Zeppelin's

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A Newsletter by Zeppelin Real Estate Analysis Limited of the Zeppelin Group
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We are pleased to announce that apart from being included in the links section of the prestigious **American Real Estate Society**'s website, part of the content from our website **www.real-estate-tech.com** has been / is carried in other portals. Collectively, our articles and analyses are read by tens of thousands of people each month including senior executives from multi-nationals and public listed companies. One recent article offers 3 simple observation tips to obtain a very rough gauge of a China's city's nature and stage of development.

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We are very honored to have **Mr. Thomas Nam**, MS in Real Estate Development (MIT), a real estate investment fund manager based in Hong Kong, to share his experience and views on the Shanghai office market. We would also like to hear from prospective readers / writers who wish to share their real estate knowledge and experience with us.

This quarterly (January, April, July and October) newsletter is circulated freely to around **8,000** real estate developers, investors, owners / users, financiers, top executives, senior managers, prominent academics and related professionals from Hong Kong and abroad. Our articles are / have also been used by the **Hong Kong Economic Journal** (a Chinese daily), the **Surveying Newsletter** of the Hong Kong Institute of Surveyors, **Centanet.com, Netvigator.com, Hongkong.com, Red-dots.com, Realtradex.com, FrogPondGroup.com,** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal**. This newsletter is now into its **6th year** and **21st** issue.

Zeppelin Real Estate Analysis Limited is involved in real estate development, investment, and asset management with a focus on **independent analysis**, investment strategy, and portfolio management. It can also assist in setting up real estate analytical computer systems, software applications and content development.

Shanghai Grade A Office Market: Will WTO Drum Up Enough Demand to Catch Up with the Supply?

Real Estate Tech, January 2002

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Shanghai is one vibrant city and has the right ingredients to become a major regional if not global metropolitan. For instance, there is the necessary population scale, there are some good universities and research institutions, the social-cultural atmosphere feels international, and the workforce is one of the most sophisticated in China. With WTO, it is likely to go even further and higher in terms of economic hierarchy. Indeed, things are changing fast, including the supply of real estate, and even regular visitors will likely find new things to see and to learn every time they are there.

For a typical real estate investor, and irrespective of which market sector he / she is interested in, the following thought may come up in his / her mind every now and then. **Will the tremendous supply be absorbed by a corresponding increase in demand as far as Class A Office properties are concerned?** To help readers contemplate the question, here are some background information:

1) **Past** = Since the mid-90s, a tremendous amount of supply has been coming onto the Shanghai office market. In aspiring to be one of the major financial centers of the world, the Luijiazui area of Pudong was designated as the financial focus and district for the city. A number of buildings were thus developed and built to accommodate the financial institutions and other multi-national corporations from all over the world. Many of such buildings were done by local companies and the quality of these office buildings in both Puxi and Pudong were relatively poor.

2) **Present** = Only a few key office buildings in Shanghai today can be considered as international grade Class A office buildings. While overall vacancy is still pretty high, buildings in a good location with quality design and construction can command comparatively high rents with practically no vacancies. In short, the vacancies are not evenly distributed and thus some real estate developers (or projects) may be doing very well while others may not. As a general statement, average rent levels are still relatively low due mainly to the oversupply situation. Nonetheless, this does not seem to have prevented or slowed down the progression towards becoming China's financial center for Shanghai and its gross domestic product (GDP) has been soaring at an average of over 10% for the past 20 years. At this rate of growth, attaining 'the' financial center status sounds like a reasonable goal to aim for. The presence of a vibrant stock market also helps.

3) **Future** = Based on anticipated projections, the supply will likely double in the next 5 years and these are expected to be of higher building quality. With WTO fuelling the economic expectations and business prospects further, demand is expected to grow and thus good quality buildings are not anticipated to experience much problem in renting out. Also, apart from demand coming from multi-national corporations entering the market for the first time or expanding their existing operations, demand from large local companies should not be underestimated as some are now taking their images more seriously. Nonetheless, whether there will be a matching rental growth given the huge supply streams to come remains at best an educated guess.

Taken in all, Shanghai, being in part an economic barometer for China, is expected to grow and prosper though the road to that is likely to involve many hurdles and investors should not always expect an easy ride. Given that real estate by and large reflects the economic performance and level of activities of any one economy (be that a place, city, or country), **if Shanghai grows, so will the real estate market, unless there are huge distortions, unintentional or otherwise, in the market**. Notwithstanding the large supply, tenants are seldom evenly spread all over (they tend to congregate in certain spots and buildings), especially when the qualities and facilities offered by different buildings vary vastly. Generally the better designed, located, built and managed buildings will attract the bulk of top tier tenants. Nonetheless, **in the short to medium term, both rentals and prices are likely to stay depressed** for some while owing to anticipated **imbalance in supply and demand** with the former still ahead of the latter. The **benefits of WTO take time to materialize** and hence may not be much of a contributing factor in the short run. This means for now prospective office real estate investors will have to do better researches, spend more time analyzing, perform comprehensive due diligence, and be more cautious in selecting their target portfolio assets, plus structuring their finance more conservatively to come up with identifying the best available gems.

Note: The relevant data and information used for reference came mostly from publications, in both hard and electronic / web copies, produced by Colliers Jardine and Chesterton Petty. As a summary and for convenience, the total supply for the major districts in Shanghai, including LuiJiazui-Podong, Huangpu, Jiagan, Changning, Luwan, and Xuhui, amounted to approximately 260,000 m2 of Class A office space and the take-up was roughly 120,000 m2, i.e. less than half of the new supply in 2001. Vacancies range from a small 4% to 55% and the total Class A office stock stood at around 840,000 m2 for these districts.

