

China Market Report

Property Investment in Second-Tier Cities

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Executive summary

- Foreign investors’ interest in China’s property sector has shown no signs of abating, despite the Chinese government’s continuing efforts to cool the property market. Greater transparency in the land sales system has helped boost interest in the market among foreign property developers.
- Limited availability of urban sites in first-tier cities, including Shanghai, Beijing, Guangzhou and Shenzhen, has increasingly driven foreign developers to shift their investment towards second-tier cities.
- However, in the short term, first-tier cities will continue to be the preferred location for foreign investors looking for en-bloc properties to hold over the long term, given the small stock of quality properties in second-tier cities.
- Many foreign developers prefer residential projects because of their relatively short payback period, but competition in the residential sector is intensifying. Local developers have been catching up fast in acquiring the know-how for developing quality residential schemes.
- Demand for Grade-A offices in many second-tier cities has to date remained weak, but the continual influx of multinational corporations will stimulate the demand for quality office space in cities that have the potential to become a regional service centre. Cities with this potential include Tianjin, Nanjing, Wuhan, Qingdao, Dalian, Chongqing and Chengdu.

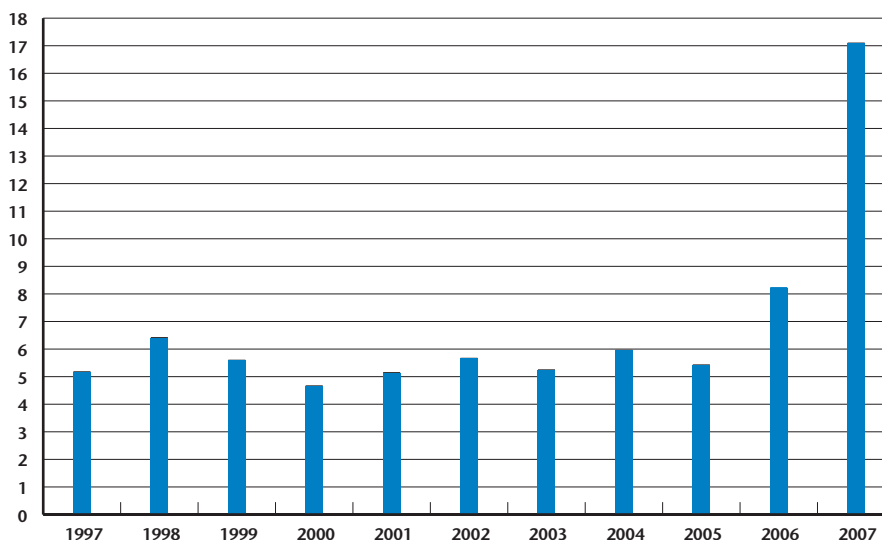
Where are international property investors heading in China?

Foreign investors have continued to pour billions of dollars into China's property sector despite the central government's heightened clampdown on the property market. In 2007, foreign direct investment in the real estate sector rose year-on-year by 108% to USD17 billion following an increase of 52% in 2006.

“Improving transparency in the land sales system has helped boost interest among foreign developers.”

Significant upside in capital values, attractive rental yields and the expectations for further appreciation of the renminbi are the key forces that lie behind foreign investors' foray into China's property market. Furthermore, increasing foreign developers attracted by the improving transparency of the land sales system, which now requires all government land to be sold by public tender or auction, also contributed to the surge in foreign investment in China's property sector.

Foreign direct investment in China's real estate sector (USD Billion)



