Zeppelin's

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A Newsletter by Zeppelin Real Estate Analysis Limited of the Zeppelin Group

Phone (852) 2401 6610 Fax (852) 2401 3084 E-mail stephenchung@zeppelin.com.hk

We are pleased to announce that our website **www.real-estate-tech.com** usually ranks in the top 10 in web searches such as "China real estate", "real estate analysis" etc, implying increased reference or readership (note: these rankings are subject to change regularly). In addition, our real estate service capabilities have also been strengthened via an expanding real estate data, knowledge and professional network, especially with reference to the markets in China. Whenever there is a need for real estate researches, analyses or investment strategies, or for an independent advice or second opinion, give us a call or email us.

In this Issue:

We are very honored to have **Mr. Howard Zhang**, a real estate fund manager with an European fund in Hong Kong, to share his experience and views with us on what and where to focus in China as far as real estate investment is concerned. Don't miss out on this one if you would like to learn from a pro. 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** via email, faxes and other means to 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 **China Daily**, **Hong Kong Economic Journal** (a Chinese daily), **21st Century Business Herald**, the **Surveying Newsletter** of the Hong Kong Institute of Surveyors, **Centanet.com, Netvigator.com, Hongkong.com, E-finet.com, Red-dots.com, Realtradex.com, FrogPondGroup.com, Soufun.com** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal**. This newsletter is now into its **7th year** and **25th** 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. It is part of the Zeppelin Group of Companies which collectively also offers project management, facility management, marketing management, architecture, and capital management services.

China Real Estate Market Post-WTO
Real Estate Tech, October 2002

By Howard Zhang, BS (Tsinghua), MS in Real Estate Development (MIT), Real Estate Fund Manager
Zeppelin Real Estate Analysis Limited - Phone (852) 24016610 / Fax (852) 2401 3084 stephenchung@zeppelin.com.hk

The following is an abstract from an investment report that our invited guest writer, Mr. Howard Zhang, had written on China real estate markets. Howard is currently a real estate investment manager with a European fund and his experience spans from North America to Asia / China. We thank him for sharing his insights with our readers.

Part I. Regional Economies

China has been growing rapidly with an average annual GDP growth rate of over 9% since economic reform and open door polices were launched in 1978. With utilized FDI of USD47bn in 2001, China is now the second largest FDI recipient after the USA. However, the developments of different regions in China are not balanced. The east coastal area is the most developed, contributing around 60% of total GDP and receiving 87% of FDI in China. The east coastal region has three economic zones formed: the Pearl River Delta (developed since the end of the 1980s), the Yangtze River Delta (developed since mid 1990s) and the Round-Bohai-Bay Zone. It is noticeable that the development has been moving northward from the Pearl River Delta to the Yangtze River Delta and now the Round-Bohai-Bay Zone. The focus should be the developed and heavily populated east coastal region with buoyant economy and sizable FDI, and the principal targets would be primary cities including Shanghai and Beijing.

Part II. Impact of WTO Accession

1. Office and Serviced Apartment/Villa Markets: More international financial institutions will establish presence in China when the financial markets are liberalized after the WTO entry. The top choice for their country/regional headquarters would be Shanghai.
2. Retail Property Markets: China will phase down tariffs on most imported goods. The average tariff on industrial products will be cut from the current 14.8% to 8.9%. Automobiles tariffs will be slashed from the current 80-100% to 25%. Retail sales as well as demand for retail space will go up.
3. Industrial Property Markets: The industrial property markets, especially the warehouse property market could be the largest beneficiary of the WTO entry. Demand will pick up from users such as logistic, trading business and manufacturing MNCs.
4. Investment Environment: China will also open its real estate services markets after the WTO entry. Consequently, transparency, liquidity, efficiency and stability of the property market will improve.

Overall, the WTO entry would be greatly positive for the real estate market.

Part III. China - World’s Future Manufacturing Base

China is developing into the manufacturing base of the world on the back of its comparative advantages: low-cost labor, industrial land, energy and natural resources. Manufacturing contributed 34.4% GDP of China in 2000 and captures 64% FDI each year. The manufacturing FDI inflow will translate into demand for quality industrial, office and residential space in the eastern region.

