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Risks in the Commercial Real Estate Markets in China

J Albert Cao* and R Keivani†

Abstract

This paper attempts to fill the knowledge gap to examine the risks in the commercial Real Estate market in Chinese cities. It utilises an institutional framework to examine the impact of urban governance, government real estate administration, and market practice in general and the current status of the property investment market in particular, on real estate market risks. Views on risks factors are gathered through a semi-structured interview programme of 200 professionals and officials and six focus groups in four major Chinese cities, i.e. Beijing, Shanghai, Guangzhou and Chongqing. The paper investigates risks in commercial property development by first conceptualising a property-led urban economic development model and then looking at aspects in urban governance, real estate administration and market practices, which are related to the model and tend to strengthen its impact on generating risks. Results of the interview programme on investment risks are then analysed according to property types and cities. The paper concludes that an institutional study needs to be built into a conventional economic analysis model to examine risks in commercial property investment in China.

Introduction

The economic reform and opening-up programme since 1979 has brought huge economic success to China with an average annual growth of 9.7% since 1979 (Exhibit 1). The Chinese economy, measured by gross domestic product (GDP), has become the fourth largest in terms of market exchange rate, and second largest in terms of purchasing power parity. The country's economy looks likely to sustain its rapid expansion, with three drivers, i.e. exports (Exhibit 2), fixed-asset investment (Exhibit 3) and domestic consumption, remaining robust in the near future. First, China's exports will continue to benefit from high levels of foreign direct investment (FDI) in manufacturing, low wages and high productivity growth. The country, currently ranking third in both exports and imports in the world, poises to become the largest trading nation in the next decade.

Second, the country's high investment ratio, at 52% of GDP in 2006 (China National Bureau of Statistics, 2007), ensures rapidly improving infrastructure to sustain fast economic growth and rapid increase in productive capacity. In particular, rapid urban growth, a major cause of the high investment ratio, will carry on as migration from

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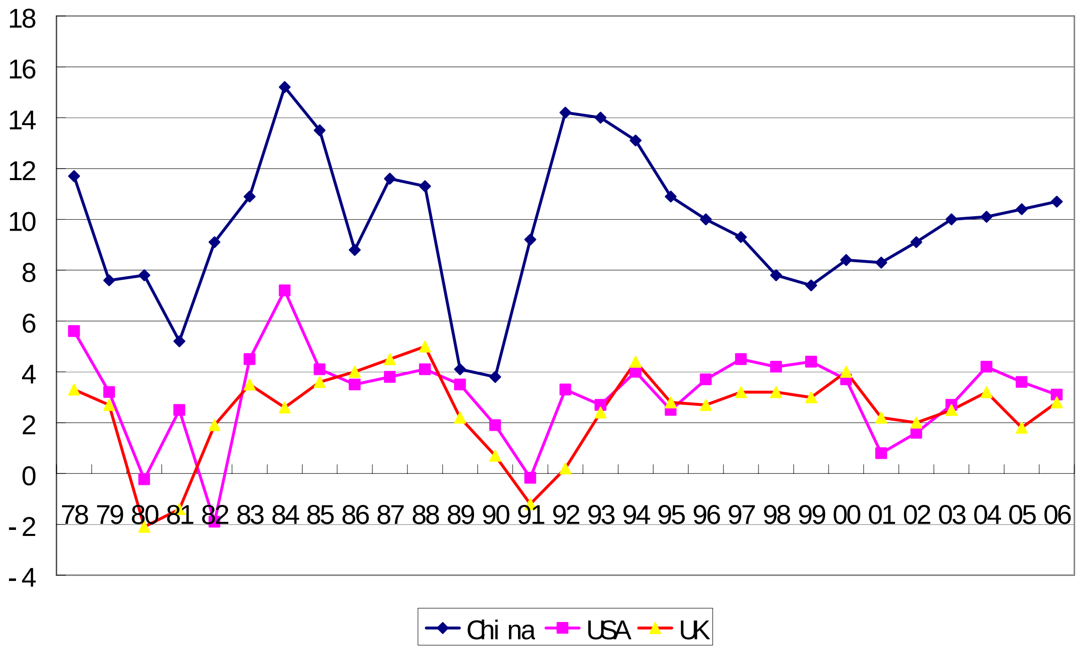
rural areas is encouraged by the government as a way to lift the living standards of the country's 730 million rural population. As a result, China's urban population increases each year at about 1% of the total population, requiring massive investment in infrastructure, housing and commercial property.

Third, domestic consumption, being promoted by the government, remains at low levels compared to other economies. Its growth will lead to expansion of the services sector, which is under-developed, compared to most developing countries (Exhibit 4). The growth of the services industry will create demand for offices and retail space, which in turn sustains investment in commercial property.

Exhibit 1
Economic growth in China, the UK and the US



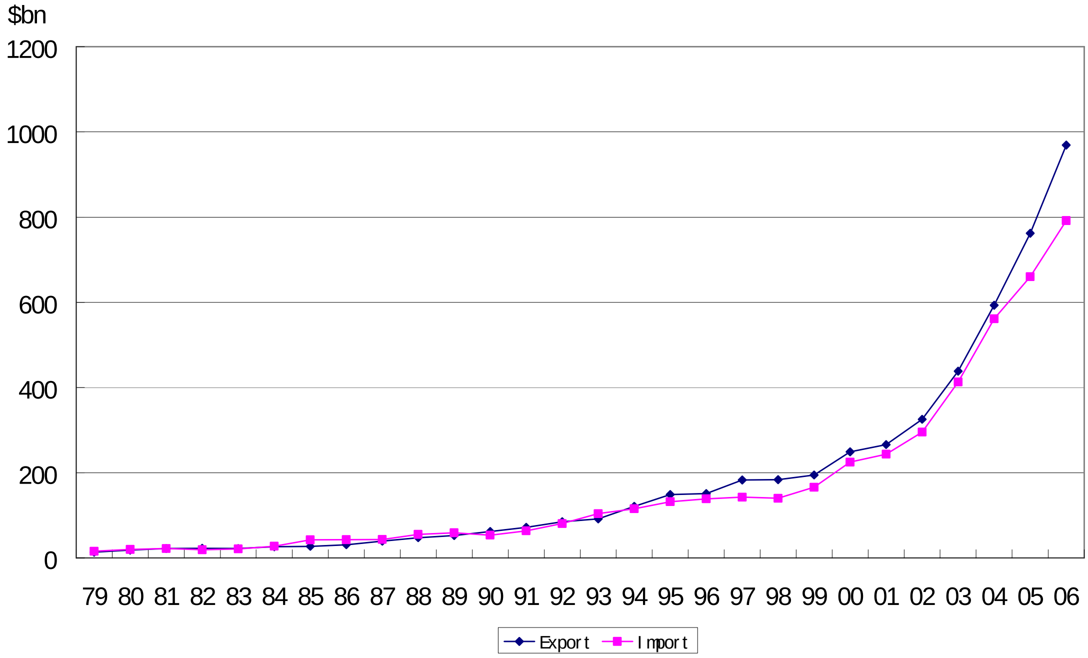
Sources: China National Bureau of Statistics (2006; 2007); OECD (www.oecd.org)

The positive prospects of the Chinese economy and the expectation of increased demand in commercial property have led to a development boom of offices and shops and an investment boom in commercial property. Since the new century, the Chinese commercial real estate has attracted increasing attention and investment from American and European investors in the last several years. In particular, such attention has recently been extended from front-line Chinese cities like Beijing and Shanghai to second-line cities like Guangzhou and Shenzhen, and in some cases third-line cities like Chengdu and Chongqing.

Contrary to the land and residential property sub-markets, the Chinese commercial property market has remained poorly studied and understood by both foreign investors and academics. The few attempts by academics to understand China's office market include Tse et al (1999) and Newell et al (2005), which provide rudimentary analysis of office returns in major Chinese cities, and Cao & Edwards (2001; 2002), which look into the institutional aspects of office development and thus the risks of office investment. However, these works are far from enough to provide up-to-date information on the rapidly changing situation in China and a through understanding of the mechanisms in office planning, development, investment and occupation.

