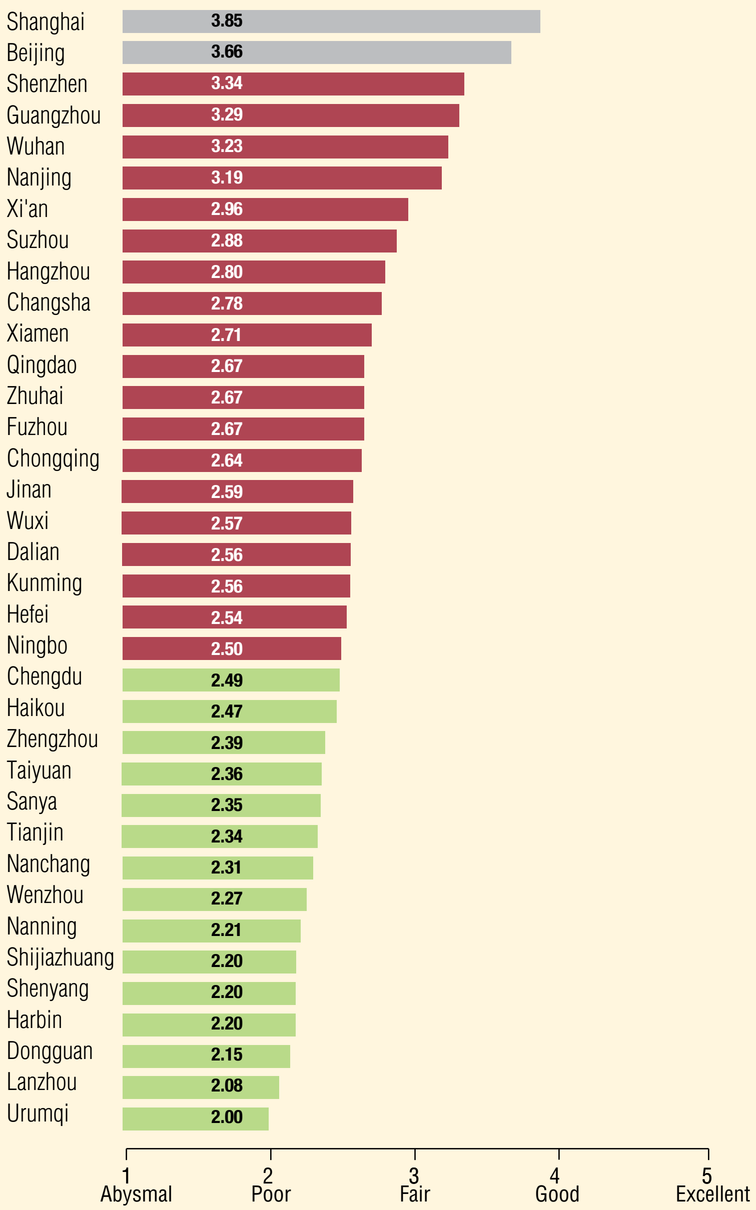
In rating city prospects by sector, survey respondents consider six cities to have "good" prospects in the industrial/distribution sector—in descending order, Shanghai, Shenzhen, Suzhou, Wuhan, Beijing, and Guangzhou. All other cities are considered "fair" prospects. Of note are Chengdu, Xi'an, and Chongqing, which now are all rated "fair" but were viewed as "good" prospects in this sector last year. It is noteworthy that while most cities' numerical ratings dropped, those for Shanghai and Shenzhen improved.

Office

A consensus exists among survey respondents and interviewees that the outlook is favorable in Tier 1 cities for office investment and development. In contrast, they are concerned about the oversupply of office properties in Tier 2 cities. Said one investor, "We are not to touch office outside of Tier 1. We are even selective in Tier 1. There is way too much space in Tier 2, and the tenant base there is too shallow." Compared with Tier 1 cities, there usually are fewer multinational companies in Tier 2 cities. In addition, large local private enterprises and state-owned enterprises prefer to build their own office buildings, another investor noted.

Exhibit 2-4

Sector Prospects: Office



Source: *Mainland China Real Estate Markets 2014* survey.

Offices in Tier 1 Cities

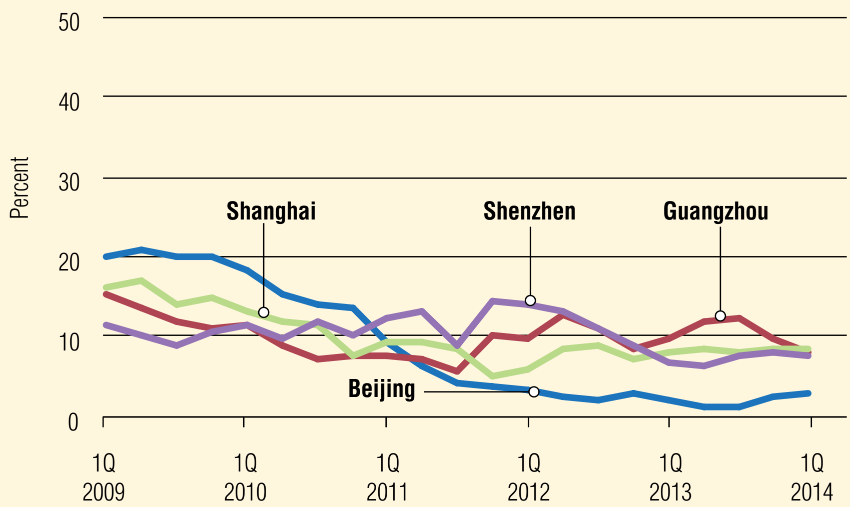
Shanghai and Beijing are the only two cities that survey respondents rated as having "good" prospects in the office sector. With Grade A office buildings in the CBD and Finance Street charging around RMB 450 per square meter of GFA per month, Beijing's office sector commands the highest rent in Mainland China. Shanghai is next with an average monthly rent of about RMB 300 per square meter. A huge increase in office rents in Beijing is due to the limited new supply in recent years, limited developable land in the city center, and a robust increase in demand coming from domestic companies. With the decentralized office areas like Wangjing reaching full occupancy, there is little sign that office rent will stabilize in the next few years.

Shanghai, on the other hand, is facing a huge new supply of office space in the next few years, especially in decentralized locations such as the Hongqiao Transportation Hub. As one international real estate broker said, "Though there will be a lot of office supply in Shanghai, especially in Yangpu, Minhang, and Hongqiao, the city absorbs new supply more quickly than Tier 2 cities like Chongqing and Chengdu. Despite the economic slowdown, market absorption is still on the rise, which is mainly driven by the technology and financial sectors."

Some interviewees expressed their preference for the Shanghai office market over that of Beijing. According to a global real estate fund manager, unlike Shanghai, Beijing has an office market mainly driven by domestic tenants. In the long run, further rent growth in Beijing is not sustainable, according to some interviewees. The

Exhibit 2-5

Grade A Office Vacancy Rate in Tier 1 Cities



Source: DTZ Research.

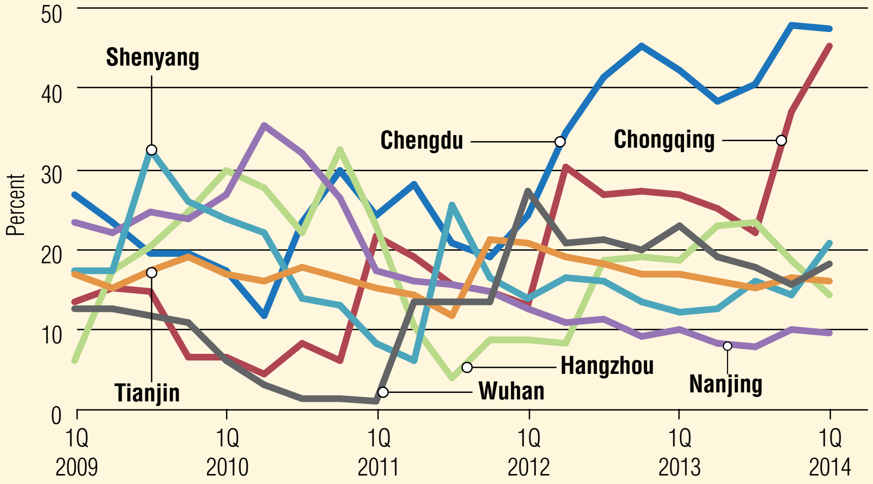
supply peak of office space there will come in 2018 when many new buildings will be completed in the CBD east expansion area. Another international broker termed the Beijing office sector "unaffordable" and pointed out that "the market rent decreased by 1 percent in the last quarter."

One local developer considers office markets in Shanghai and Shenzhen promising because the cities will benefit from the development of and reforms in the financial sector. As recently announced in the Bo'ao Forum, Hong Kong can invest directly in Shanghai and Shenzhen stock markets, and money from Mainland China can be invested directly in Hong Kong stocks. "The office sector in the two cities will receive capital inflow," the developer added.

Concerns exist regarding other Tier 1 cities: relative to Beijing and Shanghai, Shenzhen and Guangzhou are viewed by some interviewees as having an oversupply of office buildings. In Shenzhen, some respondents are concerned about the huge office supply in the pipeline in the Houhai and Qianhai areas. According to a research analyst at an international real estate agency, "Developers and investors are betting on Shenzhen and think it will become a mini–Hong Kong. They are speculating on favorable government policies." In Guangzhou, the Guangzhou International Finance Town, adjacent to the New Pearl River Town, will start releasing a large supply of office buildings over the next decade, putting downward pressure on office rents. Already, Guangzhou lags behind the other Tier 1 cities in rents for Grade A office buildings at around RMB 150 per square meter of GFA per month, roughly one-third Beijing's rates and one-half of Shanghai's.

Exhibit 2-6

Grade A Office Vacancy Rate in Key Tier 2 Cities



Source: DTZ Research.

For Tier 1 cities, further decentralization of office markets is taking place. Said an executive in an international real estate agency, “There is a strong demand for decentralized office space in some cities, especially Shanghai and Beijing. Rents in core business districts in Beijing keep rising. Tenants prefer to move to suburban and decentralized locations. It’s the expansion of metro systems that makes the office decentralization possible.” Another agency executive agreed: “For office tenants, it would be easier for them to shop around and look for more cost-effective options in decentralized locations.”

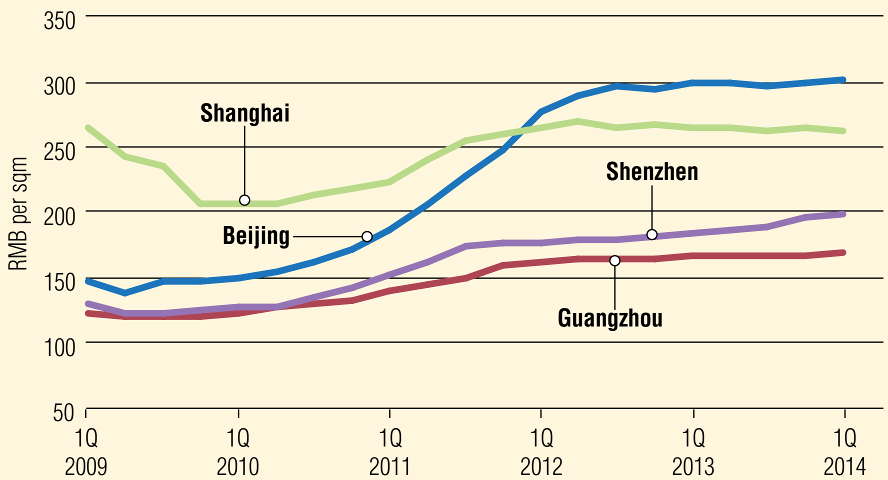
Offices in Tier 2 Cities

The oversupply of office buildings in many Tier 2 cities is mainly attributable to the large amount of commercial land put up for sale each year. Said a research analyst at an international investment bank, “Government officials in some Tier 2 cities, including Chengdu, Wuxi, and Shenyang, are pro-investment. They sell land at a cheap price and want you to hold the properties.” A Hong Kong–based developer with operations in Mainland China agreed, saying, “The government gives a high plot ratio and makes us build tall towers. The construction cost is expensive. A lot of cities are overzealous about building tall buildings.” In addition, city governments across the country share a strong appetite to build CBDs. According to a local developer in Chongqing, local governments like office buildings because they attract enterprises, which, especially in the service sector, contribute tax revenue. “An office building of less than 100,000 square meters can contribute substantial tax revenues each year from its tenants,” the developer noted.

In a growing number of Tier 2 cities, interviewees observe flattening rent growth and soaring vacancies. Said an executive in a private equity investment firm, “We don’t

Exhibit 2-7

Grade A Office Rents in Tier 1 Cities



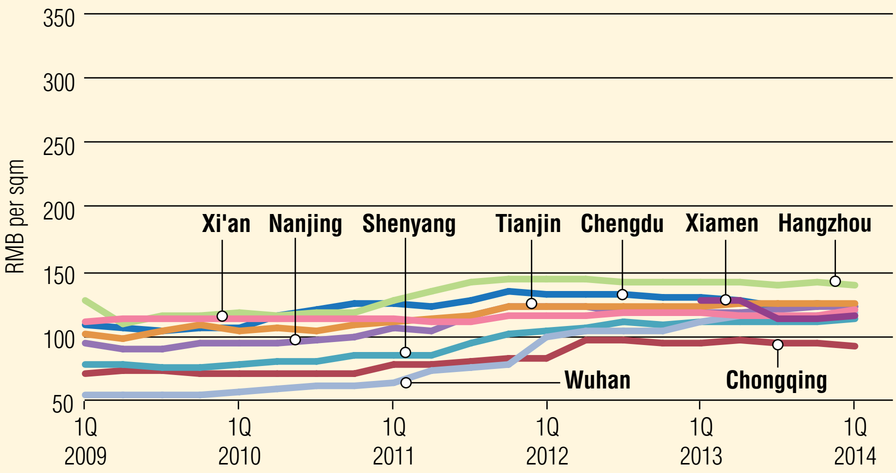
Source: DTZ Research.

see the right pricing while office leasing is softening." In regards to oversupply, an executive at an international estate agency noted, "While the face rent will be stable, landlords may allow a longer rent-free period or higher fit-out cost contributions." A local investor who acquired office buildings in second-tier cities during the past two years said she would like to see the acquired assets mature first before acquiring more office buildings.

