Urban Land Institute

Mainland China Real Estate Markets 2013

ULI Analysis of City Investment Prospects

城市土地学会

2013年中国大陆主要城市房地产投资前景分析

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About ULI

The Urban Land Institute is a 501(c) (3) nonprofit research and education organization supported by its members. Founded in 1936, the Institute now has nearly 30,000 members worldwide representing the entire spectrum of land use and real estate development disciplines, working in private enterprise and public service. As the preeminent, multidisciplinary real estate forum, ULI facilitates the open exchange of ideas, information, and experience among local, national, and international industry leaders and policy makers dedicated to creating better places.

The mission of the Urban Land Institute is to provide leadership in the responsible use of land and in creating and sustaining thriving communities worldwide. ULI is committed to bringing together leaders from across the fields of real estate and land use policy to exchange best practices and serve community needs by

- Fostering collaboration within and beyond ULI's membership through mentoring, dialogue, and problem-solving;
- Exploring issues of urbanization, conservation, regeneration, land use, capital formation, and sustainable development;
- Advancing land use policies and design practices that respect the uniqueness of both built and natural environments;
- Sharing knowledge through education, applied research, publishing, and electronic media; and
- Sustaining a diverse global network of local practice and advisory efforts that address current and future challenges.

About the ULI Center for Capital Markets and Real Estate

The ULI Center for Capital Markets and Real Estate focuses on tracking, analyzing, and exploring real estate investment trends globally. The mission of the Center is to promote understanding of the real estate capital markets and provide leadership in fostering a healthy and productive real estate capital markets sector that, in turn, promotes thriving and sustainable communities worldwide. The Center pursues this mission through research, trend analysis, education, events, publications, web-based resources, advocacy, and thought leadership.

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About ULI Asia Pacific

Across Asia Pacific, the Institute has over 1,200 members, with a particularly strong presence in Japan, Greater China, Singapore, Philippines, and Australia. The regional headquarters is in Hong Kong with an office in Tokyo. ULI Asia Pacific brings together industry leaders with a common commitment to improving professional standards, seeking the best use of land, and following excellent practices. By engaging experts from various disciplines, the Institute can arrive at responsible answers to problems that would be difficult to achieve independently. ULI shares its knowledge through various discussion forums, research, publications, and electronic media. ULI's activities in the region are aimed at providing information that is practical, down to earth, and useful so that on-the-ground changes can be made. By building and sustaining a diverse network of local experts in the region, the Institute is able to address the current and future challenges facing Asia's cities.

ULI Asia Pacific

ULI is the acknowledged authority for policy information and best practices in land use in the Asia Pacific region.

Supporting principles:

- Collaboration with universities, government agencies, and like-minded organizations strengthens and disseminates the Institute's expertise.
- Priority initiatives effectively address local land use issues.
- High-quality programs enhance the integrity of the Institute.
- Substantial interdisciplinary membership is engaged throughout the region.

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Executive Summary

M*ainland China Real Estate Markets 2013: ULI Analysis of City Investment Prospects*—the third such annual survey conducted by the Urban Land Institute (ULI)—reports on real estate development and investment prospects in 36 of the largest Mainland China cities and related issues, as evaluated by real estate industry leaders active in Mainland China.

Investment and Development Prospects

▷ The 2013 ULI Mainland China cities survey revealed that respondents were decidedly more upbeat with respect to prospects for China's real estate markets than they were at the beginning of last year:

- Investment rating scores for this year's four top-ranked cities—Shanghai, Suzhou, Beijing, and Wuhan, in descending order—are all higher than the investment rating awarded to top-ranked Chengdu in 2012.
- The development rating for Shanghai—this year's top-rated city for development—is also higher than the development score of top-rated Chengdu in 2012. Development ratings for Suzhou and Guangzhou—the second- and third-rated cities for development prospects this year, respectively—exceed all 2012 development scores, save Chengdu's.

▷ Shanghai—China's most populated city—moved up to first place for both investment and development prospects after being second in both to Chengdu for the last two years. Shanghai is viewed as one of the two most mature, deepest, and most liquid markets in China, strong in all sectors. The maturity of Shanghai as a real estate market is reflected by the fact that the city's residential prices—while clearly still on an upward trend overall—are among the less volatile.

▷ Suzhou saw a jump in its investment rating score that brought its ranking up a dramatic 11 places—from 13th to second place for investment prospects. The jump in its development rating score brought it up 12 places—from 14th to second place for development prospects. Suzhou is Shanghai's largest industrial satellite with a substantial concentration of high-tech manufacturing and a vibrant, expanding city in its own right.

▷ Beijing also rose dramatically in ranking of investment prospects, from ninth to third place, and in development prospects, from 16th to fifth place. The country's capital and second-largest city, Beijing drew attention for its maturing and sophisticated office sector, which includes the Grade A office market in the central business district (CBD) but also growing decentralized suburban fringe office nodes and urban fringe business parks.

▷ Previous feelings of ennui toward some solid first- and second-tier markets like Guangzhou, Suzhou, and Wuhan were replaced by a new attitude of "yes, we'll have a look at that," particularly following the recent revival of the residential sales market in many strong second-tier cities.

▷ Chengdu—the top-ranked city for both investment and development prospects the last two years—fell to eighth and seventh place, respectively, this year. Although its ratings shifted only slightly downward, it was outdone by other cities' quick ascent. The recent rapid development in Chengdu has led to concerns about oversupply of CBD commercial development, although this was viewed as somewhat temporary as Chengdu is the most economically dominant city in southwest China.

▷ However, underlying the optimism about prospects for China's real estate markets in a year of revival, the in-person interviews provided a clear sense of respondents' frustration with government's increasing willingness to intervene directly in the residential market sales and pricing mechanism going forward. The effect of this, as commonly voiced by the interviewees, is that profitably developing residential property in China is, if anything, getting harder rather than easier, as the central government has repeatedly dug in its heels about halting the rise in the capital value of housing. As the head of one Mainland developer stated in an interview, "For developers, the basic set of principles according to which the 'residential development game' is played in China have changed. Formerly, given the virtual inevitability that land prices would continue to appreciate, especially in the economically stronger Tier 2 and 3 cities, the game was simply to grab the largest and most prime parcel of land that one could lay one's hands on, and then develop [it] in phased stages, while waiting for the property to appreciate. However, given the uncertainty that the capital value of the project being developed will, in fact, appreciate at all, the market has effectively become much more competitive, and winning the game is now much more related to the intrinsic quality of the development itself."

Sector Engagement

▷ The biggest changes among respondents have taken place within the industrial/distribution sector, with involvement increasing from just over 40 percent of the survey respondents in 2010 to almost 60 percent expected by the end of 2013. Reponses reflect a broad and growing interest in the industrial/distribution sector, responding to China's critical lack of modern warehousing and distribution facilities.

▷ Respondents were clearly alert to the fact that e-commerce transactions have soared and this is driving acute, partially unsatisfied need for more e-commerce distribution facilities.

▷ The industrial/distribution sector, however, is not easily entered into in China due to the lack of sufficient quantities of appropriately zoned land made available by local government.

Niche Markets

▷ While e-commerce/distribution centers received the highest rating in the survey, the in-person interviews indicated that this may be mostly aspirational due to the difficulty of gaining access to logistics-zoned land sites. Still, the high rating of e-commerce/distribution centers reflected respondents' interest in all areas where the growing use of information technology is stimulating demand for real estate, as high-tech/cyber/knowledge parks and business parks emerged as third and fifth in niche markets. Respondents rated seniors' housing second to e-commerce/distribution centers, aware of the acute shortfall in such accommodation that China faces over the next two to three decades. The huge frustrated demand that the continued imposition of home purchase restrictions (HPRs) has created in affluent would-be investors resulted in developing luxury housing abroad, emerging as the fourth-most-popular niche market.

2013 Ranking of Cities by Livability

▷ In giving Hangzhou, Xiamen, Chengdu, and Qingdao top ranking in terms of livability, respondents clearly showed a preference for scenic beauty, attractive heritage architecture, sense of scale, reasonably good environmental quality, and, finally, laid-back atmosphere and well-developed consumerist culture.

▷ The big surprise was Beijing, ranked 31 out of the 36 cities, despite China's capital ranking number three in investment prospects. This finding suggests that in light of its deteriorating environmental quality and persisting traffic problems, Beijing was an urban center in which it was desirable to own prime commercial assets for leasing but not to live oneself.

2013 Assessment of Impact of Issues of Concern

▷ The ULI 2013 China cities survey revealed a substantial recovery in market sentiment, which was substantiated by their views that the outlook for the domestic economy was one of the issues likely to have the most positive impact on the domestic real estate market. However, the same section of the survey also revealed respondents' concern that the present environment for developing residential sales property is increasingly fraught with difficulty, evident in the negative scores assigned to central government tax policies and the continued imposition of HPRs.

▷ That the difficulty of raising external finance was viewed as being only a moderately negative factor is an indication of how much more liquid China's real estate market has become over the past 12 months. However, the in-person interviews revealed that the main beneficiaries of the increase in liquidity are larger developers who can use their greater access to liquidity to acquire land banks and development assets from weaker, more indebted developers. For private equity funds, the more-liquid market conditions further constrict the space in which they can place preferred equity in China real estate development projects, as the cost of capital for larger Mainland developers has been lowered. While the assessment scores appeared fairly neutral with respect to central government land release policies and local government land release and development and sales practices, the interviews revealed that behind this neutrality lies a complex web of issues that potentially cut in many directions, depending on a player's market position and relationship with the government.

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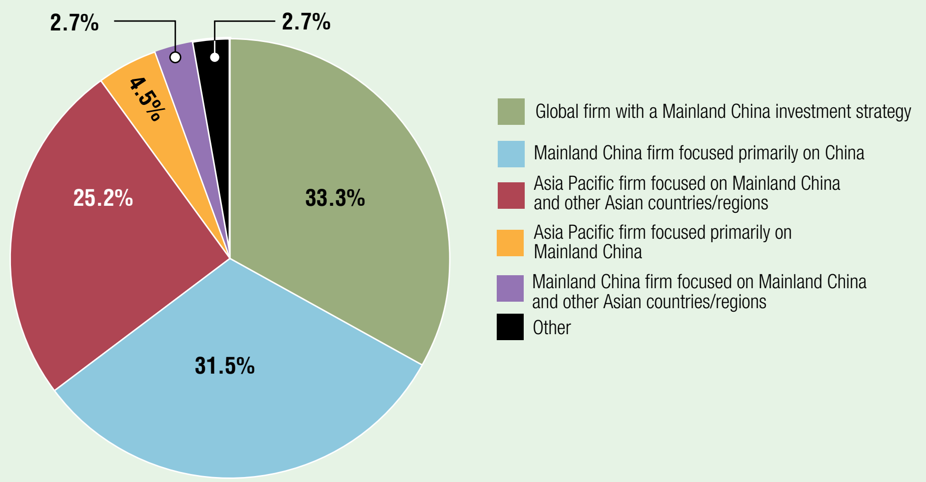
China Cities Survey 2013

ULI ANALYSIS OF CITY INVESTMENT PROSPECTS

Introduction

Mainland China Real Estate Markets 2013: *ULI Analysis of City Investment Prospects*—the third such annual survey conducted by the Urban Land Institute—focuses on real estate development and investment prospects in 36 of the largest Mainland China cities over the next 12 months. Insights and expert opinions were collected through a survey of and interviews with real estate industry leaders in Mainland China and Hong Kong: 65 percent of the survey respondents and 60 percent of the interviewees are based in Mainland China, with almost all of the balance based in Hong Kong. In addition, 34 percent of the survey respondents and 51 percent of the interviewees are with Mainland China firms, 33 percent of respondents and 26 percent of interviewees are with global firms, and 30 percent of respondents and 23 percent of interviewees are with Asia Pacific (excluding Mainland China) firms. Survey respondents and interviewees were ULI members or had been otherwise identified by ULI Asia Pacific as being involved in Mainland China real estate.

Survey Responses by Geographic Scope of Firm



Source: Mainland China Real Estate Markets 2013 *survey.*

The survey, undertaken in March and April 2013, first assessed each city's overall investment and development prospects. Respondents were also asked to assess the prospects by property sector—office, retail, industrial, hotel, and apartment residential—in each city. Other questions included the nature of their real estate activity by sector, recent changes, and issues affecting those changes. For the first time this year, a question about the livability of each city was included. Interviewees were asked analogous questions.

The 36 cities—up from 28 covered in the 2012 China cities survey—include seven metropolises with urban populations ranging from 8.5 million to 19.6 million, an additional 28 cities with populations ranging from 1.4 million to 7.2 million, and only one city with fewer than 750,000 residents. The cities are considered first-tier, second-tier, and third-tier, as well as fourth-tier cities transitioning toward third-tier, according to their size and function as key economic centers. The survey was intended to focus on cities commonly perceived to be among the strongest economically.

Population, 2010–2025 (Millions)

			2010–2025 Growth	
	2010	2025[a]	Change	Percentage
Shanghai[b]	19.55	28.40	8.85	45%
Beijing[b]	15.00	22.63	7.63	51%
Guangzhou[c]	10.49	15.47	4.99	48%
Shenzhen	10.22	15.54	5.32	52%
Chongqing[b]	9.73	13.63	3.89	40%
Wuhan[c]	8.90	12.73	3.82	43%
Tianjin[b]	8.54	11.93	3.40	40%
Dongguan	7.16	9.61	2.45	34%
Chengdu[c]	6.40	9.97	3.57	56%
Nanjing[c]	5.66	8.50	2.83	50%
Harbin[c]	5.50	8.21	2.71	49%
Shenyang[c]	5.47	7.43	1.96	36%
Hangzhou[c]	5.19	8.45	3.26	63%
Xi'an[c]	4.85	6.93	2.08	43%
Zhengzhou[c]	3.80	6.02	2.22	59%
Qingdao	3.68	5.44	1.76	48%
Jinan[c]	3.58	5.32	1.74	48%
Taiyuan[c]	3.39	4.99	1.59	47%
Kunming[c]	3.39	4.82	1.43	42%
Dalian	3.31	4.48	1.18	36%
Suzhou	3.25	5.83	2.58	80%
Wuxi	3.22	5.14	1.92	60%
Changsha[c]	3.21	4.94	1.73	54%
Urumqi[d]	2.95	5.06	2.10	71%
Hefei[c]	2.83	5.04	2.21	78%
Fuzhou[c]	2.80	4.24	1.44	51%
Shijiazhuang[c]	2.74	4.19	1.45	53%
Xiamen	2.70	4.87	2.17	80%
Wenzhou	2.64	4.04	1.41	53%
Ningbo	2.63	4.26	1.62	62%
Lanzhou[c]	2.49	3.61	1.13	45%
Nanchang[c]	2.33	3.53	1.20	51%
Nanning[d]	2.10	2.91	0.82	39%
Haikou[c]	1.59	2.28	0.69	43%
Zhuhai	1.36	1.98	0.63	46%
Sanya	<0.75			

Source: United Nations, Department of Economic and Social Affairs, Population Division, Population Estimates and Projections Section, World Urbanization Prospects. The *2011 Revision Data* report, used here, is for urban agglomerations, which refer to the de facto population contained within the contours of a contiguous territory inhabited at urban density levels without regard to administrative boundaries. It usually incorporates the population in a city or town plus that in the suburban areas lying outside of but adjacent to the city boundaries. This source tracks only cities with an urban agglomeration of 750,000 or more.

a. Projections. b. Municipality with provincial status. c. Provincial capital. d. Autonomous region capital.

2011 Gross Regional Product

	RMB (Billions)	US $ (Billions)
Shanghai	1,919.6	297.0
Beijing	1,625.2	251.5
Guangzhou	1,242.3	192.2
Shenzhen	1,150.6	178.0
Tianjin	1,130.7	175.0
Suzhou	1071.7	165.8
Chongqing	1001.1	154.9
Hangzhou	701.9	108.6
Wuxi	688.0	106.5
Chengdu	685.5	106.1
Wuhan	676.2	104.6
Qingdao	661.6	102.4
Dalian	615.1	95.2
Nanjing	614.6	95.1
Ningbo	605.9	93.8
Shenyang	591.6	91.5
Changsha	561.9	86.9
Zhengzhou	498.0	77.1
Dongguan	473.5	73.3
Jinan	440.6	68.2
Harbin	424.2	65.6
Shijiazhuang	408.3	63.2
Xi'an	386.4	59.8
Fuzhou	373.6	57.8
Hefei	363.7	56.3
Wenzhou	335.1	51.8
Nanchang	268.9	41.6
Xiamen	253.9	39.3
Kunming	251.0	38.8
Nanning	221.1	34.2
Taiyuan	208.0	32.2
Urumqi	169.0	26.1
Zhuhai	140.3	21.7
Lanzhou	136.0	21.0
Haikou	71.3	11.0
Sanya	28.4	4.4

Source: National Bureau of Statistics of China.

CHAPTER 1

Investment and Development Prospects

Respondents were asked to rate the overall investment and development prospects for each city on a scale of 1 to 5, with 1 being abysmal, 3 fair, and 5 excellent. The following discussion touches on the changes in these ratings for the 28 of the 36 cities in this year's survey that were also in last year's, as well as the subsequent changes in ranking. The eight cities that were added to this year's survey are discussed in terms of ranking.

All four of China's first-tier cities ranked within the top seven places in terms of investment prospects, but Beijing and Guangzhou improved dramatically over their previous year's ranking. This reembracing of what had previously been regarded as the country's four most mature real estate markets is much in line with what one would expect during a year of broad market recovery.