Source: National Bureau of Statistics of China and Knight Frank

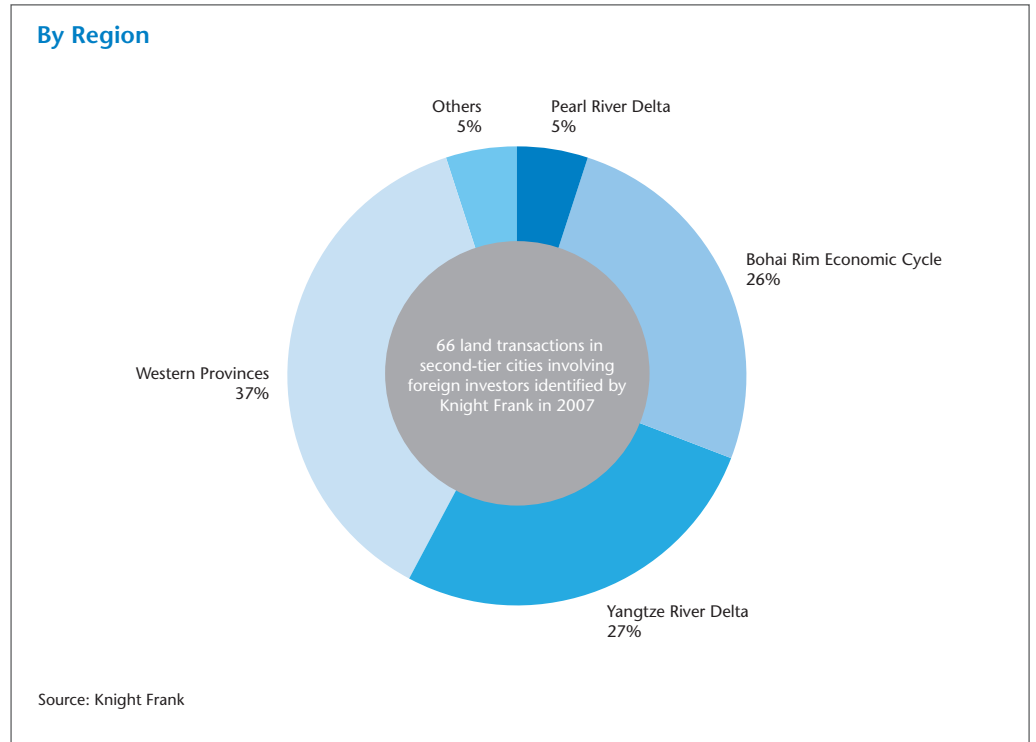
“The stock of quality properties in second-tier cities has remained small.”

Shanghai, Beijing, Guangzhou and Shenzhen have been widely taken by international property investors as the first-tier cities in China given their high levels of urbanization, mature property markets and extensive supply of quality buildings. First-tier cities have so far been the preferred location for foreign investors looking to acquire en-bloc properties for long-term investment as the stock of quality properties in second-tier cities has remained small.

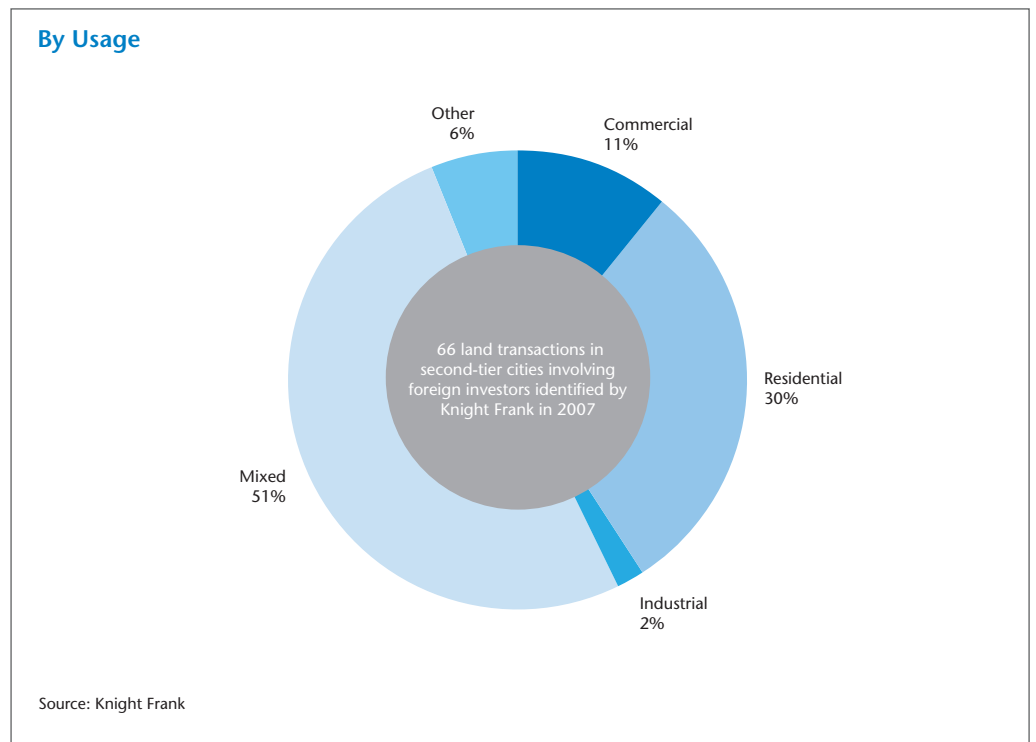
Notwithstanding this, foreign developers have been increasingly shifting their attention towards second-tier cities given the surging land prices and lack of urban land sites in first-tier cities. In 2007, 66 out of the 88 land transactions identified by Knight Frank involving foreign investment were located in second-tier cities. Hong Kong property investors have been especially active in the second-tier cities. Of the 66 land transactions in second-tier cities involving foreign investment, 63 involved Hong Kong companies.