For Tier 2 cities, the local government's attitude toward strata sale is seen as a key factor in making investment decisions. A number of developers interviewed said that they would not develop office buildings in Tier 2 cities if they are not allowed to strata sell. Strata sale of office buildings generally provides the developer with a higher unit price and a faster exit compared with a sale en bloc. According to some respondents, certain cities are discouraging strata-title sale of commercial properties because, as one said, "buildings will look terrible, and it's not good for taxation either." Said a local fund manager, "You cannot strata-title sell commercial properties along Qingnian Street in Shenyang. The government regulates that only 20 to 30 percent of GFA in each mixed-use project can be strata-title sold." He added, "one of the problems for a strata-title-sale building is that the strata-title owners are always fighting over property management and they cannot even change the facade." Chengdu was cited as another Tier 2 city in which the local government does not allow developers to strata sell office buildings in core office districts. One investor observed that tenants in some Tier 2 cities, like Chongqing, want to own their own space, but strata-title buildings are fully occupied. "In Chongqing, for example, we don't find any unsold strata-title office or SOHO [small office/home office] units," the investor said. "We are more concerned about vacancies in en bloc–owned office buildings."

Exhibit 2-8

Grade A Office Rents in Tier 2 Cities



Source: DTZ Research.

For some foreign investors, it is difficult to get approval from investment committees for office building projects that intend to exit through strata sale. Said a private equity fund manager, "We will have to take our investors from the U.S. to look at what we have invested in. If we have a project that is for strata-title sale, they do not understand. Projects with good risk-adjusted returns also have to be shown well."

Office REITs

After many year of speculation, there is a sign that China's real estate investment trust (REIT) market may actually get underway. Early this year, CITIC Group's REIT product

Exhibit 2-9

Investment in Office Development (100 million RMB)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Beijing	97.3	142.8	187.9	196.2	216.7	242.2	170.5	166.7	259.1	363.8	384.8
Shanghai	33.5	66.7	83.2	102.2	124.3	157.5	194.1	187.9	224.5	227.9	262.9
Guangzhou	27.9	22.3	33.1	50.5	73.1	63.1	53.5	74.5	81.6	125.2	153.6
Hangzhou	14.6	15.2	22.7	26.3	47.2	42.6	54.2	72.3	80.8	119.1	141.8
Wuhan	6.2	6.5	6.3	11.6	11.7	8.5	12.2	19.3	26.5	52.9	126.5
Chengdu	4.1	8.3	9.9	14.9	12.4	18.3	22.3	30.9	50.5	83.4	125.9
Zhengzhou	0.8	3.1	2.7	8.7	14.0	23.0	24.1	21.9	49.6	93.7	105.4
Chongqing	9.6	11.9	11.0	17.1	12.8	16.6	12.3	22.1	31.5	52.7	101.6
Shenyang	7.9	3.4	8.6	15.1	20.7	25.3	46.3	61.3	63.9	50.8	100.1
Tianjin	7.5	7.8	15.8	12.0	23.7	34.6	31.0	32.8	77.2	109.8	85.7
Fuzhou	4.6	5.6	4.3	4.9	2.3	2.7	2.8	4.0	24.9	53.3	81.2
Kunming	2.0	2.8	1.7	2.2	7.2	5.2	9.4	15.4	18.1	41.1	74.6
Hefei	1.8	3.8	6.1	8.4	11.6	19.1	30.9	59.5	49.1	37.5	73.4
Qingdao	6.3	5.0	7.5	13.9	18.1	17.3	20.7	24.6	20.3	28.7	68.6
Ningbo	3.1	7.7	12.6	14.7	27.4	31.0	27.2	26.5	51.4	71.1	66.7
Nanjing	15.8	13.3	18.6	17.2	21.7	18.8	22.3	28.4	27.2	42.7	64.6
Changsha	3.8	4.6	7.1	7.7	8.6	7.3	12.4	9.0	7.2	41.1	56.0
Jinan	6.1	5.4	4.0	4.0	4.7	5.2	8.2	13.8	20.0	25.8	55.3
Shijiazhuang	1.7	2.0	3.3	4.7	3.1	1.4	12.9	16.6	22.9	38.6	53.2
Nanchang	1.5	1.4	3.8	2.6	1.1	1.4	2.5	8.3	7.5	16.4	52.0
Xiamen	2.8	3.0	3.0	3.3	18.5	14.9	18.0	29.3	16.9	34.2	45.8
Xi'an	6.3	12.9	17.7	11.0	14.9	17.9	27.3	23.3	33.7	31.9	37.3
Dalian	6.1	4.5	6.5	8.6	13.0	7.6	14.8	14.0	18.4	18.0	30.4
Shenzhen	13.0	15.1	22.3	28.0	30.6	30.1	26.1	35.3	37.9	36.8	27.0
Harbin	6.3	4.9	6.9	6.6	5.2	3.2	1.5	4.1	3.8	12.5	21.7
Taiyuan	2.8	3.9	6.2	8.4	5.9	2.7	3.7	3.5	7.0	6.5	13.4
Nanning	0.4	0.8	1.5	3.9	5.2	5.0	2.9	5.4	6.8	12.9	11.1
Lanzhou	1.3	1.4	1.3	2.8	2.1	2.3	3.3	1.6	4.4	5.8	6.0
Urumqi	7.2	6.5	4.0	2.5	1.5	1.6	3.9	5.8	7.8	7.2	5.3
Haikou	1.3	0.7	0.7	0.4	0.9	2.5	2.7	1.3	6.0	10.7	1.1

Source: National Bureau of Statistics of China.

with office assets in Beijing and Shenzhen was listed on the Shenzhen Stock Exchange. This was the first Mainland Chinese REIT product approved by China Securities Regulatory Commission (CSRC). The products are now mainly for block trading on the Shenzhen Stock Exchange but are planned to become a real mutual fund–type product in three to five years. “It’s good to have a scheme like Singapore’s in which developers put the properties in REIT products and buyers of commercial properties can instead invest in those REIT products,” said a local fund manager. When the local REIT market actually takes off, investors may finally start heading to cities like Chengdu and Shenyang where plenty of international-grade office buildings are held en bloc. But the wait could be too long for some of the commercial property developers in those cities.

Land Conversion

Another potential legal change that could significantly affect the office sector is conversion of industrial land to other uses, including commercial. According to a lawyer specializing in real estate practice, conversion of industrial land to commercial use is the trend in certain areas of certain cities. “Shanghai is exploring land use policy that transforms industrial-use land into commercial-use parcels in its pilot free trade zone,” the lawyer said. “With the further opening of the financial industry, more offshore U.S. dollars will flow in while onshore money will flow out to support overseas investments. The financial policy and increasing financial activities will raise the demand for office space in the free trade zone area. However, the land uses of existing land parcels are mainly industrial or logistics. So, the pilot free trade zone encourages landowners to negotiate with the government to change the land use. However, issues such as paying an additional land premium for the change of use have not been detailed.”

Retail

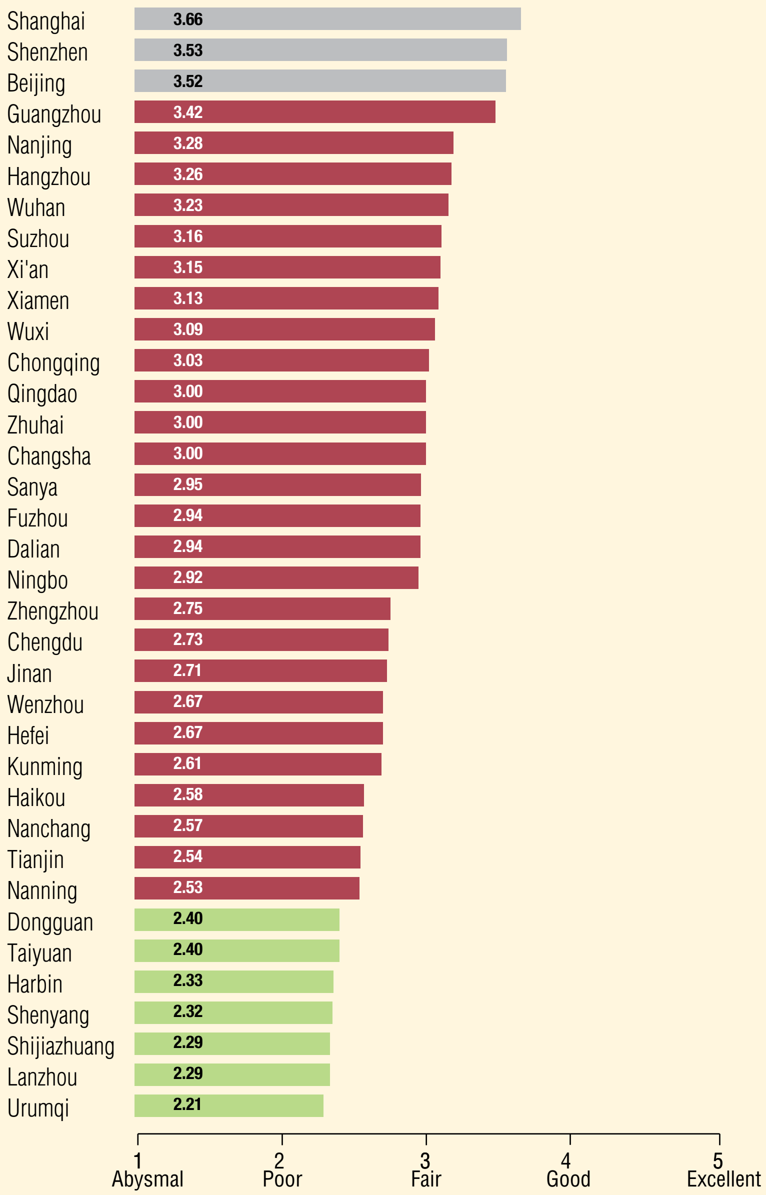
Partly attracted by the a double-digit rate of increase in consumption and partly required by local governments to build retail shopping centers as part of large-scale primarily residential development projects, many local developers who had mainly or even exclusively built residential properties have tapped into the retail sector in recent years. For many, retail development and operations have proved significantly more challenging. “A lot of developers have gone for retail development projects in lots of cities but have suffered,” a local developer said. Meanwhile, because “everyone went and tried to do mixed-use development projects,” there has been an oversupply of retail properties. Poor town planning and land use policy share the blame for the oversupply in many cities. “Local governments do not calculate how much retail space is needed in a certain district,” the same developer said. “Malls compete for tenants, and tenants are becoming choosier to protect their brand,” noted a retail consultant.

Even malls with good design still face stiff competition. “There are too many similar things across the street,” said one Asia-focused fund manager. “Competition for retail malls is from within four subway stations, not even a one-kilometer radius. That developers are doing the same thing is really killing the market. We do see dropping rental or at least stagnant rental growth."

Another foreign developer was more optimistic. He said his firm would not only consider the absolute amount of new supply in the next four to five years that may put pressure on leasing and rent levels, but also the per capita supply in the area. Some cities may face large amounts of new supply in the next few years, but the per capita

Exhibit 2-10

Sector Prospects: Retail



Source: *Mainland China Real Estate Markets 2014* survey.

stock may still be limited. As such, whereas in the short term the city may face leasing pressure, in the long run leasing and rent growth may be promising.

Many respondents pointed out that the key for retail properties is the catchment area. A developer said he does not like Shenyang and Chengdu for retail development because there is an excessive supply of retail space. However, he added, “In certain parts of Shenyang, there are mature residential neighborhoods with limited retail shop-

Exhibit 2-11

Investment in Retail Property Development (100 million RMB)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Shenyang	17.5	32.4	58.8	64.5	75.0	107.5	174.7	262.9	290.5	272.8	359.0
Chongqing	42.0	50.8	59.9	71.4	69.5	75.2	80.4	116.8	134.4	218.0	307.5
Shanghai	62.5	67.8	78.9	102.6	155.1	158.9	176.7	184.6	244.7	251.6	293.8
Beijing	57.6	61.4	94.8	112.9	226.0	267.4	240.4	200.7	336.3	296.7	275.9
Chengdu	21.6	30.1	55.2	76.6	61.6	53.6	61.9	69.7	100.4	178.2	246.4
Wuhan	9.3	9.9	23.1	21.2	37.7	41.4	31.1	77.0	102.5	166.7	201.5
Guangzhou	40.5	43.4	54.2	58.1	55.1	68.5	84.0	112.2	179.1	178.0	197.6
Dalian	19.1	24.5	33.8	50.0	38.2	36.1	51.7	45.7	94.4	130.1	164.9
Tianjin	14.7	24.3	28.2	41.7	35.7	63.8	79.9	97.3	127.4	176.8	155.3
Hefei	4.1	16.8	18.8	25.7	25.4	29.6	49.3	70.8	80.5	142.3	142.0
Qingdao	16.1	14.5	14.9	18.1	22.6	45.4	44.0	71.6	73.4	101.0	140.4
Shijiazhuang	5.3	3.6	9.2	18.3	14.4	8.8	21.6	39.2	81.6	143.4	138.9
Hangzhou	22.1	30.8	30.9	33.8	35.2	46.1	40.1	50.0	69.2	131.2	137.8
Changsha	7.7	15.8	25.6	25.8	22.7	27.6	27.7	33.2	37.8	86.3	124.3
Harbin	11.2	20.1	27.3	25.6	27.0	28.4	29.9	34.5	37.0	53.3	121.9
Zhengzhou	6.9	3.9	14.7	26.2	27.2	35.2	35.7	50.8	80.3	86.3	120.0
Ningbo	16.9	20.1	24.3	33.2	29.9	36.8	34.3	40.9	67.9	96.1	110.0
Xi’an	6.7	16.5	27.6	34.0	29.3	37.2	53.7	65.9	81.0	82.5	107.6
Kunming	4.4	2.4	4.0	11.2	12.3	17.3	21.0	33.6	46.4	75.1	98.0
Nanjing	10.9	13.7	22.7	26.3	28.3	31.3	36.8	67.9	79.6	75.7	95.4
Shenzhen	35.3	47.3	58.1	53.1	67.4	53.5	52.0	53.2	59.4	64.6	90.1
Fuzhou	9.5	14.6	13.3	17.2	20.9	15.0	15.9	20.3	48.2	86.5	87.9
Jinan	2.0	6.4	15.0	10.2	18.7	13.5	33.7	49.7	56.9	56.5	71.4
Xiamen	7.2	9.0	12.0	10.4	11.3	22.9	26.6	19.4	36.2	40.2	52.9
Taiyuan	3.1	9.7	16.0	15.1	10.2	8.8	14.5	14.1	20.2	22.4	40.9
Nanning	1.9	3.2	14.6	13.3	19.4	14.6	18.1	17.6	25.9	33.0	30.4
Lanzhou	3.7	3.7	5.1	6.7	4.9	5.6	6.7	10.1	9.5	13.3	22.3
Urumqi	7.4	10.3	10.2	7.2	6.7	9.2	7.7	12.5	11.5	13.5	15.0
Haikou	1.3	2.7	3.7	6.6	5.0	6.5	5.8	4.3	4.7	8.2	9.4

Source: National Bureau of Statistics of China.

ping centers nearby. These areas can be attractive places for retail development." In order to be successful in a competitive market like China, malls need a good city-center location or a well-connected suburban location. As one retail consultant noted, "Subway and public transportation are important. Direct access from the subway and sufficient parking can complement each other."