Top-Ranked Cities: Shanghai (1), Suzhou (2), Beijing (3), and Wuhan (4)

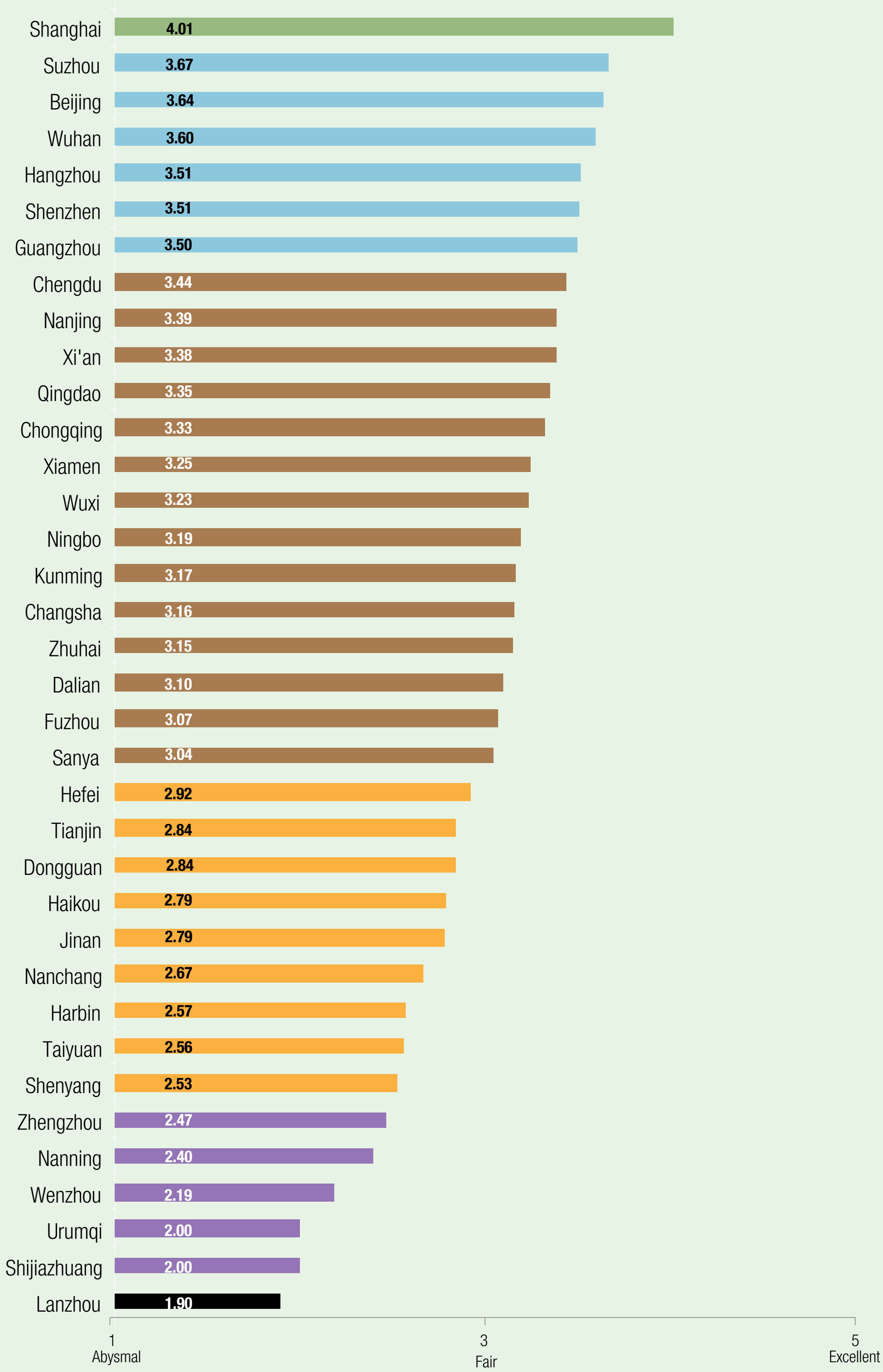
The mood this year is decidedly more upbeat than last year. Not only is Shanghai the top-rated city for both investment and development prospects, with scores of 4.01 and 3.74, respectively, after two years of being outranked by Chengdu, but these scores also represent a significant jump in ratings for Shanghai, surpassing those of Chengdu last year. As one leading fund manager neatly described Shanghai: "A very good city in which to make money in real estate. Will do investment or development across all real estate sectors in Shanghai." This sentiment was seconded by another overseas fund manager, who described Shanghai as being "one of the two most mature, deepest, and most liquid markets in China." The maturity of Shanghai as a real estate market is reflected in the fact that the city's residential prices—while clearly still on an upward trend overall, are less volatile than those in some other cities that are more prone to experience major price swings—have risen by 3.8 percent over the past year and 7.4 percent over the past 24 months according to the SouFun-CREIS 100 Cities Index, showing less change than Guangzhou, Shenzhen, and Beijing, which were up by 12 percent, 11.1 percent, and 9.5 percent, respectively, within the same two-year period, according to the same source.

Furthermore, the next three highest-ranked cities for investment, in descending order—Suzhou, Beijing, and Wuhan—all jumped in their rating scores, also surpassing that of Chengdu last year. This jump in scores brought Suzhou up 11 places in its investment ranking (to second place)—the largest jump among all cities—and Beijing up six places (to third place), while Wuhan remained in fourth place for investment prospects.

Suzhou is also ranked second in development prospects; with a jump in its rating score to exceed all of last year's scores, except Chengdu's, it moved up 12 places. Beijing's development score increased and its ranking moved up 11 places to fifth place this year. Wuhan's development rating score, on the other hand, shifted downward; while this shift was slight, Wuhan's rank went from third place last year to eighth place this year as other cities' rating scores strengthened.

EXHIBIT 1-1

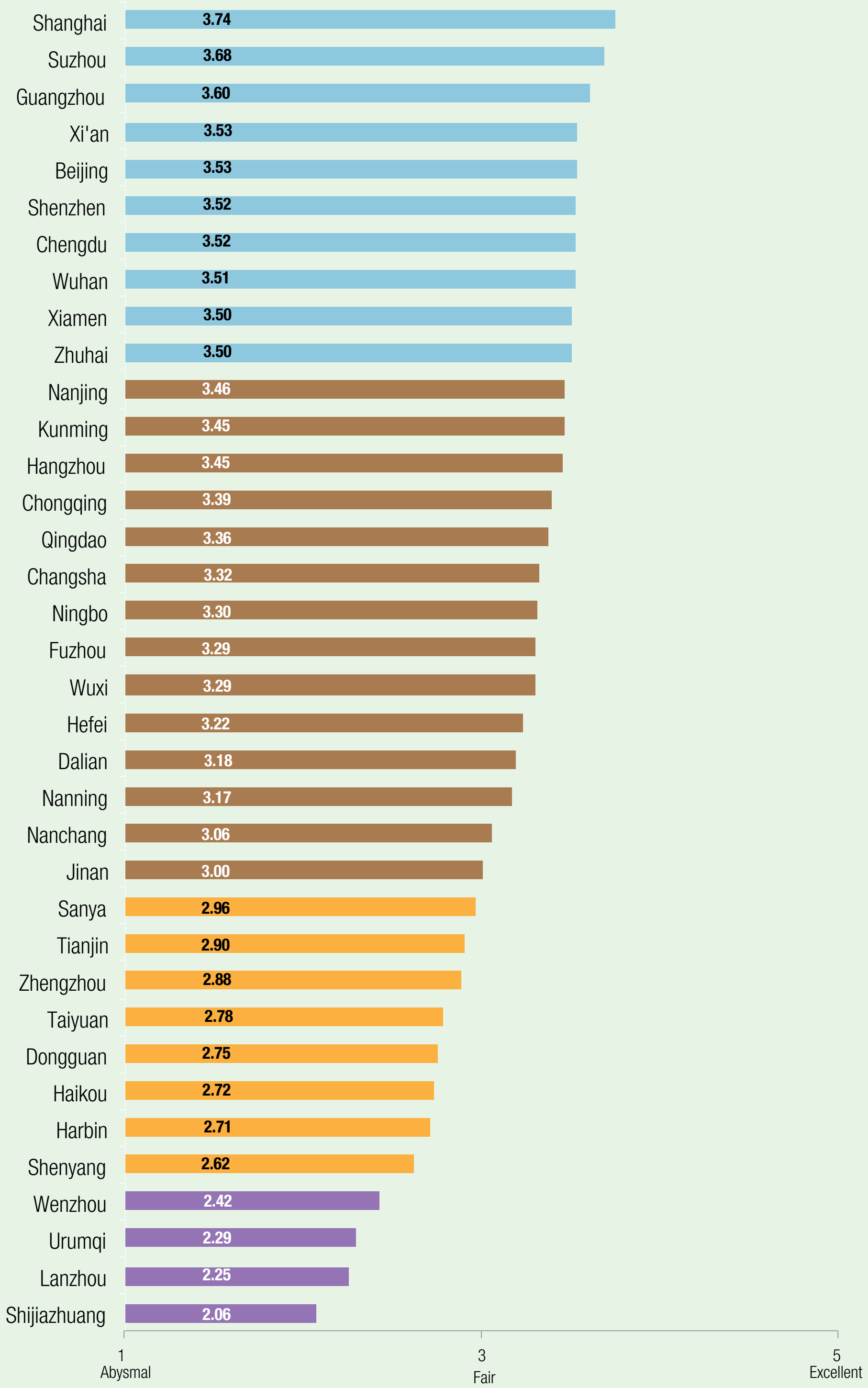
City Investment Prospects



Source: Mainland China Real Estate Markets 2013 *survey.*

EXHIBIT 1-2

City Development Prospects



Source: Mainland China Real Estate Markets 2013 *survey.*

With a substantial concentration of high-tech manufacturing, Suzhou is Shanghai's largest industrial satellite and a vibrant, expanding city in its own right. After the initiation of high-speed rail service between Shanghai and Suzhou in 2010, Suzhou is now within 30 minutes' traveling time to Shanghai, making the city more readily and quickly accessible than Shanghai's own outlying suburbs. This year's rise in ranking is due, in part, to a larger reassessment of the prospects of several first- and second-tier cities, following the significant revival in the residential sales market that commenced in mid-2012 and has continued through to the first half of 2013. Respondents' previous feelings of ennui with respect to solid second-tier markets like Suzhou were replaced by a new attitude of "yes, we'll have a look at that." For example, according to the SouFun-CREIS 100 Cities Index, residential prices in Suzhou are up by 7.3 percent over the past 12 months, but up by only 0.7 percent when viewed over the past two years—the kind of steady price performance that speaks to the city's status as one of China's more mature residential markets. As one major Chinese merchant homebuilder put it, "Between Suzhou and Wuxi, we are more interested in undertaking mid-market residential development in and around Suzhou, because the potential market of buyers concentrated in and around Suzhou is larger." Still, a note of caution was sounded in the face of—or possibly due to—the maturity of the local property market, with one overseas fund manager commenting: "Suzhou city's commercial market is highly competitive and amply supplied, the Suzhou Industrial Park having developed to where it is virtually a 'city within a city,' so it is not easy to secure prime commercial land parcels here at prices at which development is viable."

Beijing—China's capital and second-largest city—drew attention for its office sector. The head of one fund that has sufficient clout to invest in the Beijing high-end commercial sector commented: "The Beijing Grade A office market is still poised to experience tremendous growth in demand and there is no significant new supply scheduled to appear until 2015, making this is a very compelling market [in which] to develop and hold a Grade A office property." The head of the same fund also saw potential to invest in the Beijing decentralized office market, continuing: "Along with the development of new suburban fringe office nodes in Beijing and urban fringe business parks, the Beijing office market is rapidly becoming more mature and sophisticated. Companies that do not need to pay CBD [central business district] rentals to accommodate a large portion of their staff are increasingly moving them to work out of decentralized office clusters and thereby achieving substantial cost savings in rent. In this sense, Beijing is simply becoming more like the way New York, London, and Tokyo have operated for years, with respect to having a tiered office market."

Beijing's average housing prices rose by 11.3 percent over the past 12 months, according to the SouFun-CREIS price index, despite the fact that administrative interference in residential pricing is probably more muscular in Beijing than in any other city in China. This growing government tendency to directly intervene in housing prices—which was first manifest in Nanjing in 2009, but has since spread to Beijing, Hangzhou, Guangzhou, and a number of other cities where housing prices have demonstrated a strong tendency to rise, even in the face of the cooling campaign—is a concern. According to one prominent merchant homebuilder, "The central government is unhappy with Beijing because the municipality's home prices have risen too fast. Furthermore, there is little likelihood that this policy will be relaxed in Beijing at any time in the short-term future, and high-end projects may find it difficult to get presales permits or receive approval to commence sales. Even in our own case, we have recently been denied permission by the Beijing government to raise the price of a property that sold very well last year in Beijing and for which we had intended to launch the next phase."

Wuhan is a very attractive city and in some respects is an economic powerhouse. However, as one knowledgeable domestic investment adviser put it, "Despite all of these advantages, up until very recently, development of Wuhan has been somewhat slower than other cities in its 'strong second tier' class, perhaps due to the fact that the municipal government was up until recently more insular and less forward-looking than that of its peers." The Wuhan government's previous lack of transparency was also cited by some as being a factor in preventing the city from advancing as quickly as some of its direct competitors, such as Chengdu. With respect to land supply for commercial sites, apparently Wuhan has not repeated the mistake of Shenyang and Tianjin of flooding its own market with a supply of mixed-use buildings, so the future supply of office properties is not too badly out of balance with demand. Furthermore, as one domestic investment advisory company noted: "As China's own giant domestic companies expand domestically and seek a location for a central China regional headquarters, Wuhan will be the natural choice."

Of slightly greater concern is the shopping mall sector, where Wuhan may be moving a little too rapidly, since, as the head of one specialist shopping mall developer noted, "If all of the shopping mall properties presently in the pipeline in Wuhan came on stream on schedule, the city would have made the transition from famine to feast rather too quickly." However, the domestic advisory countered this concern with a more positive assessment of Wuhan's potential of becoming oversupplied, saying, "The Wuhan market is protected by the fact that the actual developable area within the core city is not large, and it comprises three districts divided off from one another by tributaries of the Yangtze River, so the city is saved by the fact that there are ultimately only a limited number of brownfield sites that can be put up for development."

Wuhan is a city whose centrality is a strong locational advantage; moreover, it has long been a center of heavy industrial manufacturing and industry in Central China. In recent years, Wuhan has made significant advances in developing information technology and other new economy–related industry as well. But, despite these advances, the city's residential sales market lagged behind that of some of the more aggressively ascendant second-tier cites. However, judging by the remarks made by the head of one fund management company that has invested in a lot of development projects in China, it may be that Wuhan's time has finally come. As he related, "Wuhan is yet another economically strong city that remains attractive for undertaking residential development because its housing prices are still fairly cheap as the market was never whipped into a speculative froth. This is supported by the fact that home prices rose by only 3.9 percent over the past 12 months and 4.7 percent within the past two years—a rate of appreciation that is unlikely to set off alarm bells within the central government."

Hangzhou (5), Shenzhen (6), and Guangzhou (7)

The investment rating scores for Hangzhou and Shenzhen were both 3.51—stronger than last year's, but their rankings shifted downward: Hangzhou went from third place last year to fifth place this year; Shenzhen went from fifth place last year to sixth place. Shenzhen's development rating score was somewhat higher this year and its ranking jumped from 11th to sixth place; Hangzhou stayed at 13th place for development prospects, just inching up in its rating score.

On the other hand, Guangzhou—the seventh-ranked city for investment prospects—was stronger in both its rating score, 3.50, and its ranking, jumping from 14th to seventh place. This was the second-largest jump in investment ranking among all cities (a distinction shared by Xi'an). Guangzhou's rating score for development prospects was also stronger this year, 3.60, and it jumped from 17th place last year to third place.

Shenzhen's slight weakening, when viewed against Guangzhou's dramatic strengthening, is attributable to the city's somewhat contradictory nature as described by a Guangdong-based developer who knows the city well: "Shenzhen has a deep employment market, because of the strength of local high-tech, innovative, and new-economy industry, but is also a 'sim city'—an artificial, manmade city with no historical roots or local tradition in a country that prides itself on its ancient culture. Hence, it is a city that people view as a convenient place to make money but to which they less frequently develop a strong attachment. For this reason, Shenzhen is essentially a city of transients; it does not have a very good public school system or sound public hospitals or provide a particularly healthy environment in which to raise children. So apart from the fact that local employment opportunities are abundant, it is less attractive than some more traditional Chinese cities from the point of view of young people wishing to raise families."

The sense of uncertainty about Hangzhou was expressed by the head of one investment fund who stated, "Real estate investment or development is interesting across all sectors in Hangzhou, and many affluent people from the wider YRD [Yangtze River Delta] area have sought to acquire flats in the city, both as investments and also to have a pied-à-terre there. But the residential market there has calmed recently as their buying is being somewhat constrained by the ongoing imposition of HPRs and credit tightening on mortgages for second flats." According to the SouFun-CREIS 100 Cities Index, residential price change has been 0 percent over the past 12 months.

While Guangzhou—Guangdong's provincial capital—was a city whose commercial property investment market people tended to view favorably, it was not without some caution on the part of some interview respondents. One Hong Kong–based developer stressed the insularity of the Guangzhou real estate market, noting that "Guangzhou is a market that is very dominated by local players who have a strong relationship with the local municipal government. Also, while the market contains demand for virtually every type of property across a wide spectrum, with the progressive completion of Guangzhou's massive new inner-city CBD area, the Pearl River New City, the market is not undersupplied with any particular type of property. So from our point of view, Guangzhou is what we would describe as a relatively well-saturated commercial market."

The head of strategy and investment for one of China's largest merchant homebuilders, which has launched numerous projects in and around Guangzhou in the past, remains strongly attracted to continuing to undertake development in the city, explaining, "We are encouraged by Guangzhou's strong underlying demand from the city's population of 12.8 million, and the firm underlying base of industries that employ them." Demand stems not only "from the core inner-city area but also from the smaller satellite cities of Panyu, Zengcheng, Huadu, Luogang, and Conghua that ring the inner-city core, making it a natural place to develop mid-market housing."

Chengdu (8)

Chengdu's investment and development rating scores shifted downward somewhat to 3.44 and 3.52, respectively. This was enough to bring this formerly top-ranked city in ULI's China city survey for both investment and development prospects down to eighth place in investment prospects and to seventh place in development prospects.

As one manager of a global investment fund commented, "While Chengdu still has considerable potential, the city has been the target of too much investment recently. It has simply been overdone, and this is especially obvious in the number of regional developers who have piled into the city to undertake downtown development commercial projects in Chengdu's emerging CBD area." This sentiment was echoed by the manager of a regional investment fund who was, however, slightly more upbeat about Chengdu's longer-term prospects: "Chengdu is a city that, like Shenyang, is facing what is emerging to be a considerable oversupply of high-end composite buildings in its CBD area. However, Chengdu is somewhat more hopeful than Shenyang because over the mid term, at least, it is likely to be rescued from this overhang in commercial stock by the fact that it is the most economically dominant city in southwest China. Many people not merely from neighboring cities in Sichuan but from the surrounding provinces and autonomous regions of Western China naturally flock to Chengdu as the nearest mecca for big business and high-end consumption."

Yet another experienced China fund manager expressed concern that the city of Chengdu was simply growing too quickly: "We are concerned about growing supply imbalance—a growing bulge in oversupply of high-end office, retail, and mixed-use commercial complexes, especially in the CBD. Like a replay of Shenyang, except that Chengdu has a more vibrant underlying economy and will be able to absorb excess supply somewhat faster. Town-planning changes occur too rapidly here and Chengdu keeps spinning off too many new satellite areas too quickly. Hard to avoid imbalances emerging when a city undergoes change as rapidly as Chengdu has undergone over the past five years."

Nanjing (9), Xi'an (10), and Qingdao (11)

Nanjing's and Qingdao's investment ratings edged up over last year's. But with other cities' ratings increasing more strongly, Nanjing's and Qingdao's rankings slipped slightly from last year's. Both of these cities' development ratings were essentially unchanged, with Qingdao's ranking also unchanged and Nanjing's ranking slipping a bit.

Xi'an, on the other hand, was stronger in both its rating score this year, 3.38, and its ranking, jumping from 17th to tenth place. Xi'an's rating score for development moved up slightly, rising from eighth to fourth place.

Regarding Nanjing, one fund manager with substantial investment in China noted, "There is larger room for action in Nanjing, as compared with Hangzhou or Suzhou. Nanjing is powerful enough to have its own satellite city [Changzhou] and so it possesses sufficient political clout and economic strength to produce a 'radial' effect. But Nanjing has not been subject to waves of investment by big regional developers, and has not gotten to the point where its market is getting overcrowded, as is now the case with Chengdu." So this would tend to confirm the view, which was expressed earlier, that with Chengdu's star having fully risen, cities like Nanjing, Wuhan, and Xi'an are now positioned to step up and occupy Chengdu's former rising-star position. This fairly positive view of Nanjing was corroborated by the fact that according to the SouFun-CREIS 100 Cities Index, residential prices have risen by 5.9 percent over the past 12 months.

