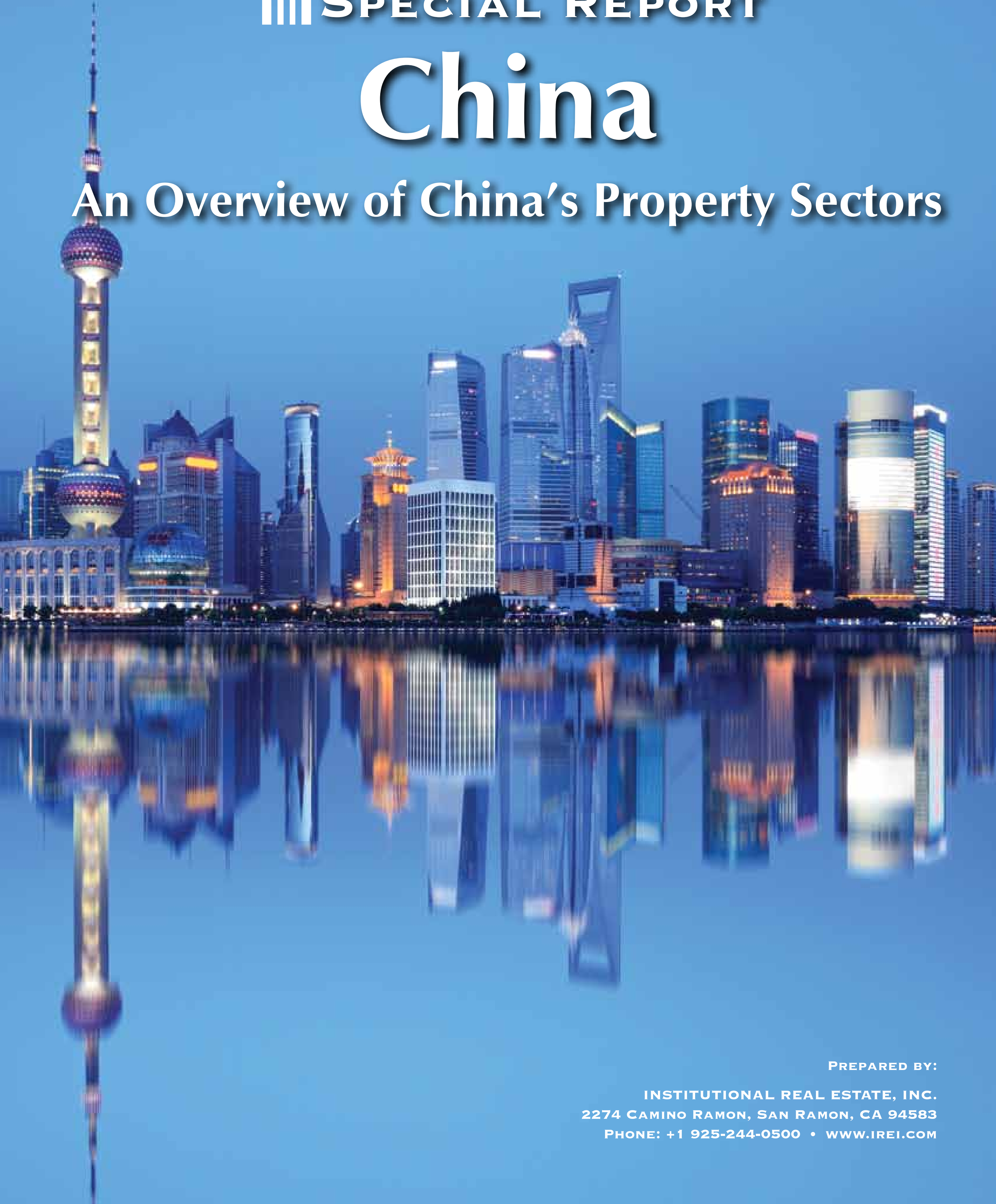
Special Report

China

An Overview of China's Property Sectors



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Introducing China

by Denise DeChaine

Being the world's most populated country, with a population of over 1.3 billion, can have its advantages and its disadvantages. Advantages: one of the world's fastest growing major economies, the world's second largest economy, the world's largest exporter and second largest importer of goods, and the world's largest army. Disadvantages: the rest of the world looking at you since you have a lot of the world's largest records.

This report focuses on China's property markets, investment trends and opportunities, as well as risks and challenges for institutional investors.

In the introductory report, "Demand During a Slowdown," Mard Naman, a freelance writer, covers how a slowing Chinese economy will affect property sectors in China and how it also will affect other Asia Pacific countries. With the lowering of its GDP target growth in March, China's economy is definitely cooling down. This article covers the growth in exports and the slowdown in imports and if investors should be worried in the long run.

In the residential article titled "China's Dual Housing Policy," it is discussed how investors can find opportunities in a simultaneously restrictive and promotional policy environment.

Author Joel Rothstein, an attorney with the international law firm of Paul Hastings LLP, covers different subjects such as restrictiveness, promoting and dual policy, current policies, why investing with the government is best, and distressed assets and companies.

The article titled "Second Tier" covers what China's second-tier office markets have to offer investors.

Author Fred Tang, head of business development – Asia with MGPA, discusses how China is still at the exotic end of many foreign investors' investment spectrum but how China is opening up to foreign capital across all sectors; specifically the office sector. Tang also covers what qualifies a city to be labeled a "second-tier" city and why second-tier is an attractive investment, as well as the risks of second-tier office markets.

In "Consuming China," Stanley Ching, senior managing director, head of real estate group, at CITIC Capital Holdings Ltd., discusses China's retail property sector and how it is entering a golden period of development.

Ching also discusses how a number of economic trends in China will drive the consumption growth even further, retail sales recording double-digit growth since 2001, making the retail property sector, particularly in the second- and third-tier cities, an attractive investment proposition.

Finally, in the senior housing market article titled "Age-Old Problem," Mard Naman outlines how the senior housing market in Asia offers new solutions to investors, in particular, China.

He discusses how China's senior housing market is relatively new and how there are no regulatory differences between independent, assisted living and acute housing in China. In addition, he talks to Mark Spitalnik, founder and CEO of China Senior Care in Hangzhou and a found of the China branch of the International Association of Homes and Services for the Aging, about how senior housing is broken down into two categories: lifestyle-based and needs-based housing. ❖

Denise DeChaine is special projects editor at **Institutional Real Estate, Inc.**

Demand During a Slowdown

How Will a Slowing Chinese Economy Affect Property Sectors in China and Other Asia Pacific Countries

by Mard Naman

The Chinese government officially lowered its GDP target growth for 2012 from 8.0 percent to 7.5 percent in March, the first time since 2005 that the target has been moved south of 8.0 percent. After GDP growth of 8.9 percent in 2011 and 10.4 percent in 2010, the world's second largest economy is definitely cooling. China has slowing growth in exports and an even greater slowdown in imports, and continued deceleration is predicted for the coming months. The "bao ba" ("protect the eight") target that the Chinese government has set as a minimum for the past seven years is now officially over. Should investors be worried?

The acceptance of slower growth by the Chinese government has certainly created some concern among investors. But actual growth will probably be higher than the government's 7.5 percent GDP target growth for 2012, and the impact of this slowdown in the region will likely be moderate. As a 5 March article in the *Financial Times* by Jamil Anderlini points out, "When it comes to economic targets, the Chinese government likes to under-promise and over-deliver."

The International Monetary Fund (IMF) appears to agree: It held steady in its projected target growth of 8.2 percent for China this year. "In China, even with the drag from external demand, growth is projected to be above 8 percent in 2012 and 2013 because consumption and investment are expected to remain robust," says the IMF in its April 2012 *World Economic Outlook.* Whether it's 7.5 percent or 8.2 percent, the growth of China's economy is still slowing.

The economic slowdown may motivate the Chinese government to ease some of the tightening measures in place sooner rather than later. The reserve requirement ratio for banks, for example, already has been lowered three times since November 2011, and some expect a further lowering to increase lending. However, the restrictive measures specifically controlling the residential sector do not appear to be changing any time soon.

"I do not see any easing of restrictions for multiple-home buyers for quite a while, maybe not until 2014," says Suchad Chiaranussati, managing director of RE Singapore Consulting Pte Ltd. These measures are a key aspect of the Chinese government's policy to slow speculation and keep housing affordable.

It's important to remember that the residential slowdown is government orchestrated. Behind the slowdown, residential demand is pent-up and strong. As the UBS *Asia Pacific Real Estate Market Outlook 2012* states, "We remain positive over the longer-term outlook for this sector given the solid underlying fundamentals."

In fact, according to Stanley Ching, senior managing director and head of the real estate group for CITIC Capital, the current slowdown in the Chinese economy isn't having much impact on China's residential market. "The residential market is very policy-centered, and it's responded very straightforwardly to the government's tightening policy," he says.

Also, the slowdown has been concentrated in China's first-tier markets, says Goodwin Gaw, chairman and managing principal of Gaw Capital Partners in Hong Kong.

A BIG SLOWDOWN WOULD BE A DIFFERENT STORY

At current projections, Chiaranussati believes the slowdown in China's economic growth will affect the logistics sector more than any other. This makes sense because much of the slowdown is a result of reduced demand for exports headed to Europe and the United States. With less demand for exports, there is a decreased demand for warehouse, distribution and other logistics space.

In the unlikely event that the economic growth dips significantly lower (for example, down to 5 percent) that would certainly have a greater effect on real estate markets. "All the sectors would be affected," says Ching. He notes that the logistics and office sectors would be affected the most, but the retail sector would be affected, too. However, in the event of such a significant drop in growth, Ching says the impact on very high-end and mid-level retail might be quite different.

"If you have quality assets, for example, high-quality office for the service industry, you should be fine," Ching concludes. He says this coincides with the government's long-term plan to slowly shift growth from the manufacturing to the service sector, along with more domestic consumption.

"Going forward in most cities in China, lower-quality assets, whether it's shopping malls or office buildings, will take a big hit if the economy slows down significantly," says Ching. People would be able to move into higher-quality places that offer attractive rent, he explains.

