The State of the Commercial Real

According to Chinese government statistics, a year after the adoption of the 4 trillion yuan ($586 billion) economic stimulus package, China's GDP grew 8.9% year on year in the third quarter of 2009, accelerating from 7.9% in the second quarter. "We have stabilized economic growth and employment and maintained social stability over the past one-year period," said Chinese Premier Wen Jiabao in a recent interview with the Chinese news agency Xinhua.

Riding the nation's strong economic growth, the rolling bull market prospects continue in China's real estate sector. Investors in China have poured capital into the property development market. In addition, as of October 1, 2009, a newly amended regulation allows Chinese insurance companies to invest directly in commercial real estate.

The growing influx of capital and a perceived soaring demand in the property markets are driving a new wave of land sales in China. As reported by Real Capital Analytics, China recorded $50 billion in land sales through August 2009, including 125 deals above $100 million. Sales above $1 billion were recorded in ten markets: Beijing, Shanghai, Hangzhou, Tianjin, Chongqing, Xiamen, Guangzhou, Chengdu, Najing, and Foshan, with the highest volume in Beijing at $9.8 billion.

Housing Market Sizzles

China's land auction is sizzling with a record bid. In a recent land auction, China Construction International (a central government–owned enterprise) successfully beat major local developers and won the bid at 4.8 billion yuan ($703 million), where the asking price was 800 million yuan ($118 million), for three plots near the Olympic Stadium in Beijing. The winning bidder paid an average price of 18,532 yuan ($2,715) per square meter for the land, which is 20% higher than the average price of the housing units currently sold in that area. This well reflects the general perception that skyrocketing house prices will continue in China's major cities.

In November, home prices in 70 large and medium-sized Chinese cities rose 5.7% from a year earlier, accelerating from October's 3.9% rise. The Chinese central government has been concerned about the rapidly rising home prices in Chinese cities. Premier Wen said recently that the government would maintain order in China's property market while cracking down on illegal activities that had driven up housing prices. Wen also said the government would stabilize real estate prices with the economic tools of taxes, interest rates, and land policies.

Prompted by fears of a bubble in the housing market, the government announced in late December that it would resume a harsher property sales tax—extending the taxable period on home sales to five years from date of purchase—to curb speculation in the housing market.

Commercial Real Estate Slowly Gains Momentum

Unlike the surging residential sector, the commercial real estate market in China is taking a much lower profile, owing to the negative impacts from the global financial crisis. The current state of the commercial

Estate Market in China

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real estate market in China is characterized by severe disequilibrium in demand and supply, low transaction volume, high vacancy, and declining rental rates. As reported by *China Real Estate,* during the first half of 2009, commercial real estate transactions declined in half the 31 major Chinese cities. In some of the cities, commercial real estate sales dropped by as much as 30%. Despite these difficulties, capital continues to pour into China's commercial real estate sectors.

State of Office Market Depends on Location

In Mainland China, office rents in the Shanghai Pudong area dropped by 11%; in Guangzhou, office rents dropped to the 2005 level. In Beijing, the vacancy rate for grade A office space increased to 21.9% by the end of the third quarter of 2009. The highest vacancy rate in some parts of the city reached 34.2%.

According to data collected by the Shanghai Bureau of Statistics, however, during the first seven months of 2009, total capital investment in office development in Shanghai reached 10.4 billion yuan ($1.5 billion), increasing 8% over 2008, higher than the 6.2% growth in capital investment in the residential housing market in Shanghai. During 2008, the new supply of grade A office space in Shanghai exceeded 800,000 square meters, while the net take-up was less than 400,000 square meters. The cumulative new supply of grade A office space in Shanghai matched the cumulative net take-up amounts to 135,100 square meters by the end of the third quarter of 2009. Shanghai's overall vacancy rate remained at 15.5% in the third quarter of 2009, increasing from 5% in 2007. In Hong Kong, the decline in office rents slowed in the third quarter. The vacancy rate for grade A office space in Hong Kong ended the third quarter of 2009 at 9.7%.[1]