When interviewed about the prospects of investing in or developing real estate in Qingdao, one national-level developer with substantial experience in the city's property market commented, "Qingdao is another scenic city that attracts buying interest from all over Shandong and other parts of northeast China due to its livability. Land prices in Qingdao are expensive in relation to the sales price of residential properties developed here and while property remains reasonably salable, the market is not nearly as competitive, deep, or liquid as Beijing's. Qingdao is one of the few coastal cities in China that are suitable for development of higher-end leisure-oriented property, which is something we would be unlikely to do under the current policy environment, given the fact that its strongest appeal would be precisely to the kind of buyers whose acquisitions the HPRs are intended to curb."

Xi'an has largely overcome its past reputation of having a less-than-transparent government. As the head of a major domestically based China investment fund commented, "Xi'an is a city that still offers great untapped potential. This is namely because of the strength of its educational base, which is reportedly the third largest in China, after Beijing and Shanghai. Hence, it has a large population of highly qualified engineers, scientists, and technical people. These people have traditionally worked in the government-backed defense R&D, avionics, and astronautics industry, but are now taking up employment with MNCs and big private domestic Chinese corporations as well. Hence, the vibrancy of Xi'an's high-tech sector creates an ongoing need to develop middle-class housing to house this growing cohort of qualified technical and professional people."

One Hong Kong–based developer with projects in China was very enthusiastic about Xi'an's investment prospects, stating that the "greater Xi'an/Xianyang area contains some 53 universities, colleges, and institutions of higher education, which collectively graduate nearly a million qualified engineers per annum, or more than all of the countries in the European Union put together. Hence, Xi'an, as a major R&D center for China's 'military industrial complex' and a central hub of national aviation and aeronautics industry, has an extraordinarily rich pool of human resources and therefore, given the city's attractiveness to corporate office occupiers, offers excellent prospects for developing office properties." The head of an investment advisory company was even more explicit, noting that "Xi'an's supply of high-quality office buildings is still relatively small, so there is definitely space for investment in Grade A office towers and similar types of accommodation for corporate front- and back-office operations." But the same investment adviser was more cautious about Xi'an's capacity to absorb high-end shopping malls, pointing out that "the overall level of discretionary spending per capita is still lower here than in some of the more advanced second-tier cities, so one would have to be cautious here about investing in the development of a regional or high-end shopping mall."

Chongqing (12), Xiamen (13), and Wuxi (14)

The rating scores for investment prospects for Chongqing, Xiamen, and Wuxi were similar—3.33, 3.25, and 3.23, respectively—and all three changed little from last year. However, due to the rise of many other cities, Chongqing's ranking fell from sixth to 12th place, while Xiamen and Wuxi shifted downward a few places to 13th and 14th place, respectively.

Chongqing's and Wuxi's ratings for development prospects decreased slightly to 3.39 and 3.29, respectively, but with enough other cities coming in with higher ratings, their rankings plummeted, with Chongqing dropping from fourth to 14th place and Wuxi dropping from sixth to 19th place. Xiamen's rating score for development prospects, on the other hand, increased slightly, with a consequent shift up to tenth place from ninth place.

Chongqing's ratings in last year's survey were directly affected by the Bo Xi Lai scandal as it peaked in the midst of the survey process. However, even now, more than one year later, some overseas funds still tend to shy away from Chongqing, with the head of one fund stating, "No need for us to place real estate investment in a city with such severe lingering 'headline risk.' While real estate prices may be cheaper in Chongqing than in Chengdu, and the market less heavily overinvested, nevertheless the Bo Xi Lai scandal still makes the kind of cornerstone investors who would inject major equity into our fund nervous. Of all industries, real estate development and investment are ones that are most closely linked with the municipal government. Scandal can also work in reverse—new government may give you problems because you chose the wrong partner from the group with links to the purged Bo Xi Lai faction."

China developers who were interviewed made no mention of last year's political events, but based their caution with respect to this market more on land prices, in the context of the present supply/demand balance for property in this city. One major merchant homebuilder made this point, stating, "As an aspiring economic gateway, Chongqing is much more recently emerged than Chengdu, but it has weaker economic fundamentals than Sichuan's provincial capital, which remains the major economic center of China's western region. Given the amount of development sites for both large-scale commercial and residential developments that have been released here in recent years, land prices here are relatively high and developers' margins are fairly thin. For this reason, and especially given the huge amount of residential supply both in the pipeline and carried forward, residential prices here seem to rarely rise, but rather always stay flat. Thus, whether advertently or not, Chongqing presents a major successful example of excess supply being used to dilute the residential market and thereby keep housing prices flat—which is precisely what the China central government wishes to achieve." This perception of the relative flatness of the Chongqing residential sales market pricing trend was further borne out by its residential price performance, which rose by 5.6 percent over the past 12 months but fell by 0.7 percent, viewed in the context of the past two years, according to the SouFun-CREIS 100 Cities Index.

Comments on Xiamen from some interviewees were very positive, despite the city's fairly neutral performance in the investment prospects ranking survey. One developer stated, "Xiamen is a city with a very bright future, since Xiamen, like other cities in Fujian, is positioned to stand, presently, on the 'right side of history,' and will emerge among the largest initial beneficiaries as political relations with Taiwan continue to improve and economic ties grow even closer."

However, the head of another fund management company cautioned that despite the city's very interesting geopolitical position, it is not an especially easy place in which to place investment capital, stating, "Along with progressively improving relations between Mainland China and Taiwan, Xiamen will gradually assume a higher profile and become an economically stronger and more dominant city, despite the fact that it is not the provincial capital. However, due to the clannishness of the southern Fujianese, speakers of the Minnan dialect have a distinct advantage in doing investment and development business in this city. Not an easy market to break into, unless you both have this cultural advantage and are properly introduced."

Wuxi is a city that is an economic powerhouse, second only to Suzhou in Jiangsu Province, but in 2013 it recorded a minor shift downward in ranking while clocking in at essentially the same score as the previous year. The Wuxi development market was one in which respondents expressed a degree of caution. As one of China's largest merchant homebuilders put it: "Wuxi is a vibrant industrial center and also an industrial satellite of Shanghai, but in a slightly farther orbit than Suzhou. However, from the perspective of developing residential property in Wuxi, land prices are rather high and sales prices of property are fairly low, so the net profit that developers earn in this market is not high. Also, because in recent years the Wuxi municipal government has been fairly aggressive in releasing new development sites, residential prices have remained rather sluggish overall and have risen only marginally, if at all. Hence, in recognition of this potential risk, we are cautious about the number of residential developments we will undertake in this city." The factualness of this quotation is borne out by the fact that Wuxi's residential prices dropped by -0.1 percent over the past year and by -7.1 percent over the past 24 months.

Another overseas investment fund manager commented on the pace of land released by the Wuxi government from the perspective of a more long-term investor: "In an East China context, the Wuxi government has behaved in a manner that is not that dissimilar to Shenyang. It has released too many land resources in recent years, and the pace of release has been much too fast. [It] makes long-term players like ourselves, who like to develop or acquire quality properties and then hold onto them for a period of time, discouraged to see the government's incautiousness cause the hemorrhaging of so much land value."

Ningbo (15) and Kunming (16)

Ningbo's investment prospects rating shifted upward slightly to 3.19 this year—enough to bring its ranking up to 15th from 19th place. And its development prospects rating changed little from last year, now at 3.30, as did its ranking, shifting up to just 17th place from 18th.

Given the fact that Kunming was new to the survey in 2013 but came into the ranking in a very middling position, directly behind Ningbo at number 16, the question is raised as to why the city did not rank more highly given that it is the capital of a province with considerable mineral and agricultural wealth and furthermore occupies an important and sensitive geopolitical location, being positioned to serve as a major trade entrepôt and transportation hub with Vietnam, Myanmar, and Laos. One domestic developer who knows the city well commented, "Despite Kunming's pleasant climate and relative affluence, the lack of transparency and the complexity in dealing the city's real estate market is well known, especially given the squabbles that have recently broken out between its urban construction company and the municipal government with respect to a change in zoning for the primary development of a huge site fronting along the city's suburban Dianchi Lake."

One Shanghai-based national developer made this interesting comment about Ningbo: "While Hebei has always positioned itself as Beijing's 'parlor maid' ready to heed its mistress's beck and call, Zhejiang made the mistake of imagining itself as Shanghai's equal, rather than its supporting hinterland. As a consequence of the somewhat cool relations that came to subsist between the province and Shanghai, some of Zhejiang's major policy initiatives, such as the urban regeneration of downtown Ningbo, did not receive as enthusiastic support from the larger YRD economic region as had been originally hoped." While many interview respondents had no definite views of the city's investment prospects, a few expressed cautious interest. As one Hong Kong–based developer with investment in China stated: "As the world's second-largest deepwater port, after Shanghai, Ningbo definitely has potential for real estate investment and is worth exploring, especially its sizable inner-city urban regeneration area. However, the Ningbo market is highly cyclical. So, one must be careful to hit the cycle at a moment of relative weakness."

One major national-level merchant homebuilder was a bit more cautious with respect to the depth of the Ningbo residential sales market: "Ningbo is a wealthy and economically important city, and moreover is Zhejiang Province's only major seaport city. However, despite all of these advantages, Ningbo remains a city that attracts relatively little inward migration and hence its population is not growing rapidly. For this precise reason, while the city has a definite quantum of annual demand for medium- to higher-end residential units, it is not likely to expand rapidly in the short- to mid-term future."

Changsha (17), Zhuhai (18), Dalian (19), Fuzhou (20), and Sanya (21)

The investment prospects ratings of these five cities fell squarely in the middle of all city ratings, ranging from 3.16 down to 3.04, or just barely above a "fair" rating. The ratings for Dalian and Fuzhou fell just slightly from last year's and their rankings slipped a bit. The investment ratings for Changsha fell more and its ranking fell from tenth to 17th place (or 16th among only the cities included in both this year's and last year's surveys). Sanya, on the other hand, saw its rating score improve somewhat and its ranking improve four places (or six places among only the cities included in both this year's and last year's surveys).

Zhuhai is new to the survey this year but came in at number 18 under investment prospects, while scoring much more highly at number 10 under the development prospects ranking. Zhuhai is a city that respondents approached with caution mixed with some interest in its development potential, as indicated by the discrepancy between its ratings as an investment destination as opposed to a target for real estate development. As one Guangdong-based developer who is well familiar with Zhuhai commented, "While Zhuhai is popular with affluent northern Chinese as a leisure travel destination, as a city of only 1.5 million people it does not have a strong underlying industrial base or the weight of demographics that Guangzhou and Shenzhen possess. Also, while Zhuhai may share a common border with Macau, Macau itself possesses only a fraction of the economic importance of Hong Kong, so the direct benefit that Zhuhai derives from its proximity to the former Portuguese enclave is nothing on the order of the benefits that Shenzhen has enjoyed from its symbiotic relationship with Hong Kong." When queried as to what type of property could be most suitably developed in Zhuhai, the same developer opined, "Frankly speaking, Zhuhai is a city most suitable for developing leisure-oriented investment properties, a property type that is not in favor under the current atmosphere of reining in luxurious excess."

From the point of view of the middling ranking and scores for development prospects that were received by Changsha at number 16 (3.32), Zhuhai at number 10 (3.50), Dalian at number 21 (3.18), Fuzhou at number 18 (3.29), and Sanya at number 25

(2.96), these were all markets that respondents viewed as being attractive to a certain extent, but about which they also had certain reservations. With respect to Zhuhai, it was because the development market has been prone to speculation in the past and is viewed as being most suitable for luxury/leisure/active-retirement housing; Changsha due to recent concerns about the potential for residential oversupply due to lax husbanding of development land resources; Fuzhou due to the city's insularity and relative slowness in attracting outsiders to its economy; Dalian due to the relative lack of depth of local demand for mid-market housing; and Sanya, which some have begun to view as mostly a happy hunting ground for emerging distressed opportunities in resort/leisure-time residential development.

One domestic Chinese development company tended to take a cautious view of Changsha, noting that the present risk level of undertaking development projects in Changsha is not low: "Changsha is a dynamic city, but right now it is suffering from a serious oversupply of development sites, which is directly the result of the fact that the government has been too loose in exercising control over land resources. Because of oversupply, the market is fragile and has become vulnerable to any downturn in the residential sales market cycle."

Dalian was similarly a city that produced somewhat conflicting comments from interviews, with some interviewees still setting considerable store by the potential of the city's retail sector, but with others expressing greater reservations about the city's residential sales potential. A senior executive with one Mainland developer stated, "While Dalian has targeted knowledge-intensive, high-tech industry as an area where it wishes to attract numerous companies with attendant fast job growth, it has been much less successful in this respect than cities like Chengdu, so the market for middle-class housing in Dalian is not especially deep, and hence one must be careful not to go overboard here with the scale of a middle-class residential development for sale." According to the SouFun-CREIS 100 Cities Index, residential prices have experienced a mild bump up of 1.2 percent over the past 12 months.

Fuzhou was yet another city in which respondents expressed less interest in the 2013 survey than the 2012 survey, such that the city fell four places and was also awarded a lower score. As one China developer who has previously launched residential sales developments in Fuzhou commented, "Fuzhou is a fairly affluent city that has many characteristics that are similar to Ningbo, in that it has a fairly large population of wealthy individuals, but the city is insular and its development market is very hard for outsiders to break into. Also, unlike more outwardly oriented and economically vibrant Xiamen, Fuzhou is a city that is not expanding quickly and hence is not an irresistible magnet to outsiders. Therefore, from a developer's point of view, one would have to approach undertaking large-scale residential development projects in this city with a high degree of caution."

In the case of Sanya, investment and development prospects are not so easily separated, since in the pre-2010 period, prior to the meltdown, the city attracted developers keen to develop five-star hotels embedded within larger resort projects. A substantial portion of these projects also contained condominium residential developments for the purpose of creating short-term cash flow, given that the resort elements are both seasonal and also require longer to break in.

However, while Sanya's residential market was distinctly "off the boil" when the 2012 survey was conducted, it was only after the recent substantial consolidation in this resort/condominium market, with residential prices having declined by 12.8 percent over the past 12 months, according to the SouFun-CREIS China 100 Cities Index, that respondents began to consider Sanya as a source of distressed development projects. To this point, the head of strategy for one overseas investment fund commented, "Recently, the fund has been bombarded with opportunities to take equity in distressed or at least financially pressed holiday resort and resort-come-luxury residential developments in Sanya. This is not surprising, since along with the decline in luxury residential prices in Hainan in 2012, there has been a shaking out in the market for these kinds of development projects. However, we have not pursued these opportunities, despite their attractive pricing, because this kind of development is not well aligned with our investment strategy."

Lowest-Rated Cities (22–36)

The remaining 15 cities were all rated below 3.00, or having less than fair prospects for investment. Of the nine cities that were also rated in last year's survey—Tianjin, Haikou, Harbin, Shenyang, Nanning, Wenzhou, Urumqi, Shijiazhuang, and Lanzhou—all but Haikou's rating declined. The most significant declines were for the prospects for Urumqi, Shijiazhuang, and Lanzhou, all of which were rated "poor" or worse. Haikou's rating increased just slightly.

Tianjin—where residential prices rose by 1.4 percent over the past 12 months but declined by 3.7 percent over the past 24 months, according to the SouFun-CREIS 100 Cities Index—is a city where a very experienced fund manager stated he would prefer to avoid at present: "The Binhai Financial District is a story that Tianjin has been telling for too long now, and people have lost interest in listening to it. Binhai comes off poorly as compared with the Shanghai Pudong Lujiazui Financial District, which it was clearly designed to emulate. The difference is that in 1990, Pudong had 100 percent central government backing to emerge as China's preeminent financial district, whereas there was obviously conflict at a high level in the central government about awarding a similar advantage to a city so near Beijing but which has long been its 'sibling rival.' Even the more middling success of Guangzhou's still-maturing Pearl River New City, which at least had the wholehearted support of the Guangdong provincial government, still compares favorably with Tianjin Binhai Financial District, which ultimately seems to have received the full support of only the Tianjin municipal government. While we regularly acquire underperforming assets, we only do so when there is some hope of ultimate turnaround, the time frame for which in Tianjin is still unclear."

Another developer whose core business is merchant homebuilding presented a slightly more balanced but still cautious view of Tianjin: "Tianjin is a city with a very strong industrial base, containing a huge high-tech manufacturing sector, and very much relates to Beijing the way that Suzhou relates to Shanghai, as an immediate, outlying industrial satellite. Tianjin has a large population and also attracts many talented people, so this is also in its favor. However, what is not in its favor is that its municipal government has released too much land in recent years to establish new satellite commercial areas, such as the Yujiapu Financial District within the larger Binhai New Area, which are purely speculative to begin with and hence easily prone to oversupply. Hence, while we have undertaken residential developments in Tianjin in the past, we are now only very selectively interested in residential development opportunities in this city."

One of the largest merchant homebuilders chalked up the problem with developing property in Harbin to the city's extremely frigid climate, which persists for approximately six months of the year. He noted, "Harbin is in many respects a charming, medium-sized city. It does not have an especially large population, and is also not especially affluent by China standards, but it does have a lot of cultural heritage buildings from the period in the early 20th century, when the city had a sizable Russian community. The main problem with the city is that it experiences six freezing months every year, when temperatures can go as low as -38 degrees Celsius, and this effectively means that there are six months a year when one can develop property and also easily market or sell property. However, because interest on bank loans is due year round, this creates a situation that makes Harbin a much riskier place in which to undertake development than other similar-scaled cities with milder climates."

A manager of a Hong Kong–based fund that exclusively invests in China provided a very balanced view of Shenyang: The investment prospects of Shenyang have been seriously affected by the serious overbuilding of its commercial market. It was the influx of so many major regional developers who launched very sizable mixed-use developments in the main business district in the post-2003 period without doing market research about the city's supply/demand dynamics which caused this. The surge in development activity that they sparked knocked the supply/demand equation for large-scale composite buildings completely out of whack.

However, one national-level developer who launched multiple residential projects in Shenyang in the past noted, "People who completely despair of Shenyang's potential as a residential development market due to a temporary supply imbalance lose sight of the fact that as the capital of Liaoning Province, the Shenyang residential market has a very sizable catchment area, which includes all of the larger cities on the Liaoning Peninsula. So mid-market housing in Shenyang still has potential, although, of course, one has to be cautious." The fact that it is too soon to write off Shenyang's potential as a mid-market housing market is borne out by the fact that housing prices in the city rose by 2.4 percent over the past year and by 18.5 percent over the past 24 months, according to the SouFun-CREIS 100 Cities Index. While residential price appreciation over the past two years in Shenyang has been quite robust, it should be noted that prices rose from a fairly low level, with the average price of private housing stock in Shenyang, at RMB 7,546 (US$1,229) per square meter as reported by SouFun-CREIS in March, being only about 50 percent of the average price reported for Hangzhou in the same month.