But Ching says a bigger slowdown is very unlikely. This is basically because the government started this slowdown, and it can end it. "This slowdown was triggered by so-called structural change," mentions Ching. "The government voluntarily said, 'We don't want to have double-digit growth; we want structural change — and during that change we will kick some of the low-tech, labor-intensive businesses out of China.'"

Ching says that if the government sees a very fast deterioration in growth, it is very capable of doing something about it. "That is the reality," says Ching. "If China's growth slows substantially, the government will say, 'OK, we've had enough slowdown; now we have to stimulate something.' That could become a threat to neighboring countries because China can offer much lower rent and land prices to manufacturers."

SLOWDOWN IN EXPORTS NO BIG DEAL?

The Pacific Star Group, in its *Asian Property Outlook & Strategy* for 2012, notes that while growth of Chinese exports, especially to Europe (its largest trading partner) has slowed significantly, the economy has proved resilient.

"We expect the prolonged economic malaise in the West to impact open Asian economies like Singapore, Hong Kong and Korea most greatly," states the report. Indeed, less demand is already reflected in slowing export growth in these countries.

These are also some of the same countries with the strongest trade linkages with China. Pacific Star says the countries with the strongest trade ties to China are Hong Kong, Taiwan and South Korea, countries that will be directly affected by a slowdown in China as well as a slowdown in demand from the West. "Export growth is hurting in Korea, and a significant portion is destined for the Chinese economy," states the Pacific Star report.

But for China itself, the slowdown of export growth is much less significant than most people think, attests Ching. "People think China relies very heavily on exports, but if you look at the composition of the GDP, exports represent a relatively small portion of it," he says. "It has always been less than 10 percent" of GDP. The impact of a slowdown in exports is not very significant in China, he concludes.

INCREASING DOMESTIC DEMAND

The challenge for China will be to boost domestic consumption among its 1.3 billion people, says Prudential Real Estate Investors' (PREI) January *Asia-Pacific Quarterly Outlook*. (PREI is the property investment arm of U.S.-based Prudential Financial, which operates in Asia Pacific under the trade name Pramerica Real Estate Investors.) That will help counteract the expected slowdown in export growth, as demand from the U.S. and Europe will likely remain muted. "Economic growth will have to come from domestic consumption," the PREI April *Asia-Pacific Quarterly Outlook* notes, "China, for example, will see consumption overtake investment as the nation's biggest driver of economic growth in 2012 for the first time since 2001."

Increasing domestic consumption has long been a stated goal of the Chinese government, but so far the increases have not been sufficient to totally offset the loss in export growth. According to the 5 March article in the *Financial Times,* some concrete measures to increase domestic consumption have until now been postponed in order to counteract the effects of the global financial crisis.

That appears to be changing. "We will move faster to set up a permanent mechanism for boosting consumption," premier Wen Jiabao said at the opening session of China's parliament in March. "We will vigorously adjust income distribution, increase the incomes of low- and middle-income groups and enhance people's ability to consume."

But Gaw notes that a drastic and extended slowdown in Europe, coupled with continued anemic growth in the United States, will still cause a slowdown in China's GDP. "Domestic consumption will rise rapidly but not enough to cover the hole," he says.

CITIC Capital's Ching says that within the past two to three years, the government has raised the minimum wage, lowered taxes for low-income people and strengthened the social safety net through improved social security and medical care. The government also has lowered the import tax for goods coming into China. With a better social security and healthcare system, people will tend to spend more because they don't have to worry as much about their futures, claims Ching. "All these things encourage domestic consumption," he says.

JAPAN MAY GAIN FROM CHINA'S SLOWDOWN

Japan is the largest, most liquid market in the Asia Pacific region. It is also more economically insulated from a slowdown in China than most other Asia Pacific countries.

"Core investors in Asia and Europe like Tokyo real estate for diversification, stability and transparency," says Seth Sulkin, president and CEO of Pacifica Capital K.K. in Tokyo. "If it becomes harder to invest in China for any reason, some of this money will flow to Japan," he adds. Sulkin says most of this money will go into prime office, and a smaller amount into residential.

"Japan is an increasingly attractive investment destination relative to China," says SC Management's Chiaranussati. He thinks the slowdown in China will reduce the investment opportunities for high-net-worth families in China, and this should encourage them to seek opportunities elsewhere. "One of those destinations for Chinese and other Asia Pacific investors may well be Japan," he says.

Mainland Chinese have shown great interest in buying small Tokyo apartments but have not yet had much of an impact on the Japanese market, notes Sulkin, "Now that Chinese tourist arrivals have recovered to levels prior to the earthquake, purchases should increase," he says. But not only Japanese office and residential will benefit. "Any drop in investment to China would also be shifted to Japanese hotel, retail and logistics as well," says Sulkin.

THE HONG KONG AND SINGAPORE CONNECTIONS

Chinese buyers have been a major cause of price surges in residential markets such as Hong Kong and Singapore. How will slower growth in China impact on these other Asian residential markets?

For the past two years, China's fiscal and monetary policies have worked to cool its own housing markets. As a result, "lots of excess liquidity has leaked into Hong Kong [and], to a lesser degree, Singapore," says Gaw. "This has caused the higher-end residential markets to soar due to a liquidity-induced supply/demand imbalance," he adds. But whether China's GDP slowdown will induce a correction in those markets remains to be seen, he says.

Gaw notes that Hong Kong and Singapore have traditionally been the first and second choices for Chinese buyers looking to buy offshore, in part because of familiarity with the language and culture in both markets, but even more importantly because of the traditionally low transaction costs and low taxes.

Mainland Chinese buy 25 percent to 40 percent of new luxury flats in Hong Kong, according to Andrew Moore, CEO of Pamfleet Group in Hong Kong. He believes demand for these properties will remain stable in 2012, even with a slowdown in China's economic growth.

"Mainland buyers remain cash-rich and are looking for fixed assets due to limited investment options in their home markets," says Moore. Because China's residential restrictions will likely remain in place for awhile, Hong Kong will remain an attractive alternative destination.

An intensification of the euro zone crisis or an abrupt slowdown in the Chinese economy remain key risks for Hong Kong office, according to the UBS *Asia Pacific*

Real Estate Market Outlook 2012 report. "This will drive cost-consciousness and increase office vacancy," the report notes. UBS predicts a sharp rental correction in Hong Kong office, especially prime office.

But Pamfleet's Moore says China's effect on Hong Kong office will not be significant, as mainland firms only account for a small minority of office leasing demand. "Any further fall in Hong Kong's office rentals would be more likely due to Western financial institutions looking to save costs," he says.

For Hong Kong retail, the UBS report also sees a direct link to China's economy: "Any prolonged weakness in the Chinese economy may adversely impact Hong Kong's retail performance. ... The weakening growth prospects in China dominate our risk assessment." UBS still expects retail rents to register a steady increase in 2012 but at a slower pace than in 2011 due to the slowdown in China.

China's slowing growth has not slowed Chinese tourism to Hong Kong. Moore says that in the first quarter, visitors from mainland China to Hong Kong grew 21 percent year-on-year. And he says retail sales in Hong Kong increased 15.2 percent year-on-year for January and February combined. "We believe that in-bound tourists from the mainland will continue to arrive in greater numbers, even in the event of a growth slowdown in the mainland, and retail sales in Hong Kong will continue to rise, but most likely at a slower pace than in recent years," he concludes.

SINGAPORE'S NEW TAX TAKES A BITE

Private home sales to foreigners reached a historical high in Singapore during 2011, and mainland Chinese were the top foreign buyers, representing 28 percent of all foreign purchases, according to Savills Research. The number of transactions by Chinese buyers tripled between 2007 and 2011. But now, more than the slowdown in the Chinese economy, a new Singapore tax enacted in December 2011 could take some of the wind out the sails.

This tax requires non-permanent residents and companies to pay an additional 10 percent stamp duty when purchasing properties. "The new curbs are expected to cool foreigner home demand in a market that is still reeling from the growing uncertainties in the euro zone," states the Savills Research report *Spotlight: Profiles of Foreign Buyers in Singapore*. Savills predicts that some mainland Chinese and Indonesian buyers may look for bargains in the United States or Europe as alternatives.

Singapore has a large supply of prime CBD office scheduled to come online between 2013 and 2015, leading the recent UBS report to predict that "lease negotiations will strongly tilt against landlords. Elevated vacancies have positioned the market for a year of rental correction." The industrial sector is also vulnerable. "As an industrial sector operating in a small, open economy, any change in the global trade cycle will have a multiplier effect on the sector," predicts UBS.

WORRIES DOWN UNDER

Australia has significant exposure to the Chinese economy, especially through China's heavy demand for Australian resources.

"Given the mining sector has generated virtually all new jobs in 2011, any hard landing in China will no doubt represent a severe economic setback," to Australia, notes the UBS report. The report says this fear of an extended Chinese slowdown is a major reason that the average Australian household continues to deleverage despite declining interest rates. Corporations will likely take "a more cautious approach to expansion, which could well dampen prospects for real estate," the report adds.

By April, a slowdown in Australia had become evident. DTZ Research, in its first quarter 2012 Australia *Investment Market Update,* reported that total commercial real estate volumes decreased 40 percent in first quarter 2012 compared to fourth quarter 2011. This new period of uncertainty has many causes. "Concerns regarding the strength of economic recovery in Europe, revised economic growth figures in China, and the underlying health of the Australian economy revealed by the weak Q4 2011 GDP growth figure of 0.4 percent have affected business confidence," the report concludes.

THE BOTTOM LINE

While growth in China and Asia Pacific in general is slowing, the effects will probably remain moderate overall. The IMF's April 2012 *World Economic Outlook* predicts, "the soft landing under way is likely to continue." For China's residential sector, the slowdown has been planned and coordinated by the government, and when the government decides it is time, it has many tools available to stimulate the sector and the economy. While problems in the euro zone and the United States have cut export growth, China's increasing domestic consumption will continue to soften the blow. Additionally, exports have never accounted for more than 10 percent of China's GDP, according to Ching.