Exhibit 2

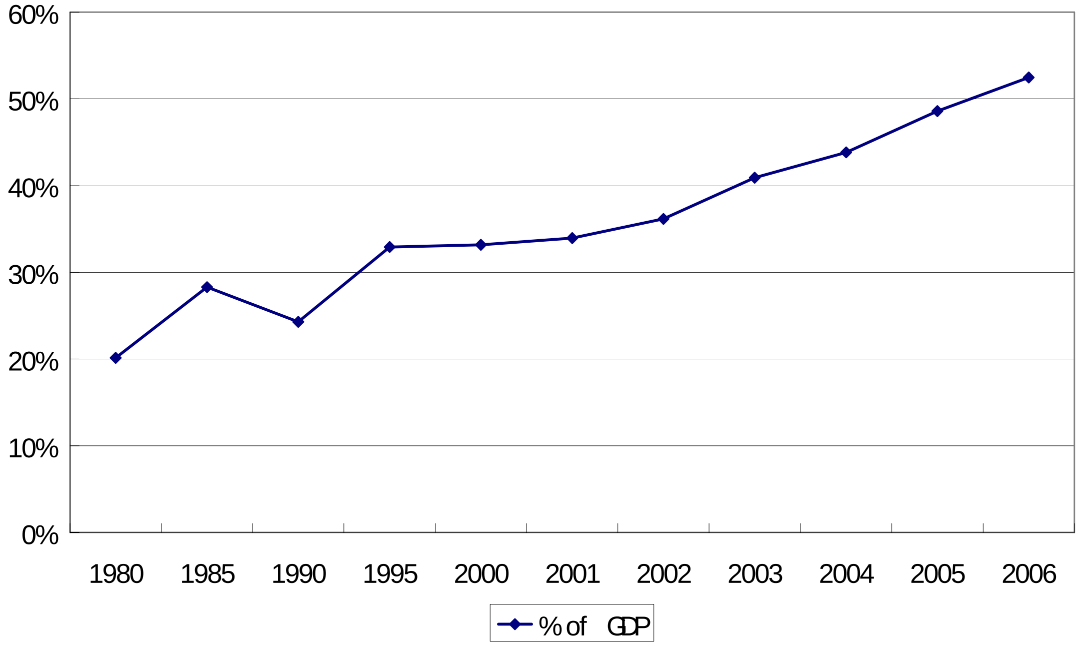
China has enjoyed a growing next export since 1993



Sources: China National Bureau of Statistics (2006; 2007)

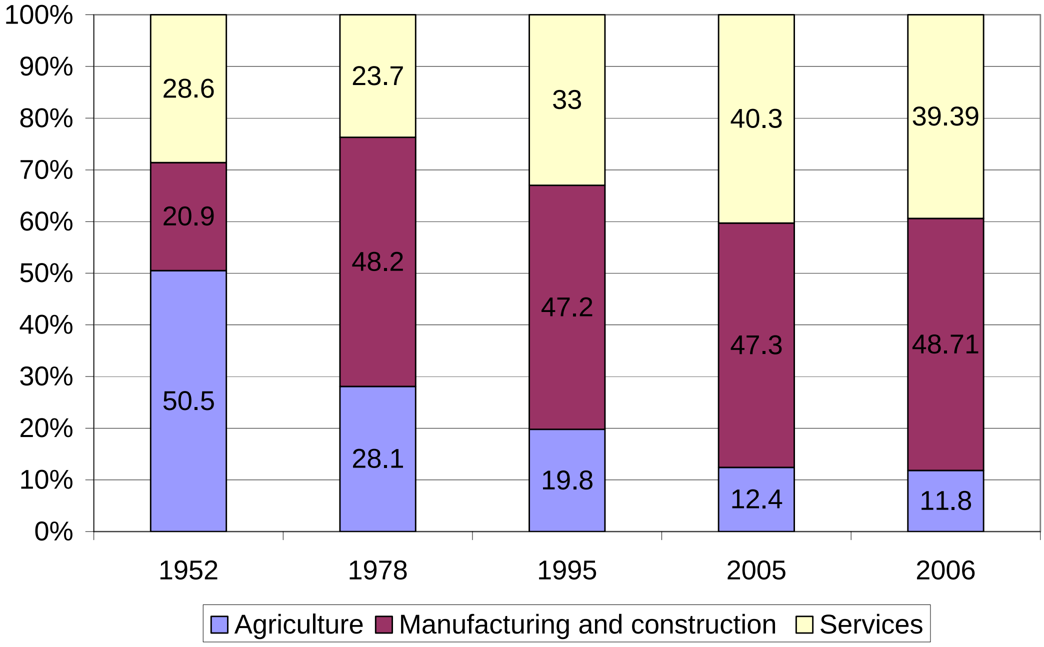
Exhibit 3

Contribution of fixed-asset investment to GDP in China



Sources: China National Bureau of Statistics (2006; 2007)

Exhibit 4
The weight of different sectors in the GDP



Sources: China National Bureau of Statistics (2006; 2007)

This paper attempts to fill the knowledge gap to examine the risks in the commercial Real Estate market in Chinese cities. It utilises an institutional framework to examine the impact of urban governance, government real estate administration, and market practice in general and the current status of the property investment market in particular, on real estate market risks. Views on risks factors are gathered through a semi-structured interview programme of 200 professionals and officials and six focus groups in four major Chinese cities, i.e. Beijing, Shanghai, Guangzhou and Chongqing. The paper investigates risks in commercial property development by first conceptualising a property-led urban economic development model and then looking at aspects in urban governance, real estate administration and market practices, which are related to the model and tend to strengthen its impact on generating risks. Results of the interview programme on investment risks are then analysed according to property types and cities. The paper concludes that an institutional study needs to be built into a conventional economic analysis model to examine risks in commercial property investment in China.

Institutions matter

This study adopts an institutional perspective, which sees '*institutions'*, or institutional arrangements, as the informal and formal rules and their enforcement mechanisms. Institutional arrangements govern the choices that people make and can either support or impede market transactions. Market-supporting *institutional arrangements* help transmit information about market conditions, goods and participants, enforce property rights and contracts to determine who gets what and when, and manage competition in markets by regulating entry and directing incentives (North, 1990). They serve to reduce transaction costs for market transactions. On the contrary, market-weakening institutional arrangements raise transaction costs and invade property rights and hinder the development or even the establishment of markets. They are the major sources of risks to market actors, including investors.

For our purpose the property market itself can be interpreted as an institution embodying a set of formal and informal rules and conventions, and a set of market actors (D'Arcy and Keogh, 1999). Through this framework this paper focuses on the institutional characteristics of the property market in the subject cities in China and how different actors operate and interrelate with each other in terms of the identified institutional arenas under examination. In so doing, the research follows a well-established qualitative approach to investigate property market processes (Healey and Barret, 1990; Healey et al, 1995; Guy and Henneberry, 2000; Henneberry and Rowley, 2002).

This process determines what is traded, the way in which trade takes place and the roles played by different market participants. Important factors that shape market structure and form at any particular juncture are both past pressures for institutional change and the market's adaptive capacity to accommodate those pressures. Moreover, the institutional structure of the property market is a device to provide certainty and reduce the transaction costs, broadly defined, associated with the acquisition and use of property. Yet it can act as a constraint on efficient economic behaviour and a source of uncertainty particularly when institutional arrangements and relations are affected by ambiguity, arbitrary decisions and lack of transparency. A recent World Bank Policy Research Paper for example notes:

> "Property rights are broadly defined as the set of laws and customs, or formal rules and informal rules, that determine how individuals may gain access to resources and the range of possible uses they may make of them. … Property rights determine who gets to make decisions about resource use, and define the incentives faced by individuals with claims against these resources. The structure of incentives created by a society's property rights regime will determine the degree of specialization in productive activities and hence the overall productivity of an economy. If property rights are improperly defined or left ambiguous and unenforced, resources will be wasted as people try to capture or defend their claims to resources" (Saleh, 2004, p3).

At the same time we must caution against the simple general application of general concepts or specific successful examples. Ultimately which policies or institutions will promote or hinder growth enhancing investments is highly path dependent on existing cultural, social, political and economic circumstances of particular societies. What works in one country may not necessarily work in another or may be contingent on other institutional and contextual factors. The relative success of the Chinese economy in comparison to Russia during the 1990s is a case in point despite the fact that Russia had instituted a legal regime based primarily on private property rights while China still had a legal system with many fundamentally socialist features. The defining issue, Saleh (2004) argues, was the relative absence of predictable judicial enforcement in Russia that led to greater insecurity for private investors whereas in China the government provided sufficient protection to encourage large investments by private entrepreneurs.

Therefore, to provide a more holistic understanding of the institutional context, its interaction with property market process and property investment we would need to take account of the broader context and institutional influences acting on and within the market.

Institutions in the context of China

The reform and opening up programme since 1979 has been a process of institutional change to demolish institutions of the command economy and replace them with institutions that support the operation of a market economy. Unlike the 'Shock Therapy' adopted by the former Soviet Union and the East European countries, the Chinese approach to the transition from command to market economy has been gradual (Liew, 1995). The advantages of gradualism are that the institutional change brought forward by the transition adds to and replaces, rather than destroys, the existing productive capacity, and that the society is allowed learning by doing to facilitate the shift from soft budget constraints to the discipline of the market. The upshot has been a steady expansion of productive capacity, rapidly rising living standards, and a smooth change in the society and continuity in institutions.