Wenzhou was a city that produced feelings of reluctance about getting involved, rather than caution, as one manager of a large overseas private equity fund stated somewhat humorously: “Wenzhou is not our cup of tea. Although Wenzhou indeed has a dense concentration of high-net-worth individuals, partner risk in this city is exceptionally high. And furthermore, since the Wenzhou people are renowned in China for their entrepreneurial skill, if they are clever enough to establish a factory exporting handbags to Europe, buttons to the Middle East, and zippers to South America, they can darn well buy a plot of suburban land and commission the design and construction of their own ideal dream house.”

Yet another fund manager interviewed stressed the insularity of the city and the peculiar fact that their own hometown seems to be a city that they are less keen on investing in: “The Wenzhounese are a clannish bunch and highly entrepreneurial. If they succeed in making money in business, they prefer to take their fortunes and invest them in real estate in Shanghai and Hangzhou, which in their opinion have greater potential for long-term growth in value than their hometown, while maintaining a small base in Wenzhou itself purely for running operations.”

While most of the respondents to both the questionnaire and the interview process shied away from the prospects of investing in Wenzhou, there was one strong, lone dissenting opinion, voiced by the head of business development for a Mainland China developer: “As home to 400,000 private enterprises, Wenzhou is the most aggressively capitalist city in Zhejiang Province and contains its largest concentration of private enterprise. So the city is both an affluent and dynamic place, but one that has been hobbled, from the point of view of undertaking commercial development, by the fact that it is the unofficial center of China’s notoriously unstable underground banking industry. However, now that the central government has moved to legalize Wenzhou’s private banking sector, the city’s potential for eventually achieving economic liftoff has been greatly enhanced.

“If China would remove the final constraints on the private banking system by loosening state control over interest rates and permitting experiments with directly opening the capital account, all of the conditions would have fallen in place to develop a Pilot Financial Reform Zone, alongside the historical city’s aging core, like a smaller version of Shanghai’s Pudong Lujiazui. And in fact, this is precisely what we intend to do.” In light of the report carried by Reuters on May 6 stating that the State Council has called for the drafting of a detailed plan for achieving full convertibility of the renminbi (RMB) under the capital account along with a specific time schedule, time may yet prove that the company that was willing to place a bet on Wenzhou had made a prescient move.

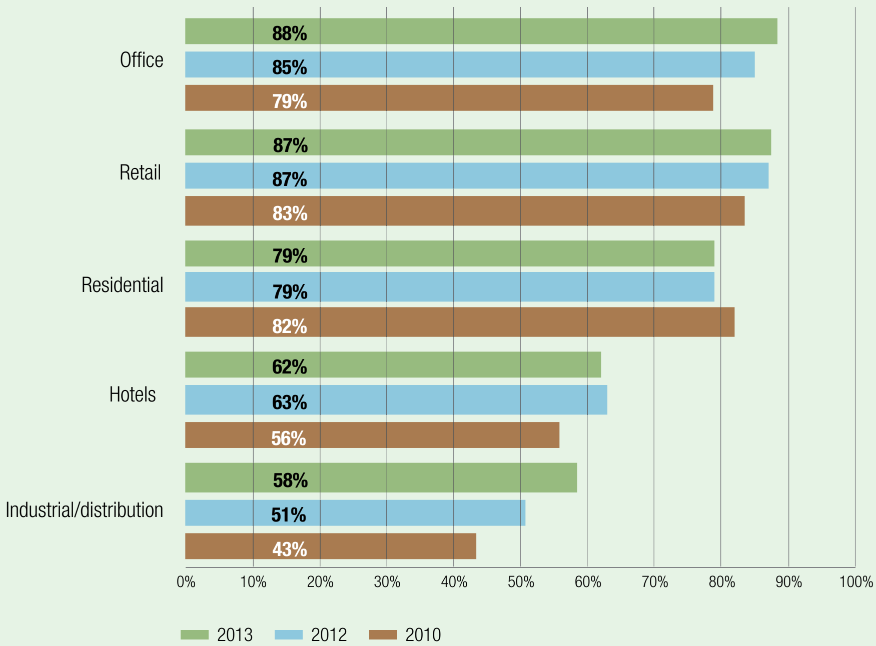
CHAPTER 2

Trends in Sector Engagement

Respondents were asked in which of five sectors—office, retail, residential, hotels, and industrial/distribution—they were currently engaged. The profile obtained was compared with the previous years' answers about sector involvement to provide an overview of changes from 2010 to 2013. Respondents were also asked about expected changes in their involvement in 2014. These changes reflect certain key trends.

EXHIBIT 2-1

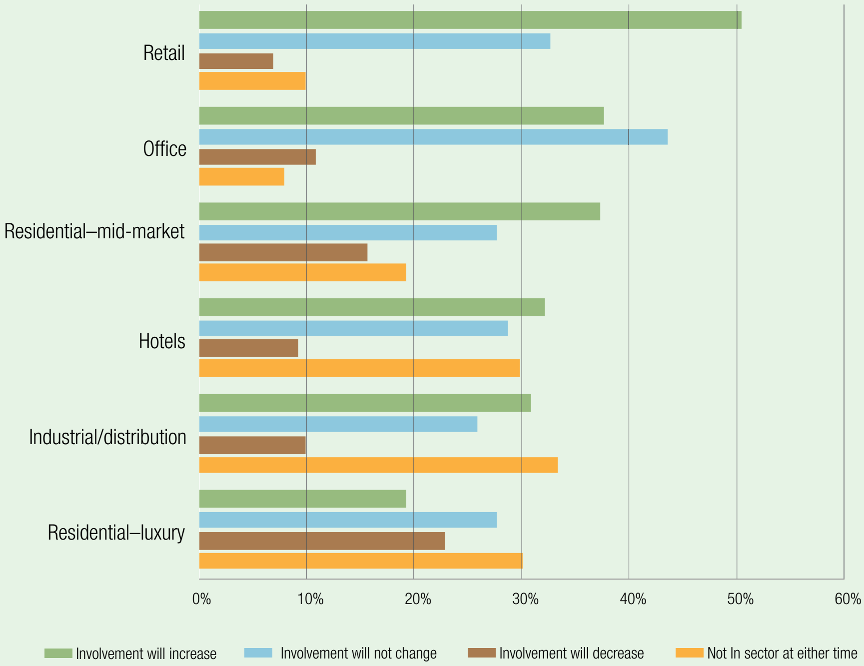
Sector Involvement by Percentage of Respondents



Sources: Mainland China Real Estate Markets *2012 and 2013 surveys.*

EXHIBIT 2-2

Expected Change in Sector Involvement from 2013 to 2014, by Percentage of Respondents



Source: Mainland China Real Estate Markets 2013 *survey.*

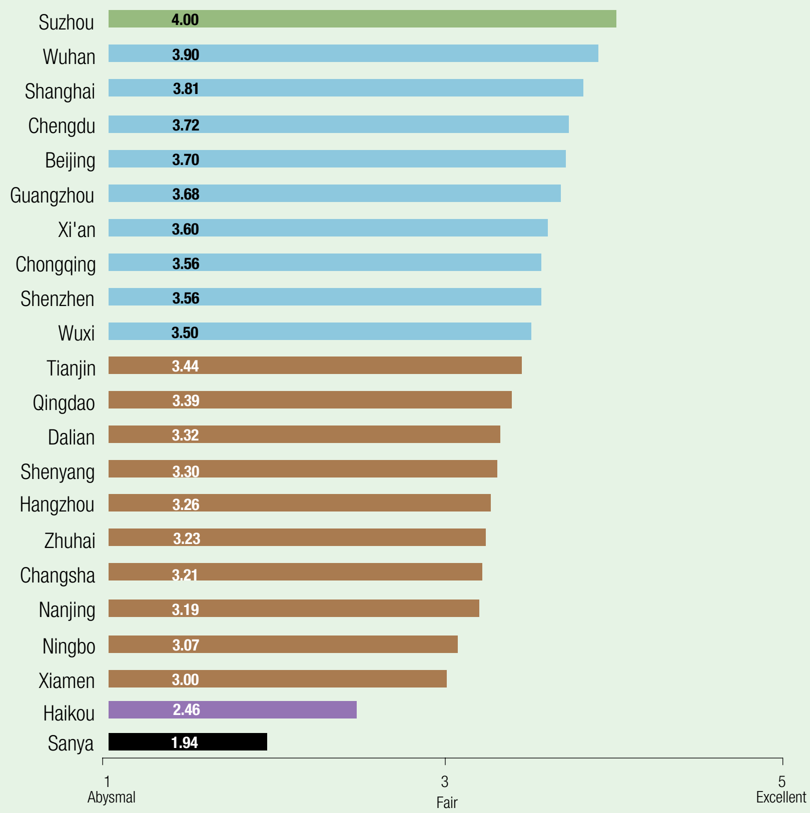
Industrial/Distribution

The biggest changes have taken place within the industrial/distribution sector, with involvement increasing from just over 40 percent of the survey respondents in 2010 to almost 60 percent by the end of 2013. Reponses reflect a broad and growing interest in the industrial/distribution sector, responding to China's critical lack of modern warehousing and distribution facilities. Demand for such facilities is growing dramatically. For example, the China Internet Network Information Center (CNNIC) reported RMB 1.3 trillion (US$212 billion) in transactions made through e-commerce in China in 2012—an increase of 66.5 percent over the 2011 total and accounting for 6.1 percent of total retail sales in China.

Still, despite huge frustrated demand for logistics sites, local governments have maintained constraints on ready entry into the sector. A senior executive in one logistics company operating in China commented, "Local-level government land authorities simply do not release a sufficient quantum of land annually that is specifically zoned for the purpose of developing logistics facilities." The same executive went on to explain that "China will never attain its goal of raising domestic consumption to account for the large majority of GDP [gross domestic product] without fundamentally changing the quota system for release of logistics-zoned land at the local level. Under the present system, local government authorities have little incentive to release land for logistics use. Being zoned for industrial use, logistics sites fetch only a fraction of the premiums

EXHIBIT 2-3

Commercial Sector Prospects: Industrial/Distribution



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for industrial/distribution sector prospects are not included.

commanded by commercial or residential development sites. Also, logistics industry makes little, if any, contribution to the local tax base, in terms of paying VAT [value-added tax]. Furthermore, the logistics industry generates relatively few jobs in the local economy and the fleets of diesel-powered trucks that service logistics facilities pollute the environment and tear up local road systems."

Looking forward, more than 30 percent of the respondents plan to expand their involvement in the industrial/distribution sector in 2014. However, for many respondents this will remain just an aspiration due to the difficulty of logistics site acquisition described above.

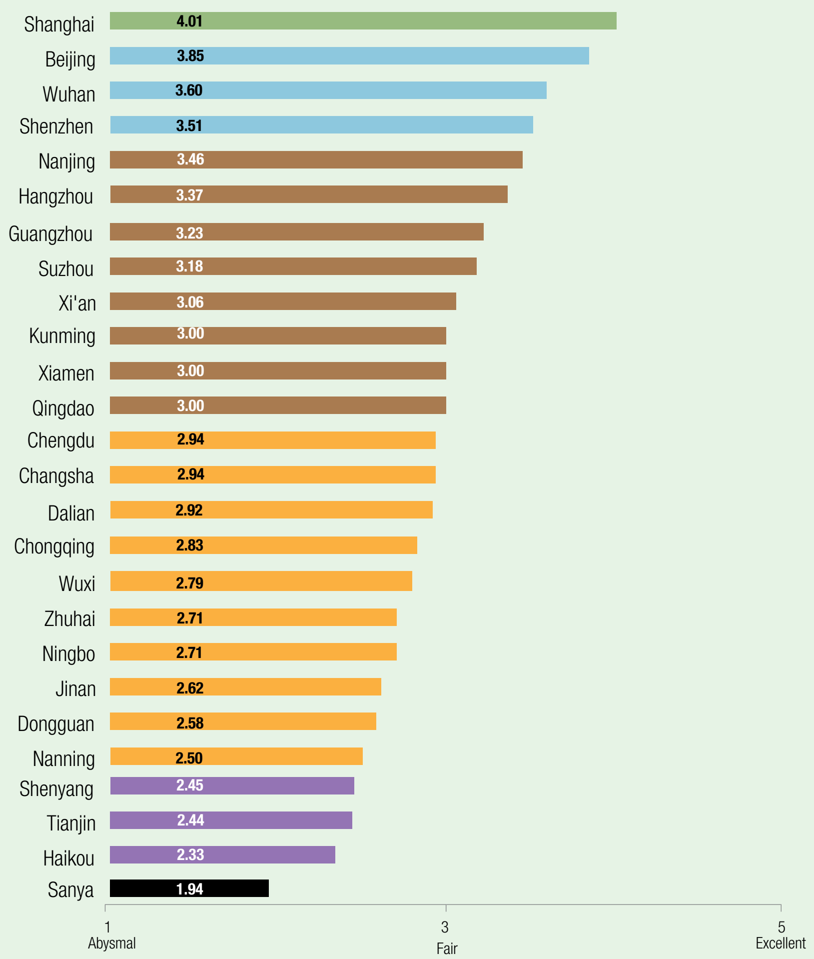
In ranking city prospects by sector, survey respondents placed Suzhou at the top for industrial/distribution. With a GDP of RMB 1.071 trillion (US$174.4 billion) in 2012, Suzhou is an industrial powerhouse that has the sixth-largest GDP of any major city in China. Moreover, the recognition of the city's role as the largest industrial satellite of Shanghai and as the center of Jiangsu's manufacturing heartland was certainly a factor in respondents' ranking Suzhou highest of all cities for investment/development prospects in logistics and warehousing.

Office

Involvement in the office sector has also stepped up. However, given the high rate of involvement in 2010—at almost 80 percent—change has been at a slower pace. Almost 90 percent of respondents expect to be involved in the office sector by the end of 2013. Furthermore, looking forward, almost 40 percent of them plan to expand their involvement in the office sector in 2014, due to the influence of a number of different factors. The change in many cities' land release planning is also a factor motivating the development of more commercial space, as local governments now are commonly requiring the development of a larger percentage of commercial gross floor area (GFA) within the planned mix of end uses in the release of commercial/residential sites. One investment fund manager noted, "Nominally, this shift was initiated by the Ministry of Land and Resources and is part of a larger effort to wean municipal

EXHIBIT 2-4

Commercial Sector Prospects: Office



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for office sector prospects are not included.

governments from being overly reliant on sales of residential sites as the principal source of municipal revenue, but rather to use the tools of land development zoning to encourage development of more office, retailing, and hospitality space, so as to create a better operating environment for business and provide a boost to the local economy." However, local governments' shift in this respect also supports the central government's recent directive that fixed-asset investment should be more focused on facilities that increase domestic consumption. Municipal governments also understand that by attracting more companies to set up business in their localities, they are making moves that will broaden the municipal tax base.

However, this shift in planning is motivating a new wave of development of office properties, retail malls, and arcades within mixed-use buildings. As one fund manager explained, "For well-positioned, well-leased shopping malls in first-tier or second-tier cities, numerous possible exit strategies exist. However, office properties, unless they are prime assets in first-tier cities, by contrast, are harder to exit from. In second-tier cities, there is a real limit as to what most occupiers are willing to pay for rent, regardless of how well a given property is specified or managed. This means that regardless of one's entrance cost in acquiring an asset, there are *real* restrictions on growth in cap rate that one can achieve upon final exit." The fund manager further explained, "Because of their potential for rental growth, these restrictions do not exist for Beijing, Shanghai, and Shenzhen, and increasingly also impact less on Guangzhou, the latter city having recently improved in this respect as well." As a consequence of this shift in the environment for merchant homebuilding, some developers have hit on the idea of selling strata title office units as an alternative development sales product. Taking a page from the playbook of Beijing-based SOHO China, which turned over the keys of its Jianwai SOHO small office/home office units to owners in Beijing in 2003, a number of developers have begun taking office floors in mixed-use buildings and dividing them into small office/home office units, which can effectively be sold as studio apartments. This has permitted some developers to offer these SOHO products for sale in cities where they would be otherwise not be keen to develop office floors for long-term hold.

As the head of one China-based investment fund related, "The attractive feature of these SOHO units is that they are not subject to HPRs and can be sold off as bachelor studios, suitable for both living and working in. Furthermore, they have a ready market in many first- and second-tier cities, with their only major drawback being the fact that they can provide only electricity, rather than gas, for cooking and heating water, and this is charged at unfavorable higher commercial rates."

However, despite the challenge that this change in planning is creating for developers, the fact remains that developing condominium residential properties in China is a simpler business.

Hence, in markets where they have more clout, developers may attempt to negotiate with local government on the exact mix of end uses on development sites, and in these negotiations, the cards are not necessarily stacked entirely in the local authorities' favor. Rather—in smaller cities, at least—the situation is sufficiently fluid that developers can sometimes turn the situation to their advantage. As the head of one investment fund noted, "Regarding emerging smaller cities, if a city ticks all of the boxes, we may, on a selective basis, be willing to take risks on behalf of the local government by putting key development projects in key areas where they are needed, such as a new composite building to support recently completed HSR [high-speed rail] stations. In some instances, local governments can provide substantial discounts on land costs to build the commercial elements of mixed-use projects if they are useful in establishing an area for which no clear demand currently exists, thereby alleviating the investor's 'first mover' project risk."

Another fund manager commented, "Now it is more typical that government will mandate a mix of 60 percent residential and 40 percent commercial in many of the second- and third-tier cities in which we undertake development. However, in some smaller cities where we have more clout with local government, the residential component can be negotiated back up to 65 percent."

Yet another developer whose residential sales business has been fairly substantially affected by this change noted that "the actual practice of the change that has really occurred is not that simple. Firstly, along with the change in zoning, compelling development of more commercial floor area, there is also the growing practice, in some cities, of awarding land tender not necessarily to the highest bidder, but rather to the most 'socially responsible bidder.' However, this tactic can be used to camouflage a bidding process for land which in some instances is becoming less transparent, since city governments can attach specific conditions for compliance with the parameters of the tender that only a select group of developers close to the local government could be entirely familiar with." Hence, not only is the residential sales market becoming exposed to increased levels of regulatory risk, but local policy risk/transparency risk with respect to the land tender market is certainly also not on the decrease.

Finally, there is a growing concern that the new zoning practice will simply lead to future supply imbalances. As one developer observed, "Because sites that were formerly zoned as 90 percent residential and 10 percent commercial are now being zoned 60 percent residential and 40 percent commercial, this will predictably lead to a huge bulge in supply of commercial properties, with some developers now being compelled to develop types of commercial property in second- and third-tier cities that do not necessarily have an immediate need for the end uses specified in the site planning."

The fact that Shanghai received the highest ranking for office investment/development prospects is by no means surprising. Shanghai and Beijing are by far the two largest, deepest, and most liquid office leasing markets in China, and are the two cities where the preponderance of major Chinese corporations and multinational corporations (MNCs) have their national headquarters—with some companies effectively maintaining headquarters in both cities. One Hong Kong–based developer summed up the importance of

Shanghai, stating: “Shanghai is the one key, indispensable city where one must be, as a developer and holder of core real estate assets in China. As a city that will predictably continue to add value to itself, it will eventually emerge as a world-class city, joining the ranks of New York, Tokyo, and London.”