Retail

Retailers in China, however, are encouraged by improving market conditions. Beijing retail sales rose to 338.9 billion yuan ($49.6 billion) in the first eight months of 2009, up 14.3% year on year. Ground floor shopping mall rents rose 1.9% in the third quarter to an average of 24.6 yuan ($3.6) per square meter per day. The citywide prime shopping mall vacancy rate in Beijing was about 16.8% in the third quarter. The average prime shopping mall rent in Shanghai remained unchanged in the third quarter of 2009 at 33.7 yuan ($5) per square meter per day. The citywide prime shopping mall vacancy rate in Shanghai stood at 3.3% at the end of the third quarter of 2009. The latest figures from the Census and Statistics Department showed that Hong Kong's real GDP returned to expansion, increasing 3.3% in the second quarter after contracting for four consecutive quarters. Private consumption expenditure increased 7% quarter on quarter. Some retailers that directly benefit from Mainland Chinese visitors (for example, Sa Sa Cosmetics and the Body Shop) are taking the opportunity to expand their business and market shares.[2]

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1. According to Savills Research and CB Richard Ellis Market View.
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Pilot REITs

One significant development in China's commercial real estate sector is that the State Council, China's Cabinet, has given REITs the green light. In recent years, there has been increased global interest in indirect investment in real estate markets through REITs. REITs were first introduced in Hong Kong in late 2005 when the first two REITs listed in Hong Kong incorporated only Hong Kong–based properties. The third REIT was unique in that it was the first REIT to be offered in Hong Kong that invested in property located on the mainland.

Although some details of the China pilot REITs have yet to be worked out, sources close to the REITs say that the framework emphasizes strong supervision, with securities and banking regulators joining forces. According to the *Daily Economic News,* a task force led by the China Central Bank, the China Banking Regulatory Commission, the China Securities Regulatory Commission, and 11 other government bodies is currently preparing the China REITs Pilot Management Practices. Select pilot REIT projects are ready to debut in Beijing, and Tianjin, once the regulation on China REITs is unraveled.

Regulators have been cautious about REITs because they require several levels of legal transactions involving investors, issuers, trustees, custodians, property managers, and property assessors. The process also involves complicated tax and mortgage details. While searching for ways to protect financial stability amid a real estate boom, the central bank looked at REITs to play a benchmark role in real estate pricing, to curb soaring prices, and to disperse market risks, said Cheng Jiansheng, director of the central bank's real estate finance department.

Candidates for pilot projects include Tianjin TEDA International Holding and CITIC Securities. Property developers in the Tianjin Binhai District and Shanghai Pudong District are seeking to list REITs on the Shenzhen and Shanghai exchanges as well. Plans drafted by CITIC Securities and Lianhua Trust are the main candidates for pilot projects backed by the central bank. While the Beijing REITs may focus on the retail/shopping mall sector of commercial real estate, Shanghai REIT may focus on the industrial/warehouse sector, and Tianjin REITs may focus on the affordable housing/multifamily sector.

According to sources, the central bank version of the pilot REITs belongs to a category of debt REITs; the claims on the rents and mortgage payments associated with the underlying commercial real estate assets are packaged into REIT shares and sold to investors. These interbank market transactions are similar to the securities and property derivatives transacted in the financial market. These new instruments eventually would take the shape of trusts, allowing REIT issuers to freely choose between the interbank market and the stock exchange. Moreover, fund managers would not be limited to trust companies, and the door would be open for participation by fund managers as well as securities firms.

In Summary

The recent price war observed in the land auction market due to soaring demand in the residential property market in China raised "bubble" concerns. The commercial real estate markets, especially the retail sector, are slowly gaining momentum, largely attributed to the recent economic recovery and improving market conditions in China. The introduction of the pilot REITs in China, supported by China's State Council, will provide commercial real estate developers another ready market for completed properties, making it easier for them to free up capital for new projects. ■

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