Hong Kong, Singapore and Australia are fairly highly exposed to China's slowdown and problems in the West. Japan is more isolated from China's slowdown and could benefit from it. Mainland Chinese will continue to buy apartments in Hong Kong, and the residential sector should remain stable there. While there may be softening in the office market, this will be due more to lessening demand from the West rather than China's slowdown.

Singapore's new stamp duty will cool Chinese and other offshore demand for residential, while oversupply of prime office space will hurt rents in the near term. Australia relies on vibrant demand from China and has entered a period of uncertainty due to China's lowered GDP predictions and ongoing turmoil in Europe.

Questions still remain about the extent of the problems in the West. With open discussions taking place about Greece possibly leaving the European Union, the euro crisis is far from over. A severe drop in outside demand will impact open economies such as Hong Kong and Singapore more than China. And while China's government has many tools to stimulate its economy, questions also remain about how quickly and how much domestic consumption can be ramped up to compensate for the slower growth in global demand. Investors would do well to keep in mind the old maxim: Hope for the best, plan for the worst. ❖

Mard Naman is a freelance writer based in Santa Cruz, Calif., USA.

Private Capital Raised Inside China

Can private capital being raised inside China for Chinese investors help buoy real estate markets in China? In May, global developer and asset manager Tishman Speyer announced the closing of the first RMB-denominated fund by a foreign developer. Tishman Speyer raised 1.2 billion yuan (US$188 million) exclusively from Chinese investors to invest in the building of a prime mixed-use development in Suzhou.

"The establishment of this fund is a watershed event in the evolution of China's capital markets," said Tishman Speyer co-CEOs Jerry Speyer and Rob Speyer in a statement.

Goodwin Gaw, chairman and managing principal of Gaw Capital Partners in Hong Kong, believes RMB investors are project-focused rather than focused on commingled funds, and therefore, he says, "the sector is far too small to be a meaningful source" of money. But Stanley Ching, senior managing director and head of the real estate group for CITIC Capital, thinks this is just the start and the sector will grow.

Right now, China's domestic real estate developers rely very heavily on bank loans. "More and more institutional investors will be coming into this sector," Ching says. He sees this as a very positive development because most Chinese developers are undercapitalized. "Today in any major city, you will see a bunch of lousy products. This is going to change," he says. "We'll see more high-quality development because you have quality developers with international standards, and at the same time longer-term capital looking for investment-grade assets."

— Mard Naman

Residential

China's Dual Housing Policy

How Can Investors Find Opportunities in a Simultaneously Restrictive and Promotional Policy Environment?

by Joel Rothstein

For more than two years China's housing policy has been dominated by a series of government measures designed to cool a supercharged market and battle rising home prices. Strange things have been happening. Transactions have stalled, and housing prices are falling in cities across the country. For many homeowners this is an unfamiliar trend. Now some local government officials, economists and property industry players are predicting that China's housing policy is about to change. Property controls will be relaxed. Yet at the same time, the word from central government officials and others is restrictions will continue firmly in place. In a recent speech, Premier Wen Jiabao affirmed that China will not waiver on its real estate controls and remains resolute in its efforts to bring home prices down to a reasonable level to ensure fairness and stability.

In China's complex regulatory environment, paradoxically, the proponents of regulatory easing and the proponents of continuing regulatory restrictions are both correct. China is entering a new transition phase that will be characterized by a dual housing policy. Under this evolving policy framework, two different housing policy approaches will exist side-by-side — restrictive and promotional. Restrictions will remain in place for some segments of the market, but there will be loosening of restrictions and even investment incentives in certain other segments of the market. This dual housing policy should create opportunities for savvy and creative international investors, fund managers and advisers.

Executive Summary

- **As a result of the Chinese government's controlled cooling measures, the country's housing policy framework will continue to be both restrictive and promotional.**
- **Ongoing restrictive measures will be most likely in first- and certain second-tier cities having experienced rapid price increases, while a number of second- and third-tier cities with cash-starved local governments will most likely receive easing property controls.**
- **To best succeed, foreign real estate investors may need to invest in a manner consistent with and not against government policy.**

FROM STIMULUS TO COOLING: THE RESTRICTIVE PHASE

In order to understand the rationale for China's current dual housing policy, it is necessary to consider the events and policies leading up to the current policy framework. The story begins with the collapse of Lehman Bros. and the subsequent global financial crisis. China responded to these events with a massive stimulus program. According to some estimates, more than US$700 billion was pumped into the economy. The market was flooded with liquidity. Large sums flowed into fixed-asset investments, including real estate and infrastructure projects. Residential housing prices soared to new heights. The stimulus policy had its intended effect and unfortunately much more. Facing the prospects of a possible dangerous property bubble and perceived real risks of social unrest caused by large portions of the upwardly striving urban population being priced out of the housing market, China reversed policy course.

Instead of stimulus, the guiding force of China housing policy became restriction. No one law, rule or regulation became the underlying basis for the country's restrictive policy framework. Instead, China turned to a whole arsenal of policy tools designed to cool the market and reduce speculation. Key policy measures included, among others, limits on multiple home purchases by individuals, stricter mortgage qualification rules including higher down payment requirements, the introduction of property tax schemes in some jurisdictions, and aggressive reductions in the availability of financing to developers.

Not only were banks required to reduce their book of new real estate loans, but Chinese regulators also cracked down on the "informal" lending market, including trust companies and their various products, which had become a key source for funding many real estate deals. Finally, the central government put pressure on local governments and various governmental agencies to more stringently enforce rules already on the books that had a restrictive impact on real estate investment, such as controls first introduced in 2006 making it more difficult for foreign institutional and individual investors to invest in China real estate.

China's restrictive housing policy phase continued for some time and had significant effects. For example, by January 2012, according to the National Bureau of Statistics, new home prices in the nation's four major cities of Beijing, Shanghai, Shenzen and Guangzhou had declined for four consecutive months in a row. In addition, none of the 70 cities surveyed by the bureau posted any notable gains in home prices, a first since the National Bureau of Statistics started conducting the monthly 70-city survey of home prices.

RESTRICTING AND PROMOTING: THE NEW DUAL POLICY PHASE

The success of China's restrictive housing policy phase together with world financial trends, which decelerated growth in China, pushed the government into its new current policy phase. Government officials recognized that they could not sit on the sidelines and watch real estate prices fall too far, particularly when other forces in the economy, such as declining manufacturing and exports, affected growth. The property sector, and particularly the residential housing sector, is recognized as a key driver of economic growth in China. China's gross domestic product is fueled by the production and purchase of building materials and equipment, the payment of wages of construction workers, and the revenues and fees generated by banks, real estate brokers and others from property transactions. Moreover, the real estate industry is an important funding source for local government budgets. Local governments depend upon land sale premiums and taxes from the sale of housing units to fund operating expenses and repay debt.

While concerns about promoting sustained and stable economic growth became paramount, concerns over affordability issues in residential housing continued. Consequently, in the new current housing policy phase, China is aiming to slowly deflate but not burst any bubble, and also to concurrently encourage certain types of activity that can boost the economy and satisfy long-term comprehensive policy goals. During this period of controlled cooling, a dual policy framework, which is both restrictive and promotional, has and will continue to be implemented.

Under this policy approach, restrictions will continue to be kept in place in cities and in types of projects where there have been the greatest excesses, such as in first-tier cities and in mid- to high-end residential projects targeting speculative investors. At the same time, policies will be adapted to promote and incentivize activities in certain areas targeted by the government for growth and promotion, such as affordable housing, housing suitable for first-time homebuyers, and senior living and care facilities. For example, China's central bank, the People's Bank of China, recently issued a statement that banks must provide loans to first-time homebuyers. Many believe as a next step the central bank may require banks to offer mortgage rate discounts to first-time homebuyers.

Pursuant to China's dual housing policy, the extent of housing curbs may increasingly vary by geographic location. To date, the central government has been diligent in putting pressure on local governments not to relax property curbs. Some cities, such as Foshan in China's Guangdong province and Wuhu in China's Anhui province, either relaxed or announced plans to relax property restrictions, only to subsequently reverse such plans. No doubt, pressure from the central government played a role in these policy reversals.

Going forward, however, some cities may be able to push through some easing of property controls without push back from the central government, particularly if general economic conditions and growth are weak and the city has not been a particular focus of real estate speculation or it already has experienced substantial price corrections. Consequently, first- and certain second-tier cities that experienced rapid price increases leading up to the most recent period will be the most likely candidates for continuing restrictions in the current policy phase, and a number of second- and third-tier cities with cash-starved local governments will be the most likely locations for easing property controls.

CURRENT POLICY ENVIRONMENT OPPORTUNITIES

In China, the residential real estate market has been a potent source of profits for foreign investors. Nevertheless, the traditional model to profitability in the form of mid- to high-end strata title build-and-sell residential projects in first-tier and some second-tier cities might not be the most viable option in the current policy environment. Instead, foreign investors may need to focus on either specialized residential real estate plays that tie into the government's specific investment promotional policies under its dual housing policy or on opportunistic plays that capitalize on the distressed situations created as a by-product of the restrictive side of China's dual housing policy.

INVESTING WITH AND NOT AGAINST GOVERNMENT POLICY

Some of the most successful foreign real estate investors in China have recognized the need to "go with the flow" and to invest in a manner consistent with and not against government policy. In order to "go with the flow" in the current policy environment, the international real estate investor interested in residential deals may need to target areas such as affordable housing and senior living or care facilities. China has vowed to build 36 million affordable housing units during the four-year period from 2011 to 2015 to meet the demands of low-income families. In addition, an aging population, rising wealth and acceleration of reforms in the healthcare industry are all working to heighten government interest to support the growth and development of the senior living and care industry.

Innovative ideas or structures for affordable housing or senior living or care deals will find a receptive audience with Chinese government officials. Not only will these deals likely overcome the burdensome approval process normally associated with foreign real estate investment in China in the dual policy environment, but they also may benefit from specific government incentives and cooperation to facilitate the deals. In contrast, in the current policy environment, proposals for new high-end residential speculative strata title build-and-sell deals in cities such as Beijing or Shanghai are not likely to progress very fast or far.