Most respondents think e-commerce will have a negative impact on bricks-and-mortar retailers. The tenant mix in retail malls has experienced a significant change, with mall operators increasing the proportion of food and beverage and entertainment elements. Some malls have increased that portion to 50 to 60 percent from 25 to 30 percent, according to a fund manager. In addition, fashion brands are reducing their storage space and expanding demonstration areas in their shops, one foreign fund manager noted. Because food and beverage and entertainment tenants usually do not pay high rents, "rent has been under pressure, and yield for malls is suffering," the fund manager said. "Rent is not growing. Operators and owners realize the top line will be significantly low in the next four to five years. It's time for retail property prices to decline."

In light of the predominantly young, tech-savvy, and middle-class customer base in China, retail developers and operators need to reinvent themselves in order to survive in the competitive market. Said one retail developer, "Developers and operators should keep in touch with current technologies and incorporate the latest technologies into their malls." The same developer has hired an IT specialist from Silicon Valley to make sure the firm's malls are equipped with the right technology, leveraging mobile phones and other gadgets.

As e-commerce weighs on traditional bricks-and-mortar retail, mall owners and operators are focusing on delivering a good shopping experience. "Malls are no longer a place for you to buy clothes," said a developer. "Malls are having more food and beverage, entertainment, and kids' components. It really depends on how good you are as an operator."

E-commerce is believed to have less impact on luxury brands because luxury shopping at traditional shops is itself an experience, said an international real estate agent. However, due to an anti-corruption campaign, luxury retail, and high-end restaurants are under pressure. As a real estate agent observed, "The market experienced 30 to 40 percent annual growth in luxury goods sales three to four years ago, and the trend was expected to continue for the next five years. But sales slowed down in 2012–2013. You are not going to see a lot of new stores opening in the future."

Shanghai, Shenzhen, and Beijing are the three cities that survey respondents rated as having "good" prospects in the retail sector. Last year, these cities and four others—Hangzhou, Wuhan, Nanjing, and Guangzhou—were rated as having good prospects; the latter four are now rated as having "fair" prospects.

None of the 36 cities had a higher numerical rating in the retail sector this year than last, reflecting the overall pessimism over the slowdown in the domestic economy, the central government's clampdown on corruption, and the general oversupply of retail space.

Shanghai retained its top rank while Hangzhou's ranking declined to seventh place from second last year, reflecting the deteriorating economic conditions of the private sector in Zhejiang province. Shenzhen, Beijing, and Guangzhou are ranked second, third, and fourth, respectively. Xi'an and Xiamen made big improvements in their rankings, moving up to ninth and tenth places from 19th and 21st, respectively.

Hotel

The hotel sector is a tough business in Mainland China, as noted by the overwhelming majority of survey respondents. "Basically, the return generated from hotel projects is not spectacular," said a local developer with several five-star hotels in operation in key cities. Another local developer said her firm does not plan to put more weight on the hospitality sector except for existing development projects with hotel components. She complained about the long return period for hotel investment. Said another developer with hotel assets in Mainland China, "There is generally an oversupply of hotels in China. The average occupancy of hotels in Shanghai is about 50 percent. Hotels take a lot of years to nurture." One investor was more straightforward: "For hotels, we don't like any city."

As a hotel consultant noted, overall demand for high-end hotels remains lukewarm in Mainland China. "For domestic business travel, many of the travelers are in the manufacturing industry with limited value added and limited budget for travel. While the financial sector and other high-value-added service sectors are growing, the current demand for five-star hotels from this group is still limited."

Moreover, the anti-corruption campaign that started in September 2012 is believed to have severely reduced the demand from the government sector for five-star hotels, including lodging and food and beverage. One lending officer in a commercial bank observed that a hotel the bank lent to experienced about a 10 percent drop in occupancy. The number of meetings held in five-star hotels is decreasing. "At one point, food and beverage revenues dropped as much as 50 percent in some five-star hotels in Beijing, while the average drop was around 30 percent," the consultant said.

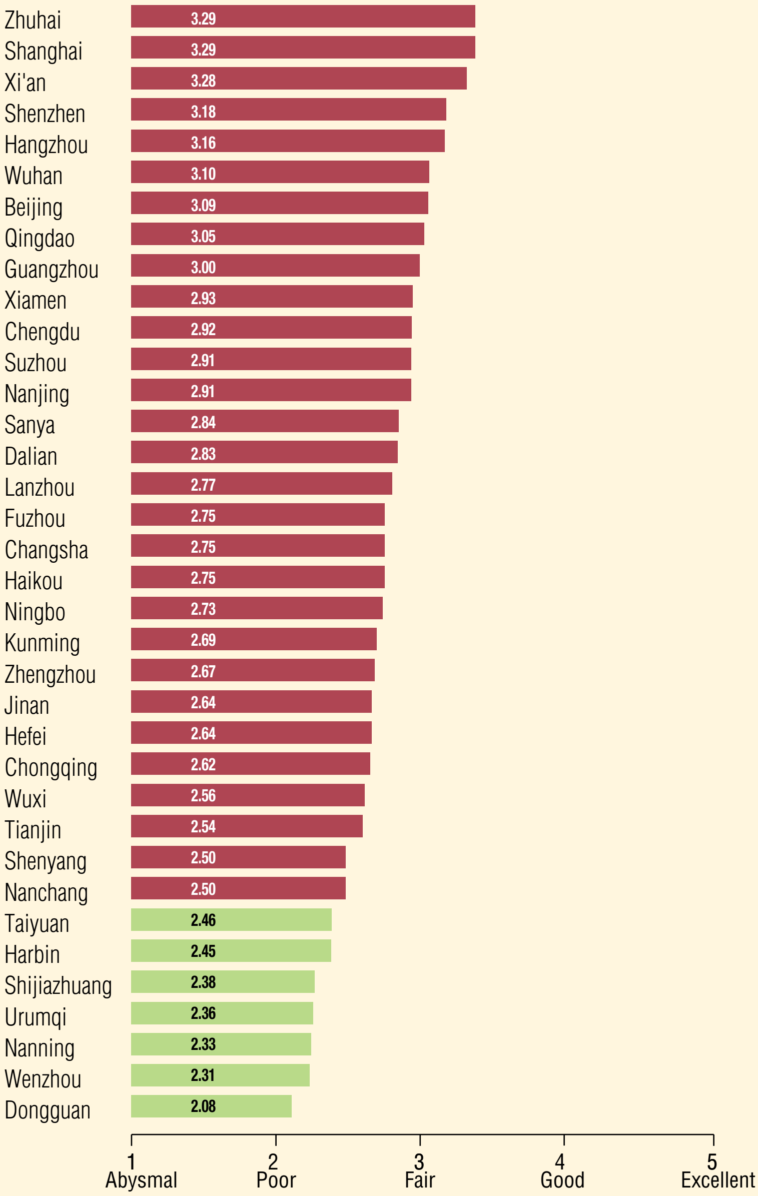
Overall, Mainland China's hotel sector suffers from an oversupply of high-end hotels. Often developers with large-scale, primarily residential mixed-use development projects are required by the local government to build five-star hotels to burnish their image. As the consultant noted, "Developers subsidize the hotel component with profits made from the residential component." The real demand for rooms in five-star-hotels and the supply in the market are thus mismatched.

The hotel consultant also noted that "while the older generation of people over 45 years old has favored grand-looking lobbies and spacious rooms, the younger generation does not feel the need for big lobbies and big hotel rooms. For the older generation, it was more about face, while the younger generation cares more about the actual comfort." Some respondents noted that they prefer budget hotels to five-star ones.

Respondents consider all but seven cities in the survey to have "fair" prospects in the hotel sector, those seven considered to have "poor" prospects. Respondents did not rate any city's prospects in the sector as "good."

Exhibit 2-12

Sector Prospects: Hotel



Source: *Mainland China Real Estate Markets 2014* survey.

Two cities are particularly notable for their change in ranking: Zhuhai and Sanya. Zhuhai's ranking jumped to number one this year from 13th. Noted one investor, "You look to find a good hotel in Zhuhai, and you only find something like a Holiday Inn." Zhuhai lacks high-quality hotels, and the city garners more of the spotlight because of the Zhuhai–Macau–Hong Kong Bridge. "Zhuhai is a better place for retirement than Sanya," the investor said. "Zhuhai appeals to people from surrounding cities in Guangdong province and Hong Kong."

Moving in the opposite direction, Sanya's ranking dropped to 14th this year from number two, likely because of investor concerns about the new supply from Haitang Bay. As a hotel consultant noted, Sanya had a good run after the opening of Yalong Bay, and the recently opened Ritz and Hilton performed well. However, the opening of more hotels in the nearby Haitang Bay and other decentralized locations has created an oversupply of five-star hotels.

Residential: Midmarket and Luxury

Sales value of commodity residential products in China dropped by 9.9 percent year over year during the first four months of this year, according to the National Bureau of Statistics. The majority of the survey respondents showed concern about the oversupply of residential products in Tier 2, 3, and 4 cities in general, but there was no such concern about Tier 1 cities. As one local developer succinctly put it, in Tier 1 cities "there are no problems." Another local developer, however, mentioned that certain suburbs of Tier 1 cities may be vulnerable, given large volumes of recent and future supply.

According to another local developer, local governments are directly responsible for the oversupply in certain cities because they put up too much land supply in the recent years. In addition, as one research analyst observed, developers have shortened their development cycle. "Previously, it typically took more than 18 months for developers to launch residential projects for presale," the analyst said. "Now it has been shortened to six months. Developers have standardized their development procedures and products. They are expanding so quickly and need cash back as soon as possible."

Given the large role real estate plays in supporting fiscal revenue and economic growth of local governments, it is in the interest of local governments to loosen the home-purchase restrictions amid a market downturn. In recent months, the central government has begun to provide local governments with greater autonomy in implementing government policies originally intended to cool the real estate industry. Many interviewees believe that local governments will relax home-purchase restrictions if home sales do not recover.

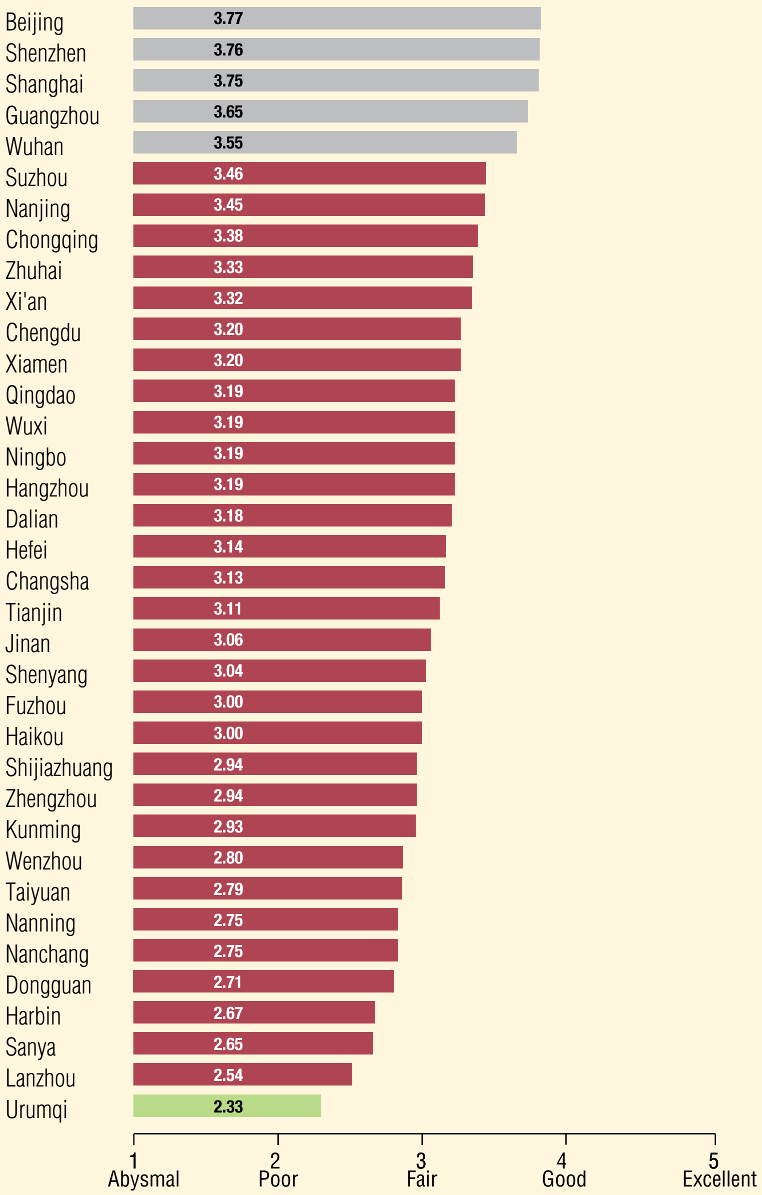
Also, it was reported that in early May, the People's Bank of China (PBOC) met with heads of commercial banks to encourage them to make mortgage loans to first-time homebuyers. They were asked by the central bank to set mortgage rates at reasonable levels and to grant mortgage loans more quickly. According to *Securities Daily*, the China

Industrial Bank has lowered the lending rate for first-home mortgage loans from 110 percent of the PBOC benchmark lending rate to 105 percent after the PBOC meeting.

