INFRASTRUCTURE

by Zheng Xiaoping

Crisis and Opportunity

How Is the Global Financial Crisis Affecting China's Real Estate and Infrastructure Investment Opportunities?

During the past six months, we have witnessed unprecedented disturbances in the global financial sectors. China is not immune to the rippling impacts and suffers most in its export industry, which had constituted 37 percent of its GDP in 2007. In anticipation of a prolonged period of export decline, China is launching major policies to stimulate domestic spending and investments in fixed assets. This will lead to substantial changes in its real estate investment focus and create a range of opportunities for infrastructure investment. This overall change in national development focus will have considerable impacts for foreign investors.

Executive Summary

- **Urbanization growth continues to drive real estate and infrastructure demand in China.**
- **New government policies to stimulate domestic economic growth will create alternative investment opportunities for domestic and foreign investors.**
- **Three emerging trends will have a significant impact on the foreign investment landscape in China's real estate and urban development markets.**

THE LONG-TERM GROWTH POTENTIAL

One-quarter of the world's population is undergoing an unparalleled urbanization process. The massive urbanization movement in China will continue to be the backbone of China's growth. Compared to the market uncertainty in many developing countries, 15 million people have been consistently migrating into China's cities every year for the past 15 years, and this pattern is expected to continue for another 20 years. Before China reaches a 70 percent urbanization rate, an additional 300 million people will migrate into its cities, and this will create phenomenal demand for real estate projects and infrastructure investments (see Urbanization Rate graphs, page 29).

According to China's government planning and leading research firms' estimates, by 2025, China will have 40 billion square meters of additional buildings, and more than 200 cities will have populations of 1 million or more. By 2010, China will build 85,000 kilometers of highways; by 2020, 15 percent of its total energy will come from green energy sources. Other infrastructures projects will include airports, harbors, railroads, social infrastructure and new suburban redevelopment. Before the recent announcement that the government will inject US$580 billion within two years to stimulate internal growth, total spending on infrastructure, according to China's original five-year plan for 2006 to 2010, had already amounted to US$1 trillion. China will remain the largest developing country that delivers growth potential. At the 17th Congress of China's Communist Party, president Hu Jintao and his team set a daring target of quadrupling per capita GDP by 2020, compared to its 2000 level. According to a 2008 research report from McKinsey Global Institute, China will "meet its per capita GDP goal with relative ease."

POLICIES CHANGE DUE TO GLOBAL FINANCIAL CRISIS

Despite China's attractive growth potential, and well before the financial crisis, its fast-paced development already faced challenges, including environmental problems, investment speculation, assimilation in urban forms, and rising land and housing prices. Since mid-2006, China's government has stepped in to control the explosive growth by enacting six related policies to discourage foreign capital from entering the real estate market. Additionally, China has tightened local bank lending to developers. Even without the global financial crisis, 2008 was already a difficult time for both foreign investors and domestic developers.

As the impact from the global financial crisis becomes more apparent, China is suffering from the declining export industry and fully realizes the most secure and manageable supports within the coming two years should come from its internal market. The Chinese government is reacting with speed in placing its key focus on stimulating its domestic spending. While many new policies are still under review, three have been made public: on 12 October 2008 at the third conference of the 17th Party Congress, major policies that support rural region economic growth, detailed policies in tax reform, and profit gain from land development for farmers; on 5 November 2008, an investment scheme of US$580 billion over two years for spending in infrastructure projects, social benefits and investment into rural regions; on 30 November 2008, a subsidizing scheme of covering 13 percent of the cost of home appliance purchases to encourage spending from 200 million rural families.

China's strategies in supporting rural region development, in stimulating investment from private sectors, and in promoting domestic spending are building a solid foundation from which its economy can compete to bounce back from the current global difficulties.

IMPACTS TO FOREIGN INVESTORS

In July 2008, the Minister of Commerce delegated the control over filling of foreign capital real estate projects to the provincial government, indicating a possible trend of easing up on the foreign capital entry control. In the near future, however, the government is not likely to modify its Foreign Investor Industry Guideline, in which the only remaining real estate category, housing, was taken out of the encouraged investment list in December 2007. Compared to the real estate sector, infrastructure investment, on the other hand, is receiving overwhelming support from the government — almost all categories are encouraged, including green energy, waste treatment, transportation and water-related infrastructure, with a few exceptions such as telecommunications and limited shareholding of airports. Under the current government policies and market conditions, foreign investors should consider the following issues when formulating their investment strategies in China.

A new era for real estate investment: The traditionally secure housing market, despite huge demand, is facing challenges from upscale government affordable housing schemes that sell projects at a relatively low price. Core assets in major cities are generating unattractive yields. Today, real estate investment in China is very competitive and requires a niche focus, superb control over the development process and a strong theme preferably built upon a scalable market foundation.