In addition to specialized residential deals in the affordable and senior housing space, foreign investors may also consider targeting mixed-use projects. These types of ventures may combine a residential component with other uses a local government desires or has been specifically mandated to attract. Examples of projects that may find favor and support include: technology research and development centers; healthcare and biomedical research facilities; and uses that generate ongoing local employment opportunities.

Making money at and successfully operating affordable housing projects, senior living and care facilities, and comprehensive mixed-use projects often requires specialized knowledge and expertise that may be lacking in some sectors of the Chinese real estate community. Consequently, some foreign developers, investors and service providers that have real deal expertise and experience in these areas can bring something to the table that may be attractive to domestic joint venture partners and to government authorities that need to approve the deals.

Foreign investors still desiring to focus on new strata title build-and-sell residential development projects may still find opportunities in the current policy environment. This type of investor, however, may need to focus particular attention on jurisdictions where restrictions have been lifted or about to be shortly lifted or on certain opportunistic plays involving distressed developers or projects.

DISTRESSED ASSETS AND COMPANIES

The fact that China may be continuing curbs on the property sector under its dual housing policy may not be all bad news for foreign investors and market participants. Continuing restrictions may actually create opportunistic plays for investors and others who were disappointed when such opportunities did not arise in the aftermath of the collapse of Lehman Bros. and subsequent global financial crises. The opportunistic plays did not arise during this period because China's massive stimulus policy propped up the market, saved deals from becoming distressed, and substantially reduced need for foreign capital and involvement to support the market.

According to some market observers, this time it may be different. Under the previous restrictive housing policy and under the current dual housing policy, many domestic real estate developers and specific projects have faced and will continue to face extremely tight credit conditions. Attractive funding from Chinese banks or from the "informal" lending market including various trust company products has become less readily available. At the same time, prospective purchasers of housing units contending with higher down payment requirements, lending restrictions and the prospects of future falling prices have increasingly moved to the sidelines. Inventories of unsold units have begun to pile up. All these factors point to an increasingly distressed market.

These kinds of market conditions may create an ideal environment for foreign investors to forge Sino-foreign joint ventures with domestic developers designed to reposition distressed projects and infuse needed capital into cash-starved deals. Chinese developers that previously saw no need for foreign capital or involvement may now seek out partners.

Chinese real estate projects and developers that currently have offshore structures, such as upstream holding companies established in jurisdictions located outside of mainland China, may be particularly attractive to international investors. In contrast to Sino-foreign joint ventures that are formed onshore in mainland China, offshore structures are not subject to the same stringent Chinese government regulatory approvals as domestic joint ventures. In addition, offshore structures offer a greater variety of options in terms of structuring debt and equity investments than onshore structures. Nevertheless, due to regulatory restrictions, in many situations only an onshore joint venture may be feasible. Approvals for some onshore Sino-foreign joint ventures could win the support of local governments and secure government approvals, particularly if the repositioned project includes some affordable housing component or other amenity or benefit appealing to the local government officials.

Another potential avenue of opportunity for international real estate players, including fund managers, is in the private equity fund space. With access to traditional funding sources such as banks and trust companies reduced, Chinese developers are seeking alternative funding sources. In many cases, Chinese developers are turning toward private equity funds.

For example, in some instances Chinese developers with no experience in creating or managing private equity real estate funds are teaming up with foreign fund managers to create joint venture China real estate funds. These funds — which may either be purely domestic RMB funds or parallel onshore RMB and offshore foreign currency funds — offer the developer a new source of capital to fund deals; offer the fund a pipeline of deals in which to invest; offer the international fund manager fees, a promote and the opportunity to develop a track record of managing a fund in China's relatively new but growing private equity space; and offer the fund investors exposure to Chinese real estate.

China's private housing market is surprisingly new. The private-sector housing market started in earnest only around 1998. In a short time, millions of units have been constructed, purchased, sold and financed. Through it all, the Chinese government's housing and economic policies have constantly changed and evolved in an effort to guide and to respond to changing market conditions. China's prospects for future economic growth and robust GDP figures are inextricably linked to whether the country can maintain stability and managed growth, including a stable but expanding housing market.

China's dual housing policy of simultaneous restriction and promotion is squarely aimed at achieving this goal. Foreign investors and other market participants who understand and capitalize on the implications and effects of the current and future housing policies will find opportunities to profit. ❖

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Office

Second Tier

What Do China's Tier II Office Markets Offer Investors?

by Fred Tang

For many foreign investors, China is still at the exotic end of their investment spectrum. However, China is opening up to foreign capital across all sectors. To date, the focus has been on Beijing and Shanghai, but that is starting to move on to other cities within China.

It is common to view China divided into first-, second- and third-tier cities. First-tier cities are Beijing, Shanghai, Guangzhou and Shenzhen. The second-tier cities are Chengdu, Chongqing, Wuhan, Qingdao, Nanjing, Shenyang, Dalian, Tianjin and Hangzhou (see "China's Second-Tier Cities," below). The third tier is the rest — and there are more than 200 cities in China with populations in excess of 1 million, so there are plenty from which to choose.

Although there is no specific definition for a second-tier city, they each have:

- GDP equal to or greater than US$50 billion
- Populations equal to or greater than 5 million
- Annual foreign direct investment (FDI) equal to or greater than US$2 billion
- Regional center status in their respective province (China is divided into 26 provinces)

China's Second-Tier Cities

Source: MGPA

The office markets in first-tier cities have much in common with other major conurbations around the globe, except that they are growing at a rapid pace with supply and absorption of 1 million square meters per year, a remarkable statistic. Beijing and Shanghai in particular are fully international cities, and their markets are followed by Chinese and international investors alike. Investment "bargains" are rare: There is a general market expectation that rents could grow at up to 10 percent per year in the medium term, and hence investors are prepared to pay cap rates as low as 4 percent. Recent history supports this expectation: In 2011, Beijing recorded 34 percent growth in rents and Shanghai 17 percent.

In contrast, second-tier office markets are relatively immature with some unique features (see table below):

- Grade A office accounts for a relatively small portion of total office stock. In many cities, new high-quality office buildings are concentrated in new municipal districts, while the traditional central areas still have many lower quality buildings built in the 1990s or early 2000s.
- The vacancy rate of grade B office is lower than that of grade A office. This is because the main tenants in second-tier office markets are small- to medium-sized domestic companies that are very sensitive to rents and do not require substantial contiguous space, unlike the larger multinationals and large national business head offices that are present in first-tier cities. The table also shows that grade B buildings become less favorable to tenants when grade B rent exceeds 70 percent of grade A rent.
- Although grade B assets may be cheaper than grade A on an absolute value basis by 30–40 percent, yield may be lower. One reason for this is that the investment markets in second-tier cities are dominated by cash-rich domestic investors with a smaller investment lot size and a preference to own strata-titled rather than en bloc. Hence a significant proportion of second-tier office is strata-titled and sold to private investors, either by the developer to provide financing during the construction, or as an easier means to sell the end product at a time when larger domestic institutions are not freely able to acquire investment property and hence en bloc sales are fewer. For the same reason, the yield of second-tier office is usually lower than first-tier office.

WHY IS SECOND-TIER OFFICE AN ATTRACTIVE INVESTMENT SEGMENT?

China's GDP growth is accentuated in key urban centers, many of which are experiencing localized GDP growth in excess

Office Market in Second-Tier Cities

	Class A as % of Total Stock	Vacancy Difference (Grade B minus Grade A	Rent Ratio (Grade B/Grade A)	Capital Value Ratio (Grade B/ Grade A)	Yield Difference (Grade B minus Grade A)
Chengdu	32.0%	–16.0%	66.1%	64.8%	0.0%
Chongqing	7.6%	0.0%	77.4%	77.5%	0.0%
Dalian	44.1%	–16.7%	57.5%	61.7%	–0.4%
Hangzhou	25.5%	–2.9%	71.7%	81.8%	–0.6%
Nanjing	21.1%	–26.1%	67.7%	59.1%	0.7%
Ningbo	7.8%	17.1%	53.0%	56.4%	–0.3%
Shenyang	14.1%	–2.4%	63.0%	57.6%	0.6%
Suzhou	28.5%	–7.3%	70.4%	69.3%	0.1%
Tianjin	8.3%	12.9%	77.4%	89.4%	–1.0%
Average	**21.0%**	**–4.6%**	**67.1%**	**68.6%**	**–0.1%**

Source: JLL Research as of 2Q/11

of national GDP growth manifested in both rapid absorption of record supply as well as surging rents.

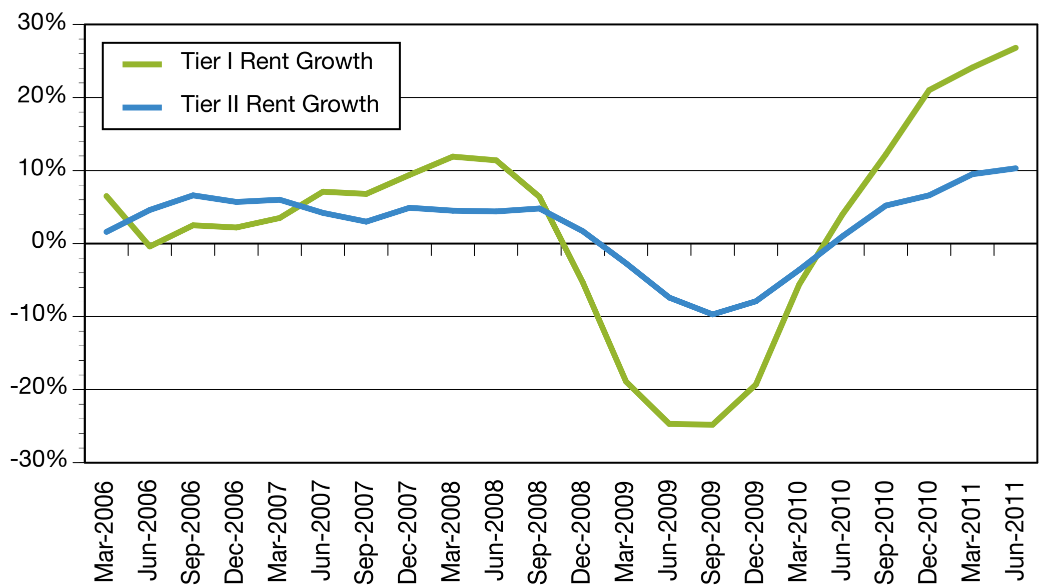
Immature markets with large growth potential can offer very attractive returns to knowledgeable investors. Second-tier markets are attractive for three key reasons:

- **Second-tier cities are likely to experience faster growth than first-tier cities.** In the past decade, the Chinese central government has implemented a series of policies to bridge the development divergence between coastal China and inland China, such as the "Go-West" policy, the "Rise of Central China" plan and the "Revitalize Northeast China" plan, which have each made inland China more attractive to businesses taking advantage of improved infrastructure, lower taxes, and lower labor costs and land costs. As the regional centers of inland China, second-tier cities are the biggest beneficiaries of these policies. Consequently, second-tier cities already have started to see faster economic growth rates than first-tier cities. The trend is likely to continue, assisted by government policy.
- **Second-tier cities provide diversification benefits.** Compared with the more internationally oriented first-tier cities, the performance of second-tier cities is more correlated to manufacturing and the domestic economy. Manufacturing industries such as electronics, chemicals, pharmaceuticals and automobiles are the main economic activities of second-tier cities in contrast to the export trade and finance functions of first-tier. Therefore, second-tier cities should be less vulnerable to external global economic and financial shocks, and should provide diversification benefits to global investors.
- **Second-tier office has been less volatile.** The performance of second-tier office has been less volatile than first-tier office because second-tier cities have relatively less exposure to global shocks. As can be seen in the "Office Rent Growth" graph below, second-tier office markets actually had a smaller variance in rental growth from 2006 to 2011 than first-tier office, even during the depths of the global financial crisis.

RISKS OF SECOND-TIER OFFICE MARKETS

Returns always come with risks. For the office markets in second-tier cities, the key risks are liquidity, transparency and supply.

Office Rent Growth in First- and Second-Tier Cities



Source: JLL Research as of 2Q/11

These risks should diminish as the markets grow and mature.

- In second-tier markets, the major property buyers are domestic conglomerates, local financial institutions and high-net-worth individuals, while offshore institutional investors are largely absent from the list. Meanwhile, domestic investors tend to favor smaller deals. In fact, second-tier markets accounted for 45 percent of the total number of office transactions in third quarter 2011 but only 28 percent of total transaction value, according to Real Capital Analytics. Liquidity is found primarily from strata-title rather than en bloc sales, whereas the reverse is true in first-tier cities.

- Compared with first-tier markets, land supply is less constrained in second-tier cities, where local governments want to promote their cities with better infrastructure hence encouraging a supply of better quality office buildings and modern shopping malls. As such, second-tier markets have higher supply risks than first-tier markets. Therefore, it is neither uncommon nor unexpected to find vacancy rates around 20 percent in many second-tier office markets despite strong tenant demand. However, as the markets mature, it can be expected that supply and demand will find equilibrium.

SUMMARY

Second-tier cities have diversified economic bases and strong growth potential, which provide fundamental support to the second-tier office market. With lower volatility, the second-tier office market offers investors a new set of investment opportunities.

Investors should focus on markets where tertiary industries have greater potential to grow and markets where there is consistent investor demand. As second-tier office markets become more mature, both development and refurbishment strategies in core areas will be attractive, as there is a short supply of grade A buildings. Investors should exercise caution where supply is less constrained. ❖

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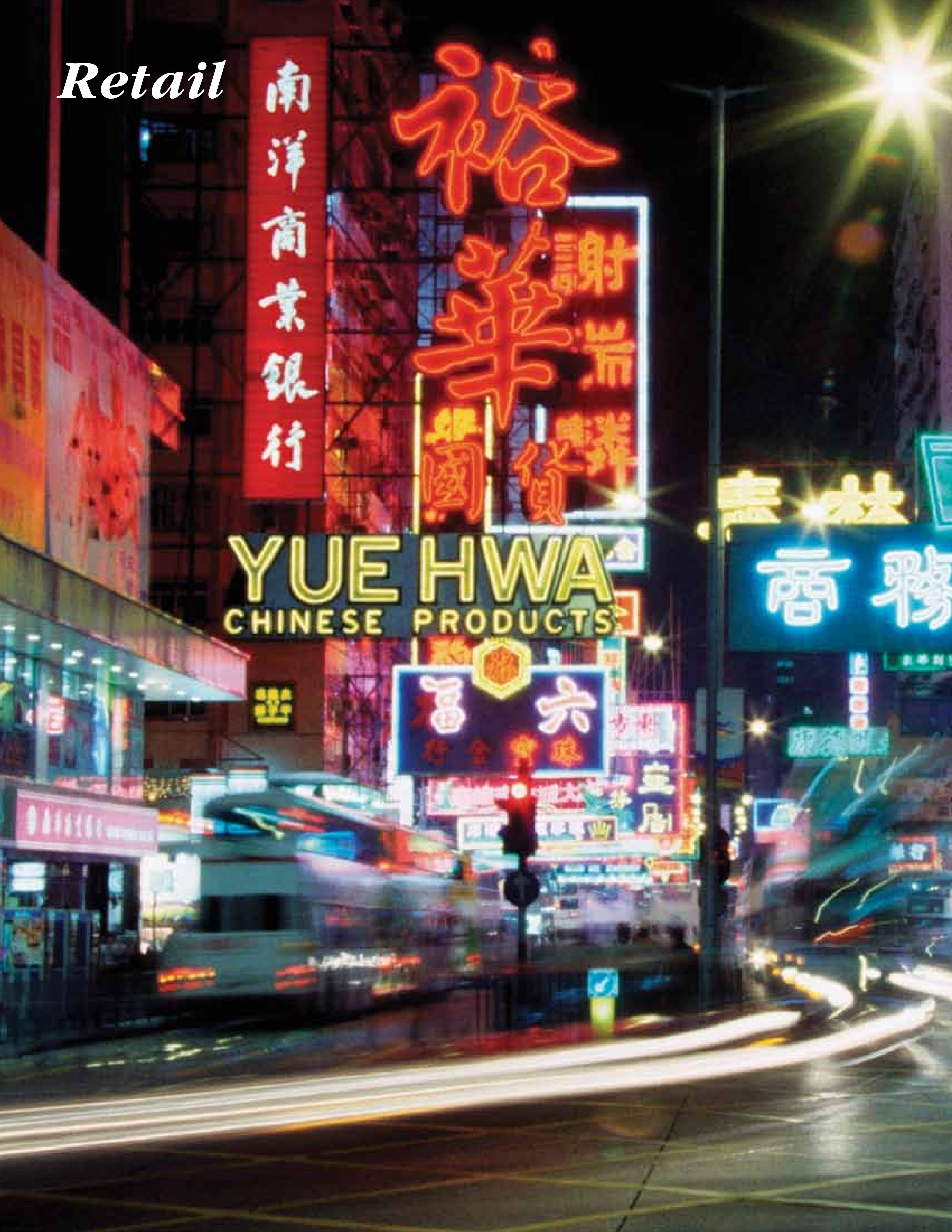
Retail



Consuming China

China's Retail Property Sector Is Entering a Golden Period of Development

by Stanley Ching

China's consumption power has enjoyed massive growth, with retail sales having recorded double-digit growth since 2001. In 2011, retail sales reached 18.12 trillion yuan (US$2.9 trillion), a year-on–year increase of 17.1 percent, while the rest of world is still struggling. This growth is set to continue as the government focuses on steering economic growth away from its current dependence on investments and exports toward a more consumption-driven economy.

Executive Summary

- **A number of economic trends, including favorable government policy, urbanization and the rise of the middle class, will drive consumption growth in China.**
- **Second- and third-tier cities are expected to experience faster growth, supported by migration of the middle-class population and improving infrastructure and transportation.**
- **China's retail property market remains at a relatively early stage of an upward trend with attractive investment opportunities.**

A comparison with other countries shows how relatively low consumption is in China. In 2008, private consumption accounted for only 37 percent of China's GDP, compared with 50 percent in Russia, 56 percent in India, 57 percent in Japan, 60 percent in Brazil and 70 percent in the United States, according to the Economist Intelligence Unit. Because this is the second-lowest proportion out of all the G-20 countries, it is reasonable to assume that Chinese consumption power has plenty of room for further growth.

A number of economic trends in China will drive the consumption growth, making the retail property sector, particularly in second- and third-tier cities, an attractive investment proposition.

CHINA'S 12TH FIVE-YEAR PLAN

In 2011, China embarked on its 12th five-year plan — the government's strategy for economic development during the period between 2011 and 2015. The plan focuses on structural adjustment and places a far greater emphasis on domestic demand and internal markets than ever before.

Expanding domestic demand, especially domestic consumption, was identified as a key to sustainable long-term growth of China in the 12th five-year plan. The government will actively boost domestic consumption by increasing government expenditure, raising household income, adjusting income distribution and improving social wellbeing. It demonstrates that the Chinese government has shifted its attention away from the pursuit of national strength toward the goal of increasing domestic consumption and the prosperity of its citizens.

The plan also addresses the issue of development disparities between different regions. The government will promote faster growth in inland regions by improving infrastructure and public services to attract more industries in those areas. In this regard, industrialization and urbanization will be two key central themes.

The 12th five-year plan shows consumption is bound to play a notable and important role in the Chinese economy and the inland market will have more potential to grow.

A CHANGING SOCIETY

The future of China's retail property market depends on two key demographic trends: urbanization and the growth of a middle class. Put simply, it means that as cities grow, consumption will remain strong; as the level of affluence increases, people have more money to spend, thus boosting the demand for retail venues.

Perhaps the single most important factor is that millions of people are continuing to leave China's vast countryside to look for a new life in the cities, a phenomenon that maintains a constant demand for housing. The urbanization process has been continuing at a steady rate ever since China started to open up its economy in 1978, that is, at a compound annual growth rate of 4.3 percent. By the end of 2011, there were 691 million people living in the cities (see "China's Urban Population," below), surpassing the number of rural residents for the first time.