Home-purchase restrictions together with tightening bank financing have accelerated the market consolidation. Some interviewees noted that the number of developers is declining from about 60,000 because small and medium-sized developers are not able

Exhibit 2-13

Sector Prospects: Midmarket Residential



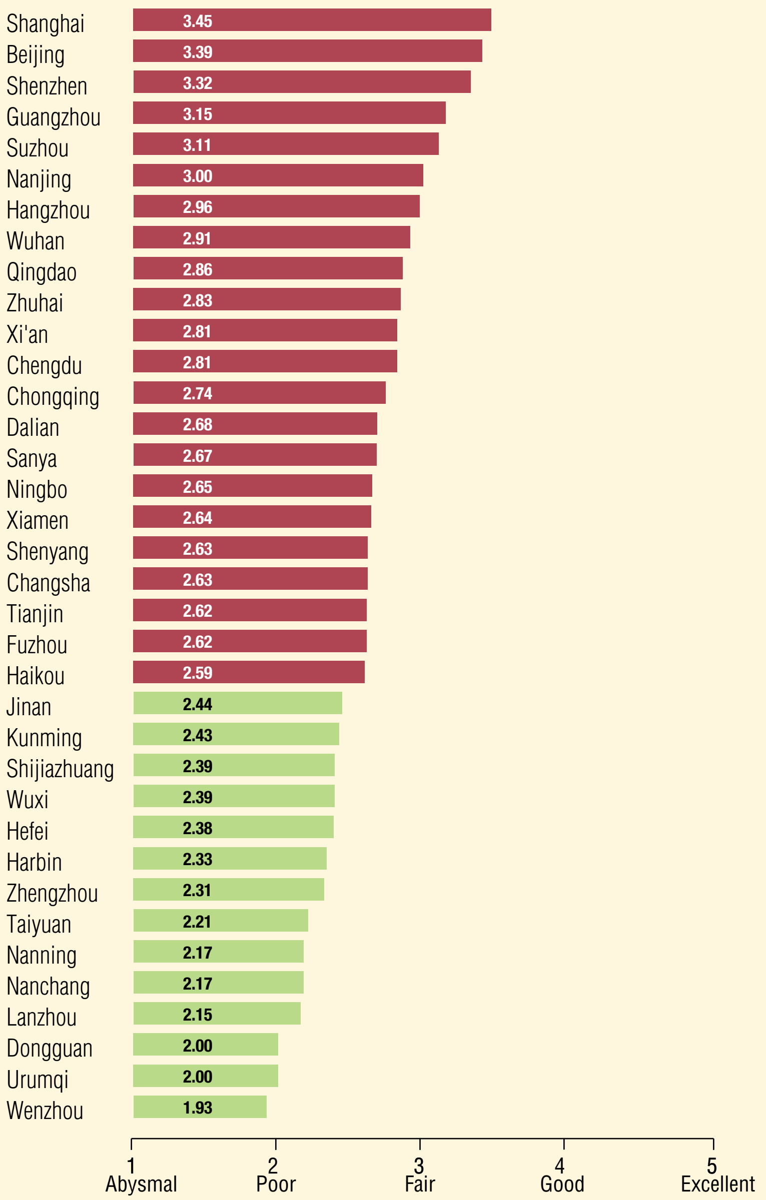
Source: *Mainland China Real Estate Markets 2014* survey.

to compete. From the investors' perspective, the tough residential market means more investment opportunities, even with high-quality developers as partners.

Respondents are divided on the outlook for luxury residential. Some believe that high-end products will sell well once home-purchase restrictions are lifted. Said one investor, "Luxury apartments may benefit more from the loosening of housing-purchase restrictions.

Exhibit 2-14

Sector Prospects: Luxury Residential



Source: *Mainland China Real Estate Markets 2014* survey.

Exhibit 2-15

Primary Commodity Residential Price Index, as of April 2014

	Month over month	Year over year	Compared with 2010
	March 2014 as 100	April 2013 as 100	Year 2010 as 100
Guangzhou	100.1	111.2	130.5
Beijing	100.2	111.2	128.9
Xiamen	100.4	112.2	128.1
Shenzhen	100.2	111.2	127.0
Shanghai	100.3	113.6	126.4
Urumqi	100.0	106.8	125.6
Changsha	100.2	108.3	124.0
Zhengzhou	100.1	106.7	122.4
Shenyang	100.1	107.9	122.0
Shijiazhuang	100.0	107.5	122.0
Fuzhou	100.0	108.9	121.2
Nanchang	100.0	106.5	119.4
Dalian	100.1	106.9	119.1
Xi'an	100.3	108.5	119.0
Nanjing	100.4	109.8	118.9
Wuhan	100.2	107.6	118.3
Kunming	100.2	106.0	117.1
Taiyuan	100.1	109.9	117.0
Lanzhou	100.1	105.3	116.9
Hefei	100.2	108.5	115.5
Chongqing	100.1	106.2	115.4
Harbin	100.0	106.4	115.4
Chengdu	100.1	106.6	115.1
Tianjin	100.1	105.1	115.0
Jinan	100.0	107.0	114.6
Nanning	100.1	108.0	113.8
Qingdao	100.1	107.5	111.5
Wuxi	99.8	103.4	108.4
Sanya	100.2	104.6	107.6
Haikou	100.0	102.5	104.0
Hangzhou	99.3	105.8	101.7
Ningbo	99.8	105.4	100.4
Wenzhou	99.9	95.6	78.3

Source: National Bureau of Statistics.

The government changes its tactics when the market is down." Added the same investor, "Luxury housing shall be more resistant even at a lower absorption rate compared with mid-income residential products. High-end residential development projects have higher margins and the numbers make sense for investors to underwrite a deal for four to five years, compared to two to three years for mid-income residential plays."

In contrast, other respondents were concerned about the slowdown in the domestic economy. Said one developer, "Slowdown in the domestic economy will have some impact on luxury residential sales. Sales in Tier 2 and Tier 3 cities are slowing down already." Another local developer mentioned that his firm prefers midmarket to high-end residential products because the take-up is quicker. Said one investor, "Most developers are scaling back from luxury. Developers are making residential units smaller and more accessible. This has happened in the last couple of years and will continue." Another local developer agreed that the trend has been for developers to reduce the unit size in their new projects, adding that the sell-through ratio for products with unit size below 120 square meters is higher. Moreover, as one local developer pointed out, the transaction volume of luxury residential units was very limited, even in Tier 1 cities.

Five cities are considered by respondents to have "good" prospects for midmarket residential—Beijing, Shenzhen, Shanghai, Guangzhou, and Wuhan—while for luxury housing, no cities were rated as having "good" prospects.

Respondents were generally optimistic about midmarket residential markets in Tier 1 cities, where demand and supply are largely balanced. The biggest cities in terms of economic scale attract most of the skilled workers. The demand from the influx of people each year is huge, and the burgeoning middle-class in those cities creates solid demand for upgrades.

For luxury residential, Tier 1 cities took the top four places—Shanghai, Beijing, Shenzhen, and Guangzhou, in that order—followed by Suzhou. Even for luxury residential, as one local developer noted, "there is short supply in Tier 1 cites." Worth noting is that though Beijing ranked second behind Shanghai, a number of interviewees were negative on Beijing's luxury residential sector. As one investor noted, in Shanghai a lot of projects have a selling price above RMB 100,000 per square meter, and demand is real. In contrast, projects with such price tags are rare in Beijing, where the luxury residential units are purchased by nonlocals who are not living in the city. In addition, she pointed out that product quality in Shanghai is higher than in Beijing, and people prefer living in Shanghai to living in Beijing. Said another local investor, "there is no future for luxury apartments in Beijing" because of the poor air quality and traffic congestion.

Exhibit 2-16

Resold Residential Price Index, as of April 2014

	Month over month	Year over year	Compared with 2010
	March 2014 as 100	April 2013 as 100	Year 2010 as 100
Shenzhen	100.1	112.0	123.8
Guangzhou	100.7	109.8	121.5
Beijing	99.8	110.2	120.2
Shanghai	100.0	108.1	117.8
Taiyuan	100.3	103.4	116.6
Kunming	100.5	105.0	115.9
Urumqi	100.3	104.9	113.9
Zhengzhou	100.4	107.8	113.8
Xiamen	100.4	106.8	113.2
Wuhan	100.0	106.7	111.8
Shenyang	100.1	105.0	110.8
Changsha	100.3	106.0	109.3
Hefei	100.7	106.7	108.7
Tianjin	100.5	104.5	108.5
Dalian	100.0	101.1	108.5
Wuxi	99.9	101.4	107.6
Nanning	100.4	103.5	107.5
Nanchang	100.4	104.1	107.3
Nanjing	100.4	106.2	106.6
Jinan	99.9	103.4	106.5
Xi'an	99.9	102.5	106.0
Chongqing	100.1	103.6	105.7
Fuzhou	99.9	106.9	105.2
Chengdu	99.8	103.7	104.8
Harbin	100.2	103.8	104.3
Qingdao	99.8	102.6	103.8
Shijiazhuang	100.1	102.5	101.6
Lanzhou	100.2	102.3	101.4
Sanya	100.0	102.1	96.6
Hangzhou	99.2	100.3	96.5
Ningbo	99.8	102.7	96.1
Haikou	100.0	100.0	95.1
Wenzhou	99.4	91.7	79.6

Source: National Bureau of Statistics.

CHAPTER 3

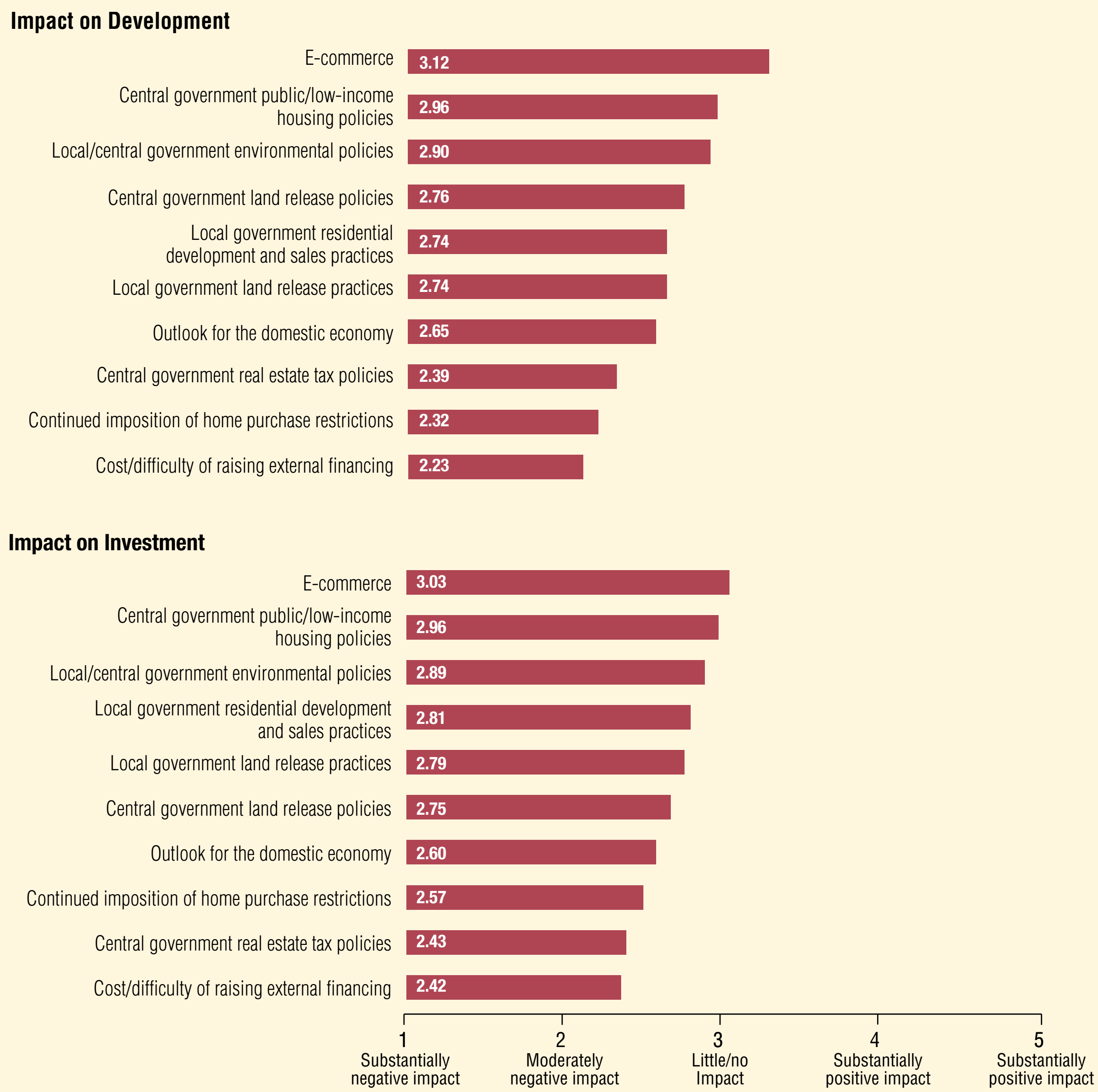
Issues Affecting Development and Investment

Two issues—central government real estate tax policies, and the cost and difficulty of raising external financing—are likely to have moderately negative impacts on both investment and development decisions during the next 12 months, survey respondents say. Continued imposition of home-purchase restrictions is also expected to have a moderately negative impact, but only on development decisions.

Four issues are expected to have very slight negative impacts on respondents' decisions—central government land release policies, local government land release practices, local government residential development and sales practices, and the outlook

Exhibit 3-1

Impact of Various Issues on Development and Investment over the Next 12 Months



Source: *Mainland China Real Estate Markets 2014* survey.

for the domestic economy. Continued imposition of home-purchase restrictions is also expected to have a very slight negative impact on investment decisions.

Three issues are expected to have little or no impact—e-commerce, central government public/low-income housing policies, and local/central government environmental policies.

Central Government Real Estate Tax Policies

Key taxes in Mainland China related to real estate are 1) the business and real estate tax on commercial properties that can range roughly between 10 and 17 percent of rental revenue, 2) the land-appreciation tax imposed on developers, and 3) the property tax on residential properties, which is being given a trial run in Shanghai and Chongqing.