Infrastructure as a new asset class: Historically, most foreign investors in China's infrastructure sector engage in Build-Operate-Transfer projects. There is a growing potential for private equity funds to participate in the phenomenal pool of projects. Within the next two years, China may be one of only a few places where substantial leverage over infrastructure projects can be achieved. Working with domestic partners who can contribute market experience, a pipeline of projects and established social connections can facilitate foreign investors' entry process.

The rising dominant power of domestic private capital: As of mid-2008, Chinese banks held 39.5 trillion yuan (US$5.8 trillion) in savings, and the Chinese government has been speeding its efforts to streamline its securitization and project-financing channels. Within a few years, foreign capital, which requires lengthy approval procedures and high-yield expectations, may not be as competitive as domestic capital. Foreign investors need to reframe their mind-set with regard to the core competitive edges that they bring to the Chinese market.

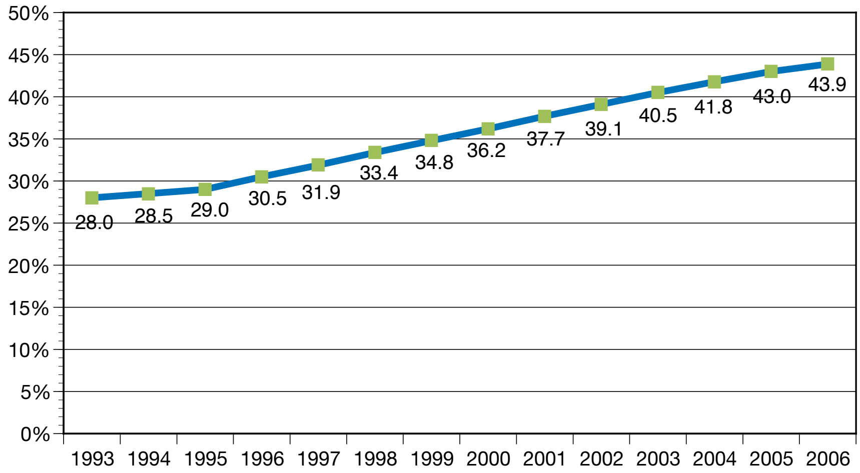
EMERGING TRENDS

There are three emerging trends that will have a significant impact on the foreign investment landscape in China's real estate and urban development markets.

Consolidation of local developers: China has more than 45,000 local developers, less than 1 percent of which are large firms; the rest are small- and medium-sized developers. Different survey and industry predictions indicate that 50 percent to 75 percent of the local developers will be forced out of the market. China is entering a period of shedding its less qualified developers. This trend will force developers to provide undervalued projects in exchange for investment capital. Since mid-2008, a large amount of projects, particularly those greenfield developments situated in less central regions, have provided a substantial discount over their pricing in 2007.

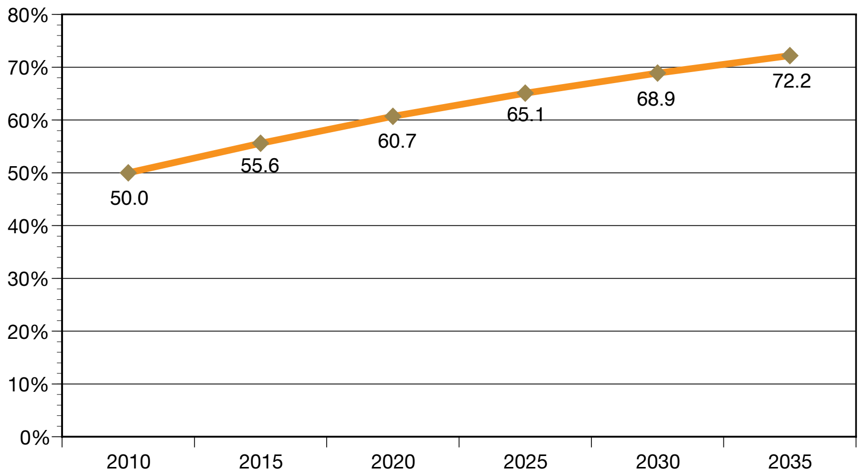
Era of investment in the second- and third-tier cities: In comparison to investment opportunities in Beijing, Shanghai, Guangzhou and Shenzhen, China's second- and third-tier cities can yield higher returns and

Urbanization Rate (1993–2006)



Sources: National Bureau of Statistics of China

Urbanization Rate Projection (2010–2035)



Multiple data sources, projections by BAZO Investments (Asia) Ltd.

lower barriers to entry. This trend is attracting domestic and international investors venturing into second- and third-tier cities and beyond. These cities have good investment potential, and city governments are more willing to contribute resources and support to attract investment capital.