According to consultancy firm McKinsey & Co., China's urban population will increase to approximately 922 million by 2025, representing an annual growth of 2.1 percent from 2011. As China's urban population increases, so too does urban consumption. The government's recent call for an acceleration of the urbanization process will lead to a further boost in urban consumption demand.

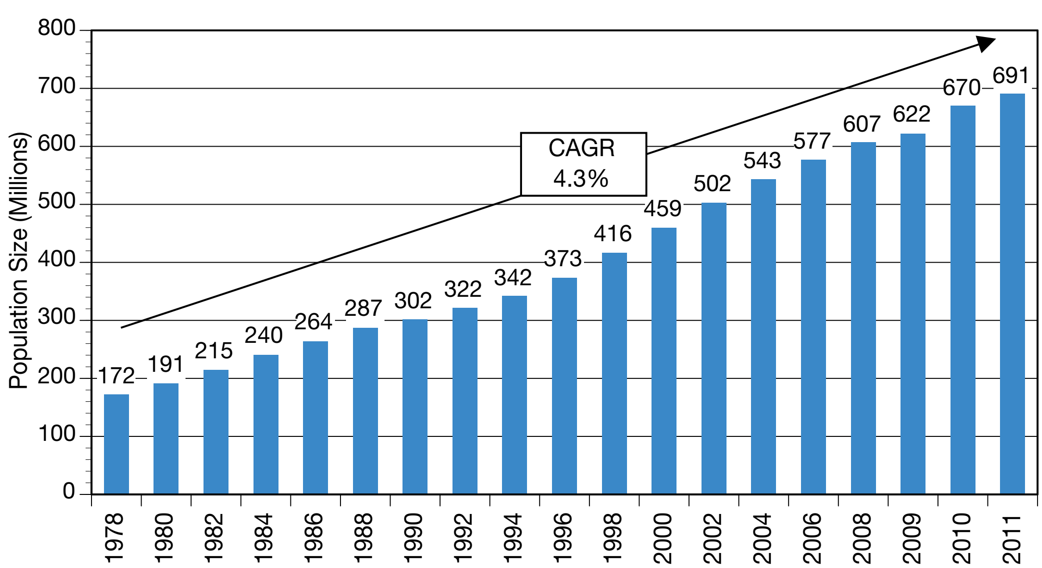
The other major factor is the rise of the middle class. McKinsey & Co. predicts that by 2015 the affluent upper middle class and above will hold 69 percent of the urban disposable income, a massive leap compared with the 20 percent they held in 2005.

The growth of the middle class is supported by the rise of China's baby boomer generation — Chinese citizens born after 1980, which, according to research by Morgan Stanley, will account for more than 50 percent of China's population by 2015. These younger Chinese have benefited from a better level of education than their parents' generation and have higher-paid jobs. They expect a better standard of living and have a higher consumption power. As such, compared to other emerging markets, China has the highest portion of young middle class (see graph on page 21), representing a sustainable purchasing power.

FROM FIRST-TIER TO SECOND-TIER CITIES

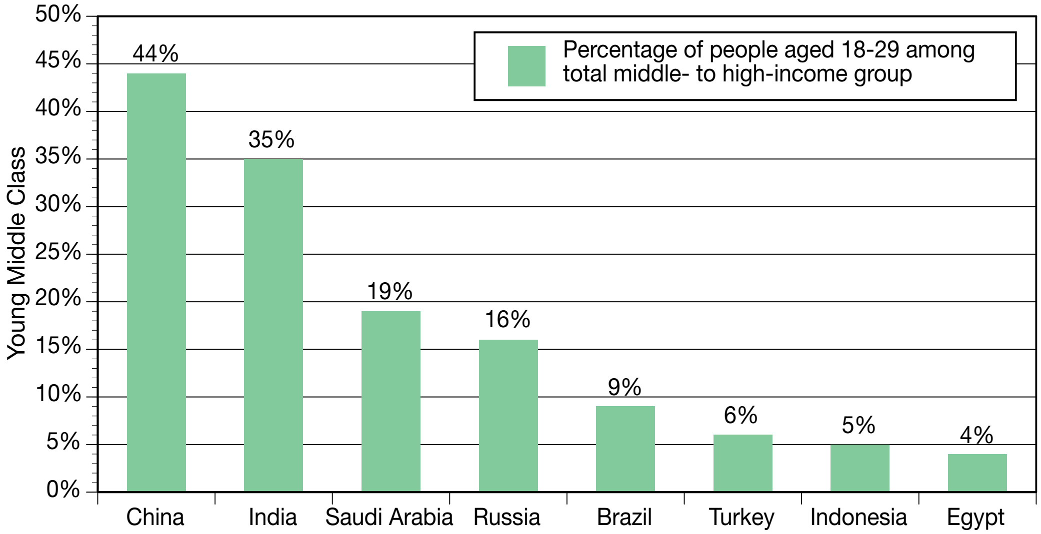
Not only are the first-tier cities (namely Beijing, Shanghai, Guangzhou and Shenzhen) the most developed cities in China, they are also the most famous, but that does not mean they monopolize all of China's real estate opportunities. A new breed of cities, those in the second and third tiers, is offering a compelling reason to look beyond the largest urban centers. In fact, as China's richest cities reach economic maturity, the country's second- and third-tier cities are expected to experience faster growth.

China's Urban Population, 1978–2011



Source: China National Bureau of Statistics

Comparison of Young Middle Class in Emerging Markets



Source: Hong Kong Economic Journal

The high cost of living in the first-tier cities is causing people to leave top-tier cities such as Shanghai for places where a good quality of life is more affordable. In 2010, the housing-price-to-disposable-income ratio was 17.7 times in Beijing, as compared with 5.7 times in Changsha and 6.9 times in Chongqing (see "Housing Affordability," page 22). Second- and third-tier cities will attract population in terms of both quantity and quality, with rapid growth in middle class and urban wealth. As these second- and third-tier cities develop their local economies, the demand for a more educated workforce will increase, resulting in growth in the middle class population. For example, in 2010 the local employment rate of local graduates in Wuhan, a second-tier city in central China, was 51 percent, double the number in 2000.

Another factor that will further increase urbanization in second- and third-tier cities is the high-speed railway system that is currently being built across the country. Better connections between cities will accelerate urbanization, assist in the formation of urban agglomerations, foster collaboration among cities to take advantage of their complementary strengths and enhance their overall competitiveness. For example, Shanghai has been improving the connections with its neighbors. The train line between Shanghai and Nanjing, the capital of Jiangsu province, has reduced the journey time from three hours to just one hour. In the western province of Sichuan and Chongqing Municipality, improved transport connections between Chengdu, Sichuan's service center, and Chongqing Municipality, the manufacturing base, are leading to a win-win situation for the two cities as economic ties become stronger. The improved accessibility will facilitate population migration and improve consumption in the cities along the high-speed railway system.

The second- and third-tier cities, being at the transformational stage of development, have the greatest investment potentials. At the end of 2010, there were 34 cities in China with a population exceeding 7.5 million, and the growing high-speed railway system will connect 30 second-tier cities and four first-tier cities. These second-tier cities will be more likely to further benefit from the future urbanization than their more developed peers, setting them up to become the next modern cities. Because these cities are already on the path to industrialization, they will present more balanced and quality economic growth than their less developed counterparts. Investors looking to put money into Chinese real estate should pay attention to this second wave of economic powerhouses.

UPWARD TREND OF RETAIL PROPERTY MARKET

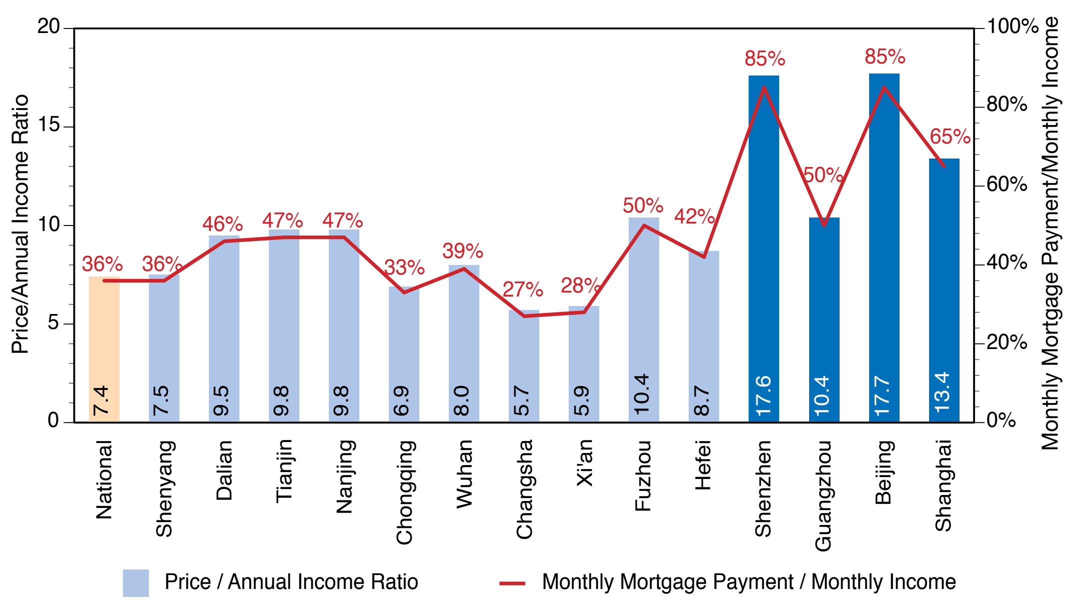
In addition to the wide range of economic factors that favor the development of China's retail property market, there are a number of characteristics that should make the market attractive to sophisticated investors. Most notably, the retail property market remains at a relatively early stage of an upward trend, especially in the less developed second- and third-tier cities.

Ever since the government opened up the property market in the mid-1990s, the focus of developers has been on residential property: the top 10 listed developers in terms of market capitalization currently have approximately 90 percent of their assets in residential property, with the remaining 10 percent allocated to commercial property.