Many interviewees view the overall taxation system as a significant factor in the creation of an oversupply of commercial properties. Local governments tend to favor commercial properties, interviewees said, because they provide substantial and continuous tax revenue, whereas residential properties provide revenue only at the time of the initial land sale through transaction-related taxes. This has led to an oversupply of commercial properties in certain cities where fundamental demand may fall far short of the new supply.

In a growing number of cities, there is a clear trend for local governments to discourage strata sale of office buildings. While strata sale of office buildings can substantially ease the financing burden for developers, local governments favor en bloc ownership of buildings, partly to ensure ongoing tax revenues. Another legitimate reason for favoring en bloc ownership is because it leads to better upkeep of buildings.

In the residential sector, after many years of debate, the central government is levying a property tax—in a trial run—in Chongqing and Shanghai. According to a developer in Chongqing, the property tax is having a negative impact on the sale of high-end residential units because only the newly sold units with a unit price that is more than twice the city's average selling price are subject to the tax. In Shanghai, a developer noted that a property tax on residential properties is applied to new large homes. The central government is starting to develop a housing registration system and will eventually roll out the property tax to the whole country, he said.

Developers also are experiencing an increasingly stringent collection of land-appreciation taxes (LATs), which is having a serious impact on their cash flow. One developer stated that "though the LAT is not fully implemented and has been back and forth," LAT collection is becoming more "stringent."

Cost and Difficulty of Raising External Financing

The interviews made it clear that raising external financing has been difficult for most developers. The recent tight lending environment has hurt all but the top developers. Said an investment banker familiar with public fundraising by Mainland Chinese developers, "Liquidity is tight. Onshore bank loans are hard to get. There is less trust financing. Listed small developers cannot issue bonds in the offshore bond market.

For smaller players raising funds from the offshore bond market, the coupon rate is between 12.5 and 13.5 percent. Tier 1 developers' financing cost on the offshore bond market is much lower. For example, China Resources Land issued a five-year US$400 million bond with a coupon rate of 4.375 percent earlier this year."

A lender based in Beijing noted that debts to finance development projects in Tier 3 and 4 cities pose greater risk of nonperformance than do those for projects in Tier 1 and 2 cities. However, for development projects of reputable developers with a strong balance sheet and good product, banks are willing to lend even if the project is located in a Tier 3 or 4 city. This sentiment is in line with that of a foreign investor, who said his fund is more focused on partners and specific projects than on the macro-environment of the city. The same investor said he is now seeing better opportunities than he did last year, with even high-quality developers seeking private-equity financing to broaden their funding sources.

Nonetheless, foreign investment in China's real estate sector will be less active than it was last year. "External funds will be cautious about their investments in China as GDP growth in China is slowing down while risk-adjusted returns in other markets, including Japan and Southeast Asia, are on the rise," said another foreign investor.

The tough financing environment appears to be accelerating consolidation of the market. "The property sector is experiencing market consolidation now," said a research analyst based in Hong Kong. "Big players play well. Vanke has 2.5 percent of the total property market share now. In comparison, the United Kingdom's largest two developers have a 5 percent market share each. If the liquidity keeps tightening and the market does not perform well, smaller developers will have to sell their projects and big players will purchase them. This is actually happening now."

According to the China Real Estate Information Corporation (CRIC), the top ten developers increased their market shares of sales value to 20.0 percent in the first quarter of 2014 from 14.3 percent two years earlier. According to CRIC's data, the next ten largest developers increased their market share to 6.3 percent from 5.1 percent. Small and medium-sized developers saw their market share drop, with developers below the top 50 seeing their combined market share drop from 73.3 percent to 64.6 percent during the same period.

Continued Imposition of Home-Purchase Restrictions

Home-purchase restrictions are seen as having seriously curbed the speculation in the residential property market. "People have got used to home-purchase restrictions," said one foreign investor. "And current transactions are primarily for real demand. Gray areas, such as people buying residential units under their relatives' names, still exist. But the scale of gray areas is getting smaller."

Exhibit 3-2

Commodity Residential Sales Volume (thousand sq m)

		April 2014	Month over month	January–April 2014	Year over year
Tier 1	Shanghai	760	-18%	2,810	-29%
	Guangzhou	710	-10%	2,860	-33%
	Beijing	530	-26%	2,290	-49%
	Shenzhen	300	1%	1,110	-33%
Tier 2	Chengdu	1,750	-20%	7,530	1%
	Chongqing	1,330	-15%	5,800	-31%
	Shenyang	910	5%	3,010	-31%
	Hefei	870	-13%	3,370	-24%
	Tianjin	860	22%	2,900	-16%
	Changsha	820	-3%	3,430	-26%
	Nanjing	730	11%	2,750	-18%
	Suzhou	620	24%	2,030	-15%
	Qingdao	590	-15%	2,410	-28%
	Nanning	560	9%	1,890	16%
	Jinan	530	17%	1,700	-22%
	Hangzhou	520	37%	1,700	-41%
	Taiyuan	450	84%	1,130	205%
	Nanchang	180	-29%	1,520	9%
	Ningbo	170	7%	640	-29%
	Fuzhou	160	-22%	800	-23%
	Xiamen	160	-47%	1,300	-38%
	Lanzhou	140	-2%	620	40%
	Xi'an	80	-40%	460	-43%
Tier 3	Foshan	590	-15%	2,140	-30%
	Dongguan	370	18%	1,330	-33%
	Wuxi	340	-7%	1,220	-25%
	Sanya	80	-40%	460	-43%

Source: *China Real Estate Information Corporation.*

Some interviewees think the central government will ease restrictions, largely allowing local governments to make decisions. One investor said if the government does relax restrictions, high-end residential properties would get a bigger bounce than midmarket units.

Central Government Land Release Policies

Local governments are directly responsible for land sales; however, the central government sets certain policies to promote efficient land use and safeguard farmland and the rights of farmers. One such policy is a regulation that took effect in 2012 that levies a penalty equal to 20 percent of the land value if land is not developed within one year of the land acquisition and takes back the land if it is not developed within two years. This regulation has made it challenging for developers to speculate on land.

Local Government Land Release Practices

Among those interviewed, there was a consensus that a local government's land release policy is the key determinant of the local real estate market conditions. While Tier 1 cities clearly benefit from strong demand, in general they have released relatively less land than lower-tier cities. Tier 2 cities currently with oversupply are suffering from the aggressive land sales of past years. Although Tier 3 and 4 cities are not included in the survey, many respondents commented that the oversupply situation is significantly more severe there than in Tier 2 cities. For lower-tier cities, one developer noted, market conditions are largely affected by local governments' land sale policies.

"The central government issued circulars aiming to decrease new land supply and improve the efficiency of use of land already supplied to the market," a partner at an international law firm noted. "This policy is expected to be strictly implemented in large cities, including Beijing, Shanghai, and Guangzhou. For instance, the Shanghai municipal government pledges to keep the growth of land for construction at zero percent."

In Tier 1 cities, conversion of industrial land for commercial and residential use is expected to be an important topic in the coming years as these cities run out of greenfield sites. Said an investor based in Hong Kong, "The policy allowing such conversion will provide a great lever for Beijing and Shanghai."

Local Government Residential Development and Sale Practices

Some developers interviewed complained that local governments often use administrative measures, including postponing the issuance of presale permits to developers for high-end residential projects, to manage the average selling price of an area. Such practices have affected the high-end residential segment in cities experiencing rapid growth in housing prices.

A potentially important change affecting the residential market, if introduced and implemented, is the requirement that all or a substantial portion of residential units be fitted out at the time of delivery to the buyer. In most high-end residential projects in urban cores in Tier 1 and many Tier 2 cities, developers have already started to deliver completed units on a fitted-out basis in response to consumer demand. In contrast, most residential units for the midmarket are delivered as a bare shell, leaving it to the individual buyers to hire contractors to fit them out.

A developer in Guangdong said an industry organization in that city has been working on setting a target to deliver 80 percent of new residential units on a fitted-out basis. Such practice would have a positive impact on the overall quality of the projects and the overall upkeep of the residential buildings. Moreover, it would increase the actual occupancy of newly built units.

Exhibit 3-3

Primary Commodity Residential Supply/Demand Ratio and Inventory

		Supply/demand ratio[1]			Inventory			
		April	January–April 2014	2013	Inventory (thousand sq m)[2]	Year over year	Inventory months[3]	Year over year
Tier 1	Beijing	2.4	1.4	0.7	8,660	-4%	17.0	92%
	Shanghai	1.1	1.2	0.9	7,250	12%	10.3	58%
	Guangzhou	2.2	1.2	1.0	8,230	23%	11.9	69%
	Shenzhen	1.0	0.6	1.2	5,190	11%	17.8	18%
Tier 2	Changsha	1.9	1.2	1.2	12,650	22%	15.9	29%
	Hangzhou	2.1	1.6	1.3	10,560	51%	28.9	182%
	Hefei	1.2	1.0	0.9	4,290	-14%	5.2	23%
	Jinan	2.1	1.3	1.2	5,650	106%	13.3	156%
	Nanjing	1.8	1.2	1.1	4,980	62%	8.0	120%
	Ningbo	2.1	1.6	1.3	5,780	33%	42.2	98%
	Qingdao	1.8	1.2	1.2	21,790	19%	37.2	73%
	Shenyang	0.8	0.9	1.3	14,930	47%	19.2	118%
	Suzhou	2.3	1.3	1.1	7,660	26%	16.0	58%
	Xiamen	2.4	0.8	0.9	2,690	-11%	11.6	93%
	Fuzhou	2.0	1.2	0.9	3,300	-5%	17.4	70%

Source: China Real Estate Information Corporation.

1 Supply/demand ratio is calculated by dividing volume of new supply by total sales volume. Supply/demand ratio of 0.8 to 1.2 is considered a healthy market.

2 Inventory is for-sale units that are completed but unsold, as well as units under construction but allowed for presale.

3 Inventory months is the average three-month sales volume divided by total inventory.

Outlook for the Domestic Economy

At the time of the survey, there were mounting signs that the economy was slowing down, and the residential sales data for the first quarter of the year showed a substantial decline from the same period last year. Since the survey was conducted, the government has released more negative statistics about the economy. First-quarter GDP growth was 7.4 percent, the central government reported, anemic by Chinese standards and the lowest rate since 2002, with the exception of the first quarter of 2009. Real estate sales for the first four months of the year showed a decline of nearly 10 percent from the same period last year. Given the importance of the real estate industry to the economy, some market watchers speculated that the real GDP growth rate may have been even lower than the official figure.

The slowdown in economic growth was not at all unexpected. The new administration in the central government has vowed to wean the country's economy off its dependence on fixed-asset investment, including in the property sector. The slowdown in the real estate markets is uneven, with Tier 1 and certain Tier 2 cities relatively unaffected, while certain Tier 2 cities with a large oversupply and Tier 3 and 4 cities experiencing a more substantial slowdown in sales.

Interviewees shared concerns about the negative impact of the slowing domestic economy. Already developers have begun adjusting the pace of development. Said an executive at an international real estate agency in Beijing, “In most Tier 2 cities, including Shenyang and Dalian, developers are delaying or even stopping development projects, most of which are mixed-use ones. Some are thinking about cashing out via en bloc sales instead of strata-title sales.”

At the same time, some interviewees think slower economic growth may benefit the real estate sector in the long run. A foreign developer said he is “more concerned about high-flying economic growth at 11 to 12 percent y-o-y, which is overheating with redundant investments. But the 7.0-plus percent figure sounds reasonable.” A local developer also commented, “Slowing economic growth will accelerate the differentiation of cities. Some cities will do better while others worse. The performance of real estate markets will depend more on market fundamentals—i.e., supply and demand.”

There was also some optimism that the central government may start to loosen the restrictions on home purchases and provide more liquidity to homebuyers and developers.

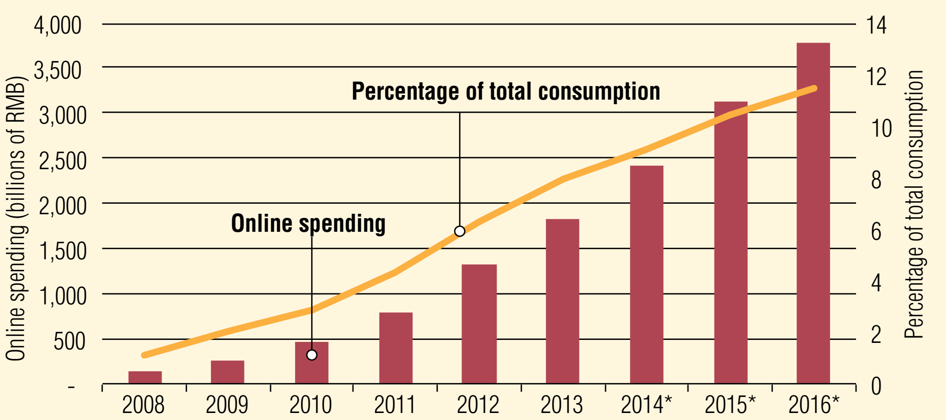
E-Commerce

E-commerce elicited strong views from many of the interviewees. It is clear that the impact of e-commerce is strongly felt in retail shopping centers.

“E-commerce is affecting international retailers, such as H&M and Gap, in respect to expansion,” explained the head of research at an international real estate agency. International brands now focus more on “sustainability of the stores instead of total number of stores,” he said. Luxury sales in off-line stores have been affected as well. “Three to four years earlier, the market experienced a 30 to 40 percent annual growth

Exhibit 3-4

Online Shopping in China



Source: iResearch, January 2012 and April 2014.

*Projection.

of luxury good sales, and the trend was expected to continue for five years or so," he said. "But sales growth slowed down in 2012–2013. You are not going to see a lot of new stores opening in the future."

The same research analyst said impact from e-commerce on retail shopping centers in decentralized locations might be significant. "For third-tier cities, the online platform does affect the physical presence of retail stores," he said. A retail consultant noted that online sales represent about 27 percent of all retail sales in Tier 4 cities, compared with 16 percent in Tier 1 cities.

One developer with a number of retail shopping center projects acknowledged that tenants are being affected and developers cannot charge high rents. "More and more shopping malls are switching to dining and entertainment, becoming more experience related," he said. Another developer with a retail shopping center said fashion brands are decreasing storage areas and increasing demonstration areas in their shops.