Part IV. Rapid Urbanization in China

China has experienced rapid urbanization with the Urbanization Ratio up from 19.6% in 1980 to 36% in 2001. To date, rudiments of three major megalopolises have formed along the east coastal region: the Round-Bohai-Bay megalopolis including Beijing, Tianjin, Dalian, and Qingdao, the Yangtze River Delta megalopolis consisting of Shanghai, Suzhou, Hangzhou and Nanjing, and the Pearl River Delta megalopolis composed of Guangzhou, Shenzhen and Zhuhai. Looking forward, China’s speedy urbanization will be sustainable because 1). The increase of manufacturing workers will expedite the urbanization process; 2) The government is investing heavily in infrastructure development; and 3). Car ownership is growing fast. Urbanization will push up the land value in the central city. The implication is to focus on established central urban area and new districts expanding quickly such as Shanghai Pudong.

Part V. Risks in the China Property Market

1. Social Unrest Risk: Massive layoffs by SOEs preparing themselves for the post-WTO competition have triggered a lot of protests. Nevertheless, Shanghai, Beijing and other southern cities will be less impacted.
2. Oversupply Risk: The China property market is fragmented with a total of 21,286 developers. However, the real estate FDI as percentage in total FDI has come down to 11-13% in 2000 and 2001 from 39.3% in 1994, which signals that high-end supply growth is slower than or in line with the demand growth. The focus is on the high-end properties (usually developed by foreign developers).
3. Low Transparency and Thin Liquidity: Among the major cities, Shanghai and Beijing have relatively higher transparence, better research coverage, and more transactions.

Part VI. General Investment Principles

1. Follow FDI: Foreign Invested Enterprises are becoming increasingly important in China's economy. MNCs have large corporate real estate spending, great demand for high-end space and good credibility as tenants. Focus on east coastal cities: primary cities of Shanghai and Beijing and secondary cities of Tianjin, Dalian and Suzhou.
2. Stick to quality office/residential properties at prime locations: With more international services providers coming after the WTO entry, the standard of property design, construction and management will be lifted very quickly. One should look for new (ideally) properties with quality design/development/management in prime locations to maintain its competitiveness.
3. Serviced apartments in urban area and villa projects in suburban area: In suburbs, large-sized villa units are in great demand, while smaller-sized serviced apartments are out of favor. On the other hand, in downtown/CBD area, serviced apartments with smaller size (100-200sm) are quite popular; while large units (300-400sm) are having high vacancy.
4. Focus on retail properties catered to middle-income consumers: Even though the consumption power of local Chinese has improved significantly, the average personal income is still way below that of developed countries. Most local people's favorite shopping places are still traditional commercial places offering middle- to low-priced goods. The strategy is to look for prime-location middle-end retail properties.
5. Focus on standard warehouses in the industrial sector: MNCs' demand for international-standard industrial space will be high. Build-to-suit type industry properties have large renewal risks. Hence, quality standard warehouse properties in prime industrial zones deserve attention.

Part VII. Primary Cities –Shanghai and Beijing

1. Shanghai: Located in the mouth of Yangtze River, Shanghai is the economic and geographic center of eastern China as well as the Yangtze River Delta. It has been rapidly developing into the economic, trading and financial center of China and becoming headquarter for many MNC's. It is well positioned to capture the demand from financial and manufacturing MNCs after the WTO entry. In 2001, Shanghai's utilized FDI climbed up to USD4.3bn, the highest among cities in China.

1). Development and Layout of Urban Shanghai: Puxi (Nanjing West Road and Huaihai Road) and Lujiazui in Pudong are most promising areas with the potential to become CBDs in Shanghai. Hongqiao is an established residential area.

2). Investment Strategy in Shanghai
(1). Quality office, serviced apartments and retail buildings along Nanjing West Road in Jingan District.
(2). Quality office, serviced apartments and retail buildings along Huaihai Middle Road in Luwan District.
(4). Quality office and serviced apartments in Lujiazui and along the Century Avenue in Pudong District.
(5). Quality low-density villa projects around the Century Park in Pudong.
(6). Quality retail properties in the Xujiahui area in Xuhui District.

(7). Quality industrial properties in Jingqiao Export Processing Zone, Weigaoqiao Free Trade Zone and Zhangjiang Hi-tech Park.

2. Beijing: As the capital of China, Beijing still commands many unique advantages. MNCs need to maintain presence in Beijing in order to obtain the first-hand economic information and lobby their companies and products. Beijing is ranked as No. 1 in terms of number and quality of universities and research institutions in China. Beijing will host the 2008 Olympic Games and a total of USD22bn will be spent over the next five years in transport system upgrade, telecommunication development, environmental protection and pollution control etc.