Gradualism is most marked in the transition of administrative allocation of real estate resources to market allocation and is typified by the housing reform (Lee, 2000), which sought to replace the welfare housing allocation system with individual purchase at the housing market. It took about 20 years for the reform to bear full fruits, with the main housing solution shifting from subsidised home purchase with partial ownership, public housing at market rent, subsidised home purchase at limited and then full ownership, to purchase at market prices. Such a gradual change allows learning by doing to avoid errors such as full scale subsidised home purchase with partial ownership in the first half of the 1980s, which was not financially feasible and would harm the development of the consumer market. The gradual approach allowed for a shift in cultural values of the Chinese public in favour of owner occupation and accepting their responsibility for meeting the cost of their own housing. Therefore the final phase of housing reforms in 1998 allowed for a smoother transition than would have been possible otherwise.

However, the gradualist reform, which allows the co-existence of administrative and market allocations, gave rise to large scale corruption, appropriation of state assets and unfair competition in the market. For example, the land use reform to change administrative to market allocation of land, started from 1990 but dragged on until August 2004. During this long time span, numerous land plots were either administratively allocated or sold at large discounts to market prices, enabling buyers to resell at market prices and develop the sites to sell property at market prices. Such a situation resulted in distortion of the property market with power and connection, rather than expertise and hard work being determinants of success. The legacy is still felt everywhere in the property market and visible in the urban landscape of many cities.

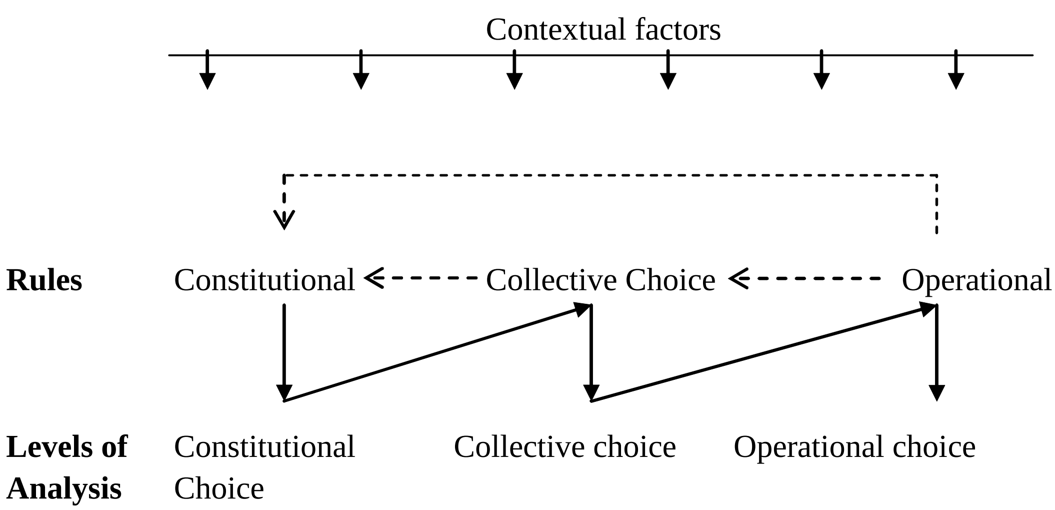
Thus, the property market is still influenced by a number of rules that have their origin in the command economy system. The role of government as a referee instead of a player is still not fully understood and observed. Laws and regulations are often not fully enforceable because of local government intervention and lack of other supporting rules. The government and the legal system are still biased towards the producer, a legacy in the era of shortage, leaving the consumer and the investor at a disadvantage.

Therefore, institutional barriers are often the most limiting factor in raising productivity and facilitating market exchange in the Chinese property market, where other factors of production like land, capital and labour are plenty.

To aid the analysis of institutional change, a three-level analytical tool, developed by Kiser and Ostrom (1982) and Ostrom (1990) is employed to assist the identification of the nature of and relationship among institutional arrangements (Exhibit 5). It stratifies rules for a particular event (in this case commercial property investment) into operational, collective-choice and constitutional levels. The operational level is the bottom level where individuals and firms make business decisions. These decisions result in actions in the market, i.e. development, purchase and holding of commercial property for investment purposes. The collective-choice level is the intermediate level where officials make decisions, which are rules bounding business decisions in a market. Officials' decisions are enforceable against non-conforming individuals in the market. For instance, officials may impose a tax on the sale of property within a number of years to deter 'speculation', which is enforced in title registration.

The constitutional level is the top level, where decisions made by senior officials and politicians in turn set the institutional arrangements for the collective choice level. These decisions form the rules that officials must obey when they formulate rules for the market. For example, central government officials may ban local officials from imposing tax on rental income. Decision-making at any level is affected by the existence of contextual factors that are independent of the institutional arrangements surrounding the particular market (Edwards & Steins, 1998). The actions of foreign investors to make substantial number of enquiries on commercial properties in China and purchase some buildings in Beijing and Shanghai are independent from and unanticipated by the Chinese officials and developers, which changes market expectations and encourages developers to take extra risks in commercial property development.

Exhibit 5
The three-level analytical framework and the contextual factors



(Adapted from Ostrom, 1990; Edwards and Steins, 1998)

The above framework can be used to explain the making of the entrepreneurial local governments in China, which are keen to take risks in development. To boost economic growth, the central government in China, i.e. the constitutional level, decides that the promotion and tenure of office of local senior officials are linked to local economical achievements (GDP) those officials promote while in office. This rule has led to local senior officials, at the collective choice level, to set out ambitious growth plans to beat their counterparts and to provide government support in streamlined planning approval and subsidies to some sectors, such as manufacturing and construction, which could generate high GDP growth. Actors in those sectors, either state-owned firms or private firms, are encouraged to undertake projects that generate high figures of GDP and employment.

Field work

This research uses an extensive interview programme in four main case study cities. The interviews were semi-structured in nature allowing for maximum objectivity yet encompassing the desired flexibility for iterative development and exploring issues in a deeper qualitative manner during the study period. The programme was designed to be comprehensive in its scope covering the full range of identified key actors. It therefore aimed to interview an average of 50 informed respondents in each city, with the target for Beijing being 60 given the city is the capital and that for Chongqing being 40 given it has a smaller property market with a shorter history. The interviewees are drawn from a range of actors including high ranking public officials at city, provincial (as in Guangdong) and national levels (as in Beijing), professional organisations and research and academic institutions and the private sector (major international, national and local developers, investors, banks and agents). Exhibit 6 provides the detail of the interviewed respondents in China.

Exhibit 6
Interview programme in China

Cities	Total number interviewed	Category			Typical length (hours)
		Private	Public	Legal	
Beijing	62	44	14	4	1.5
Shanghai	53	40	10	3	1.25
Guangzhou	50	39	9	2	1.5
Chongqing	39	28	8	3	1.5
Total	204	151	41	12	

The focus groups (Exhibit 7) were a complementary tool to the interview programme to discuss emerging issues in greater detail and gain additional insights in to the operation of the property investment market. In total we conducted 5 focus groups in China. The main objective of this focus group was to gain an insight in to the current thinking and perceptions of international actors on property investment market in

China and its inherent risks and opportunities.

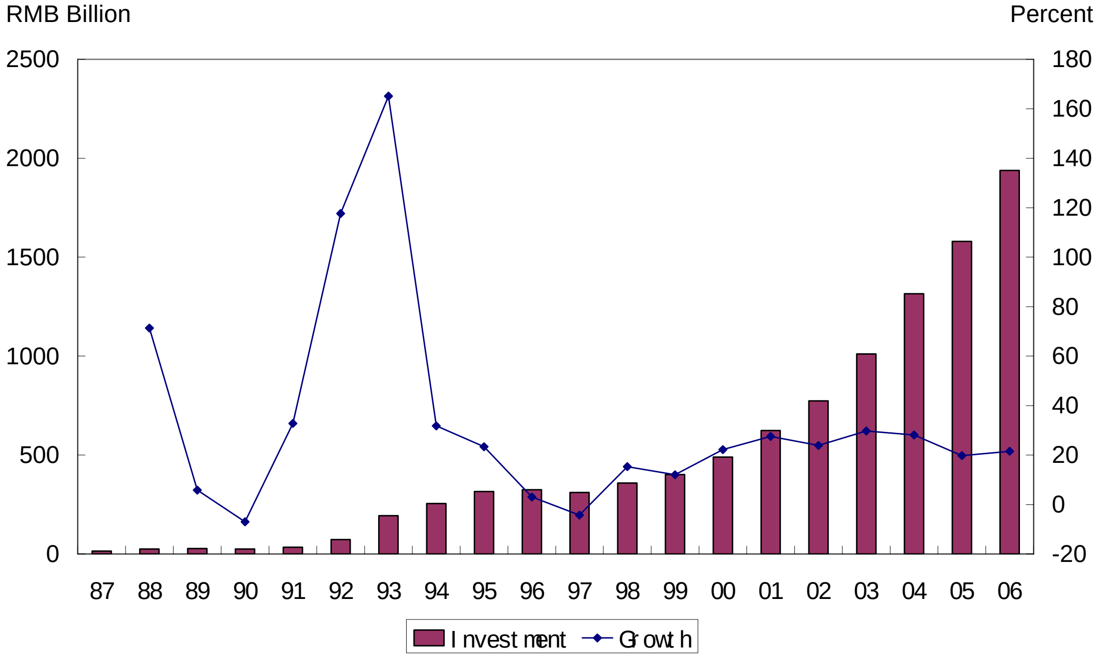
Exhibit 7
Focus Groups in China

Cities	Nature of participants	Number of participants	Date of meeting	Time (hours)
Beijing	Domestic & foreign	13	20 September 2005	2.5
Shanghai	Mainly domestic	12	13 September 2005	2.5
Shanghai	Mainly foreign	7	26 September 2005	2
Guangzhou	Domestic & foreign	16	16 September 2005	2.5
Chongqing	Domestic	18	23 September 2005	3
Total		73		