Hotel

Involvement in the hotel sector in 2013 decreased over last year’s, and was the only sector to show a decrease, though just a slight one. This response confirms a growing avoidance of deeper involvement in the China hotel sector, with many interview respondents noting the growing oversupply of luxury hotels in first-tier and stronger second-tier cities. Beijing and Shanghai, for example, both brought on a huge quantum of luxury hotel properties to prepare for the surge in visitors during the 2008 Summer Olympic Games and 2010 World Expo events, respectively. While these events have passed, the hotel rooms remain.

That only Hangzhou and Sanya came out as clearly top preferences in the hotel sector is certainly due to the fact that Hangzhou’s West Lake is one of the greatest scenic attractions in China, and subtropical Sanya enjoys the status of being the Middle Kingdom’s favorite “sun, sand, and surf” destination.

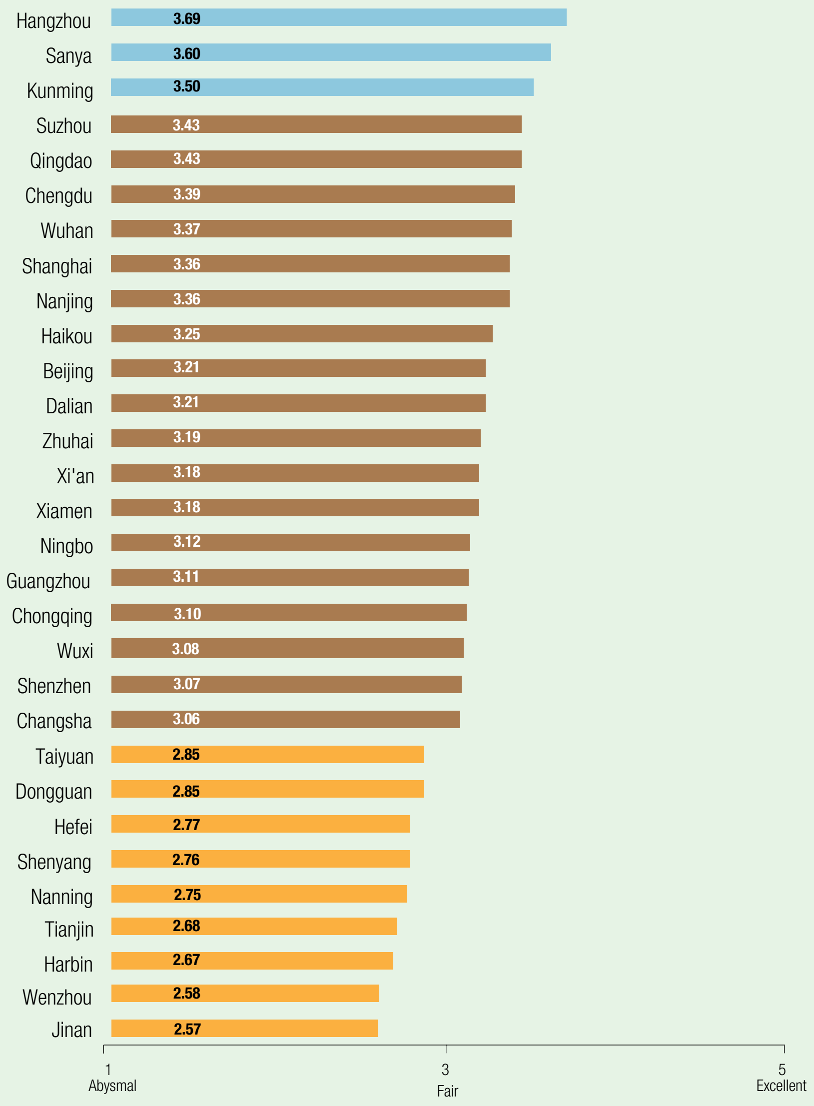
Hangzhou, however, was generally viewed by respondents as being a difficult city in which to invest in the hospitality sector at present. As one investment fund manager related, “Fantastic city, but land prices are not at all cheap and viable sites are hard to find.” Similarly, Yalong Bay in Sanya has witnessed the completion and commencement of operation of more than 20 hotels in the past decade, so the city is neither suffering from a shortage of hotel rooms nor does it offer many beachfront sites that could be acquired at prices that make commercial sense.

A significant proportion of the interviewees who had expressed interest in hospitality were interested in developing certain kinds of “niche” hospitality properties targeted at affluent city dwellers keen on escaping the smog and plunging temperatures of wintertime and year-round traffic congestion of cities such as Beijing, which one interviewee cynically classified as “lung clearance” real estate.

While many developers of such “health-restoring retreats” certainly planned to provide hotel accommodations for short-term visitors, most also intended to build villas or serviced units for sale, under hotel rather than residential title, thereby enabling their purchase to fall outside of the HPRs. For developers, this strategy provides the benefit of also generating some immediate short-term cash flow, giving the resorts time to be properly promoted and broken in. While some of these weekend escape resorts were as close to their customer base as the distant suburbs of major cities such as Beijing or Chengdu, more typically they were located in places of great natural beauty, which have been completely unaffected by problems of pollution, industrialization, and urbanization, including locations such as Xishuangbanna, Shangri-la, and Pu’er

EXHIBIT 2-5

Commercial Sector Prospects: Hotel



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for hotel sector prospects are not included.

in Yunnan; Huangshan in Anhui; Changbaishan in Jilin; Yinchuan in the Ningxia Autonomous Region; and Yangshuo in the Guangxi Zhuang Autonomous Region.

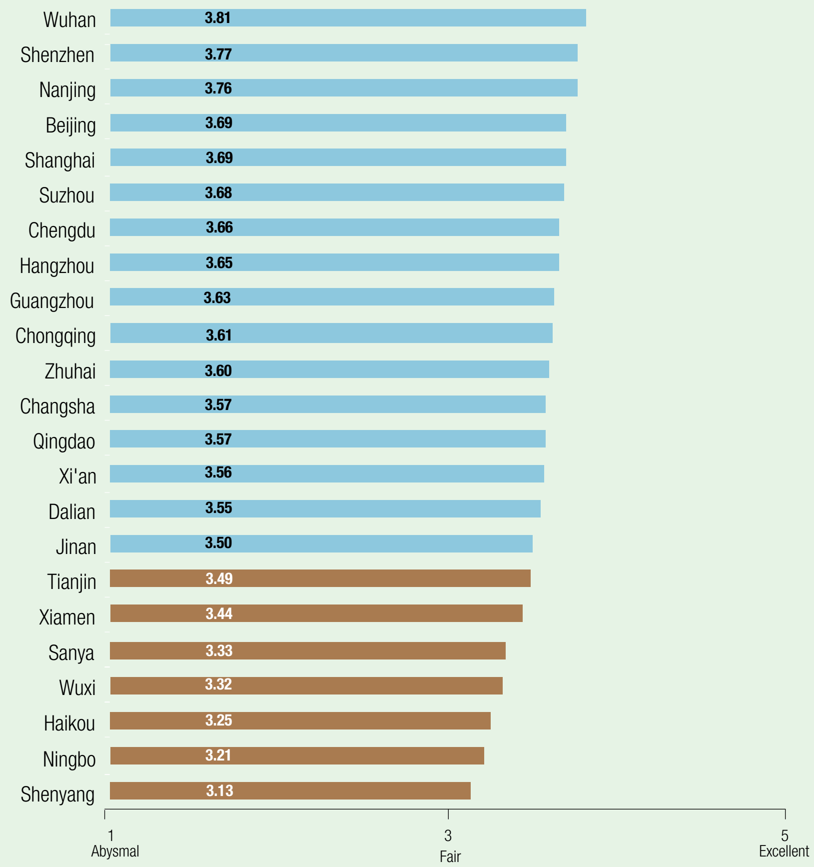
Other companies that mentioned that they were in the midst of developing or planning to develop such resorts also combined their "back to nature" projects with historical conservation, or with preservation of traditional ethnic minority folklore, lifestyle, and customs, targeting active retirees or Chinese urbanites whose workaday existences are spent within the air-conditioned glass-curtained walls of high-rise office towers.

Residential

The results of the questionnaire survey demonstrated that intentions with respect to involvement in the residential sector remain stable this year (2012–2013), after a slight decrease from 2010 to 2012. In the *ULI 2013 Mainland China Cities Survey*, mid-market housing was the only sector in the survey in which 17 cities—or just half of the cities surveyed—were awarded scores of 3.5 or above, with respect to their development prospects. Looking forward, over 30 percent of the respondents said that they plan to expand their involvement in the mid-market residential sector in 2014. Only 19 percent, however, plan to expand their involvement in luxury housing, the smallest relative percentage out of all sectors where expansion is sought. Furthermore, 23 percent plan to decrease their involvement in luxury housing, the highest relative number of all sectors in which respondents stated that they were seeking to be “less involved.” So, how to explain this divergence in interest level in developing medium-end and high-end housing in China?

EXHIBIT 2-6

Mid-Market Residential



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for mid-market residential sector prospects are not included.

First, operating as they do in a market that is as highly politicized as China's, domestic developers have to be masters at "trimming their sales to suit the prevailing winds" in order to survive. In China, since 2003—but with progressively increasing intensity up until 2010, when the central government launched the present residential market cooling campaign, which is still underway—the central government has devoted great effort to try to curtail the continuous capital appreciation of urban private housing, with former Premier Wen Jiabao having made statements to the effect that "[striving to contain residential prices] is not merely an economic struggle, but is rather a political struggle." While the phenomenon of continuous capital appreciation of housing has affected both mid-market as well as high-end properties, the fact remains that the preponderance of investment funds have been targeted at acquiring higher-end properties.

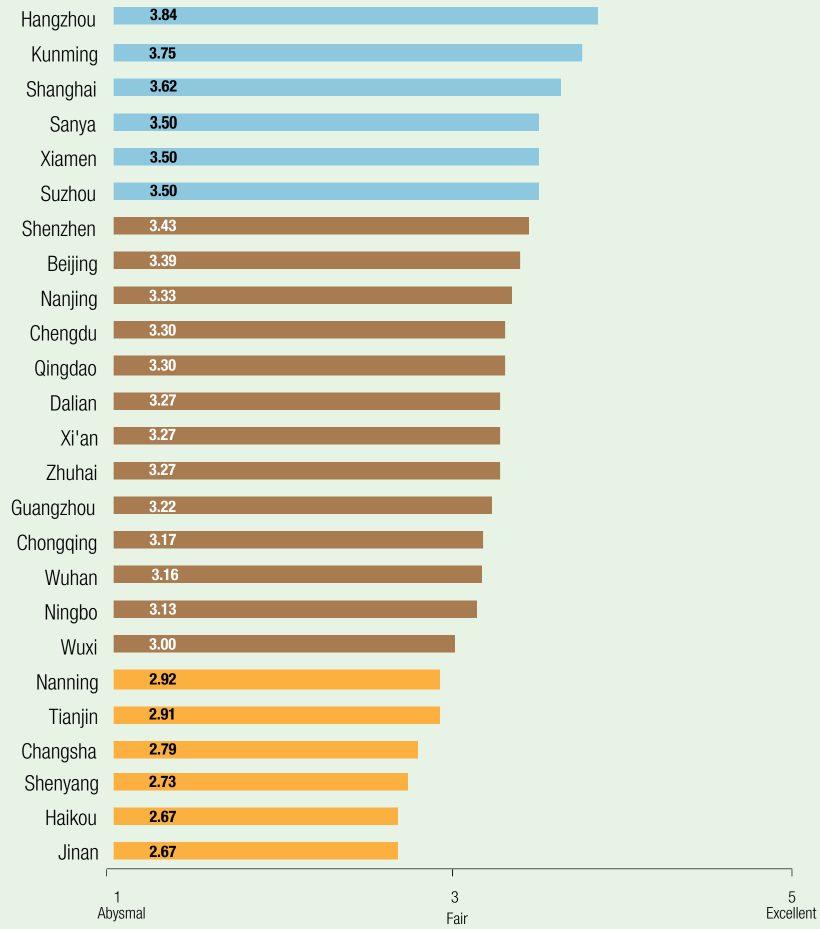
For the past four years, China's central government has been engaged in the somewhat tricky balancing act of trying to encourage development of "ordinary housing units" targeted at first-time homebuyers and occupiers, while adopting a much cooler attitude toward the development of high-end/luxury residential properties, especially those not targeted for sale as primary residences. The situation was exacerbated by the fact that Xi Jinping began his presidential term by launching an anticorruption campaign, in which a number of provincial- and municipal-level government officials were "found to own luxury residential assets whose value was incommensurate with their salaries as public servants."

Hence, as was clearly demonstrated by the *2013 ULI Mainland China Cities Survey*, in which 23 percent of respondents stated that they plan to decrease their involvement in luxury housing, developing high-end residential property in China has taken on the aura of being "politically incorrect." As one major national-level merchant homebuilder confessed: "In the past, on the relatively rare occasions in which we had deviated from our mainstream activity of developing mid-market housing toward developing luxury product, we always ended up regretting it. For instance, several years when we made our first venture into the super-high-end Tier 1 detached townhouse market, we got badly burned by market volatility and ended up with a substantial number of unsold units on our hands."

However, People's Republic of China (PRC) developers—especially the state-linked developers and financially strong private developers with large existing development portfolios and land banks—are, in nearly all cases, longstanding "political survivors." As such, they know how to ensure that their business not merely survives but indeed prospers in the midst of campaigns such as the current prolonged residential market cooling initiative. Hence, despite this constant seesawing in the regulatory environment, one senior executive in a major homebuilding company noted, "From our point of view, China's residential sales market is the deepest, most liquid, and most profitable residential market in the world and also the market with the best long-term prospects." And then in the next breath, the executive mentioned that the present campaign to clamp down on speculation while ensuring an adequate supply of housing targeted at middle-class

EXHIBIT 2-7

Luxury Residential



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for luxury residential sector prospects are not included.

urban wage earners presented no problem whatsoever from his company's point of view, since "our company, from its very inception, has taken as its core competence the development of mid-market housing for China's urbanites to occupy as primary residences."

However, it should be noted that the whole subject of the suitability of investing in or developing residential sales properties is the one concern where many domestic Chinese developers diverged most sharply with overseas fund managers, who are not well practiced in the fine art of Mainland political gamesmanship. The view of a number of overseas private equity fund managers, who have no special predisposition to invest in the residential sector, was succinctly stated by one senior fund manager: "We have deliberately shifted over the past year to shrink our exposure to China's residential sales sector. Right now, from our perspective, this sector represents a bad combination of circumstances: increasingly competitive market conditions, presence of larger developers who have become quite liquid and cashed up, and all of this is taking place against a backdrop of a gradual slowdown in residential sales caused by the continued imposition of HPRs, credit tightening moves, and the threat of wider imposition of new capital gains taxes. All of this adds up to create an environment that is both volatile and also less accommodating to residential sales."

It is important to note that the China residential sales market has basically been in a state of mild rebound since the commencement of the second half of 2012, following the two successive cuts in the benchmark lending rate, which occurred at the time, and the double-digit rise in bank lending, which was witnessed in the ensuing months. Furthermore, the resurgence of these high levels of liquidity in the China residential market has been actively beneficial to major listed PRC developers, many of whom have taken advantage of these more upbeat circumstances to issue corporate bonds and replenish their land banks, making acquisitions either via primary land tender or auction or by acquiring development portfolios from smaller, financially pressured developers. Against the backdrop of these more buoyant market conditions, asset prices have risen and the cost of borrowing for the bigger players has dropped, and this has made preferred equity investment deals harder to place from the point of view of overseas investment funds and financial institutions.

However, as social financing rose to historically high levels in the first quarter of 2013 and was accompanied by a sharp spike in nonbank financing, another round of strong residential price appreciation was triggered in February and March. Predictably, this has led to the next round of tightening measures, with Bloomberg reporting that in March former Premier Wen Jiabao ordered the central bank to raise downpayment requirements for second mortgages in cities with excessive price gains and told local governments in cities with the biggest recent price escalations to tighten home-purchase limits and set effective price-control targets.

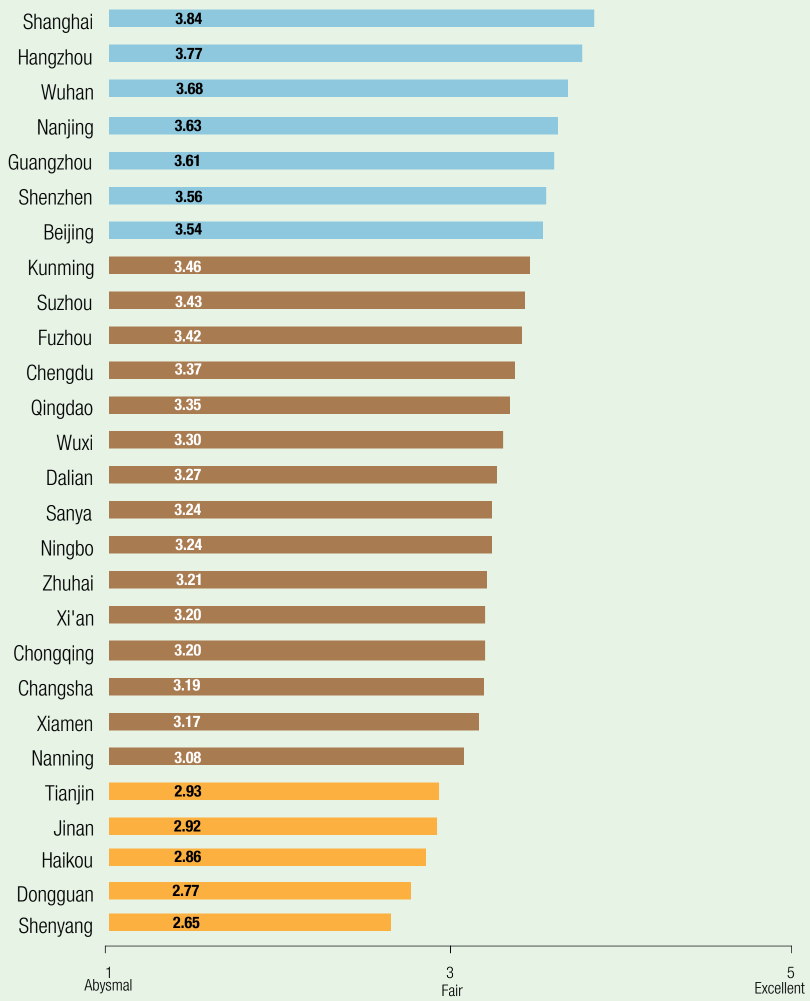
Despite the prospects of the imposition of another round of market-curbing measures, large state-linked developers and some of the larger private developers, with their privileged access to funding complemented by their strong residential sales execution, are apt to continue to do very well in selling mid-market housing units, even under present tightened market conditions. So, the fact that over 30 percent of the respondents said that they plan to expand their involvement in the mid-market residential sector in 2014, but only 19 percent plan to expand their involvement in luxury housing is not surprising at all.