Intensity in the Use of Land: More Outbidding Less

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Generally, **the more intense use of land will displace the less intense use of land**. Or in other words, a group of people with lower financial capability may group together and outbid one person with higher financial capability in pursue of precious land resource. The following <u>example</u> illustrates the point:

a) **Assume** there was a piece of land with an area of 10,000 ft2, and the owner had built a 2000 ft2 house on it, i.e. the plot ratio was 2,000/10,000 = 0.2. Now also assume the property had a value of $4M, and the total development cost was $3M. Of the latter, $2M was used for construction while the remaining $1M paid for the land i.e. in terms of 'Accommodation Value' (AV) i.e. land cost divided by gross floor area of the house, it was $1M / 2,000 ft2 = $500 / ft2. [Miscellaneous development expenses were assumed to have been included].
b) **4 potential buyers** now set their sights on this property, and each had $1.50M and wanted a 1000ft2 unit. Eventually they purchased the property for $4M. [Why 4? 2 obviously could not have done it while 3 might have bought it but there would be no money left to add the extra 2,000 ft2 of floor space required].
c) **As they required** a total of 4,000 ft2, they would have to spend the remaining $2M of their total budget of ($1.50M x 4) $6M on adding another 2,000 ft2 of floor space to the property. [Actual construction feasibility is not a concern in this example].
d) **Say after construction** each unit would be worth $2M, thus the total property value was now $8M. Again, the total development cost to these 4 new buyers was $6M, of which $4M was used for construction ($2M for the original portion and another $2M for the 2,000 ft2 added on). The land cost now became $2M, double that of the previous yet the AV remained the same at $2M / 4,000 ft2 = $500 / ft2.
e) **Looking from another angle**, the 4 new owners via their more intense use (4,000 ft2 floor area versus the previous 2,000 ft2, and plot ratio from 0.2 to 0.4) had doubled the value of the property (from $4M to $8M) and the land price (from $1M to $2M).

Note that throughout the process, there was no need for any increase (or decrease) in property values (the average price per ft2 remained at $2,000), nor was a change of use (all owners used it as residences) required. Nonetheless, it was assumed that no town planning regulations or huge land premiums existed to deter or even stop the process. A couple of revelations / **speculations** though:

1) **Owners of land underutilized** in terms of intensity of use may expect to reap a windfall when and if land economics justify much higher intensity of use;
2) **Extremely wealthy owners** who treasure their neighborhood status and the particular category of neighbors more than a higher land price may actually wish to have as low an allowable density (plot ratio) as possible, or for that matter, some rules and laws to make higher intensity of use difficult if not impossible. Rare cases may involve some form of neighborhood council to screen prospective new owners.

Data and Statistics – Issue of Accuracy

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"Garbage In, Garbage Out" – Many would have heard of this expression. One analogy is that even a world-renowned chef may have difficulties in creating a matching masterpiece dish if the ingredients provided are rotten. Nonetheless, the author would advocate doing some analysis is always better than doing none, even if the raw ingredients, i.e. the available data and statistics, are not overly accurate or updated. Some of the reasons are:

a) **No data and statistics are completely accurate** = Insisting on having extremely accurate data and statistics before anything is done may imply doing nothing at all. Deficiencies in the data and statistics may be due to their method of collection, the people or aspects studied, the questionnaire used (if market surveys are done), their assembly process, the subsequent interpretation and so on. Sometimes it may even simply be human error e.g. an input error by someone along the processes. Even if these data and statistics are completely sound, they are always out-dated, even if only by a few hours, albeit data and statistics that are not up-to-date do not automatically mean they are unusable. In any event, data and statistics are to be 'used accordingly' based on their perceived degree of accuracy and the purpose of the exercise. An element of human judgment is required at times.

b) **If the market participants rely on data and statistics that may be of suspected accuracy**, one would then need to take them into account = in terms of gauging the impact of such relatively inaccurate data and statistics on market behavior or tendencies, and more importantly, whether there is an opportunity to gain from the mismatches between the less accurate data and the reality / actual situation, assuming the latter is known but only used by a few.

c) **If ONLY relatively inaccurate data and statistics are available in the market**, the disadvantages brought about by using them would be cancelled out = though this assumes these data and statistics are not entirely way off from reality. Generally, this can be a potentially dangerous situation as once the market realizes the inaccuracies and finds that it may have overpaid for the assets, be it real estate, stocks or bonds etc, panic and volatility may set in.

d) **The inaccuracy may in part be supplemented by other methods** = such as actual market or site observations, tailor made surveys or investigations, or using data and statistics from another independent source for double-checking etc. This may be required for developing economies / emerging markets anyway, as they evolve and change almost constantly on a daily basis.

e) **Accurate data and statistics may NOT necessarily lead to good investment decisions** = First, the interpretation and analytical processes may be flawed. Second, corporate politics may at times prevent the best possible decisions to be adopted. This in turn implies an investor with somewhat less (but not entirely way off) accurate data and statistics but skillful interpretation and insight may actually beat an investor with resources to acquire the best available data and statistics yet hampered by unproductive and inefficient internal strife in terms of making good investment decisions. It is indeed erroneous to think just because one has done a lot of sophisticated data calculations and models that the investment decision is bound to be good. Investment still has an element of art in it.

To sum up, it is still better to do some analyses using not too accurate data and statistics than not to do anything at all because **the alternative would be to make guesses, which are even more dangerous**.

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