Property-led urban economic growth

The Chinese economic miracle owes to and also contributes to rapid urbanisation in the last 20 years. From 1988 to 2006 market investment in property development grew at 29.2% year-on-year (Exhibit 8). 12 million sqm prime office space and 7.7 million sqm prime retail space have been built since 1992 in Beijing, Guangzhou and Shanghai (CB RICHARD ELLIS, 2006). Major cities boast modern bridges, ports, airports, mass transit railways (MTR), ring roads and other express roads. By 2006, MTR lines were in operation in 10 cities and were under construction in another 20 cities. Beijing, Shanghai, Guangzhou and Chongqing have a total of 10 lines in operation, are building over 10 lines and plan to have an additional 30 lines in total in the future.

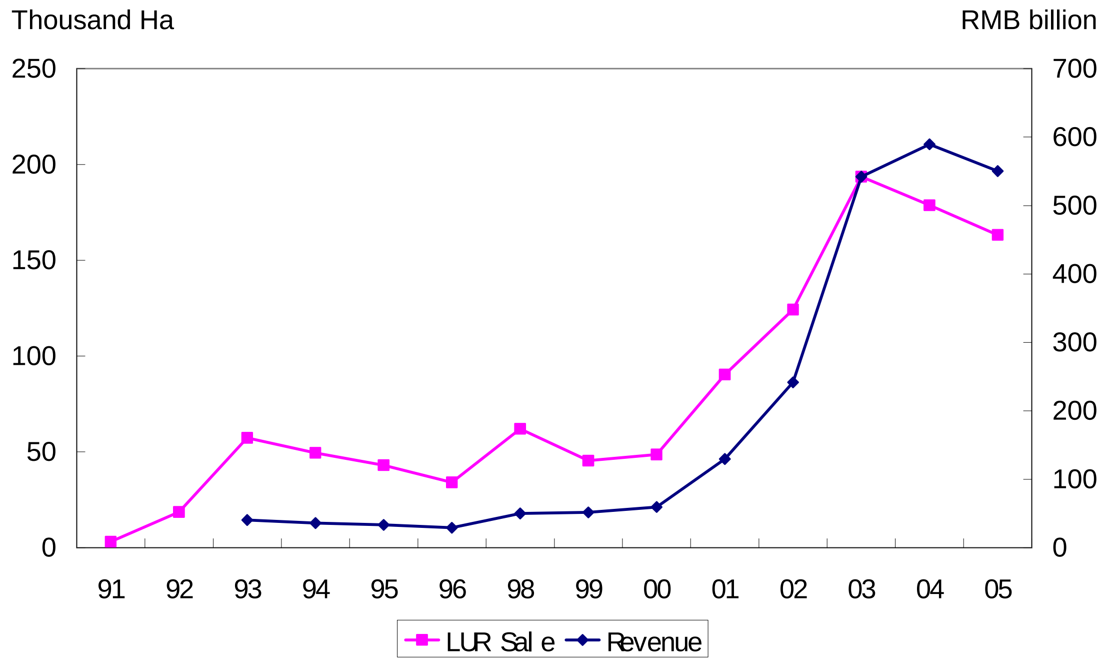
Exhibit 8
Growth of investment in market-oriented property development



Sources: China National Bureau of Statistics (2006; 2007)

Behind this remarkable urban growth is the distinct property-led urban economic development model (hereafter referred to as the property-led development model) which partly explains the urban economic development miracle in China. Local governments are given the task of local economic development but not the funds. To compensate for this, the central government at the constitutional level gives local governments almost full planning power and unencumbered administrative power to acquire and sell state land to generate funds. Local governments, in turn, use their planning powers to formulate ambitious city master plans and designate growth areas, such as central business districts (CBD), central commercial districts, and industrial parks. They then use their administrative powers to sell long leaseholds on state-owned land, referred to as Land Use Right (LUR), and compulsorily purchase collectively-owned rural land to convert it into state-owned land for sale. Large amount of extra-budgetary funds is generated in this way for urban investment. After land was required to be disposed of publicly in 2002, local governments often choose public auctions to maximise land sale revenues. The impact of open market disposal of land on land sale revenues is shown in Exhibit 9.

Exhibit 9
Total sale of land by government and total revenues



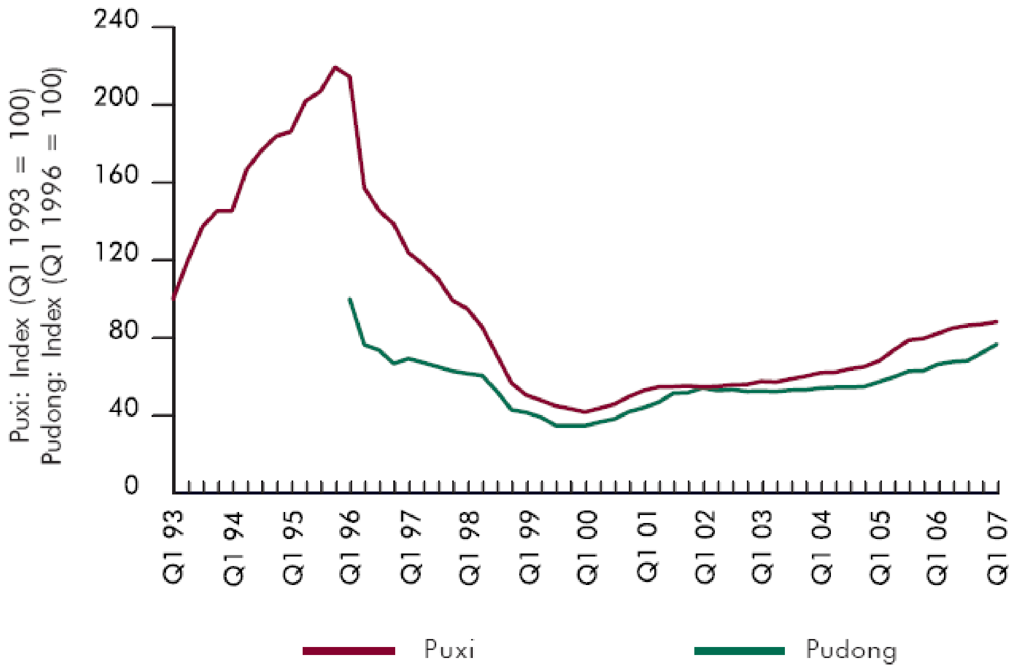
Source: Ministry of Land and Resources, 2006

Nevertheless, the property-led development model has brought substantial risks to commercial property investment. The model gives Chinese cities land and funds to implement their often unrealistically ambitious development plans. While it helps to prepare cities to capture opportunities presented by rapid economic growth, over-ambition in urban development is often translated into government sponsored city-wide property speculation, which imposes risks throughout the property market.

The risks imposed are substantiated in a wave of nationwide project failures. Frontline cities are not exempt to such risks. Shanghai tried to transform itself in a short time by approving many dozens of major office projects from 1992 to 1995, which led to 642 failed projects (21 Century Business Herald, 2003), many of which were offices, and falling office rental values in 1996 to 1999 (Exhibit 11). At present office rental value has recovered its 1993 position due to Shanghai's prominence in attracting foreign and domestic firms to set up headquarters and regional headquarters. However, Beijing, having the same experience as Shanghai up to 2000, has still subdued office rental value (Exhibit 11) due to the city's ambition, which leads to huge amount of projects given go-ahead in the same time.