Government policy also pays greater attention to residential property — therefore, the current policy measures designed to cool the booming residential market leave the retail market relatively untouched. If it does have an effect, it will be to put pressure on the cash position of some developers, which could lead to attractive acquisition opportunities as developers offload their retail assets to improve liquidity.

In the meantime, the retail property market is a relatively unsophisticated market where there is a mismatch between the product available and the increasingly sophisticated demands of both shoppers and tenants. From the perspective of the retailer, famous brands are looking for something unique in the space that they rent, which will provide them with greater control over their image and operations. However, many developers do not have much experience in catering for the needs of high-profile retailers, partly due to the government's restrictions on the operation of foreign retail businesses in China before 2004. On the consumer side, shoppers are looking for more than a plain shopping experience; they are now more interested in combining their shopping with other entertainment activities, such as going to the cinema or dining at a restaurant. Therefore, both shoppers and tenants are often disappointed by the generic retail space (such as traditional department stores) that is typically on offer in China, especially in most second- and third-tier cities.

Housing Affordability, 2010



Note: Average per capita living area is assumed to be 30 square meters. The mortgage loan-to-value ratio is assumed to be 60 percent with terms of 25 years on average.

Source: China National Bureau of Statistics

As a result, China's retail property market has very low inventory of quality assets. Prime retail space available in most of the first- and second-tier cities in China is estimated to be less than 0.3 square meters per capita at the end of 2012, which is much less than that of Tokyo (approximately 0.5 square meters), Hong Kong (approximately 0.65 square meters) and New York City (approximately 0.72 square meters), according to Jones Lang LaSalle.

The absence of mature market players alongside the scarcity of investment-grade assets has led to a relatively inactive retail property market. The process of urbanization and the increase of urban consumption power will boost the demand for high-quality, income-generating properties, which will in turn stimulate investment activity. In fact, many domestic and international brands are expanding rapidly. One prominent example is Japanese clothing retailer Uniqlo, which plans to open 1,000 large-scale stores in China during the next decade.

On the investor side, the market will gain a greater range of participants — domestic insurance companies will become significant buyers, due to a 2010 announcement by the insurance regulator that insurers will be able to invest 10 percent of their assets in commercial real estate. The introduction of REITs is also on the Chinese government's agenda, which will increase the demand for quality income-generating assets as well.

Retail property is an asset where careful asset management plays a key role in performance. Not only does this mean that retail properties are subject to a relatively low level of volatility compared to residential property, it also means that an investor with experience in managing retail properties has the potential to stand out in China, as many of its local competitors learn how to conduct business and transact for the first time.

While the opportunities are out there, taking advantage of them requires preparation. China at times can be confusing for first-time investors, especially in the essential task of dealing with the bureaucracy. Investors should therefore take the following steps before committing their money: do the local groundwork, learn about the peculiarities of the Chinese market and find a competent local partner. Upon completing these steps, investors will be in a position to participate in the golden development period of China's retail property market. ❖

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Senior Housing

Age-Old Problem

The Senior Housing Market in Asia Requires New Solutions for Investors

by Mard Naman

With neighboring countries having years to fine-tune their approach to senior housing, China is just beginning to tackle the problem. What are the issues and challenges, and what opportunities exist for investors?

The age demographics tell the story: 13 percent of Chinese are 60 and over, and 8.9 percent are 65-plus. It's not only people who are already officially seniors: China's median age is 35.5 and with few youngsters in the pipeline — the birth rates in China, with its one-child policy, ranks 158th in the world.

Who will take care of all of these seniors? The numbers all point to huge senior housing needs now, and needs that will only grow in the next decades.

The demographics may make it look like a no-brainer in terms of investing in senior housing, but the reality of the situation is more complicated and fraught with risk than a simple look at the burgeoning demand would indicate. For the Chinese people and their government, senior housing is a relatively new concept.

CHINA'S SENIOR MOMENT ARRIVES

China's nascent senior housing industry is not exactly exploding out of the starting blocks. The sector is so new that official metrics do not exist. But Bromme Cole, president of Hampton Hoerter China, has spent much of the past three years visiting each senior housing project in China, and informally collecting data about operations, cost, size, occupancy and other critical data. "To my knowledge, this data yields the only available metrics on current supply of senior living in China," he says.

Based on Cole's analysis, of the 170 million people over 65 in China, approximately 10.2 million, or 6 percent, are (through income and other cultural inclinations) good candidates for senior housing. And according to his data, the 25 senior housing facilities currently operating have an abysmal 35 percent occupancy rate. By comparison, the overall occupancy rate in the United States for independent and assisted living senior housing projects is 88.6 percent, and 87.9 percent for acute nursing care facilities.

The penetration rate in the United States is 7 percent, in Japan it's 13 percent, but in China it's a miniscule .04 percent, according to Cole. The penetration rate is the percent of those who are predisposed to some sort of senior living arrangement that actually choose to go into a senior living facility. (Cole is not including the approximately 48,000 existing nursing homes in China run by the government. He says these are basically shoddy holding facilities for the indigent poor, and no middle class or wealthy person would ever want to be inside one.)

Cole explains this low penetration rate by saying the industry just started two to three years ago in China, so there's a huge education curve. The low birth rate and rapidly growing percentage of elderly demonstrate there is no way adult children will be able to continue to take care of their parents and grandparents to the extent they traditionally have. But old traditions don't change overnight. Realizing this, the Chinese government made senior housing a priority in its 12th Five-year Plan (2011–2015).

Today, the field remains wide open, with developers and investors trying different models to see what sticks. "When the 12th Five-year Plan talked about providing better care for the aged, everyone started going crazy," says Cole. "Practically every developer said, 'We are now a senior living developer.' Large, high-end and high-profile developments such as General's Garden, Yanda and Cherish Yearn have sprung up, and they are utter disasters," says Cole.

There are numerous reasons these and similar facilities are not attracting tenants, including a primary rule of real estate: location. Many are an hour or more away from major urban living centres, often because that is where land is available. "A lot of these developments are in the boonies, and people are saying, 'Why should I move there?'" says Mark Spitalnik, founder and CEO of China Senior Care in Hangzhou. "If someone doesn't need help with the activities of daily living and it's choice-based, why would they move an hour and a half away from their family and friends?"

Even though most of the current developments call themselves CCRCs (continuing care retirement communities) and do have some capabilities for assisted living and acute care, they are primarily independent living. "They are pretty much 80 percent to 95 percent independent living developments," says Spitalnik. "They may have a few beds for skilled nursing and some handrails on the wall, but pretty much it's hard to distinguish between those projects and regular real estate projects. They're not needs-based; they're lifestyle-based."

Poor operational quality is another problem. Because there is no government-backed long-term care programme in China, almost all current senior developments target the super-wealthy who can afford to pay. But today's operators are still insufficiently skilled, notes Cole. "No truly five-star senior living operator exists in China to complement a high-end facility, so residents are left without meaningful services or a high-end experience," he adds.

Cole now believes developers might do better by targeting the middle class. He says 23 of the 25 facilities that have opened to date in China are focused on the high end. "None of them are doing that well. In fact, some are completely vacant," he says.

"Despite all the market chatter, there is no successful high-end senior living project in China … none, period," writes Cole on his blog site "The successful (read: moderately successful) projects that exist today are solidly in the mid-range of the market," he writes. "There is little to no data to support high-end senior lifestyle facilities [in China at present]."

However, it is important to remember that Cole is writing only about the independent living segment of senior housing here. "Specifically excluded from this discussion is a high-end, need-based product … I see tremendous demand here as every single skilled geriatric nursing facility in China has a long waiting list, especially the elite hospitals that cater to high government or military officials." And it is this needs-based market that, if done right, could be a great opportunity for investors.

NEEDS-BASED VERSUS LIFESTYLE-BASED HOUSING

Because there are no regulatory differences between independent, assisted living and acute care housing in China, Spitalnik prefers to think of senior housing in two broad categories: lifestyle-based and needs-based housing. He is in the process of developing a high-end, needs-based facility in Hangzhou, projected to open in early 2014.

He looks at senior housing on a continuum scale, with independent living on the left and skilled nursing care on the right. In the middle would be various levels of assisted care to help people with the activities of daily living. He views senior independent living as a lifestyle choice. "The independent living facilities are mostly real estate, and the more real estate it gets, the more real estate fundamentals count," says Spitalnik.

As a lifestyle choice, senior living in China still has a long ways to go before it is accepted. And that's a problem for the independent living developers selling to wealthy individuals. "If I'm a high-net-worth person, and I'm living in a great villa or apartment in Shanghai or Beijing, and it's a lifestyle choice and not needs-based, why should I move?" asks Spitalnik.

However, Chinese are becoming quite accepting of high-end, needs-based facilities. When Spitalnik started putting together a business plan for senior housing in 2007 and told people he planned to build nursing homes, the first reaction was, "We have filial piety. You Americans would use this, but we Chinese would never use it. But in the past five years, he has seen a sea change in attitude. Part of this is due to all the attention from the government and the demographic realities. "Now when I say I'm building a high-end nursing home, they ask when I am opening," says Spitalnik. "So the education has already taken place on the needs-based side."

Ultimately, the vast majority of people needing age-care facilities will not be wealthy; they will be middle class (the poor will continue to use the government nursing homes). "Our model is first building a residential age-care facility for high-net-worth individuals," says Spitalnik. "Ultimately, we'll have a five-star, a four-star and a three-star, and each product will be different, meaning the amenities and the staff to resident ratios," he adds. This is very similar to the hotel model, where one company owns multiple brands, depending on the price points and the amenities.

THE TIPPING POINTS

There are two "tipping points" that need to happen for the China senior living industry to really take off, according to Hampton Hoerter's Cole. First is the development of government-sponsored healthcare insurance to enable more seniors to pay for housing and services, and second, there needs to be high-quality senior living healthcare service operators developed in China. "Those are the two primary ingredients to move this industry from a trend to a real, full-fledged business," says Cole.