Another developer offered a more alarming view. "Traditional retailers and mall operators have to reinvent themselves," he said. "Those who fail to reinvent will fail, and this will create opportunities for those who can reinvent to acquire. The gap between good and bad malls will become big. This creates opportunities for strong retail developers to make acquisitions. There is low-hanging fruit even in Shanghai with a growing number of distressed malls." As to how off-line stores can compete with online ones, he offered, "There is a trend that online and off-line guys engage with each other. For example, Alibaba bought into Intime," a leading retail developer and operator in China. He continued, "Collaborations between off-line and online are happening, but there are not enough communications between the two."

Said a retail consultant experienced in combining off-line and online sales, "We used to suspect that the most valuable shoppers are those who shop both off-line and online, and data show that this is the case. Chinese consumers with money are much younger than their counterparts in developed countries. As a late mover, China has a unique opportunity to do a better job of integrating off line and online. Shoppers are younger and more tech-savvy and have more money."

Central Government Public/Low-Income Housing Policies

The role of the central government's public/low-income housing policies elicited little to no response from the interviewees, with only one interviewee indicating involvement in public and low-income housing. The public and low-income housing sector is mainly policy driven, and developers who participate in the sector are largely state-owned enterprises.

Local/Central Government Environmental Policies

Curbing pollution has been a key policy goal of the central government since early March, when Premier Li Keqiang declared China's "war on pollution." Perhaps the most direct result of this commitment is the recently announced policy to integrate the economic development of Beijing, Tianjin, and Hebei province, which will lead to enterprises and factories that cause heavy pollution being moved out of the nation's capital. Cities in Hebei are expected to benefit significantly from new manufacturing jobs and the central government's heavy investment in public and transportation infrastructure.

Another important way to combat pollution is reducing dependence on automobiles. With road congestion worsening, Tier 1 and 2 cities have been aggressively expanding subway systems, which will go a long way to help reduce reliance on cars. The expansion of subway systems will also create opportunities for real estate development, especially around key interchanges and stations, a number of interviewees noted.

In the building sector, the central government has adopted the Green Building Design Label, or Three Star System, which is similar to the Leadership in Energy and Environmental Design (LEED) program. It is widely believed that China's building certification program is stringent and on par with LEED.

Even without the government-mandated rating system, market forces are leading developers and owners to embrace more stringent building codes. In Phase II of Beijing's central business district, all the buildings currently under construction are understood to be pursuing a LEED Gold–equivalent rating or higher. With the often dangerously high level of particulate matter of 2.5 micrometers (PM 2.5) in Beijing, companies find it imperative to be working in buildings that provide clean air for their employees. Already office buildings not properly designed, built, or maintained are suffering from generally lower occupancy and rent.

Wintergarden atrium at the MixC development in Shenyang.

HANSEN/MF VISION

CHAPTER 4

What's New? What's Livable?

As part of the China city report survey, respondents were asked to rate investment prospects for niche sectors and the relative livability of the cities surveyed.

Niche Sectors

Most notable of the niche or emerging markets rated by respondents are e-commerce distribution centers, which retain their top rank from last year and are rated "good" as an investment prospect, moving up slightly from last year. Overseas investment ranked second, moving up from fourth place last year; the sector is rated "good," up from "fair" last year.

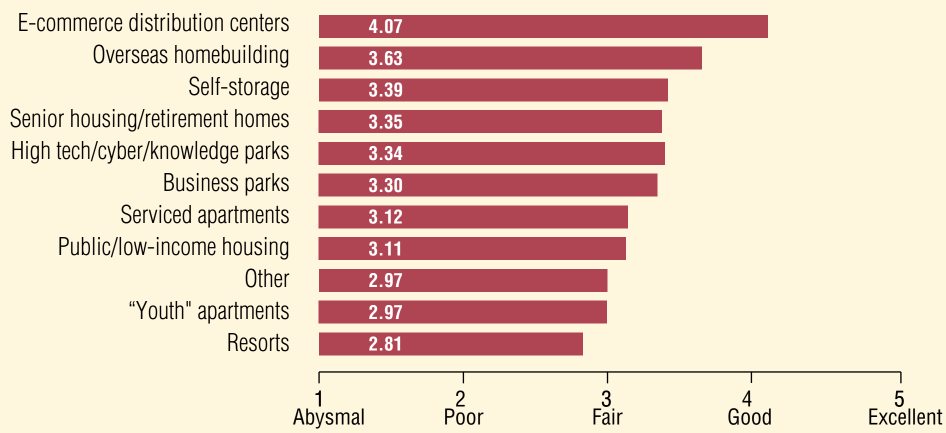
All other niche or emerging markets are rated "fair," as they were last year, although, with the exception of self-storage, they received slightly lower numerical ratings.

E-Commerce Distribution Centers

At 4.07, this sector received the highest average rating by far of the seven niche markets, representing a slight increase from last year's rating, 3.91. The increase is most likely tied to the strong growth in e-commerce sales, which totaled US$296 billion in 2013, up by a remarkable 56 percent from 2012. According to iResearch, China's online shopping is expected to increase to US$610 billion in 2016, a compound annual growth rate of 27.2 percent. China's online shopping penetration rate, defined as online shopping's share of total consumption, is also expected to increase, climbing to 11.5 percent at the end of 2016 from 7.9 percent in 2013. According to KPMG, by 2020, China's e-commerce sector will be larger than those of the United States, the United Kingdom, Japan, Germany, and France combined.

Exhibit 4-1

Investment Prospects for Niche Sectors



Source: *Mainland China Real Estate Markets 2014* survey.

With rapid growth in e-commerce and the need for logistics facilities, leading e-commerce companies have started to invest heavily in distribution centers and logistics warehouses. In May 2013, Alibaba announced plans to form a consortium to create a nationwide logistics platform with retailers and couriers; in December, the firm invested US$364 million to create a logistics joint venture with Haier, the white-goods manufacturer.

Alibaba's competitor JD.com, which ranks second in Chinese e-commerce, is also investing in e-commerce centers. In a recent filing for listing on the NASDAQ exchange, it said it plans to spend up to US$1.2 billion over the next three years to buy land and vehicles and build warehouses.

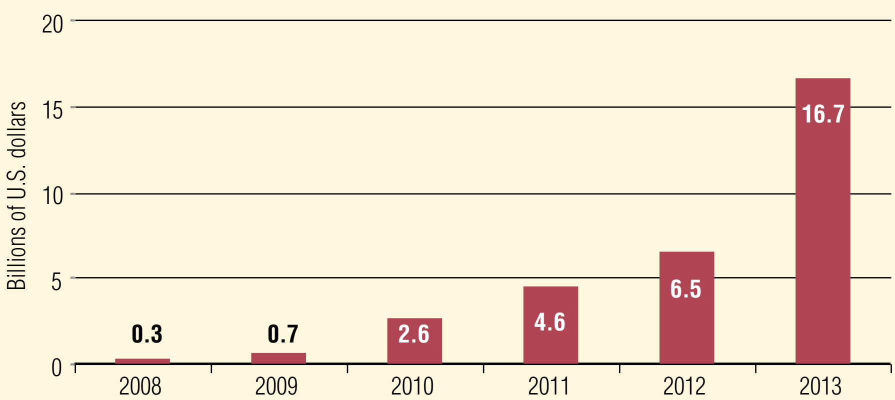
According to a JLL report last November, the e-commerce boom has triggered transformation in retail logistics. "The first wave of e-commerce take-up of warehouse space was concentrated in Tier 1 cities like Beijing, Shanghai, and Guangzhou, but since 2011, major e-commerce firms have also set up distribution centers in emerging inland retail markets," JLL said.

Overseas Homebuilding

The second-highest-ranked niche sector is overseas homebuilding, up from the fourth last year. Since last year's survey, Chinese developers and investors such as Fosun Group and Dalian Wanda have made a string of major investments in key gateway cities around the world, acquiring trophy office buildings; greenfield development projects were also targets of Chinese developers, with top players like China Vanke and Greenland acquiring sites in cities such as San Francisco, Los Angeles, Sydney, and London.

Exhibit 4-2

Total Volume of Chinese Overseas Real Estate Investment



Source: Colliers International.

Higher returns and portfolio diversification are seen as the main motivations for Chinese developers. “Land prices are cheaper overseas than in China,” said a real estate developer whose firm has invested in residential development projects in Southeast Asia. Others mentioned that some overseas markets provide better risk-adjusted returns than Mainland China. “As there is a huge inventory of properties in China, overseas homebuilding becomes a diversification play for Chinese developers,” said a real estate developer involved in the sector.

The CEO of a large local real estate development company said the location of overseas homebuilding is closely tied to the presence of large Chinese populations in those markets, either as immigrants or students. For example, of the about 7,000 EB-5 U.S. visas approved in 2013, more than 6,000 were for Chinese families. EB-5 visas are granted by the U.S. government to immigrant families who invest at least $500,000 in qualified investment projects.

An investment manager at a real estate fund noted that in the past, it was primarily high-net-worth individuals who bought homes overseas. Recently, though, more and more upper-middle-class families are also involved in buying homes overseas or making investments under immigration programs such as EB-5.

Interviewees generally are optimistic about the continuous trends of overseas homebuilding. Overseas homebuilding will become more common and is subtly encouraged by the Chinese government, said the CEO of another local developer. “Instead of buying U.S. Treasury bonds, buy their properties!” he said. Said another developer, “Overseas homebuilding is a permanent, irreversible trend.”

According to a partner in a local law firm, individual Chinese investors now can invest in products for qualified domestic institutional investors (QDIIs), either in the form of private equity products or trust products, in order to ultimately invest in real estate markets overseas. In addition, domestic commercial banks are piloting a program to allow individuals to wire money overseas, helping with their overseas investments.

Regarding project location of overseas homebuilding, one interviewee said, “The success of overseas homebuilding projects heavily depends on project locations. Chinese who are buying a home overseas are usually rich, and they prefer to buy properties in prime locations. They are transferring their assets overseas, and they would like to live in quality projects.” In addition, some respondents think developers principally focus on cities like San Francisco, Melbourne, and Sydney that have many Chinese immigrants and good universities for their children.

Self-Storage

Survey respondents ranked self-storage third among the niche sectors; none of the interviewees, however, had direct exposure to the self-storage sector. An investment manager in a real estate fund noted that like densely populated U.S. cities such as Chicago and New York, Beijing and Shanghai see business opportunities in self-storage.

People usually lease out their additional apartments and store their possessions at self-storage sites. For now, self-storage facilities are primarily located in Shanghai and Beijing, which have sizable expatatriate communities. Also, self-storage facilities are used by small e-commerce resellers to store goods.

Housing for Seniors and Retirement Housing

The ranking for this niche sector dropped to fourth place from second last year. An investment manager in a real estate fund observed that despite many discussions, only a few seniors' housing projects are in operation. Another executive in a fund manager noted that in China, seniors' housing projects have been more concerned with selling apartments and that the market lacks true housing products for seniors.

Three business models for the seniors' housing sector exist—build and sell, build and rent, and lease in and lease out, said the CEO of a local developer familiar with the sector. Most developers in China are doing build and sell for seniors' housing. Build and rent is the business model prevalent in the United States, the United Kingdom, and Japan, and usually incorporates services in these facilities and provides potential capital appreciation in the long run. The old model of developers building seniors' living facilities in the suburbs on a big piece of land is only good for property sales, the developer said, and seniors do not want to move from the city center to the outskirts. Based on this observation, his development team will take on small-scale renovation projects for its seniors' housing platform in city centers.

Despite the shortage of success stories in the sector, the interviewees were generally optimistic because of the tremendous potential demand. A foreign investor active in Mainland China believes that ultimately the demographic shift and single-child policy will lead to huge demand for seniors' housing. "We have not figured out the right model for senior housing," he said. "The existing products are too expensive for the average person. The market shall deliver products on a lower pricing." Said an executive in a foreign development company with broad experiences in developing and operating seniors' housing projects, the aging population, the "4-2-1" family structure, and the growing income in China make the sector promising. However, because senior living facilities cannot have as many stories as a typical high-rise residential project, the land price will need to be lower than for residential-use land parcels in order for such projects to be built.

Said another executive in a foreign private equity investor, "Senior living is definitely something we will look at. It's all about timing and the experience of the operator. We are still monitoring the sector on a regular basis. People are doing one or two projects only. There will be a greater demand for projects in downtown than in remote locations. Some senior living projects are developed on industrial-use land. Developers and investors are waiting for supporting policies, including tax and land policy, for the senior living sector to take off."

In terms of the performance and positioning of seniors' housing, one respondent noted, "The bottom end of senior living is doing pretty well, and the top end is about a healthy, nice environment and facilities." Good senior living products should provide services and facilities to cater to different needs at different stages of aging.

High-Tech/Cyber/Knowledge Parks and Business Parks

The investment ranking for high-tech/cyber/knowledge parks dropped to fifth place from third last year, and the ranking for business parks slipped slightly to sixth from fifth. A local developer said her firm has looked at the business parks sector in Chengdu and Xi'an but finds it hard to do business in the sector in Tier 2 cities because leasing is difficult. However, the firm may consider Zhangjiang Hi-Tech Park and Waigaoqiao in Shanghai if presented with an opportunity. The firm likes Shanghai as a potential market, but few suitable greenfield land parcels are available, either for office use or industrial/distribution use.

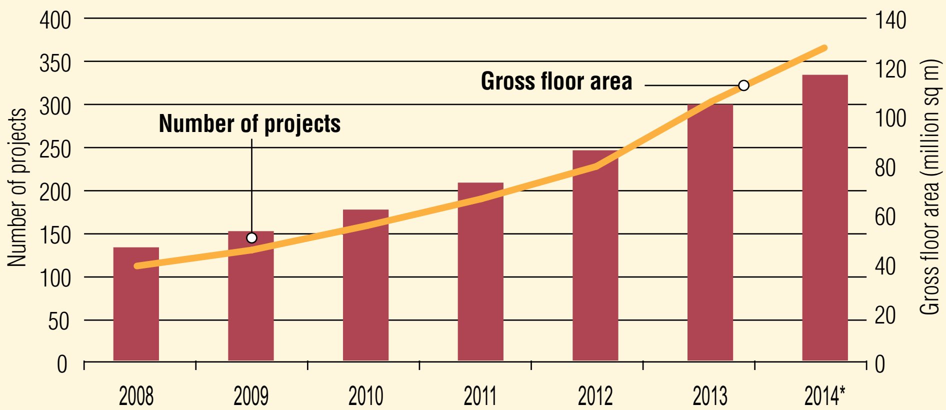
One real estate developer who is mainly focused on high-tech/business/industrial parks noted that his firm also does residential projects as amenities for its business parks.