Policy reform in embracing multiple financing vehicles: China has a huge potential for developing its own capital markets. Its total bank savings reached 1.7 times its national GDP in 2006. China also has large sums of pension and insurance capital that are currently blocked by government policy from accessing its domestic real estate market. This situation will quickly change as the Chinese government streamlines its regulatory process to establish multiple securitization vehicles. These will include:

- China mainland REITs (likely to launch within the first two quarters of 2009)
- Local trusts and private equity funds with real estate as a focus
- IPOs at domestic stock markets, and the launch of a junior investment board at Shenzhen
- Allowing insurance capital into the urban development market.

INVESTMENT OPPORTUNITIES IN SPECIFIC SECTORS

Residential: Housing will remain the primary driving force in China's real estate market. However, as the Chinese government is stepping up its affordable housing scheme, developers that focus on housing projects alone are facing increasing market competition. Compared to just two years ago, housing for the mass domestic buyer may no longer be the most secure investment sector. Investors and developers need to be innovative and to provide quality products beyond ordinary measures.

Senior housing: By the end of 2004, China had more than 140 million people older than 60 years, constituting 11 percent of the total population. From 2001 to 2020, China's senior population will increase by 6 million per year, a 3.28 percent annual increase, far in excess of the national population increase rate of 0.66 percent. China's senior population will reach 270 million by 2023, and 400 million by 2050. The demand for senior housing exceeds the current supply.

Regional shopping centers: The explosive urbanization process creates demand for central commercial and shopping facilities; rapid urban development also creates the need to remodel downtown areas. While there are concerns over the quantity of commercial projects and modern shopping malls in first-tier cities, the demand and market potential in second-tier cities and beyond are still apparent. Foreign investors have begun to enter third-tier cities seeking better market support and investment return.

Logistics: China has 2,500 industrial parks, most of which are greenfield land development where basic infrastructure and land are provided for factories and manufacturing companies to build their facilities. China lacks an international standard logistics operation structure to coordinate the complete operating chain. This void had attracted industry-leading firms, such as ProLogis, to enter the market as early as 2002. Despite the increasing competition between local and international firms, logistics remains a potential investment sector with stable yield.

Infrastructure: China has been consistently investing 10 percent of its GDP in infrastructure. During its 11th five-year plan (covering 2006 to 2010), China anticipates investing a total of US$1 trillion into infrastructure, including expressways, harbors, railways, water treatment plants, environmental projects and other urban facilities. A substantial amount of the investment will come from the private and foreign sectors. The background is that the Chinese government embraces foreign investment in infrastructure.

Underground commercial development: During the past decade, China's cities have focused on the speed of development; relatively less attention has been paid to the potential of below ground development. While the land shortage is now apparent in most major cities, China's government has more incentive to explore its underground development potential. With the possibility of building subway systems in more than 100 cities, we will see more commercial projects along subway lines and under cities' open parks and plazas.

Tourism-related projects: China has 11 public holidays. When added to weekends, five of which are three days long, and two major national holidays, each of these holidays becomes seven days long. China's local tourism spending will rise from 250 billion yuan (US$36.4 billion) in 2000 to 1 trillion yuan (US$145.4 billion) by 2010. Tourism-related projects have huge potential and may enjoy more favorable policies over some other investment sectors.

New suburban redevelopment: A major redevelopment plan is associated with the urbanization process. When 300 million people migrate from rural areas into urban centers, they leave behind their houses, which are scattered across the countryside. Significant investment and development should consolidate individual unconnected farmhouse plots into central areas that can be put into effective use. This suburban redevelopment plan will play a key role in releasing 7,800 square kilometers of land for urban development while preserving the already very limited amount of farmland in China.

LOOKING AHEAD

In the Chinese language, the two characters "wei" and "ji" have different meanings. When put together, "weiji" stands for "crisis." When used separately, "wei" stands for "danger, emergency," and "ji" stands for "opportunity."

Under the current global financial crisis, China's real estate and urban development markets cannot be immune from the huge impact. There are major challenges that the Chinese government and its people will have to face. However, when reviewed in a global context, China's unparalleled urbanization trends and enormous domestic market will still form the backbone for secure long-term investment. Its extremely diverse regional cities and provinces will create a range of attractive investment opportunities. Foreign investors, particularly those who start to include China on their investment radar screens, need to understand the implications behind government policies, and to keep a sharp focus on emerging investment trends. Determination, dedication and patience will pay off in the long run. ❖

Zheng Xiaoping is founder of **BAZO Group** and principal of **BAZO Investments (Asia) Ltd.** based in Shanghai.