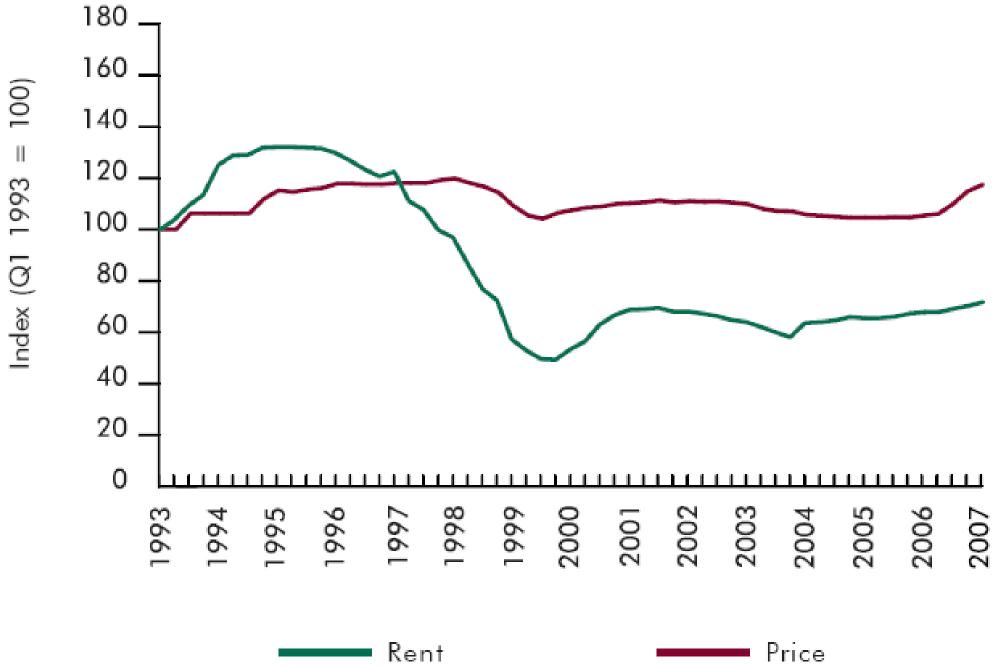
Exhibit 10

CB RICHARD ELLIS Shanghai prime office rental index



Source: CB RICHARD ELLIS (2007)

Exhibit 11
CB RICHARD ELLIS Beijing prime office rental and price index



Source: CB RICHARD ELLIS (2007)

The property-led development model imposes greater risks to second-line and third line cities. The mid-1990s property development boom also affected third-line cities like Chongqing and Chengdu, which had over 93 and 66 failed projects (Chongqing Business Post, 2007; Sichuan Daily, 2006), respectively. In Chongqing, 1 remaining failed project was yet to be sold off for re-development by early 2007. In Chengdu, 30 of the failed projects have been completed and 29 resumed construction by the end of 2006, leaving 7 to be disposed of in the future.

For marginal cities, the property-led development model could bring devastating impacts. Beihai City of Guangxi Province had a population of only 200,000 in 1992 (550,000 in 2005) but large number of development projects approved in 1992 to 1993. Eventually 136 projects failed (Xinhua, 2007), which were all disposed of by 2006. The city, having the best coastline for tourism and port in province, has lost the opportunity to become a growth pole.

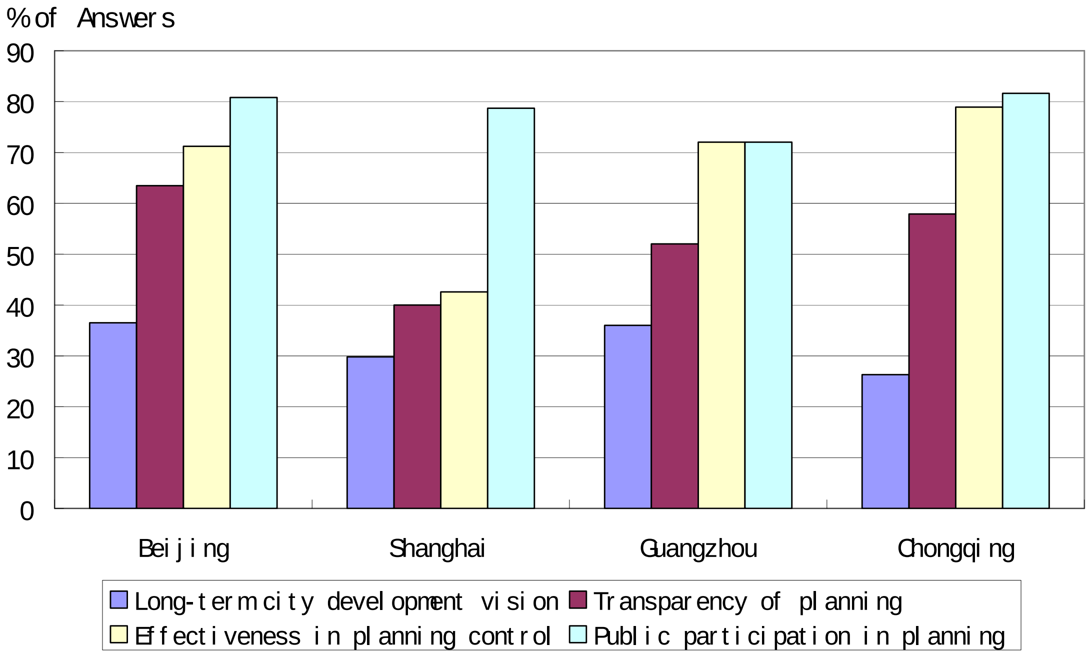
However, many cities have now ignored the lesson and embarked on a new round of city-scale property development. The most notable case is Zhengzhou, a third-line city and the capital city of Henan Province, China's most populous province. The city is building a new Central Business District (CBD) on a huge green-field site, with 60 office buildings (30 120-metre-high buildings in the outer ring and another 30 80-metre-high buildings in the inner ring) and a 3.4 kilometre shopping street. In particular, 55 of these 60 buildings were built in the same time with 35 completed in 2006 (Zhengzhou Municipal Bureau of Statistics, 2007). It is not sure who are going to occupy these office buildings, with those finished experiencing difficulty of sale and leasing.

Urban governance

The absolute power of local governments leads to poor transparency in urban governance. In our interview programme we asked interviewees to comment on the following number of aspects of urban governance: long-term city development vision; transparency in planning; effectiveness of planning control; and public participation in planning. The outcome of the answers is illustrated in Exhibit 12.

Exhibit 12

Percentage of interviewees unsatisfied with the way the planning system operate



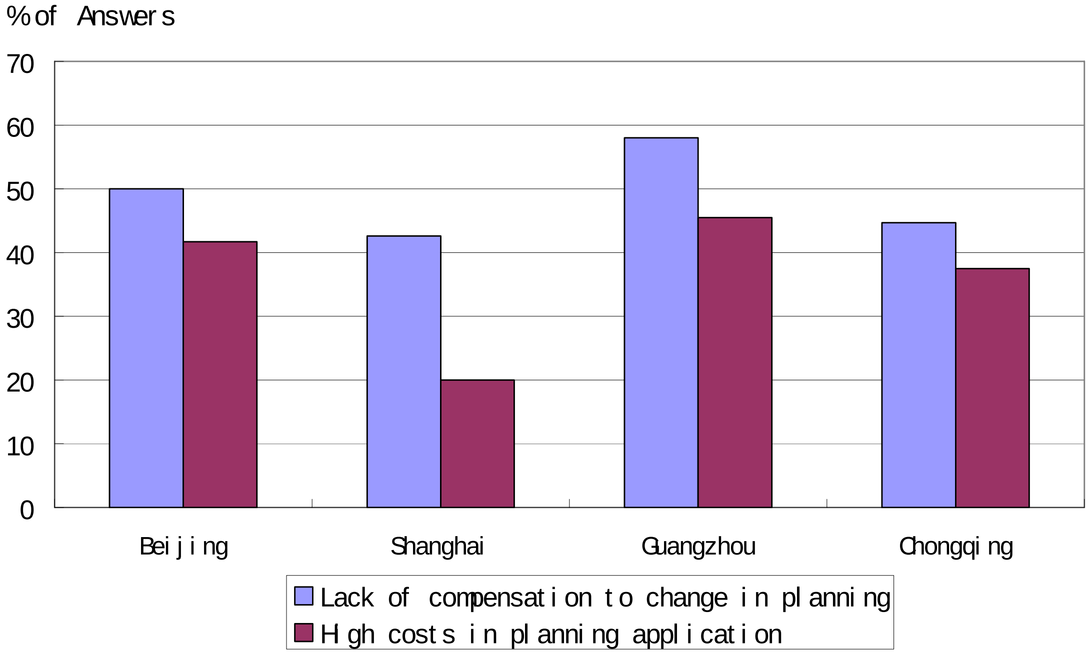
First, more than 25% of interviewees in each of the four cities are unsatisfied about the long-term city development vision set by their local governments. This is especially so in Beijing and Guangzhou. For example, Beijing recently re-defined its vision to be an administrative and business centre, designating a CBD and relocating its heavy industry, e.g. the giant steel company. However, some interviewees argued that Beijing is not suitable for a business centre.