He doesn't expect the first point to happen anytime soon. "A meaningful government-sponsored care programme that offers financial assistance to older people will not appear within the next five years," Cole predicts. "You won't see the number of different products you see in the U.S. or Japan until China announces how it will fund the healthcare needs of seniors," adds Biggs. "That's when things will get interesting."

In the meantime, there are now 450 or more projects in the pipeline, with at least 30 coming online in the next 12 months, and there could be a major oversupply issue coming up in a couple of years, according to Cole. "It would stand to reason," he says. "If people don't start getting it right soon, you're going to have all these buildings, and they're going to be vacant in 2014 or 2015."

This could usher in an era of good value-added or distressed investing in Chinese senior housing. Cole believes the best opportunities may lie ahead for those who wait and have the operational component right. "The biggest opportunity is the very likely potential there will be this huge overhang in supply in the next five years," Cole says.

The operational component also will take time to develop in China. There are virtually no skilled geriatric nurses in China. Geriatrics as a specialty is new to China, and according to Jim Biggs, managing director of Honghui Senior Housing Management Consulting in Shanghai, rehabilitation and dementia care similar to what is available in the United States simply does not exist yet in China. For the industry to succeed, healthcare workers have to be trained.

Cole believes the solution to China's senior healthcare human resources problem is Taiwan, which is a very modern, highly advanced society. "Taiwan is the model," he says. "The Taiwanese are indistinguishable from the Mainlanders culturally and linguistically. You look at Taiwan, and it is like looking at the future of China."

He says to build an acute care facility operator in China, one can bring back administrators and head nurses from Taiwan, and have them train your staff in China. "You take a regular nurse and make her a geriatric nurse; a regular healthcare worker and turn him into someone who can care for the elderly," says Cole. He adds that this process takes 18 to 36 months.

THE BIGGEST UNKNOWNS

On the independent living side, the biggest unknown is what product is going to work, according to Spitalnik: "Ultimately I think a product that works will be something that gets people to say, 'This is going to give me a better quality of life than I have now. It's close enough to my family, it's got a lot of activities and a design where I can age in place.' At the end of the day, the business model for all these developments, both lifestyle and needs-based, is, 'What makes my life better?'"

While the unregulated nature of the industry offers developers and investors certain freedoms today, it's also a big unknown. "The biggest single risk in the China senior living industry right now is the impetuous nature of the central government to impose regulations or policies tomorrow," Cole says.

There's also a lack of comprehensive data. "If you're a fund that wants financial metrics on how the industry is going, they don't exist," Spitalnik says. And if you're the type of fund that doesn't want to take on development risk, it's too early to invest. "But if you want to get in on a new industry and get first-mover advantage, there's a huge potential upside," he concludes.

THE BOTTOM LINE

China's senior housing sector is nascent and virtually unregulated. Opportunities exist for investors, particularly in needs-based versus independent-living senior housing.

Investors who get involved in senior housing beyond the independent living category are getting into more than pure real estate — there is a crucial operational component to assisted living and acute care facilities that requires specialized knowledge and expertise.

In China, skilled geriatric operators need to be developed, and government-sponsored elder care insurance needs to be implemented before the sector can flourish. In the meantime, while developers are targeting high-net-worth Chinese, their efforts will likely be hit and miss, and China will probably face an oversupply of independent-living senior housing. ❖

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Filial Piety: A New Wrinkle for an Old Concept

The traditional concept of filial piety, which teaches respect, devotion and care toward one's parents, has long been strong in China, Japan and Korea. For thousands of years, this concept has also been the main source of support for the elderly in all three countries, with adult children looking after their parents as a matter of course. While the concept is still strong, its expression is changing, especially in Japan.

The concept of filial piety is still deep-rooted in the Chinese and Korean societies, but it receives less attention in contemporary Japan, probably due to the well-developed social security and social service programmes for the elderly, according to Barry Hirschfeld Jr, CEO of Asia Investment Partners (AIP-JAPAN), a Tokyo-based private equity firm that specialises in the Japanese healthcare sector. "The bias against people who can't provide care for their parents directly in their homes has subsided, due to the emergence of a strong Japanese senior living operator culture, backed up by the establishment of long-term care insurance in Japan," he says.

Staying close to family is an important consideration in all three countries; the few large senior developments that have been built in out-of-the way locations are not attracting many residents in China. In Japan, people who live in assisted living communities tend to live within 5 kilometres of their family, according to Steve Bass, partner with Orion Partners in Tokyo.

In South Korea, senior housing facilities are commonly called "Silver Towns". "Several years ago, there were several development projects in rural areas, most of which failed to get residents," says InKyu Song, executive managing director with Samil PricewaterhouseCoopers Consulting in Seoul. But Song adds that recently, development has been taking place inside Seoul, where residents get good access to other family members. It clearly appears that elders in China, Japan and South Korea want to remain close to their grown children and grandchildren, not an hour or more away.

That said, it is becoming increasingly acceptable for elders to not stay in the same home as their children. Mark Spitalnik, founder and CEO of China Senior Care in Hangzhou, says the definition of filial piety is changing in China, especially for wealthy and middle class people. Historically, if a child put their aged parent in a nursing home, they were considered a bad kid.

But the advent of high-quality, residential-like nursing homes, combined with the overwhelming demographic need for elder care, will change that, Spitalnik believes. "Filial piety is alive and well, but how people deal with it will be different," he notes. Spitalnik says the notion of 'contracting out filial piety' is gaining traction. "It's basically saying, 'I'm a good kid. I got mom a place in this great facility that's hard to get into, it's expensive, and there aren't a lot of spots.'" Instead of losing face, Spitalnik says these adult children can now gain face instead through this reinterpretation of filial piety.

"We are learning that seniors in China know their families are busy and do not want to be a burden," adds Jim Biggs, managing director of Honghui Senior Housing Management Consulting in Shanghai. "In Japan, there is acceptance of CCRCs — continuing care retirement communities — that are well-designed and have great reputations. China will most likely follow this model."

— Mard Naman

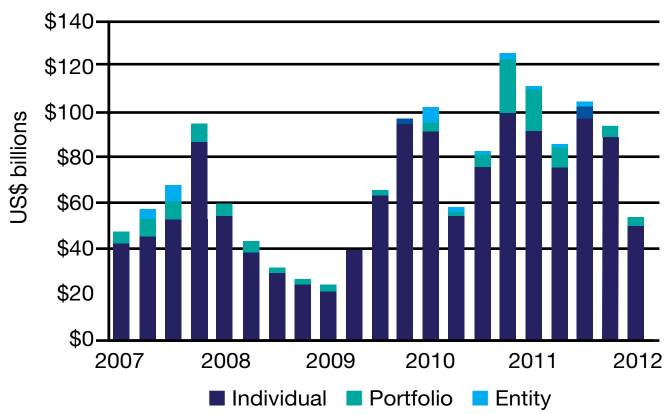
Sampling of China Transactions

Buyer	Seller	Size (sq. meters)	Location	Price (M)	Price/Unit
RESIDENTIAL					
Hong Da	Aoyuan	273 units	Beijing	$632.27	$2,316,030.00
HOTEL					
Hui Xian REIT	Cheung Kong Holdings	590 units	Shenyang	$155.69	$376.98
OFFICE					
Sinotrans&CSC	Not disclosed	82,000	Beijing	$650.00	$736.00
Soho China	Deluxe Family	137,442	Shanghai	$394.55	$2,870.65
Not disclosed	Not disclosed	35,154	Shanghai	$368.40	$974.00
Baoshang Bank	Not disclosed	54,200	Shanghai	$307.90	$528.00
Guanghou Automobile Group Co.	Poly Real Estate Group Co.	45,600	Guangzhou	$221.42	$4,855.91
WPG Holdings	Shanghai Huichung Modern Service Park Development	15,235	Shanghai	$46.92	$3,080.08
Chinatrust Financial Holding Co.	Shanghai World Financial Center	3,616	Shanghai	$46.69	$12,913.80
DEVELOPMENT					
CapitaMalls Asia	Suzhou Industrial Park Jinji Lake Urban Development Co.	350,000	Suzhou	$426.98	$1,219.98
Pramerica Real Estate Investors	China Overseas L&I	80,000	Guanghou	$315.79	$3,947.48
Changsha Haxin Plaza	Changsha Juyun Investment	107,000	Changsha	$204.30	$1,909.35
Doxen Enerey Group	Chongqing Dong Yin	10,043	Chongqing	$47.34	$2,624.13

Source: Real Capital Analytics

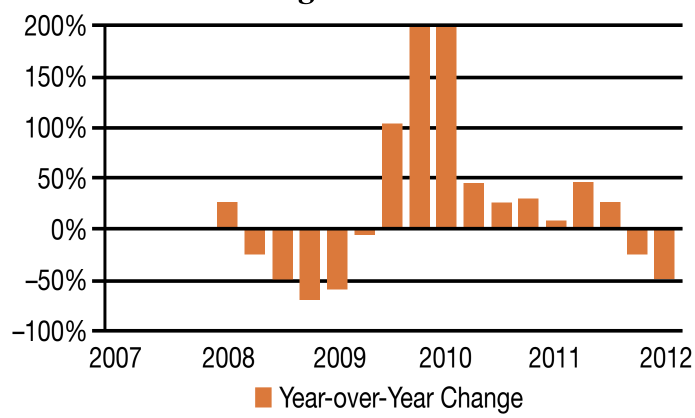
Note: Currency conversions as of September 21, 2012

Quarterly Transaction Volume



Source: Real Capital Analytics

Year-over-Year Change in Transaction Volume



Source: Real Capital Analytics

Q1/2012 Transaction Summary*				
	Volume (US$B)	Year-over-Year Change	Number of Properties	Year-over-Year Change
Office	$8.6	–42%	122	–39%
Industrial	$3.8	12%	75	–23%
Retail	$4.1	–15%	102	–14%
Apartment	$2.1	–16%	69	–8%
Hotel	$1.5	8%	32	–14%
Development Site	$34.5	–59%	721	–47%
TOTAL	$54.6	–51%	1,121	–40%

**Totals may not sum due to rounding*
Source: Real Capital Analytics

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