Serviced Apartments

Though the ranking for serviced apartments dropped slightly to seventh place from sixth, some interviewees were more optimistic about the sector. One interviewee observed, "Rich local people are replacing expats as tenants of serviced apartments in Beijing. About two-thirds of the tenants in our serviced apartment project are local people." A research analyst at an international real estate agency agreed.

Exhibit 4-3

Commercial Business Parks in Top 20 Mainland Chinese Cities



Source: Savills

*Projection.

He said serviced apartments are becoming more popular with local people, such as affluent suburban families who sell or rent out their villas and reside in serviced apartments downtown.

The same research analyst observed that the average stay at serviced apartments has gotten shorter. Multinational corporations are strict with their budgets for expatriate employees, who have been the main customer base of serviced apartments, especially in Tier 1 cities. While demand from expatriates seems stable, demand has increased among domestic business travelers, who tend to stay in serviced apartments for shorter periods. As a result, serviced apartments did “fantastically better” in “mid-tier markets in second-tier cities,” he noted.

On the supply side, however, “there is limited serviced apartment supply, especially the hotel-managed serviced apartment,” he said.

Public/Low-Income Housing

The ranking for this niche sector is the same as last year.

One investor observed that the public and low-income housing sector is dominated by state-owned enterprises and large developers, including China Vanke, China Overseas Land & Investment, and Poly Real Estate. The role of developers in these projects is more like that of contractors, she noted. Local governments usually buy back low-income housing units from developers upon completion at an agreed price. The yield for developers is guaranteed but low. State-owned enterprises and large developers are involved in public housing development primarily because they are required to be by the government.

One interesting development in this sector is the recently announced public-housing investment fund organized by UBS AG, the Hongkou District of Shanghai, and a subsidiary of China Taiping Insurance Group. The fund will invest in rental residential properties for low-income families in the Hongkou District, where rental demand is strong, according to UBS. The fund eventually will be converted to a publicly traded REIT when the regulator allows.

Youth Apartments

The ranking for youth apartments remains the same as last year, with the numerical rating dropping slightly from 3.04 to 2.97. The demand exists, said a senior executive in an international real estate agency: many young people are moving to cities, like Beijing, to study or work but cannot afford to buy apartments in those cities even many years after graduation. However, he said he has not seen much of this type of development in China. “Youth apartments could be the sector that people have overlooked,” he said.

The bottleneck for youth apartments is the land cost, said a senior executive in a commercial bank. One solution is to allow youth apartment projects to be built on industrial-use land: existing youth apartments generally cater to high-tech firms that are located in business parks and hire a large number of recent college graduates, the senior executive said.

Resorts

The resort sector dropped to 11th place—the bottom—from ninth place last year, and the rating declined to 2.81 from 3.11.

The low rating is not surprising given the sensitivity of the sector to overall economic conditions. Said a local developer, "We do not like resorts as they are a seasonal business and may be severely affected by natural disasters." In addition to seasonality and uncertainty, one respondent cited profitability as a concern: "I have not found many resorts to be profitable."

In Mainland China, the largest resorts are located in and around Sanya on the island of Hainan. People have started to worry about oversupply. Said an executive in a fund management company with exposure to Sanya, "The Sanya government has released a new policy that limits the number of small units that usually appeal to buyers from the northeast part of China. If Sanya relies purely on luxury apartments, there will be problems."

Other factors such as airline fares are also affecting Sanya's tourism. With the island's two main airports near capacity, "airlines charge high airfare, driving travelers to other resort destinations such as Phuket, Guam, Jeju, and Japan," said a hotel consultant.

City Livability

Shanghai is rated the most livable city in Mainland China, moving up from eighth place in last year's survey and slightly ahead of Hangzhou, last year's number one. Asked why she rated the city as the most livable, a foreign investor responded that Shanghai offers the best job opportunities as well as good living conditions.

It is not surprising that of this year's ten most livable cities, all but two are economically prosperous cities located along the coast. The two inland cities, Chengdu and Kunming, continue to be ranked high in livability because of their temperate weather and easy lifestyle.

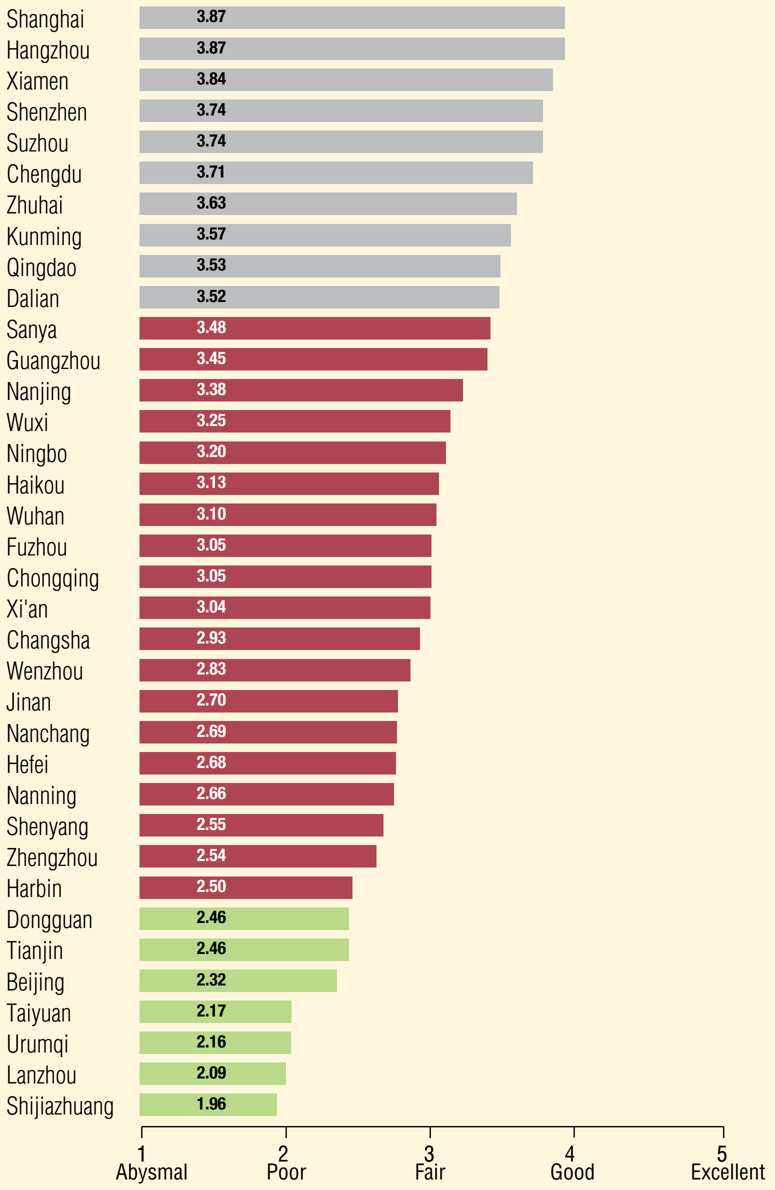
Guangzhou moved up to 12th from 17th last year. A developer with a project in the city noted that because of the Asian Olympic Games, the city built a lot of modern buildings in the Pearl River New Town. He believes that the demand of the affluent population in Guangzhou is met by the city's master plan.

The same developer said Qingdao is another city that has done good urban planning. Qingdao is ranked ninth in livability, down from fourth last year.

The three largest cities in the Bohai region—Beijing, Tianjin, and Shenyang—again rated low in livability. Beijing is ranked 32nd, down one notch from last year. The air

Exhibit 4-4

City Livability



Source: *Mainland China Real Estate Markets 2014* survey.

pollution continues to attract unfavorable coverage from both local and foreign media. In recent months, Beijing announced plans to move heavily polluting enterprises out of the capital.

The capital's pollution and relatively poor living conditions are believed to be taking a toll on the real estate market. Expats reportedly are increasingly wary of living in Beijing and have started leaving to protect their children's health. A developer with projects in Beijing and Shanghai said prices in Beijing for high-end residential units are about 30 percent lower than for similar units in Shanghai because rich Chinese and overseas Chinese prefer to live there rather than Beijing. Foreign travelers, both leisure and business, have reduced their travel to Beijing, affecting the hotel sector, a hotel consultant said.

At the same time, one investor who lives in Beijing observed that when expats move out of high-end serviced apartments, they are replaced by rich local Chinese. Similarly, because of increasing demand from local companies, Beijing's office sector has done well with rent, which is well above Shanghai's.

Job opportunities and other amenities like education are important considerations for the Chinese, an investor noted. With the nation's best universities, plenty of well-paying jobs, some of the country's best hospitals, and cultural amenities, Beijing is likely much more livable than its low ranking reflects. After all, after Shanghai, Beijing has the largest population of migrants, with 7.7 million, slightly ahead of Shenzhen's 7.6 million.

The sector that is perhaps helped most by the pollution problems in a growing number of Chinese cities is the overseas homebuilding sector. Noting that air pollution in China has reached a dangerous level, a research analyst at an international real estate agency said Chinese families are motivated to migrate to other countries in part to provide a better environment for their children. Upper-class people in China alone constitute large demand for overseas homes.

Winland International,
Finance Street, Beijing.

WINLAND INTERNATIONAL

APPENDIX

Recent Regulatory Changes in the Chinese Real Estate Market

The following is a summary of the key regulatory changes in the Chinese real estate market since last year's release of the *Mainland China Real Estate Markets 2013: ULI Analysis of City Investment Prospects.*

Policy Changes: Supply Side

Local Governments Increase Control over Land Supply

Land supply policies have experienced major changes as local governments, particularly in coastal areas, have increased control over supply in their respective jurisdictions.

The Shanghai government, for example, issued a regulation in February aimed at capping the amount of land that may be released for development, reinvigorating existing land use projects and reducing land supply.[1] Under current regulations, the cap amount of land that may be released in Shanghai before 2020 is 3,226 square kilometers, which means the aggregate amount of land that may be released to the public market in the next six years would be no more than 150 square kilometers.

In March, Shanghai issued another set of regulations that permit a holder of land use rights to develop commercial properties on land zoned for industrial uses.[2] The conversion of industrial land into commercial land usually requires the holder of the land use rights to pay a premium in an amount equal to the difference between the current market value of industrial land and commercial land.

Similar policies have been adopted in Beijing. Last October, Beijing issued regulations under which local institutions, enterprises, and organizations are encouraged to construct and develop commodity housing on land they own themselves.[3] This policy enables companies to convert land zoned for industrial use into land for residential use. For example, in December 2013 and this January, BBMG Corporation (金隅股份), a state-owned developer dually listed in Hong Kong and Shanghai, obtained two plots of land for commodity housing that were previously zoned for industrial use. Given that BBMG had to compete with third-party bidders at the public auctions, the government imposed tailor-made qualifications on participants that favored BBMG, so that the only ones that could join the auction were state-owned enterprises affiliated with the Beijing municipal government that had obtained approvals from the Beijing State-Owned Asset Administration Commission.

1. See "Several Opinions on Further Improving the Administration of Land Saving and Intensive Use of Land in Shanghai" (关于进一步提高本市土地节约集约利用水平的若干意见).

2. See "Trial Implementing Measures Regarding Invigorating Stock Industrial Land in Shanghai" (关于本市盘活存量工业用地的实施办法（试行）).

3. See "Opinions Regarding Accelerating Construction of Mid-Low Priced Self-Occupied and Improvement-Oriented Type Commodity Housing" (关于加快中低价位自住型改善型商品住房建设的意见).

Industrial Land Use Term Shortened to 20 Years

Shanghai issued sweeping changes to the regulation of industrial land use rights in March and is in the process of formulating a new standard form of land-grant contract (for industrial land use rights, with the current draft to be adopted starting July 1).[4] Among other things, the Shanghai rules stipulate that the term for new grants of industrial land use rights will be shortened from 50 to 20 years. In addition, investors are required to achieve certain targets with respect to investment amounts, annual sales, and tax revenues. Failure to meet these targets within an agreed-upon time period may result in penalties arising from the breach of the underlying land-grant contract and/or reclamation of the land.

From an investor's perspective, the introduction of these new regulations appears to be a step backward in terms of stability, predictability, and affordability, and will require investors to reassess the risks and pricing of industrial projects in China. While such moves will create some uncertainty in the investment environment during the short term, they do appear to be the "new normal" for nationwide land grant policies in the industrial sector, particularly since other Chinese cities (including Shenzhen, Linyi City in Shandong, Foshan City in Guangdong, and the Beijing Economic and Technical Development Zone) have adopted or are in the process of adopting similar policies.

Idle Land

The Ministry of Land and Resources released a new regulation in June 2012 regarding idle land.[5] The new regulation provides that investors must pay an "idle fee" in the amount of 20 percent of the land grant premium if land remains idle for one to two years; if land remains idle for more than two years, the government may reclaim the land without compensation.

In response to the new regulation, a number of local governments have issued implementing rules. For example, these rules in Hangzhou provide that (a) construction on land granted through public tendering, auction, and listing must start within 18 months of delivery, and (b) the start of construction on a project must be confirmed by local land administration officials, who have a right to conduct on-site inspections.

Rural Land Reform

Land in rural areas is generally collectively owned by farmers and/or villagers. Due to the complexity of its rural land laws, China has been dealing with rural land issues with extreme care. This cautious approach is reflected in the "Circular Regarding Key Objectives on Intensification of Economic System Reform" (深化经济体制改革重点任务

4. See "Several Provisions on Strengthening the Administration of Grants of Industrial Land in Shanghai" (关于加强本市工业用地出让管理的若干规定).

5. See "Measures for Disposal of Idle Land" (闲置土地处置办法).

意见的通知) issued by the State Council on April 30. For example, the circular provided that the collective ownership of rural land must be maintained, and the so-called arable land red line—a minimum of 1.8 billion mu (120 million hectares) of arable land to provide food security—must be ensured. On the other hand, the circular vows to "properly promote reforms with respect to rural construction land (农村集体经营性建设用地), rural land for residential housing (农村宅基地), and land expropriation." The circular also calls for "reforms with respect to collateralization, guarantee, and transfer of rural land contract management rights (承包地经营权)" to increase farmers' revenues in a few pilot regions.