Second, a minimum of 40% (Shanghai) and a maximum of 63% (Beijing) of interviewees in the four cities are unsatisfied with transparency of planning. It is often difficult or impossible to know how the urban plan is made and changed, and why some similar planning applications are accepted while others rejected. As a result, investors are often not well-informed of the latest changes in the cities they are operating in. Sometimes a new announcement could change the location of an area with serious consequences on the value of property on the previously 'right' locations.

Third, from 42% (Shanghai) to 79% (Chongqing) of interviewees were not satisfied with effectiveness in planning control. Even in Shanghai, as one interviewee revealed, strict obedience of the plan is an exception rather than the norm. Thus, there is high degree of uncertainty on neighbouring developments and competitive projects even though the plan is known.

Fourth, 71% (Guangzhou) to 81% (Chongqing) of interviewees were not satisfied with public participation in planning. The result for Shanghai is also unexpected as the substantial difference with other cities on other aspects is not repeated in public participation. There are some changes toward greater public participation. However, as a few interviewees in Beijing and Guangzhou put it, the very limited public participation is not heeded in earnest by the local governments.

Exhibit 13
Percentage of interviewees who perceived the problems in the planning system as serious



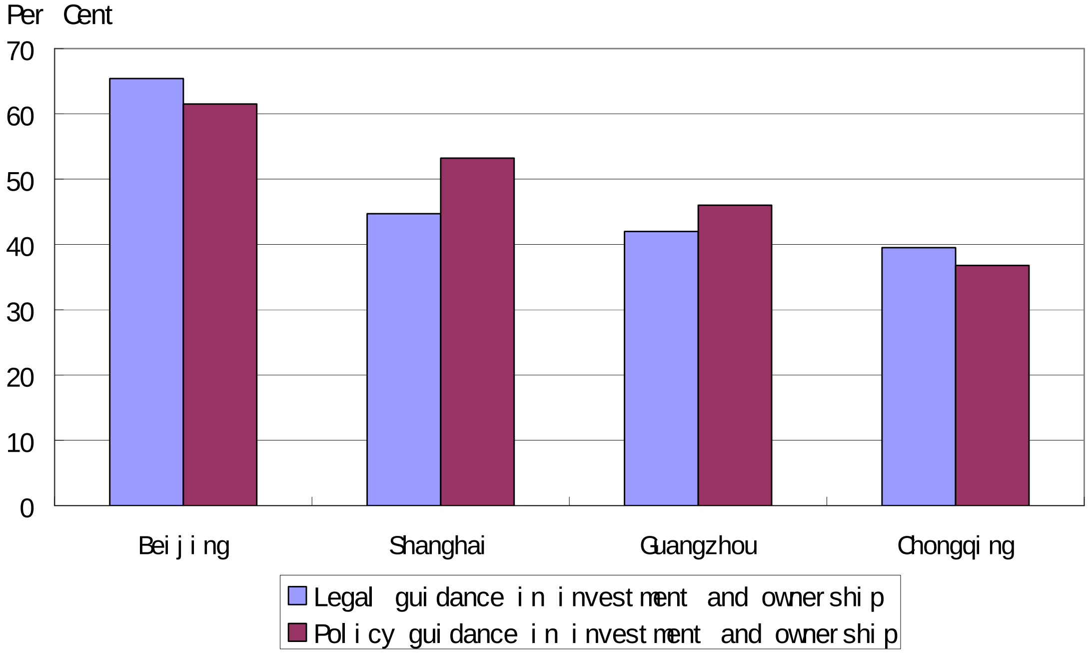
One further problem is that the rights of existing owners are often not protected when planning conditions change, with 43% to 58% of interviewees unsatisfied with the compensation (Exhibition 13). In addition, planning application is expensive in Beijing, Guangzhou and Chongqing, with 38% (Chongqing) to 45% (Guangzhou) of interviewees considering the costs as very high.

Real estate administration

After formally creating LUR on land in 1990, the legitimacy of private property rights was recognised by the Constitution in 2004. On 16 March 2007, the Property Rights Law was approved by the National People's Congress, ending the decade long effort to enact a law to protect property rights.

However, from 40% (Chongqing) to 65% (Beijing) of interviewees were not satisfied with the legal guidance on property investment and ownership (Exhibit 14). An obvious problem is the delay in legislation on extension and renewal of the long leasehold tenure in land. Interviewees pointed out that the length of LUR on commercial uses (office, retail, industrial, education and culture, and mixed uses), which was stipulated in 1990 as from 40 to 50 years, were too short. There was a case that a commercial property was rejected after the buyer found out the remaining length of the LUR was less than 30 years. In a few years time, most of the commercial property (mostly in mixed uses) built on LUR sold around 1992/1993 will incur the same problem. Unfortunately, both the government and the industry tend to ignore the importance of this issue, with the recently passed Property Rights Law ignoring the renewal issue, not to mention the extension issue.

Exhibit 14
Percentage of interviewees unsatisfied with legal and policy guidance on property investment and ownership



Also, from 38% to 61% of interviewees were not satisfied with policy guidance in investment and ownership. In fact, there is no formal national policy on commercial property. Without a state policy, new developments allowed in great numbers are often at the expense of existing buildings and the owners are often unable to prevent the expected intense competition and over-supply. As a result, issues like using housing as offices and opening shops in ground floor housing are very difficult to ban. In Beijing, a high-tech science park, Zhongguancun, has actually been developed into a huge office cluster for high-tech firms and other firms. In Guangzhou, the 100,000 sqm Teemall was the first super-mall in the country and became very successful. However, the owners were unable to prevent the local planning authority to approve the development of a 300,000 sqm Grandview Mall built 200 metres away. So far Teemall is able to maintain its competitive advantage because it has a direct link to the underground railway. However, the future is uncertain as three other projects offering another 100,000 sqm retail space have been completed recently in just 500 metres away, and two new projects, offer more than 100,000 sqm space have been approved.

Market practices

Current market practices also generate risks in a number of areas. Exhibit 15 illustrates the views of interviewees on the standard of professional services, indicating some problems in Beijing, Guangzhou and Chongqing. However, if the issues of data availability and quality are considered (Exhibit 16), the quality of professional services is very problematic, at least in Beijing, Guangzhou and Chongqing. One interviewee in Beijing found holes in data provided by the government and chased the issue. Yet the answer was that the data were the best the government could offer and that the data would be improved. As a result he had to conduct supplementary surveys to improve the quality of the data.

Exhibit 15

Percentage of interviewees regarding quality of professional services, valuation and training as seriously problematic