1). Development and Layout of Urban Beijing: Eastern Beijing, primarily along Changan Street, East Second Ring Road and East Third Ring Road in Chaoyang District and Dongcheng District, is relatively developed and houses more than 80% foreign and MNC activities. Tow major commercial streets, namely Xidan Street and Wangfujing Street are located on two sides of the Forbidden City.

2). Strategy in Beijing
(1). Quality office and serviced apartment buildings in the CBD area
(2). Quality office and serviced apartments buildings in the Landmark Road area
(3). Quality low-density villa projects in the Airport Expressway area
(4). Prime-location shopping centers targeting middle-income customers in traditional commercial streets such as Xidan Street and Wangfujing Street.
(5). Quality industry/warehouse properties in Beijing Yizhuang Economic and Technological Development Zone and Tianzhu Industrial Zone.

Part VIII. Secondary Cities

1. Pearl River Delta

1). Guangzhou & Shenzhen:
Guangzhou and Shenzhen do not have large presence of major MNCs from America or Europe, so the rental yields are low at 9-10% compared with 10-12% in Beijing and Shanghai. Guangzhou and Shenzhen also have issues in urban planning, public security, availability of intellectual human resources etc. However, Their urban residents have highest disposable income per capita in China (USD2,637 in Shenzhen and USD1,703 in Guangzhou). Some retail properties at prime locations can be considered.

2. Round-Bohai-Bay Area

1). Tianjin:
Tianjin is one of the four Centrally Administrated Cities in China. It is the geographic and economic center of the Round-Bohai-Bay zone. Tianjin is a traditional industrial city in China and has solid bases for auto, chemical, metal and machinery industries. It is developing into the trading, commercial, transportation and international communication center in the north. Tianjin sees high gross rental yield of 11-13%.
2). Dalian:
Dalian City is located at the south end of the Liaodong peninsula. It is the window for Inner Mongolia and Northeastern China to trade with overseas market. It is also the front gate for Japanese and Korean companies to enter China. Currently, Dalian offers high gross rental yield at 13-14%.

3. Yangtze River Delta

1). Suzhou:
The city evidently stands out among the secondary cities in terms of many economic indicators such as utilized FDI, total GDP and savings per capital etc. Its property market has better supply and demand balance.

4. Western China

1). Chongqing:
Chongqing is the only one Centrally Administrated City in the west. It is the economic center and river, land and air transportation hub in the upstream region of Yangtze River. It is the front gate to the west China. However, we

still do not see meaningful FDI into Chongqing or the West. The GDP growth and personal income are still low too.

In summary, Tianjin, Dalian and Suzhou among the secondary cities have larger growth potential and better investment environment.

Part IX. Conclusion

The suggested investment strategy will be to “follow the demand, follow the crowd, and follow the FDI”. Therefore, the FDI-heavy east coastal region (including primary cities such as Shanghai and Beijing and secondary cities such as Tianjin, Dalian and Suzhou) would be the focus. Sector wise, sticking to high-end office and serviced apartments/villas, retail properties targeting middle-income people, and industrial warehouses is suggested. However, it must be noted that one should have realistic expectations and be aware that the benefit from the WTO entry can only be felt gradually over a long period of time. There are good opportunities out there in this giant and mixed market, but it takes hard work, deep local knowledge and accurate judgment to identify quality investments that can add value.

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Paralysis By Analysis
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Stephen Chung BS BBldg(HKU) MS in Real Estate(MIT) MRICS AHKIS MAACE NAREIT FPFM PQS RPS-QS
Zeppelin Real Estate Analysis Limited - Phone (852) 24016610 / Fax (852) 2401 3084 stephenchung@zeppelin.com.hk

Many real estate participants tend to under-analyze things. Thus, the above phenomenon applies to perhaps a minority only, in particular some of the well-resourced corporations and cautious investors. In any event, when analysis is over-done, at least it looks impressive quantitatively speaking with your humble author gasping at the resources used and subtly wondering what more marvelous things could have been achieved. Nonetheless, a few aspects to note:

a) **If the rough calculation done "at the back of an envelope" does not entice enough financial appetite to look deeper into the investment opportunity presented, then it is not worthwhile to do a full-blown estimate** = because so doing means a waste of time and precious resources. Sometimes the investment opportunity may not be the issue, it is just that it does not fit into one's overall investment strategy and portfolio. In short, screen the various opportunities using short but concise methods and let go of the unsuitable ones. Perform time-consuming financial analyses only on the more suitable / likely projects.