Retail

Existing involvement in the retail sector remained the same in 2013 as in 2012, after a slight increase from 2010 to 2012; however, with just under 90 percent of respondents already in the retail sector, there is little expectation that this will change. Looking forward, while only 7 percent plan to decrease their involvement in it—the smallest such change among all sectors—over 50 percent of the respondents plan to expand their involvement

EXHIBIT 2-8

Commercial Sector Prospects: Retail



Source: Mainland China Real Estate Markets 2013 *survey.*

Note: Cities with insufficient responses for retail sector prospects are not included.

in the retail sector, the largest such forecasted shift among sectors. This large shift is due to the existence of significant "push and pull" factors driving them to develop more retail property. Among the "push" factors are the increased tightening over residential development and sales and the switch on the part of local governments to releasing a larger proportion of gross floor area (GFA) programmed for retail facilities, in the sale of mixed-use development sites, which is also related to a drive to create more distinct central "shopping precincts" in second- and third-tier cities them do not already have them. Among the "pull" factors are the desire to tap into the growing disposable income and rising aspirations of China's middle class, which, in turn, are supported by the proactive policies that the central government has adopted since 2009 to stimulate retail sales growth, including encouraging the growth of consumer credit and changing China's schedule of public holidays so as to promote shopping. These policies, combined with China's own economic growth, have driven continuous growth in China's consumption levels, as represented by an annualized 15 percent increase in retail sales targeted by China's 12th Five-Year Plan. The "pull" is furthermore exerted by China's rising level of consumer confidence and with it an increasing willingness to spend a larger percentage of disposable income on a variety of consumer goods and personal services.

Taken together, the "pull" and "push" factors for developing retail facilities in China have been so strong that most first- and second-tier cities are already saturated with larger retail facilities, such that China's top 100 domestic retailers are now more focused on third- and fourth-tier cities, where there is still market share to be fought over. But with these forces working simultaneously, the fact that China's larger cities are heading for an oversupply of organized format retailing did not escape the 2013 survey interview respondents. One company developing a number of prime composite buildings for longer-term hold stated: "While we have traditionally played the role of developer in China, there will come a time when the mass of composite commercial properties under development in China's stronger Tier 2 cities will finally come on stream. In cities that have strong economic fundamentals but which are becoming increasingly oversupplied, this may give rise to opportunities for value-add plays in which we may acquire some composite buildings or standalone malls for relaunching under our own branding."

The fact that Shanghai and Hangzhou were rated the highest in retail development and investment prospects is no surprise, since both of these cities contain a disproportionate number of high-end malls that feature luxury-brand retailers. This, in turn, is attributable not only to the substantial concentration of high-net-worth individuals residing in each city, but also to the fact that they are among China's leading destinations for tourism and business travel. Furthermore, both cities are not merely leading centers of conspicuous spending, but in fact are among the key places that define contemporary styles in consumption and fashion.

CHAPTER 3

Issues Affecting Development and Investment Strategies

Survey respondents were asked to rate the expected impact of ten issues on their investment and development decisions in China over the next 12 months. Ratings were on a 1-to-5 scale, with 1 being a substantially negative impact, 3 little or no impact, and 5 a substantially positive impact.

Two issues were rated as having a moderately positive impact on both their development and investment strategies:

▷ Outlook for the domestic economy; and

▷ Impact of e-commerce on demand for real estate.

Two issues were rated as having just a moderately negative impact on both development and investment strategies:

▷ Continued imposition of home purchase restrictions (HPRs); and

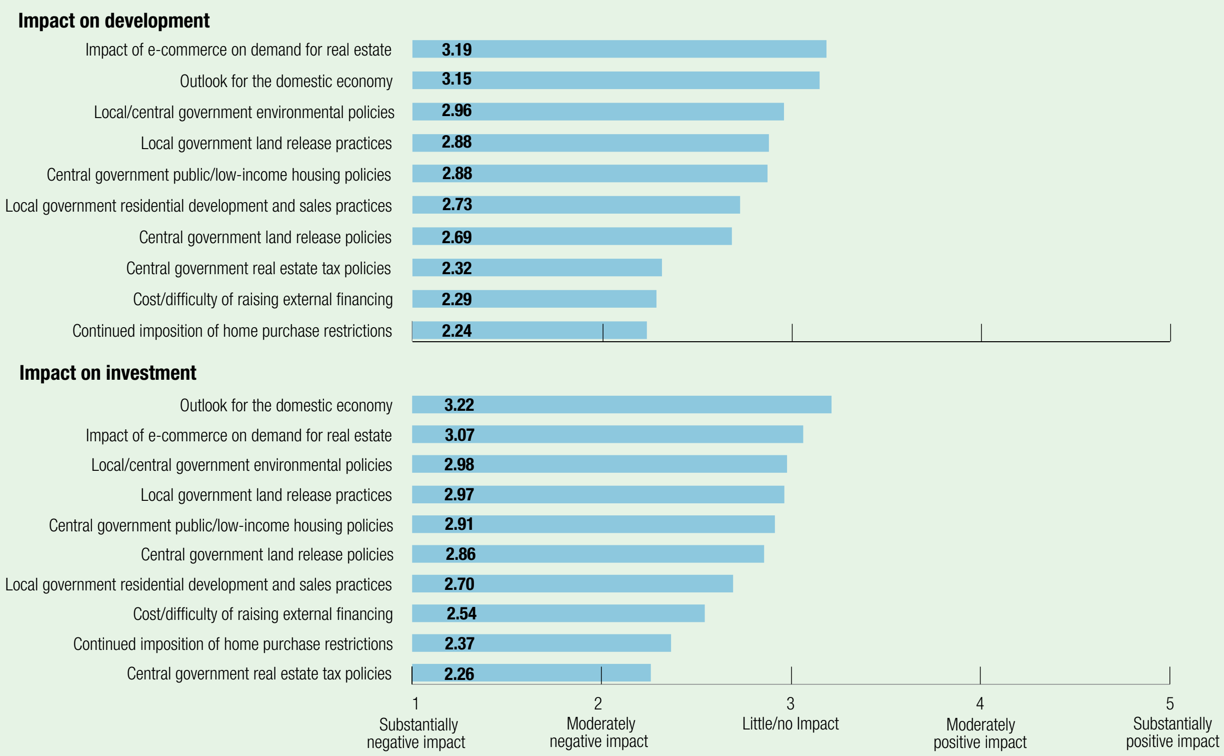
▷ Central government real estate tax policies.

And one issue was rated as having a moderately negative impact on development:

▷ The cost/difficulty of raising external financing.

EXHIBIT 3-1

Impact of Various Issues on Development and Investment over the Next 12 Months



Source: Mainland China Real Estate Markets 2013 *survey.*

The remaining issues were local/central government environmental policies, local government land release policies, central government public/low-income housing policies, central government land release policies, and local government residential development and sales practices.

Issues with Moderately Positive Impact

Outlook of domestic economy

The respondents to the ULI 2013 survey all had such confidence in China's economic future that it barely emerged as an issue during the interview process, but received a high score for positive impact in the questionnaire survey. Basically, most respondents took it as a given that China, based on its gross domestic product (GDP) growth, population size, military spending, and technological investment, will emerge as the largest economy in the world in the run-up to 2030, if not earlier. The respondents were aware that China's middle class already numbers more than 300 million and that younger Mainland Chinese, born in the era of consumerism, are apt to spend far more on their housing, clothing, lifestyle, personal care, and vacations than the older generation. Hence, a great deal of the development and investment activity that the survey's respondents plan to undertake is aimed at this group. While China's economy is not entirely without its dark clouds, such as the unsustainable buildup of local government debt and issuance of shadow bank loans, these matters apparently did not influence the respondents' overall confidence in China's future.

Impact of e-commerce on demand for real estate

While respondents to the questionnaire gave e-commerce a very positive score, with respect to the manner in which they felt it would affect demand for real estate, interviews with more than 40 companies that are investing in or developing property in China revealed a somewhat more nuanced situation, where e-commerce was seen to possibly cut two ways, depending on a given company's specific purchase on the China real estate market. On the positive side, recognizing the power of e-commerce to transform the way in which Mainland China shops, many interviewees mentioned their specific interest in entering or increasing their existing exposure to the logistics and e-commerce distribution center sector during the next decade.

Operators of large shopping malls commonly felt that the sudden rise of e-commerce puts their physical stores somewhat at a disadvantage by the way it empowers consumers to effortlessly conduct comparison shopping and find the source for the lowest-priced product. However, e-commerce does not permit consumers to physically experience products, so shopping malls are not immediately about to fall by the wayside. Rather, as a specialist developer/investor in shopping malls in Asia noted: "Certainly, e-commerce will tend to undermine some categories of bricks-and-mortar retailing, but what e-commerce takes away with one hand, it gives back with the other. In order to be successful, a new generation of anchor tenants is coming into being, retailers that have been forced to reinvent themselves and make themselves more relevant for the age of IT and e-commerce. So, as technology changes, the mall and its retail and service offerings also change with it."

Issues with Moderately Negative Impact

Central government tax policies

Uncertainty surrounding the contents and implementation of central government real estate tax policies is definitely a headache for people contemplating investing in real estate in China at present. While the imposition of a 20 percent capital gains tax on profits earned in selling residential property was one of the main points contained in a key central government policy statement, Five Policies and Measures to Regulate and Control the Country's Real Estate Market (hereafter referred to as the State Council Five Point circular), which was released by the State Council on March 1, a lack of clarification about the timing of the rollout of the capital gains tax and whether it will be expanded beyond an initial group of pilot cities or whether it can be legally passed from vendors on to purchasers is creating uncertainty with respect to the sales pricing of secondary residential property. Beyond this, the continued uncertainty about the timing of the broad imposition of the national real estate tax, and the manner in which it will be assessed, also creates anxiety in the minds of would-be investors.

So, given the confusion and uncertainty surrounding the property taxation situation, it is quite plausible that the survey respondents would cite property taxation as a mildly negative factor, although during the in-person interviews the sense came through that the negativity of their impact was a good deal more than "mild."

Continued imposition of the HPRs

The State Council Five Point circular on real estate also specifically dealt with how HPRs will be handled in 2013, but the tone of the March circular is not so much focused on expanding the scope or increasing the intensity of the HPRs, but is more concerned with improving the efficiency of their implementation and plugging loopholes that had previously not been detected.

The fact that the continued imposition of the HPRs was viewed only as "moderately negative" by the respondents to the questionnaire is certainly due to the fact that, to some degree, these measures, in place for nearly four years now, have taken on the aspect of being a long-term policy of the central government. To this extent, while developers and investors who were interviewed did note that they were disruptive to their business, they have come to live with these restrictions.

Cost/difficulty of raising external financing

The fact that the cost/difficulty of raising external financing was appraised by the ULI 2013 questionnaire respondents as being an issue that had only "moderately negative impact" on their real estate investment or development business in China is directly a function of the fact that ULI did not interview any of the small to medium-sized developers in China, for whom access to credit is a major issue. These smaller players have no recourse but to take out the kind of loosely regulated trust loans that are the core products of China's shadow banking system and which carry interest rates of as much as 20 percent per annum. For such smaller companies, if their developments do not proceed smoothly, such that they are unable to achieve the presales according to the originally anticipated schedule, they can easily get crushed by the weight of such heavy interest. However, in the interviews with larger domestic developers, it turned out that the financially strongest ones actually benefited from the financial problems these trust loans are causing the smaller players, with the larger players opportunistically acquiring the smaller players' development projects or land banks.

At one step down from the giant national-level developers, the regional-level developers who were interviewed for the study complained not of being unable to enter into lending agreements with domestic banks, but rather of having problems drawing the loans down. As the manager of one overseas fund with operations in China related, "We have no problem entering into borrowing arrangements with legitimate Mainland China banks, but our ability to draw down the loans is frequently highly unpredictable, and we not infrequently find that we have to renegotiate lending agreements that have already been signed and that have the legal force of contracts simply in order to draw down a loan on time."

Overseas financial institutions whose core strategy for China is taking preferred equity investment stakes in domestic development projects with financially sound China developers are finding that the present high liquidity levels in the market—along with the relative ease with which these larger players can raise funds from the issuance of corporate bonds—has sharply constricted their field of play for preferred equity investing. As the head of one overseas financial institution related:

"We like to do preferred equity investment deals in China real estate, but as market conditions have grown more liquid since mid-2012 our business in undertaking preferred equity investment deals has contracted. Commencing at this time, the flurry of issuance of corporate bonds by China developers at lower coupon rates than had prevailed in the first half year made the yield hurdles of preferred equity structures appear expensive by comparison. Preferred equity structures are most viable when markets are nervous and investing is perceived as risky. The requirement for preferred equity begins to dry up when markets relax and conditions appear to be turning more optimistic. Given the more liquid environment that has prevailed in China since mid-2012, we projected that all appetite for preferred finance would disappear completely by the first quarter of 2013. However, this proved to be wrong, since it turned out there are still some developers that in some situations will opt for preferred equity, because it appears on their balance sheets as new equity and not debt, and therefore does not affect their gearing ratios. However, we have had to accept IRRs [internal rates of return] at levels that are now in the high teens—as much as 600 basis points lower than when market conditions were nervous, in the first half of 2012."

Issues with Little or No Impact

Local government environmental policies

As was demonstrated by the ULI livability index, three of the four top-ranking cities in terms of livability—namely, Hangzhou, Xiamen, and Qingdao—have reasonably good air quality by Mainland China standards, so in the minds of the questionnaire respondents at least, air quality and quality of life are very directly related. However, and ironically in a finding that supports the “issues with little or no impact” to which local government environment policies were relegated, when it came to which cities would provide the best prospects for making profitable investments in real estate or undertaking profitable development projects, the matter became more complicated as the 2013 ULI survey saw Beijing rising in both rank and numerical score and also where home sales prices and transacted prices for development sites continued to rise during the winter of 2012–2013, despite city’s hazardous air quality readings. So Beijing was a city where worsening air quality was serious enough to cause a rising tide of expatriates and some senior Chinese nationals to move away from the city, but which, despite this loss of some valuable human resources, remains such an unrivaled center of political and corporate power that neither its residential nor its office markets have appeared to even ripple.

However, although there is a tendency to target Beijing because of the severity of its wintertime pollution, the fact is that among all of the cities that were ranked in the top ten in terms of investment prospects, with the sole possible exception of Qingdao, all of them registered pollution readings ranging from moderate to unhealthy at some point during the five-month period from January to May. This further reinforces the notion that less-than-ideal air quality is something that investors are prepared to accept in China, or at least for the time being.

Local government land release policies

While the questionnaire survey showed that local government land release was an issue with “little or no impact” on respondents’ business, the in-person interviews revealed that local government’s approach in releasing development sites, and especially its skill in properly husbanding land resources, was a matter that strongly influenced their views of the viability of investing in the cities included in the 2013 ULI survey. As one overseas fund manager commented with respect to cities in China that have been imprudent in releasing excessive amounts of development sites: “It makes long-term players like us, who like to develop or acquire quality properties and then hold onto them for a period of time, discouraged to see local governments cause so much land value to hemorrhage out of the market due to their own incautious behavior.”

However, apart from the recent drive by the Ministry of Housing and Urban and Rural Development to push more residential sites onto the market at unescalated prices and thereby dilute China’s broader housing market, since 2003 there has been a tendency on the part of some second-tier cities simply to release too much development land too soon, with the head of land acquisition for one national-level real estate developer summing up his views very precisely: “Cities that in the past decade have demonstrated weaker control over the release of development land assets are Shenyang, Chongqing, and Chengdu [referring only to the release of commercial sites in the CBD]; Tianjin, Changsha, Wuxi, Guiyang, and basically all of the major cities in Shandong, with the exception of Laiwu; Tangshan in Hebei and cities in northeast Liaoning, including Fushun and Yingkou; Changchun in Jilin Province; Guiyang in Guizhou; and in northern Jiangsu in Huia’an, Lianyungang, and Yencheng.”

In addition, beginning in 2010 and 2011 but occurring with increasing frequency in 2012, there is also the completely separate issue of recent change in the planning mix of development uses for new sites released by municipal governments so as to skew developments that formerly were overwhelmingly residential toward having a larger commercial component, with the extent of change varying by city. As a consequence of this shift, interviewees who had been previously focused on pure merchant homebuilding agreed that this most recent change was disruptive to their development business in China. The sole exception, however, was a few of the largest companies, which explained that since their main products were large-scale housing subdivisions that from the beginning have been zoned so as to provide the new communities with substantial ancillary facilities, the impact on them was not significant.

Local government residential development and sales practices

While local government residential development and sales practices theoretically fall under “issues with little or no impact,” one aspect of the State Council’s Five Point circular about which the survey interviewees were not all complacent was the section of the March 3 central government directive that stated the following: “Local governments will be held accountable for curbing soaring home prices, and asked to make specific schedules. The country’s major cities have been asked to set annual price-curbing targets for newly built homes in their localities and release these targets in the first quarter of the year.”

While broader taxation of real estate is certainly a looming threat, the central government–motivated direct curbing of city-level price appreciation in residential sales markets is something that hits developers directly in the pocketbook. Furthermore, the fact that the State Council’s Five Point circular also contained the statement that “the central government will step up inspections of provincial-level governments’ property market control work. Those who fail to meet their targets will be penalized” clearly intimates that while this system of price curbs has been on the books for several years now, local government implementation of these curbs has been less than enthusiastic.

Moreover, there are clearly more moves underway to further strengthen local government price intervention, as Guangzhou has reportedly also recently joined the ranks of second-tier cities that have been forced to step up efforts to prevent developers from escalating the prices of the newest phases of residential projects being readied for sale or presale this year. Nanjing also recently reiterated that it would not approve of any developer marking up residential prices for new launches within 2013 in excess of 5 percent, and Hangzhou jumped on the bandwagon, underscoring the notion that no property could be offered for presale in the city in 2013 without having its presale price checked and approved by the municipal government.

Amid the national-level merchant homebuilders who were interviewed for the purpose of preparing the ULI 2013 survey report, this most recent round of strengthening existing curbs on property price escalation, while not "life threatening," was also clearly felt to be unwelcome, completely removing as it does the happy anticipation of future price appreciation that, in tandem with real occupational demand, has been such a powerful force driving China's residential sales market for over a decade.

Indeed, it is only in those cities that are already grossly oversupplied with residential property (in relation to their capacity to absorb it) and where residential prices have been steadily declining for more than 24 months (cities such as Guiyang in Guizhou, and Beihai in Guangxi) that municipal governments can still have a relatively free hand with development land release and pricing. However, it is precisely these markets that are least likely to attract any overseas or domestic development interest.

Central government public/low-income housing policies

From the responses to the questionnaire, it is clear that this issue had very little impact on the respondents' development and investment business in China. In fact, among the more than 40 interviews conducted in conjunction with the ULI 2013 survey report, not a single interviewee expressed any proactive interest in getting involved in the public housing/low-cost housing sector. However, to the extent that they tended to acquire some sites that require the successful bidder to develop a certain quantum of public housing as one precondition to being awarded the site, the interviewees simply viewed it as a kind of public duty that they had to fulfill in conjunction with undertaking the development, similar to paying an additional tax as the price for involvement in the project. According to one overseas fund manager whose fund enters into equity joint ventures at the project level with a major China developer, it is entirely their local China partner who deals with requirements to develop public housing, as they arise, explaining:

"For some projects, being compelled to develop an element of public housing within the development package is part of the overall mandate. However, since we always co-invest in real estate development with a Chinese partner that is a leading, national-level developer, dealing with this requirement falls under the category of 'handling relationship with local government.' Hence, our China partner generally deals with the necessity of delivering these units, either within the on-site development package [undesirable, to be avoided if at all possible] or off campus [desirable]. In some cities where it is feasible, the PRC partner does not develop this mandatory public housing component itself, but rather outsources this job to a specialist local building contractor."