Policy Changes: Demand Side

Slowdown in Home Purchases

Since late 2013, Chinese regulators have issued a series of policies to cool the real estate market. Banks have also tightened lending requirements for homebuyers and developers. Figures from China's National Bureau of Statistics indicate that the total area of residential property sold nationwide in the first quarter of this year was down 3.8 percent from a year earlier, and combined sales revenue edged down 5.2 percent.

Due to the significant role land sales and property development play in supporting local governments' fiscal revenue, local authorities are feeling the pinch of the market slowdown. A number of Chinese local governments—including Tongling in Anhui province, Ningbo in the eastern Zhejiang province, the Tianjin Binhai New Area, Nanning in Guangxi, the Hangzhou Xiaoshan District, Wuxi and Yangzhou in Jiangxu province, and Zhengzhou in the central Henan province—responded by rolling out measures, formally or informally, to encourage home purchases and ease the restrictions that were passed a few years earlier aiming at curbing the property price surge and speculation.

As an example, Nanning, the capital of Guangxi, since 2011 has required nonlocal residents to present documents demonstrating that they had paid local income taxes for at least one year in order to become eligible to buy homes in the city. Under Nanning's new regulations, residents of five neighboring cities are now entitled to the same right as Nanning residents to buy homes in the capital.

If the slowdown persists, more local governments are likely to follow the trend of loosening home-purchase restrictions. By relaxing those restrictions, local governments are effectively calling for an end to the four-year-old policy of reining in China's red-hot real property market.

It is worth noting that local governments do not always get the central government's support when attempting to loosen controls on the property market. In 2012, the central government ordered the local governments of various locations to retract their plans to ease controls on the real estate sector. Nevertheless, market analysts believe the central government is very likely to support the local governments' moves this time because the property sector is not only a key driver of the economy, which is growing at its slowest pace in decades, but also an important revenue source for local government budgets.

So far, the policy change on home purchases is confined to Tier 2 and 3 cities. In Tier 1 cities such as Shanghai, Beijing, Guangzhou, and Shenzhen, home prices have been rising at a slower pace. Local governments in these cities have indicated in various situations that they have no intention of easing the home-purchase restrictions.

Reform of the Residence Permit System

China's household registration system has been another variable affecting the property market because many local jurisdictions only grant the privilege of buying homes to local residents. A relaxation of the household registration system typically creates new demand in the property market, such as buyers from the nonlocal talent pool employed by local enterprises as well as affluent investors from other parts of the country.

In February 2012, the State Council published the "Circular Concerning the Active Yet Prudent Advancement of the Reform of the Household Registration Management System" (关于积极稳妥推进户籍管理制度改革的通知), which provided that towns and small cities must lift all restrictions on household registration, medium-sized cities must remove the restrictions in a gradual and systematic way, and the largest cities must exercise strict control over the size of their population. More specifically, the circular provides that nonlocal residents in a medium-sized city who work for a period of three years and pay their own shares of local social insurance for a certain period may apply for local residence permits not only for themselves, but also for their spouses, unmarried children, and parents.

On November 15, 2013, the Central Committee of the Chinese Communist Party reiterated the policy change in the "Decision Regarding Several Significant Problems on the Comprehensive Intensification of Reform" (关于全面深化改革若干重大问题的决定), urging that reform of the household registration system be expedited, a view also reflected in the "Circular Regarding Key Objectives on Intensification of Economic System Reform" (深化经济体制改革重点任务意见的通知), issued by the State Council in April.

Unified Real Property Registration

Establishment of a unified real estate registration system has been under discussion for a number of years. A nationwide real estate registration system would combine the real estate registration processes that had been supervised by about ten government agencies into a single system overseen by the Ministry of Land and Resources, thus removing inconsistencies and contradictions in practice. Many cities, for example, still consider registration of land and registration of buildings located on land to be separate.

In May, the Ministry of Land and Resources announced that the much-awaited "Regulations on Real Property Registration" is scheduled to be released by the end of June. There has been much resistance to establishing the unified real estate registration system because many corrupt government officials who own multiple properties are against the move.

Release of the “Regulations on Real Property Registration” is likely to have a positive impact on the housing market, such as removing the inconsistencies in the real estate registration systems currently in practice in different local jurisdictions and allowing the government to manage the real estate industry in a more effective manner.

Second-Child Policy

China’s one-child policy was partially lifted at the end of 2013. On December 28, 2013, the National People’s Congress passed the “Resolution of the Standing Committee of the National People’s Congress on Adjusting and Improving the Family Planning Policy” (全国人大常委会关于调整完善生育政策的决议), which formally approved easing the decades-old policy. According to the new policy, a couple may have up to two children, as long as one of the parents is an only child.

The policy change comes as China seeks to address a shortage of migrant workers in the face of a rapidly aging population. Such demographic changes could also ripple across an unexpected part of China’s economy—the housing market, which is showing signs of a downward trajectory. It has been estimated that the policy change could add 1 million to 2 million births every year to the current 15 million births per year. In the short run, the policy change is a boost to the housing market as the larger families look to improve their living conditions with bigger and better homes. In the long run, additional real estate market demand will be created when the children of the second-child policy grow up.

Real Estate Taxes

The long-discussed real estate tax has come closer to fruition this year. In May, the National Development and Reform Commission, the national economic policy maker of China, announced a list of priority policies for the year during the 2014 National Economic System Reform Conference (2014全国经济体制改革工作会议). On that list of priorities was progress with a national real estate tax, which is intended to be paid annually on the privilege of holding real properties.

A real estate tax has already been implemented on a trial basis in Shanghai and Chongqing since 2011. The local real estate tax regimes in both cities were formulated to ensure that the policy does minimal damage to the local real estate market. In the case of Chongqing, a real property tax of 0.5 to 1.2 percent of property value was limited to villas and other high-value properties that cost more than two times the average home price in the area. In the case of Shanghai, the tax is 0.4 to 0.6 percent on second homes of residents and first homes of nonlocal residents.

In the three years since the trial of the property taxes began, the goals of the tax, which include curbing speculation and reining in surging home prices, have hardly been accomplished in either city. Nevertheless, the real estate tax could deal another blow to the already cooling market if it is not carefully structured and enforced. Therefore, the market has always closely followed news about the final version of the real estate tax.

Real Estate Finance

Banking

On February 20, 2013, the State Council, China's cabinet, released a new round of measures aimed at reducing speculation and reining in housing prices.[6] Chinese banks have responded by tightening lending to homebuyers and developers. The personal housing loan quota has become strained, and preferential mortgage rates have become rare. On the national level, most banks are no longer offering preferential mortgage rates to first-time homebuyers, with some banks increasing the lending rates 5 percentage points to 15 percentage points above the benchmark rate.

Loans to developers, particularly small and medium-sized developers, have come under severe scrutiny. In some cases, developers have had to rely on "shadow banking"—underground lenders that typically charge higher interest rates—to finance their developments. In March, the collapse of Zhejiang Xingrun Properties, an unlisted developer in the eastern city of Fenghua in Zhejiang province, was likely due to defaults on loans to 15 domestic banks totaling US$389 million, as well as to individual investors from the shadow banking sector in the amount of US$180 million. This case indicates that the credit environment has rapidly deteriorated for unlisted developers in Tier 3 and 4 cities.

As an increasing number of signals point to a property-market slowdown and a cooling in downstream industries such as cement, iron, and steel, the People's Bank of China (PBOC), China's central bank, convened a meeting on housing financial services with executives from 15 commercial banks on May 12, during which it urged commercial banks to properly allocate credit resources and prioritize credit demand for first-time homebuyers while keeping a closer eye on the associated risks. The central bank also asked Chinese banks to set mortgage rates at "reasonable" levels and grant housing loans more quickly.

Although loans to real estate developers are still restricted, the central bank's new policy to loosen lending to first-time homebuyers is a significant reversal of previous policies and reflects regulators' concerns about the real estate market slowdown.

6. See the "Circular of the General Office of the State Council on Further Improving Regulation of the Real Estate Market" (国务院办公厅关于继续做好 房地产市场调控工作的通知), also known as "State Five Measures."

Offshore Debt Financing

Cross-border use of offshore renminbi funds continues to be a source of funding for Chinese companies. As of May, Chinese real estate companies have raised about US$13.3 billion through the issuance of renminbi bonds on overseas markets.

To develop the internationalization of the renminbi, China has established financial reform pilot programs in areas such as Shanghai and Qianhai. Policies in these two regions provide an alternative to raising foreign debt through renminbi loans. For example, the Shenzhen branch of the People's Bank of China in January 2013 issued the "Implementing Rules Regarding the Interim Measures for the Administration of Cross-Border RMB Loans in Qianhai" (前海跨境人民币贷款管理暂行办法实施细则), which allowed companies registered in Qianhai to borrow offshore renminbi loans. Similarly, the Shanghai office of China's central bank this February 20 issued the "Circular on Supporting the Expansion of RMB Cross-Border Business in China (Shanghai) Pilot Free Trade Zone" (关于支持中国(上海)自由贸易试验区扩大人民币跨境使用的通知), which allowed companies based in the Shanghai Free Trade Zone to take out renminbi loans from offshore lenders.

Another significant policy change took place this May 19, when the State Administration of Foreign Exchange released the "Administrative Rules Regarding Cross-Border Security" (跨境担保外汇管理规定). These rules removed both the approval and the quota requirements under the existing outbound security regime, paving the way for property developers to get much easier access to offshore financing to fund projects in China.

Capital Markets

Amid concerns that surging home prices were creating an asset bubble, China's State Council imposed a moratorium on share offerings in 2010, including bans on initial public offerings (IPOs) and private placements by real property developers.[7]

The ban was partially lifted this March when the China Securities Regulatory Commission (CSRC) granted approvals to four Chinese developers—Tianjin Tianbao Infrastructure (天保基建), Join.In Holding (中茵股份), Beijing Urban Construction (北京城建), and Dima Industry (迪马股份)—for private placements of yuan-denominated A shares. Three more developers—Wolong (卧龙地产), Fuxing (福星股份), and Greattown Holdings (大名城)—received CSRC approval in April to issue yuan-denominated corporate bonds. These seven property developers intended to raise an aggregate of about US$2.5 billion. The CSRC approvals were granted amid concerns of defaults in the real property sector after the collapse of Zhejiang Xingrun Real Estate. All such approvals were seen as signs the government may be relaxing the moratorium on private placements.

7. See the "Notice Regarding Resolutely Curbing the Soaring of Housing Prices in Some Cities" (关于坚决遏制部分城市房价过快上涨的通知).

In contrast with private placements, there have been no signs that IPOs (A-share offerings) will be reopened anytime soon. As of May 9, China had about 560 domestic companies in the IPO pipeline awaiting listing approval. Among these applicants, only one property developer—Wanda Commercial Properties (万达商业地产)—submitted its application before the moratorium.

Overseas capital markets continue to be a source of funds for Chinese real estate developers. In the past three years, more than 20 Chinese developers—including China Merchants Property Development (招商地产) and Vanke (万科)—have listed either through IPOs or reverse takeovers in Hong Kong.

REITS

Chinese policy makers have been discussing the possibility of exchange-traded real estate investment trusts (REITs) for nearly a decade, but progress has been delayed by concerns about property market speculation and tight controls on real estate financings. Along with the lifting of the moratorium on private placements for listed property developers for the first time in four years, another step that could herald less government intervention in the sector is REIT products.

On May 21, the CITIC Qihang Specific Asset Management Plan (中信启航专项资产管理计划), China's first exchange-traded REIT, led by CITIC Securities (中信证券), began trading on the Shenzhen Stock Exchange. CITIC Securities (中信证券) is China's largest brokerage by assets. Its REIT product received CSRC approval in January and was sold to a handful of institutional investors. CITIC Securities' US$854 million product has a term of three to five years and includes two tranches. The senior tranche, which has an AAA rating, yields 5 to 7 percent, while the unrated subordinate tranche offers a yield of 12 to 42 percent. The two tranches are backed by rental payments from two office buildings owned by CITIC itself in prime business districts in Beijing and Shenzhen.

Approval of CITIC Securities' product is consistent with other market regulators' policy changes to relax financing restrictions on property developers, as property prices have fallen to more reasonable levels since the beginning of the year.

Outbound Investment

Relaxation of China's Outbound Investment Regime

In April, the National Development and Reform Commission issued a set of rules on outbound investment. Key changes include applying a universal approval threshold of US$1 billion for all projects and removing the approval requirement for overseas investments made by a Chinese company's overseas subsidiary, provided the Chinese parent company provides no acquisition funding or guarantee. The Ministry of Commerce, the other key regulator of outbound investment projects, is in the process of soliciting comments on a set of new outbound investment rules. It is expected that the Ministry of

Commerce's approval authority will be confined to outbound projects involving sensitive countries and regions or sensitive industries.

In February, the Shanghai Branch of the State Administration of Foreign Exchange released a set of detailed foreign-exchange guidance rules introducing more flexibility into the foreign exchange–control regime in the Shanghai Pilot Free Trade Zone. Outbound investments by an entity established in the Pilot Free Trade Zone can now be processed directly with commercial banks without requiring, as is the case outside the zone, approval by the State Administration of Foreign Exchange.

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Xintiandi, Huangpu District, Shanghai.

SHUI ON LAND

Authors

Kenneth Rhee
Chief Executive Officer
Huhan Advisory
Chief Representative, Mainland China, ULI

Anita Kramer
Vice President
ULI Center for Capital Markets and Real Estate

Project Staff

John Fitzgerald
Chief Executive
ULI Asia Pacific

Basil Hallberg
Senior Associate
ULI Center for Capital Markets and Real Estate

Mark Federman
Project Assistant
ULI Center for Capital Markets and Real Estate

Xiaoning Mao
Intern
ULI Center for Capital Markets and Real Estate

Abel Xu
Senior Associate
Huhan Advisory

ULI Editorial and Production Staff

James A. Mulligan
Managing Editor/Manuscript Editor

Anne Morgan
Graphic Designer

1025 Thomas Jefferson Street, NW
Suite 500 West
Washington, DC 20007
www.uli.org

ULI Asia Pacific
Level 16, Nexxus Building
41 Connaught Road
Central, Hong Kong
uli_asiapac@uli.org

ULI Japan
COI Uchikanda Building 8F, 3-2-8 Uchikanda, Chiyoda-ku
Tokyo 101-0047
info@japan.uli.org