b) **Use 'matching' analytical methods and resources** = suppose a US$1B real estate fund is looking at 2 investment opportunities; a US$250M project and a US$5M project. No matter from an investment size angle (US$250M) or a portfolio percentage share angle (25%), the larger investment opportunity deserves more analytical resources and attention as even a small risk reduction may mean huge savings / profits or at times even the survivability of the fund. The smaller project may not even fit the portfolio profile.

c) **Do not use 'overly precise, detail or acute' figure assumptions in the analyses** = your humble author has seen financial estimates with very precise figure assumptions such as having 5.38% growth per annum for rental rates etc. This is fine for past data records but looks presumptuous for estimates. It is also very dangerous if the financials are so tight they only look good with a 5.38% growth pa but not with a 5.30% growth pa. It may be better if estimates are done on e.g. 5.00%, 5.25%, 5.50% or the like increments. This is NOT to avoid taking responsibility for accuracy. On the contrary, it is an act of responsibility and professionalism in NOT pretending to know / project what cannot be accurately known / projected. If not, a false sense of investment comfort may result.

d) **One objective of analysis is in helping to make the best possible decisions** = in a way, analysis can go on and on, layer after layer, deeper and deeper, i.e. almost into anything without stopping. Nonetheless, users have monetary budgets to meet and limited resources including time to spend. Decisions need to be made and perhaps a so-so decision made at the right time may still be a bit better overall than a very good decision made in the worst possible moment. Also, the limited analytical resources may be better spent on analyzing a few vital aspects than across a spectrum of aspects indiscriminately.

Analysis involves the use of data and quantitative tools, though it does not replace having good common sense.

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Average Real Estate Market Prices Could Mislead
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Stephen Chung BS BBldg(HKU) MS in Real Estate(MIT) MRICS AHKIS MAACE NAREIT FPFM PQS RPS-QS
Zeppelin Real Estate Analysis Limited - Phone (852) 24016610 / Fax (852) 2401 3084 stephenchung@zeppelin.com.hk

When people talk about average real estate market prices, they may mean the average home price in so many dollars or they may be speaking of an average price per unit floor area in so many HK$ / m2 floor area. Either way, these averages not only represent the interactive financial outcome of the then sellers and buyers in a market, they may also affect other pending transactions and their related sellers and buyers, apart from being important data for analysts like your humble author. Nonetheless, useful though these may be, there are also a few points to note, otherwise they may be more like traps than tools:

a) **There is always a likelihood (i.e. a chance) that no actual property exists at the 'average' market price** = for instance, say there is a simpleton market with only 5 properties and their prices are in order of ascending value 30, 50, 50, 90, and 150, thus totaling 370 and averaging 74. If a prospective buyer just looks at the average price and ignores the distribution, he / she would have a frustrating time trying to find a suitable property. Either the two 50 properties are too low-priced for his / her taste, or the 90 property being out of budget. The problem may partly be solved by looking at the median and mode figures, though these two will give an understated 50 compared to 74. Perhaps looking at all three plus the distribution would be practicably best.

b) **Average market prices are likely to contain both market-wide financial considerations and certain case-specific non-financial considerations** = normally, it is assumed that most transactions occur between unrelated parties and the parties will try to maximize their own benefits or well-being in the transactions, especially if market information is openly available. Hence, given a certain number of transactions is reached, it may be safe to assume the average price thus calculated largely represents a figure derived via market interaction with insignificant undue skewed circumstances. Nonetheless, the same may not be said of an average price where the transactions during the period are comparatively sparse, thus making the influence of one skewed transaction, if any, greater in such circumstances. Skewed transactions could involve a seller disposing the property for peanuts because he / she thinks it has bad fung-shui, yet the market is unlikely to know the true reason other than observing a particularly low-priced transaction. One method is to discard the utterly out of range transactions, be they on the very low or very high side.

c) **Average market prices strictly speaking represent the prices 'those bunch of sellers and buyers' are willing to deal during a particular period** = normally they constitute at best a small percentage of the overall market, yet statistically they are assumed to 'represent' the market. Yet, though the mathematical probability is usually small, what if they really do not represent the market at all? For one, investment plans and strategies based on market observations will need to be amended. Even if they do represent the market, it does not follow the market views thus implied are correct (and in many cases they are not).

Average real estate prices are very useful, and while they usually do reflect the interaction or even the competition between sellers and buyers, they should not be immune from being questioned. The statement that "the price is right because someone is willing to pay it" is basically garbage. In actual fact, market prices are usually either too low or too high given any lengthy period of observation (cyclic market patterns) and thus in a sense are wrong most of the time. Nonetheless, larger profits are made via these ups and downs.

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