Urging by the State Council for local governments to step up the supply of local land for developing residential property in 2013 figures as an important point in the State Council's Five Point circular, which was first publicized on March 3. The directive explicitly states that "China will work to increase land supplies for housing, and the total amount of such land nationwide in 2013 should be greater than, or equal to, the annual average over the last five years." The directive further stresses the necessity of making such local government commitments a matter of public record: "Cities and counties are required to make information on land supplies available to the public and reveal annual land supply plans before the end of March."

The whole notion of using increases in residential land supply to dilute the market first emerged in July 2012, when a number of think tanks directly connected with the State Council publicly questioned whether the HPRs and direct administrative interference in the pricing mechanism represented a suitable way of keeping China's residential market on the path of long-term, sustainable growth. However, the fact that the central government was compelled to issue a warning in November 2012 that city governments that did not meet their land release targets by year-end would be penalized, clearly suggests that there was some pushback from the local governments.

As one investment advisory company commented on what would appear to be this "less-than-ideal level of compliance": "The problem with this policy of ordering municipal governments to release more sites suitable for developing ordinary housing is that it is too broad brush, and whereas it is workable in some cities, in other cities, like Beijing, Shanghai, and Shenzhen, sites suitable for residential development have become scarce. Furthermore, in these latter cities land prices have risen to the point citywide where, if one takes relocation and site clearance costs into account, it is quite difficult to find any reasonably located site on which one could undertake more moderate-priced mid-market housing of the type the central government desires to see rolled out. Rather, this concept of diluting the mid-market segment with supply is more workable in cities like Wuhan, Xi'an, and Hefei, where land prices have not yet been bid up. And yet another, related problem is that even if the sites are released, the municipal government cannot necessarily compel developers to develop them, since undertaking such activity is pure market-oriented behavior."

CHAPTER 4

What's New? Where's Livable?

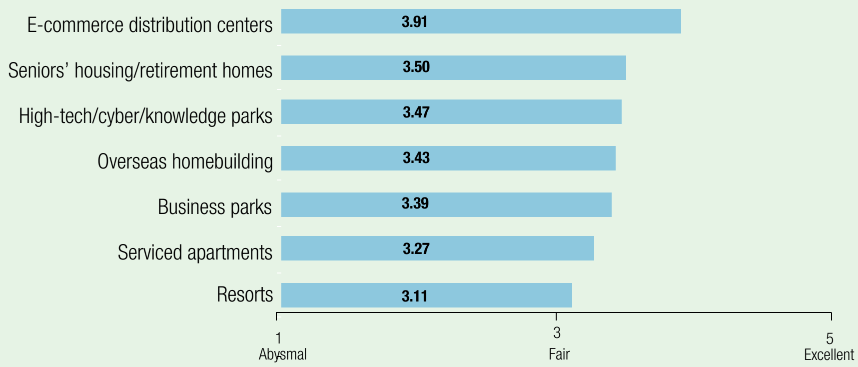
Respondents to the survey were asked two sets of questions potentially indicative of new directions: investment prospects of niche sectors and the relative livability of the surveyed cities.

Niche Sectors

Survey respondents were asked to rate the investment prospects of seven niche or emerging market sectors over the next 12 months. As China's economy continues to grow at a slightly slower but more sustainable space, within the next decade or so it will contain the largest and deepest pool of consumers of any economy in the world, having already overtaken the United States as the world's largest automobile market and grocery shopping market in 2009 and 2012, respectively. However, the ways that real estate is used to tap the consumption potential of this particular group are changing as the China marketplace itself is becoming not merely more affluent but also more sophisticated.

EXHIBIT 4-1

Investment Prospects for Niche Sectors



Source: Mainland China Real Estate Markets 2013 *survey.*

In 2010 and 2011, simply developing housing for sale—any consumer's largest single-ticket item—and acquiring or developing shopping malls were the easiest and most common ways to gain access to this cohort of consumers. However, as can be seen by the respondents' responses regarding niche markets, it is evident that their strategies are becoming more sophisticated to accommodate an aging population, work locations that for many will be increasingly remote from the central business district (CBD), expansion of online shopping, and a growing ability to vacation and interest in taking trips, particularly to destinations where they can breathe easily again.

E-Commerce Distribution Centers

At 3.91, this niche garnered the highest average rating by far of the seven niche markets. E-commerce sales in China totaled US$190 billion in 2012, up by a remarkable 66.5 percent over the total for 2011. If online sales in China continue to grow at a similar clip over the next three years, it has been predicted that by 2015 China will overtake the United States as the world's largest e-commerce market, driven by the twin, intertwined trends of China's continuing rise in consumerism and further growth in its online population, which, at 130 million, is already the world's largest.

However, the specific factor that caused distribution centers positioned to serve e-commerce to secure the top place among survey respondents was the recognition that with online penetration in China still at under 40 percent of the population, as compared with more than 70 percent in most developed economies, e-commerce and the real estate infrastructure that supports its supply chain clearly have plenty of room to grow in China. The respondents recognized that China's need for more distribution centers is pressing, especially outside of the larger cities, where in some instances the shortage of good logistics facilities is acute.

However, according to a senior executive of a logistics company that is actively developing and operating logistics facilities in the world's most populous country, "China's entire logistics sector is beset by a number of major problems at present. In its 12th Five-Year Plan and elsewhere, the central government has avowed that it wishes to transform China's economic paradigm from one driven by investment in fixed assets and export-oriented manufacturing to one driven by domestic consumption. However, local-level government land authorities simply do not release a sufficient quantum of land annually that is specifically zoned for logistics development."

Therefore, it can be observed that potential expansion of e-commerce sales to embrace virtually all of China is stymied by the fact that large areas in the Middle Kingdom continue to be underserved by modern distribution facilities. This insight was underscored by a report published by DTZ in 2012 that stated that the true challenge to logistics operators in the People's Republic of China (PRC) "lies in the efficient delivery of goods to China's 220 million online shoppers. Limited infrastructure, lack of warehouses outside the main conurbations, and a shortage of last-mile delivery expertise make servicing lower-tier cities and inland areas difficult."

However, gaining entry to this sector is easier said than done. As the head of one overseas investment fund that is very active in developing property China noted, "We have great interest now in developing or acquiring logistics, warehousing, and e-commerce distribution center facilities. This is very much driven by the storage and distribution requirements being generated by China's e-commerce industry, which is growing at a terrific rate. However, despite our keen appetite, we are unlikely to expand quickly into this area, since land zoned for logistics development and portfolios of logistics properties are very hard to acquire at present."

Housing for Seniors and Retirement Housing

The second-highest-ranked niche sector is seniors' housing/retirement homes. While its appeal stems from several factors, there is one main one—namely, the continued aging of China's population, combined with rapid urbanization that has weakened the nuclear family as the basic demographic structure supporting family-based elder care—has made improvement and broadening of caring for the elderly in China a priority. At the same time, simply developing residential property for its own sake is now less politically acceptable in China, unless it is part of the armature of support of some other initiative being pursued by the Chinese government, or else genuinely consists of smaller housing units positioned to appeal to urban homebuyers who do not have a great deal of money.

One thing that surely got respondents' attention was the size and growth potential of the Chinese market for senior care facilities. As of 2012, China's population of people 60 years of age or older was 178 million. Of these, only 4.25 million people in China currently live in seniors' living facilities, or the equivalent of a market penetration rate of approximately 2 percent, a figure that compares unfavorably with some of the world's more advanced economies. Furthermore, China is one of the world's more rapidly aging countries; it has been forecasted that by 2040, if the single-child policy is not reversed, fully 34 percent of the Chinese population will be older than 65, or the equivalent of 390 million people.

Even provinces with well-above-average gross domestic product (GDP) per capita are experiencing an acute shortfall in senior care accommodations in relation to the size of their growing elderly population cohort, and their elderly populations possess relatively strong economic means to pay for such services and accommodation, making them potentially interesting locations for private investment in the sector.

Furthermore, even as some major Chinese residential developers are finding their merchant homebuilding business in China increasingly fraught with both government policy risk and market risk—and they are increasingly seeking new ways to channel their residential development expertise, apart from building ordinary housing subdivisions—entry into seniors' housing presents some challenges. Operating a retirement home or even managing a mixed facility, in which some units are for sale and others are only for lease, involves a great deal more managerial expertise than simply running an apartment building—combining, as it does, medical care, hospitality, and real estate. As such, Chinese developers are still exploring what kind of operational model works best for them and forming alliances with companies with expertise in managing continuing care retirement communities (CCRCs) and facilities of this type before launching their own facilities.

High-Tech/Cyber/Knowledge Parks and Business Parks

The investment prospects for high-tech/cyber/knowledge parks, ranked third, and business parks, ranked fifth, can arguably be discussed as one large niche market opportunity, as both refer to the same kind of high-specification, low-density industrial/office parks, typically developed in campuslike settings in suburban locations.

Also, the fact that business parks, knowledge parks, and cyber parks are directly aligned with industries that have been singled out for special support in China's 12th Five-Year Plan—notably, biotechnology, new IT (broadband, internet security), new energy technology, clean-energy vehicles, environmental protection, aerospace, and telecommunications—suggests that there will be ample government funding to support the growth of the enterprises that such facilities are targeted to accommodate.

In fact, development of suburban business parks, software parks, and decentralized office clusters is not new in China, and developers in Beijing, Shanghai, Suzhou, Shenzhen, Chengdu, Dalian, and Hangzhou have developed and opened such parks over the course of the past decade, with varying degrees of success. However, over the last five to six years, as China has increasingly emerged as a competitor of India, the Philippines, and Malaysia in the fields not only of business process outsourcing (BPO) and knowledge process outsourcing (KPO) but also of back-officing and captive services generally, some business parks in China, such as the Chengdu Tianfu Business Park, have achieved especially outstanding success in these latter areas.

Indeed, it can be argued that China is just now standing between its first and second wave of development of business and knowledge parks, under conditions that current leaders such as Chengdu and Suzhou will continue to do well, but the growing scarcity of suitable suburban land in these cities and rising development land costs will begin to favor slightly lower-ranking second-tier cities such as Xi'an, Wuhan, Chongqing, Zhengzhou, and Wuxi. This latter group of cities similarly possesses ample reserves of skilled and trained people to take up the jobs that will be created in the second-generation business and knowledge parks that are now under preparation or have already been pushed out. The development of business, cyber, and knowledge parks in China would thus appear to "tick all of the boxes." The only hitch is that the largest occupiers of such parks have always been the back-office and research-and-development (R&D) functions of major Chinese corporations that opt for these places because their rent is only a fraction of that commanded by CBD office buildings. However, because of these low rents, it only makes sense to develop such business campus properties if one can obtain the underlying land at negligible cost.

In China, what this means in practice is that developing and operating business parks is essentially the preserve of quasi-government entities that formerly owned and operated the manufacturing zones and industrial parks with which most larger cities in China are ringed. And their ideal joint venture partner is a domestic state-owned enterprise (SOE) with a background in developing high-tech parks and similar facilities and which is large enough to have a secure, central source of funding and debt.

In the course of the interviews, we did come across one private specialized domestic developer of "knowledge-industry clusters" that comprise specialized, smaller-themed innovative industry parks designed to attract and capture certain niche players within knowledge-intensive industry, such as specialist industrial design companies, and whose parks provide an array of facilities catering to their special needs along with a component of residential sales property targeted at their staff. However, while this developer was a private company, it would appear that this activity would not be feasible without some privileged relationships with the relevant local government authorities, so not an especially easy act for an overseas firm to follow.

Overseas Homebuilding

Demand for luxury housing as a store of value has not disappeared in China, but has merely been suppressed by home purchase restrictions (HPRs). In fact, a senior person on the business development side of one of China's top-ten merchant homebuilders candidly related in an interview, "The HPRs have had a definite, negative impact on our homes sales, which is the company's core business. As a result of the imposition of the restrictions, there are many projects [citing one leisure-related condo project in a coastal area of South China], where we can only sell one residential unit to buyers who are not resident taxpayers [in the province where the development is located] and this prevents sales to persons who would have acquired multiple units, of whom there are many." The same spokesperson went on to mention that "except for our stepping up our overseas investments in real estate developments, the pace of which will definitely step up over the next 12 to 24 months, we do not anticipate any major change in our basic China business model, at least for the short term."

In fact, the frustration of such demand for the acquisition of residential units for investment purposes has led to such phenomena as Mainland China capital entering the Hong Kong housing market in record quantities in 2010–2012. This became one of the factors that drove the rapid escalation of Hong Kong housing values during this period, with nonresident Mainland buyers coming to account for as much as 30 percent of the purchase of all new flats sold in Hong Kong, and a higher percentage of high-end flats. During the same time interval, Mainland buyers began to constitute a distinct force in the Singapore, London, and New York condominium residential markets as well.

One of the most prolific buyers of overseas residential sites abroad, Shanghai-based Greenland Group, has already acquired sites or projects in Australia and Canada; and, according to a report that was recently published in the Asia edition of the *Wall Street Journal*, Zhang Yu Liang, Greenland Group's chairman, said the company also is considering investing in the U.S. West Coast, commenting, "We are interested in places where there are many Chinese people," he said.

Also, given that a sizable percentage of the more affluent Mainland Chinese aspire to send their children abroad for higher education, it is only natural that they should consider acquiring housing for them in the cities where they are attending university. Hence, some China merchant homebuilders, including China Vanke, Country Garden, and Henan Xinyuan, are following their buyers abroad to either develop or acquire properties in locations such as San Francisco (in the case of China Vanke), the south Malaysian city of Johor Bahru (in the case of Country Garden), and New York City (in the case of Xinyuan). And indeed, the initial forays by these developers into the U.S., Canadian, Australian, and Malaysian markets are just the tip of a huge wave of development-related investment that is still to come.

Serviced Apartments

Despite what some interview respondents perceived as the supersaturation of some first-tier cities with branded international five-star hotel accommodations, the fact is that business travel in China is continuing to grow apace. The Alexandria, Virginia–based Global Business Travel Association recently released a report predicting that business travel in China will continue to grow by 17 percent and rise to a level of US$245 billion, overtaking turnover for business travel in the United States for the first time.

What is interesting, from the point of view of both hotel and serviced-apartment operators, is that the rise in expenditure for China business travel is driven by the growing number of business trips being taken and average spending per business trip, rather than the pricing of accommodation. In order to accommodate this trend, Beijing, Guangzhou, Shanghai Pudong, and Shanghai Hongqiao have all doubled their flight handling capacity over the past decade. However, the reason why serviced apartments achieved a solid 6 ranking in terms of the niche markets favored by the questionnaire respondents was their recognition that many business travelers—and especially many senior Chinese executives making extended trips—prefer to stay in serviced apartments rather than hotel rooms. This preference is a factor influencing growing demand for this type of accommodation.

Our respondents also recognized that it is not just this preference on the part of senior executives but also the aggressive expansion of the operations of Asian regional companies and multinational corporations beyond the familiar first-tier cities into the second- and third-tier cities that is driving demand for more professionally operated serviced-apartment facilities in China. The need to station staff for periods of several months as well as the flexibility to rotate staff in and out of these cities is compounding the need for furnished, serviced-apartment units as well, and also the need for international brands to operate them. In recognition of the huge potential of this market, international serviced-apartment operator Fraser's was quoted in a recent article in the *China Daily* that they plan to open between eight to ten new serviced-apartment projects in China per annum for at least the next three to five years, with the greatest opportunity being in larger second-tier cities.

Resorts

Coming in last, developing resorts in China is nevertheless still firmly part of the list of interesting future categories for investment or development. Domestic consumption takes many forms, beyond the simple acquisition of consumer durables. Spending one's disposable income on weekend getaways, tourism, and vacations, while once frowned upon as purely bourgeois pursuits, is now strongly sanctioned as key to China's evolution toward possessing an economic model that increasingly resembles that of advanced, developed countries.

When rising levels of disposable income possessed by white-collar urbanites are further linked with the recent deterioration in the living environment in a number of major

Chinese cities, especially with the advent of wintertime with its deteriorating environmental conditions, this means that nature resorts catering to the health-conscious urban Chinese have all the makings of a huge future market. Many of the people interviewed stated that they were planning to launch projects in this market segment, if they had not already entered it.

Hence, the list of remote resort locations in which interview respondents stated they were already planning or in the early stages of rolling out resort or minority-themed or cultural preservation developments comprises Changbaishan (Jilin); Yinchuan (Ningxia Autonomous Region); Yangshuo (Guangxi Autonomous Region); Kashgar and Kezhou (Xinjiang Autonomous Region); Huangcun (Anhui); Yueyang (Hunan); and Xishuangbanna, Pu'er, and Shangri-la (Yunnan). However, without a sophisticated tour company operator who possesses a substantial database of potential excursion tour applicants, it would appear hopeless to attract a significant volume of visitors to these places. Hence, it is not surprising that most of the interviewees who mentioned that they were interested in getting more deeply involved in this sector also intended to build some private luxury townhouses or low-rise apartment blocks alongside the themed or specially featured areas, either for lease or for sale, with presumably a hotel title in place for the units so that their sale and purchase would not be constrained by continuation of the HPRs and residential cooling campaign.

City Livability

What makes a city livable? Looking at the characteristics shared by cities that ranked in the top four in terms of livability, with strong scores ranging from 4.11 to 4.00—namely, Hangzhou, Xiamen, Chengdu, and Qingdao—we note a range of factors that make them appealing places in which to reside.

In the case of Hangzhou, it is not just the presence of areas of great beauty, such as the city's West Lake, but also that it is a well-governed and carefully planned city that offers a wide array of amenities.