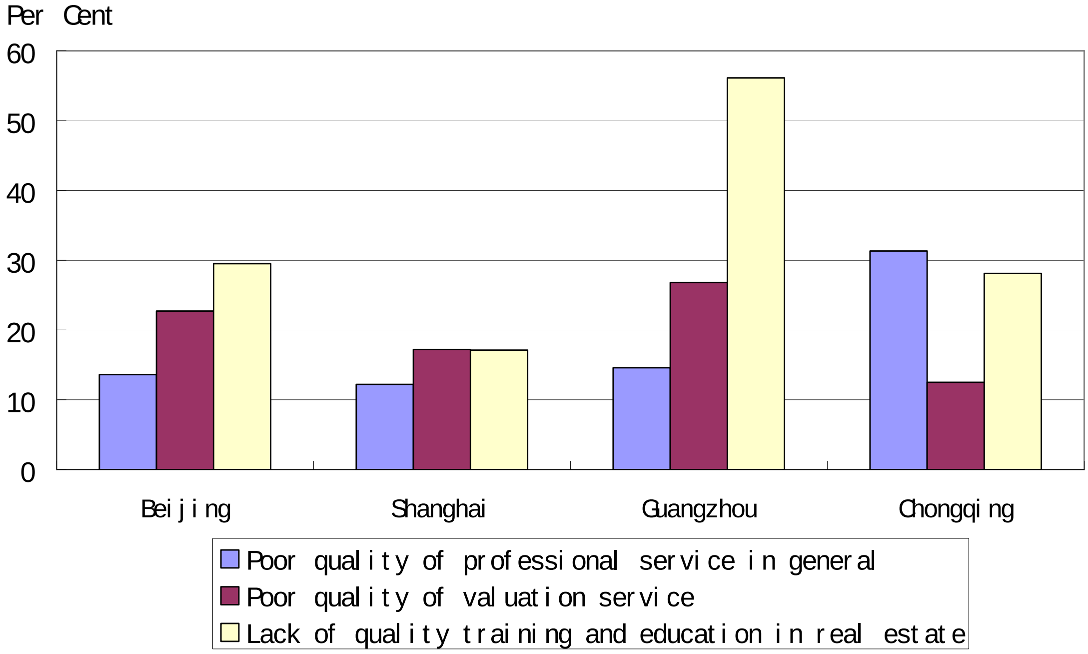
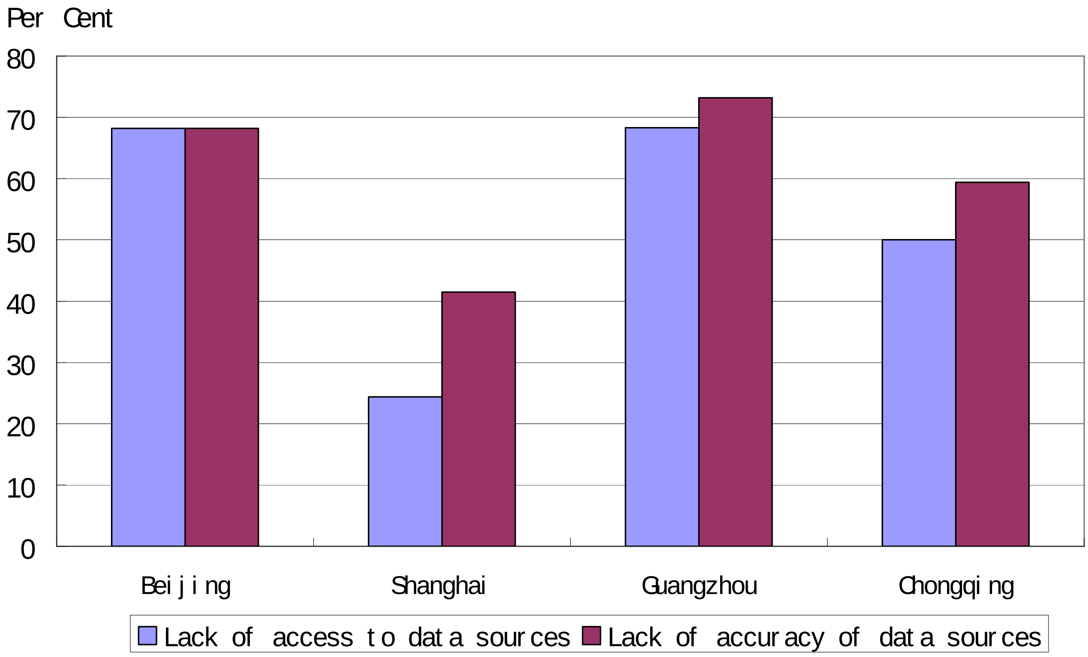


Exhibit 16

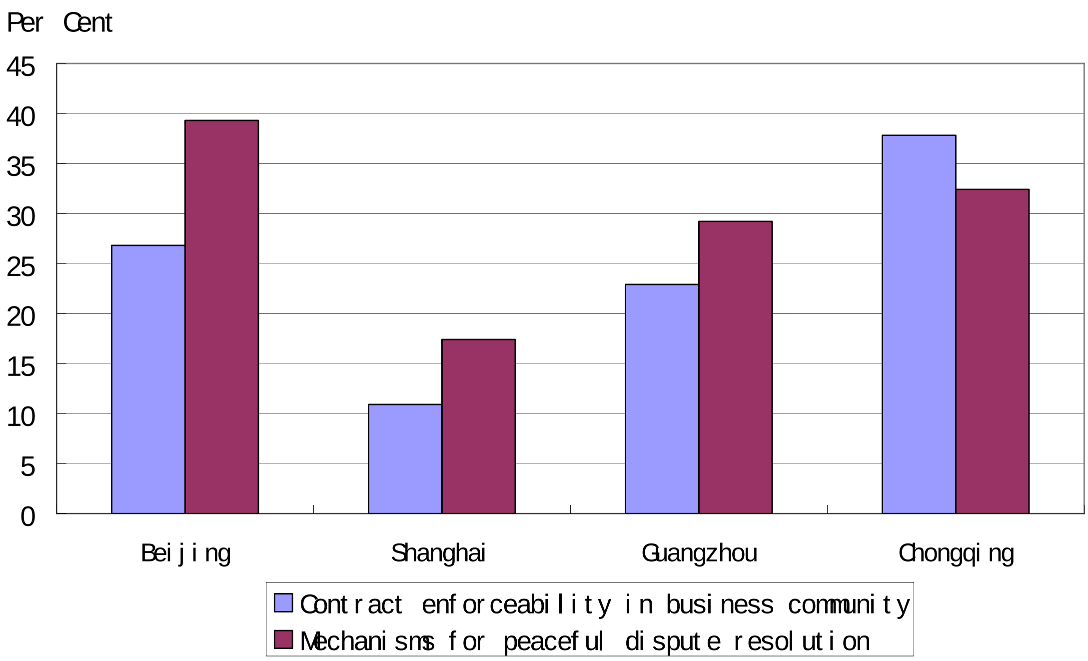
Percentage of interviewees regarding access to, and accuracy of information, in the property market to be seriously problematic



Difficulties in contract enforcement and dispute resolution in the business community substantially increase the risks of market operations. Exhibit 17 shows with the exception of Shanghai, 23% (Guangzhou) to 37% (Chongqing) of interviewees were not satisfied with contract enforcement in the business communities. Furthermore, mechanisms to allow peaceful (arbitration) resolution of disputes are regarded as unsatisfactory by 29% (Guangzhou) to 39% (Beijing) interviewees.

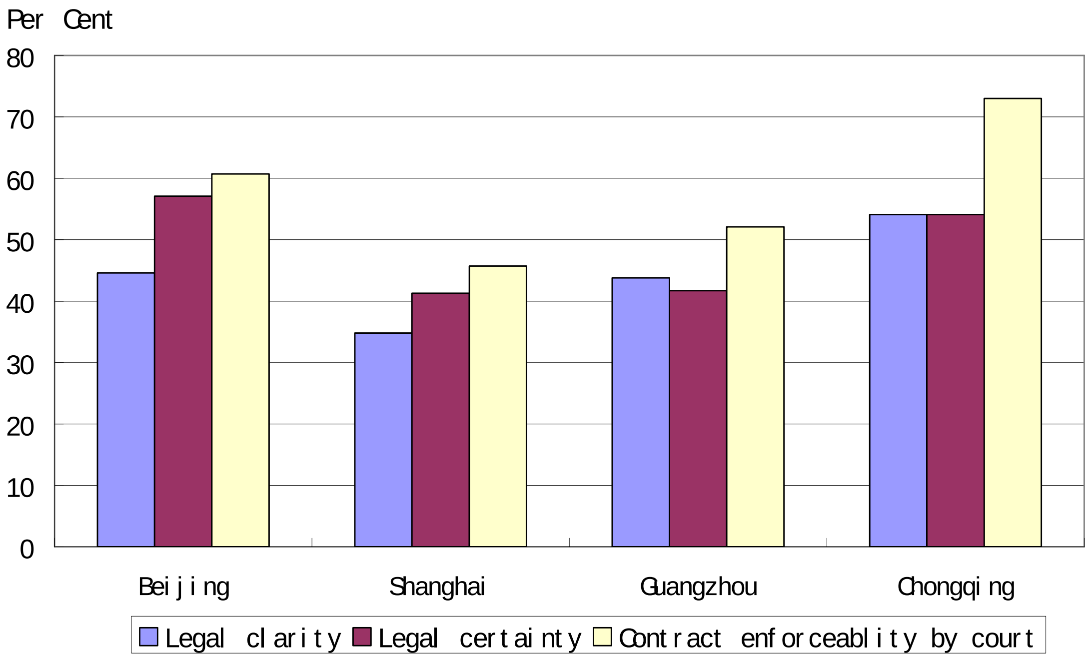
Exhibit 17

Percentage of interviewees regarding contract enforceability and dispute resolution as being unsatisfactory



In many cases, going to court is inevitable. However, there is some degree of uncertainty in court, as Exhibit 18 shows. Both legal clarity and legal certainty are poorly regarded by interviewees in the four cities. Contract enforcement by court is the worst aspect in the court system, with 61% (Beijing) and 72% of interviewees unsatisfied about their court's contract enforcement.

Exhibit 18
Uncertainty in court: Percentage of interviewees unsatisfied with selected legal indicators



In addition to the above practices, there are a number of issues that amplify risks from market operations. Over-optimism and poor risk control in the poorly experienced and educated property industry often result in failed projects or intensive competition due to over supply. Inexperienced and poorly financed developers often produce buildings at the wrong location with poor design, imposing negative externality to neighbours. One interviewee, a director of a major property consultancy, complained about the lack of high-specification offices in Shanghai. Another interviewee in a similar position in Chongqing indicated only one building could be truly regarded as a grade A office building. Finally, the cultivation of Guanxi (Chinese style personal connection and nepotism) is so important that non-local firms are often disadvantaged in opportunities and information, although reform on disposal of government land has reduced uncertainty in land acquisition.