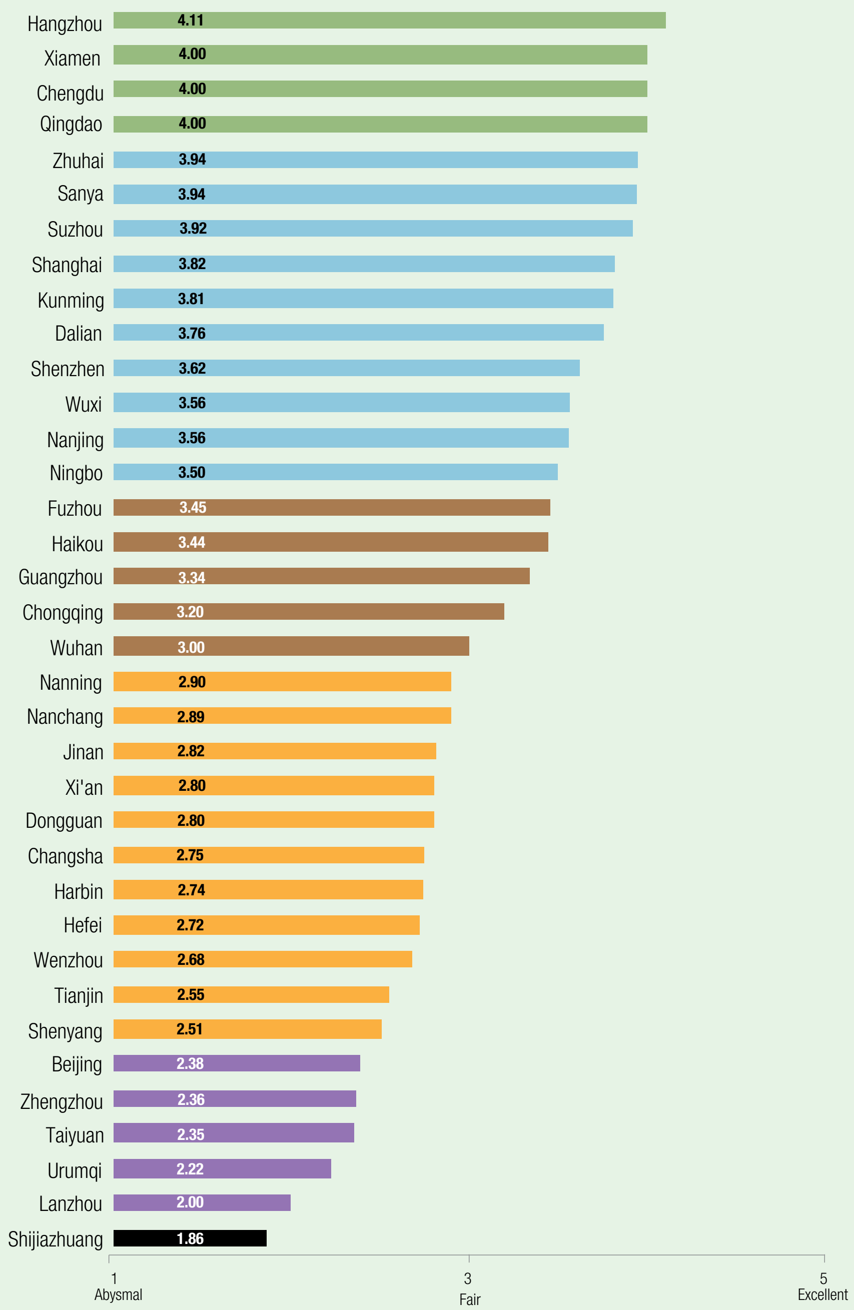
Xiamen and Qingdao are both cities that were formerly foreign treaty ports or foreign concessions, and which retain some of their colonial-era architecture while remaining tranquil, laid-back coastal cities that are fairly small in scale and hence more intimate than sprawling cities such as Beijing or Shanghai.

Chengdu's high ranking is due not so much to the attractiveness of the inner-city area—the core central city being modern but not "beautiful" by any stretch of the imagination—but rather to the city's reputation for being a center for lifestyle, known not only for its affluence but also for its leisurely pace of life and robust consumerist culture.

The next-highest-ranked cities in terms of livability (3.94 to 3.50)—Zhuhai, Sanya, Suzhou, Shanghai, Kunming, Dalian, Shenzhen, Wuxi, Nanjing, and Ningbo—similarly have a range of features that recommends them as good places to live.

EXHIBIT 4-2

City Livability



Source: Mainland China Real Estate Markets 2013 *survey.*

Zhuhai and Sanya are known for their uncongested and laid-back environment, with the latter also known for its subtropical climate, white sand beaches, and large concentration of resorts. Zhuhai, by contrast, is appealing because of its immediate access to Macau and wide array of golf courses and other leisure facilities.

Suzhou, Shanghai, Shenzhen, Wuxi, Nanjing, and Ningbo all appealed to respondents due to the fact that they are modern, efficient, and relatively well-governed cities, with convenient transportation links to other regions and air pollution that generally stays within the "moderate band." In addition, Shenzhen provides the added convenience of providing immediate access to Hong Kong.

The third group of cities—Fuhou, Haikou, Guangzhou, Chongqing, and Wuhan—were rated "fairly livable" (3.45–3.00). These five cities were viewed by the respondents as being slightly less comfortable than the top two groups but still acceptable places to live, providing most of the amenities of modern life and being reasonably convenient to transportation, even if slightly less idyllic or charming than some of the other cities that ranked higher on the livability scale. This group includes two of China's famous "three furnaces" (Chongqing, Wuhan, and Nanjing), this description referring to their especially hot and humid summer weather (to which are sometimes added Changsha or Nanchang).

Further down, the ten cities garnering scores ranging from 2.90 to 2.51—Nanning, Nanchang, Jinan, Dongguan, Changsha, Harbin, Hefei, Wenzhou, Tianjin, and Shenyang—were viewed by the respondents as being "less comfortable." And furthermore, the following five cities, with livability scores ranging from 2.38 to 2.00—Beijing, Zhengzhou, Taiyuan, Urumqi, and Lanzhou—were viewed by the respondents as having more, different challenges with respect to residing for longer periods of time.

Finally, in last place, Shijiazhuang was viewed by the respondents as being "the least livable" of the 36 cities surveyed. The city also ranked second—just after Tangshan—in terms of the seriousness of its year-round average pollution levels in a recently published survey of the air quality in China's 17 most polluted cities.

CHAPTER 5

Ten of the Largest Mainland China Cities

This chapter draws from comments made by interviewees about real estate investment and development prospects for ten of the largest Mainland China Cities: Shanghai, Beijing, Guangzhou, Shenzhen, Chongqing, Wuhan, Tianjin, Chengdu, Nanjing, Hangzhou.

Shanghai

SHANGHAI

The following are remarks made by interviewees about Shanghai.

"A very good city in which to make money in real estate. Will do investment or development across all real estate sectors in Shanghai."

"One of the two most mature, deepest, and most liquid markets in China."

"Shanghai is the one key, indispensable city where one must be, as a developer and holder of core real estate assets in China. As a city that will predictably continue to add value to itself, it will eventually emerge as a world-class city, joining the ranks of New York, Tokyo, and London."

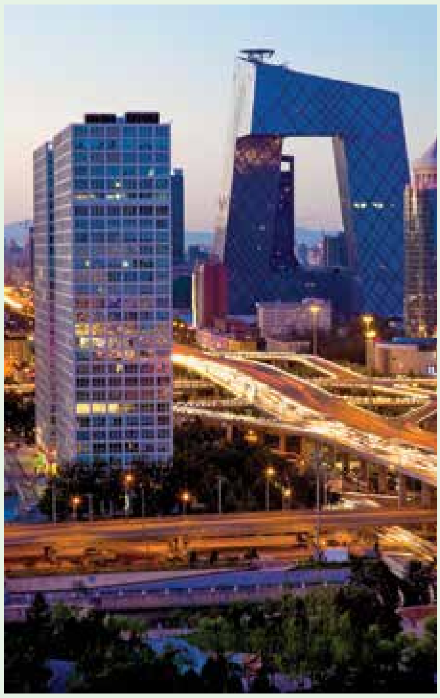
Beijing

BEIJING

The following are remarks made by interviewees about Beijing.

"The Beijing Grade A office market is still poised to experience tremendous growth in demand and there is no significant new supply scheduled to appear until 2015, making this is a very compelling market [in which] to develop and hold a Grade A office property."

"Along with the development of new suburban fringe office nodes in Beijing and urban fringe business parks, the Beijing office market is rapidly becoming more mature and sophisticated. Companies that do not need to pay CBD [central business district] rentals to accommodate a large portion of their staff are increasingly moving them to work out of decentralized office clusters and thereby achieving substantial cost savings in rent. In this sense, Beijing is simply becoming more like the way New York, London, and Tokyo have operated for years, with respect to having a tiered office market."



"The central government is unhappy with Beijing because the municipality's home prices have risen too fast. Furthermore, there is little likelihood that this policy will be relaxed in Beijing at any time in the short-term future, and high-end projects may find it difficult to get presales permits or receive approval to commence sales. Even in our own case, we have recently been denied permission by the Beijing government to raise the price of a property that sold very well last year in Beijing and for which we had intended to launch the next phase."

Guangzhou

GUANGZHOU

The following are remarks made by interviewees about Guangzhou.

"We are encouraged by Guangzhou's strong underlying demand from the city's population of 12.8 million, and the firm underlying base of industries that employ them." Demand stems not only "from the core inner-city area but also from the smaller satellite cities of Panyu, Zengcheng, Huadu, Luogang, and Conghua that ring the inner-city core, making it a natural place to develop mid-market housing."

"Guangzhou is a market that is very dominated by local players who have a strong relationship with the local municipal government. Also, while the market contains demand for virtually every type of property across a wide spectrum, with the progressive completion of Guangzhou's massive new inner-city CBD area, the Pearl River New City, the market is not undersupplied with any particular type of property. So from our point of view, Guangzhou is what we would describe as a relatively well-saturated commercial market."

Shenzhen

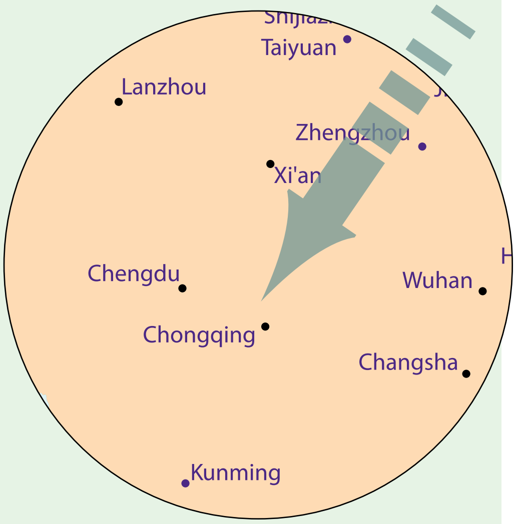
SHENZHEN

The following is a remark made by an interviewee about Shenzhen.

"Shenzhen has become increasingly interlinked with Hong Kong and it is only a matter of time before the two cities eventually meld into one greater conurbation and economic powerhouse of 20 million–plus people. Shenzhen is benefiting from a number of factors: its growing HSR linkages with the interior, via the national HSR system, with several terminals located in Shenzhen; and its strong and growing high-tech, IT, and innovative industry sector, in which the Shenzhen government is continuing to invest in supporting and nurturing. Also, as a city that is attractive to the best and brightest of China's graduates, it is the home of a growing, affluent white-collar population that aspires to lifestyles that are identical to those enjoyed by the middle class in Hong Kong, so the city still has further untapped potential for properties that promote and support consumerism, lifestyle, and leisure-time pursuits."

CHINA RESOURCES

Chongqing



CHONGQING

The following are remarks made by interviewees about Chongqing.

"As an aspiring economic gateway, Chongqing is much more recently emerged than Chengdu, but it has weaker economic fundamentals than Sichuan's provincial capital, which remains the major economic center of China's western region. Given the amount of development sites for both large-scale commercial and residential developments that have been released here in recent years, land prices here are relatively high and developers' margins are fairly thin. For this reason, and especially given the huge amount of residential supply both in the pipeline and carried forward, residential prices here seem to rarely rise, but rather always stay flat. Thus, whether advertently or not, Chongqing presents a major successful example of excess supply being used to dilute the residential market and thereby keep housing prices flat—which is precisely what the China central government wishes to achieve."

"No need for us to place real estate investment in a city with such severe lingering 'headline risk.' While real estate prices may be cheaper in Chongqing than in Chengdu, and the market less heavily overinvested, nevertheless the Bo Xi Lai scandal still makes the kind of cornerstone investors who would inject major equity into our fund nervous. Of all industries, real estate development and investment are ones that are most closely linked with the municipal government. Scandal can also work in reverse—new government may give you problems because you chose the wrong partner from the group with links to the purged Bo Xi Lai faction."

Wuhan

WUHAN

The following are remarks made by interviewees about Wuhan.

"Despite all of these advantages, up until very recently, development of Wuhan has been somewhat slower than other cities in its 'strong second tier' class, perhaps due to the fact that the municipal government was up until recently more insular and less forward-looking than that of its peers."

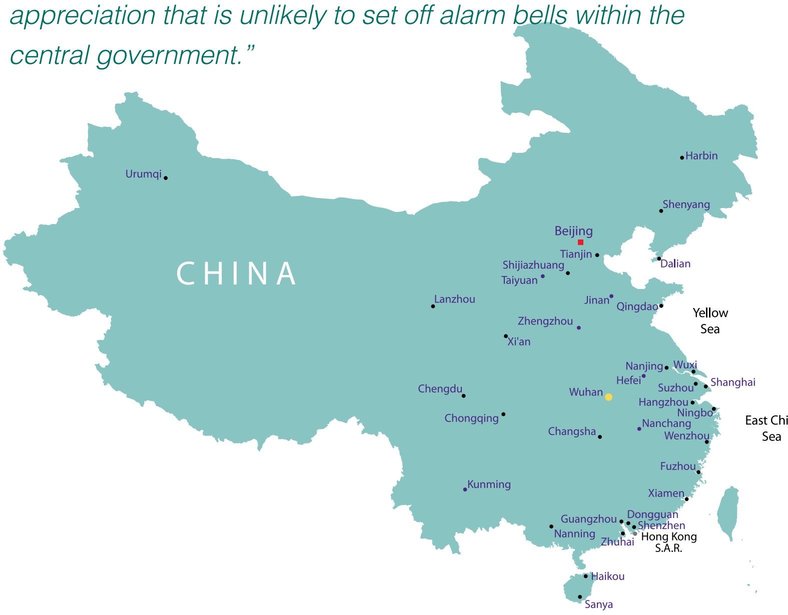
"As China's own giant domestic companies expand domestically and seek a location for a central China regional headquarters, Wuhan will be the natural choice."

"If all of the shopping mall properties presently in the pipeline in Wuhan came on stream on schedule, the city would have made the transition from famine to feast rather too quickly."

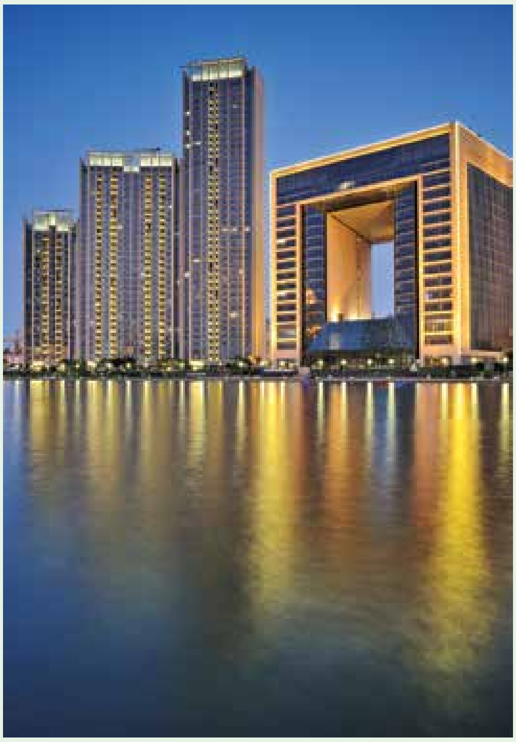
"The Wuhan market is protected by the fact that the actual developable area within the core city is not large, and it comprises three districts divided off from one another by tributaries of the Yangtze River, so the city is saved by the fact that there are ultimately only a limited number of brownfield sites that can be put up for development."

"Wuhan is yet another economically strong city that remains attractive for undertaking residential development because its housing prices are still fairly cheap as the market was never whipped into a speculative froth. This is supported by the fact that home prices rose only by 3.9 percent over the past 12 months and 4.7 percent within the past two years—a rate of appreciation that is unlikely to set off alarm bells within the central government."


SHUI ON LAND



Tianjin

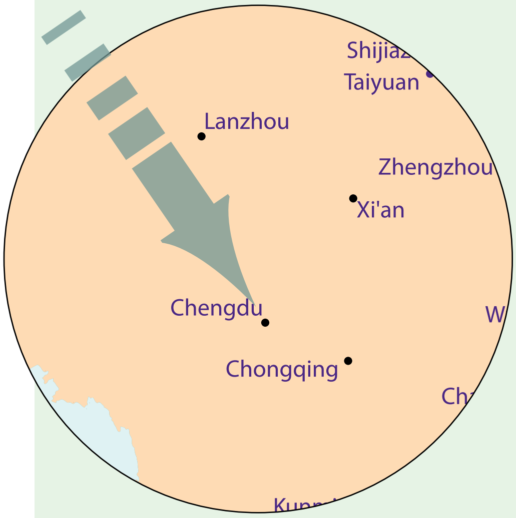


TIANJIN

The following is a remark made by an interviewee about Tianjin.

"Tianjin is a city with a very strong industrial base, containing a huge high-tech manufacturing sector, and very much relates to Beijing the way that Suzhou relates to Shanghai, as an immediate, outlying industrial satellite. Tianjin has a large population and also attracts many talented people, so this is also in its favor. However, what is not in its favor is that its municipal government has released too much land in recent years to establish new satellite commercial areas, such as the Yujiapu Financial District within the larger Binhai New Area, which are purely speculative to begin with and hence easily prone to oversupply. Hence, while we have undertaken residential developments in Tianjin in the past, we are now only very selectively interested in residential development opportunities in this city."

Chengdu



CHENGDU

The following are remarks made by interviewees about Chengdu.

"While Chengdu still has considerable potential, the city has been the target of too much investment recently. It has simply been overdone, and this is especially obvious in the number of regional developers who have piled into the city to undertake downtown development commercial projects in Chengdu's emerging CBD area."

"Chengdu is a city that, like Shenyang, is facing what is emerging to be a considerable oversupply of high-end composite buildings in its CBD area. However, Chengdu is somewhat more hopeful than Shenyang because over the mid term, at least, it is likely to be rescued from this overhang in commercial stock by the fact that it is the most economically dominant city in southwest China. Many people not merely from neighboring cities in Sichuan but from the surrounding provinces and autonomous regions of Western China naturally flock to Chengdu as the nearest mecca for big business and high-end consumption."

"We are concerned about growing supply imbalance—a growing bulge in oversupply of high-end office, retail, and mixed-use commercial complexes, especially in the CBD. Like a replay of Shenyang, except that Chengdu has a more vibrant underlying economy and will be able to absorb excess supply somewhat faster. Town-planning changes occur too rapidly here and Chengdu keeps spinning off too many new satellite areas too quickly. Hard to avoid imbalances emerging when a city undergoes change as rapidly as Chengdu has undergone over the past five years."

Nanjing

NANJING

The following is a remark made by an interviewee about Nanjing.

"There is larger room for action in Nanjing, as compared with Hangzhou or Suzhou. Nanjing is powerful enough to have its own satellite city [Changzhou] and so it possesses sufficient political clout and economic strength to produce a 'radial' effect. But Nanjing has not been subject to waves of investment by big regional developers, and has not gotten to the point where its market is getting overcrowded, as is now the case with Chengdu."

Hangzhou

HANGZHOU

The following are remarks made by interviewees about Hangzhou.

"Real estate investment or development is interesting across all sectors in Hangzhou, and many affluent people from the wider Yangtze River Delta area have sought to acquire flats in the city, both as investments and also to have a pied-à-terre there. But the residential market there has calmed recently as their buying is being somewhat constrained now by the ongoing imposition of HPRs and credit tightening on mortgages for second flats."

"Fantastic city, but land prices are not at all cheap and viable sites are hard to find."

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