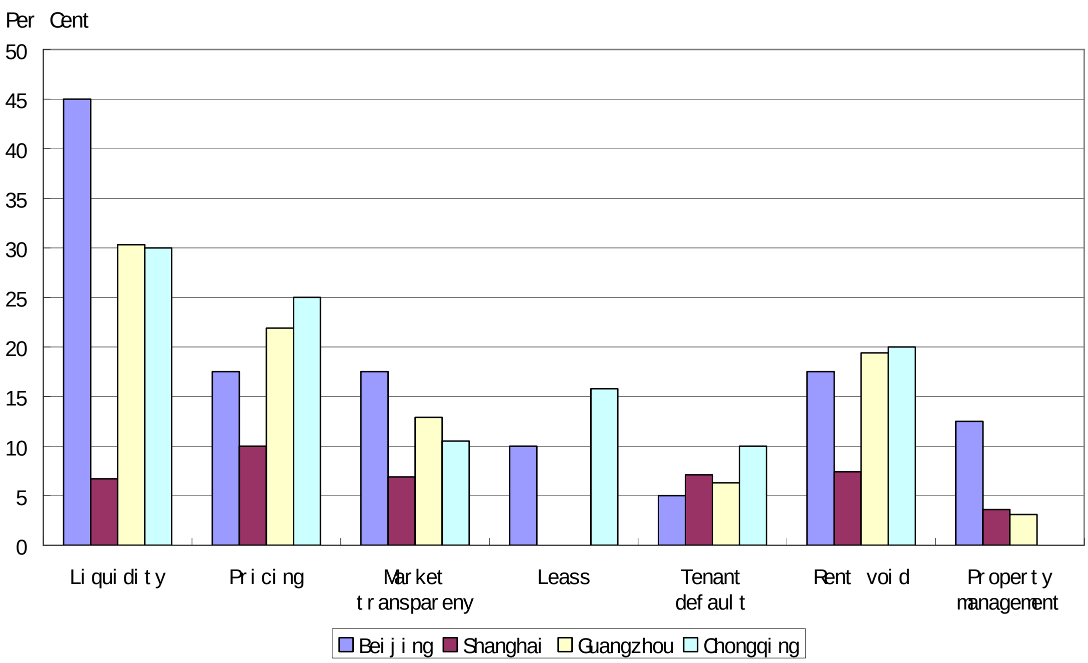
Investment risks

The real estate investment market in China is still in its early stages and most real estate professionals are yet to develop themselves in this market. Even so, the interview programme still produces very interesting results. Exhibits 19 and 20 illustrate the interviewees' perception of office and retail investment risks. It can be seen that liquidity, pricing and rent void are the most risky factors in office and retail investment.

In terms of offices, even though increasing number of domestic owner-occupiers and some foreign investors are making en-bloc purchase deals in Beijing and Shanghai, liquidity is still problematic for both developers and investors in Beijing, Guangzhou and Chongqing due to the poorly developed domestic financing system. In second line cities, liquidity is more problematic. Pricing could also be an issue as many of the risks detailed above, like urban governance, real estate administration and market practices, are not taken into account in appraisals. Rent voids often occurs as there are large amount of new supply coming onto the market and retention of occupiers, who often only sign for two years, is proved to be difficult.

Exhibit 19

Percentage of interviewees regarding the office market as high risk

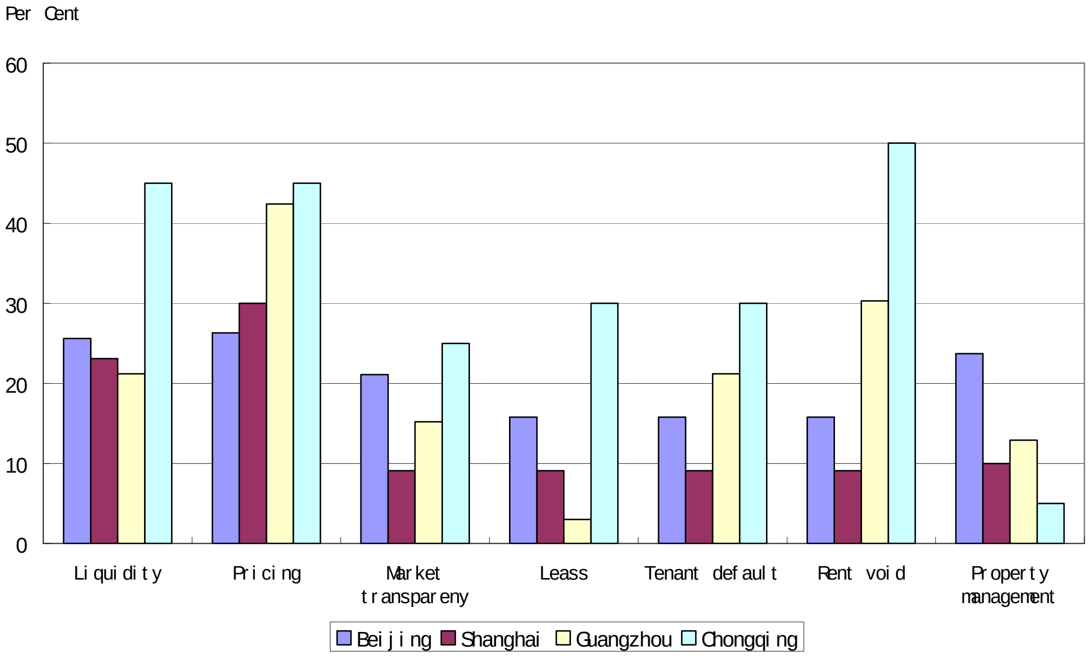


In terms of retail property, liquidity of non-prime property is very problematic due to oversupply, especially in Chongqing. Prime shops also have very few transaction records, partly because a lack of buyers able to pay the high prices. The pricing risk is related to the fact that the risks imposed by urban governance, real estate administration and market practices, which is higher than in offices, are not priced into the appraisals. Rent void is a major problem for secondary shops. However, oversupply and intensive competition may render some former prime shops having extended rent voids.

In terms of property types, retail property has been found to be consistently riskier than offices, a fact related to the higher sensitivity of retail property to location and competition. In terms of cities, risks in frontline cities have been found to be lower than those in second-line cities, which in turn are lower than in third-line cities. Within the frontline cities, Shanghai is found to be much less risky than Beijing in terms of offices and retail property.

Exhibit 20

Percentage of interviewees regarding the retail market as high risk



Conclusions

China is on the path of rapid and sustained economic growth at least for the near future, which has resulted in general growth of demand for property and rental and capital values of property. Yet the past performance of property investments in different parts of the country and at different times has shown high risks to unwary investors.

The robust economic fundamentals in China signal that risks in Chinese commercial real estate investment will be alleviated by the rapidly growing economy, maturing real estate market, and ongoing reform and government intervention to increase transparency and accountability of local officials. However, our study suggests that the positive impact on investment risks in commercial property brought forward by robust economic growth is largely offset by the widespread adoption of the property-led urban economic growth model, which exacerbates the problems in urban governance, real estate administration and market practices.

Thus risk assessment on commercial property investment in China has to take into account parameters in urban governance, real estate administration and market practices, which are difficult to quantify. A short-cut to avoid a lengthy risk assessment is to invest in prime properties in the frontline cities only. Opportunities in second-line and third-line cities need to be assessed by a model that includes an institutional analysis as well as a conventional economic analysis. Future research can be focused on developing such a model based on the insights gained in this paper.

Endnotes

1. This paper is based on a research project funded by Royal Institution of Chartered Surveyors (RICS) and Shui On Holdings. The full report is due for publication in early 2007.
2. China's GDP in 2006 was USD2,681.7billion (China National Bureau Of Statistics, 2007) in market exchange terms, which is close to the USD2,984billion of Germany (Economist, 2007), currently at the third place. In purchasing power parity terms, the Chinese GDP in 2006 was USD9,861billion, about three quarters of that of the US's (Economist, 2007).
3. For example, European investors like ING and Arlington have been involved in property development in Beijing and Shanghai. American developers like Hines and AMB and investment bankers like Morgan Stanley, Goldman Sachs and Merrill Lynch have been involved in both development and investment of commercial in Beijing and Shanghai.
4. Such a classification of cities is based on their economic size, growth prospects and investment risks. For Beijing and Shanghai, this is not controversial. For the rest, there is no consensus. The classification in the paper, which differentiates front-line, second-line, third-line and marginal cities, is for illustrative purpose only.
5. The Chinese equivalent for the 'failed project' is Lan Wei Lou, meaning the project has not funding to complete and no purchase interest in the market even though a large discount in price is always available.

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