Site acquisitions by foreign investors in second-tier cities in 2007

“Though most site acquisitions are in coastal cities, an increasing number are now in the western provinces.”



“About half of all sites acquired by foreign investors are for mixed-use developments, while the remainder are for residential (30%), commercial (11%) and industrial (2%).”

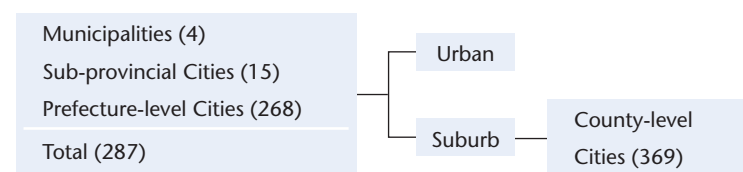


Cities in China

It is a huge challenge for foreign property investors to identify the right locations for investment given China's vast land area. According to 2007 official statistics, the numbers of cities on the Mainland categorized by their administrative power were as follows:

- Four provincial-level cities (or municipalities) that enjoy an autonomy similar to provinces;
- 15 sub-provincial cities that are mostly provincial capitals;
- 268 cities at the prefecture level; and
- 369 cities at the county level.

China's city system



Source: National Bureau of Statistics of China and Knight Frank

“We believe only the urban areas of 287 cities are on the radar screen of international property investors.”

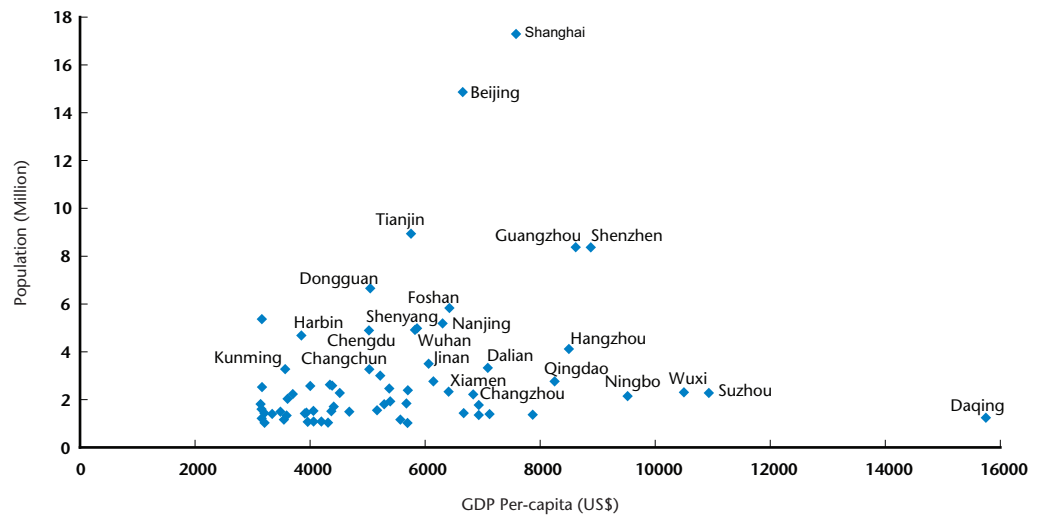
On the surface, the total number of cities in mainland China amounted to 656 in 2007. However, adding the numbers of these cities together may involve some double-counting. This is because the 369 county-level cities are actually affiliated to the suburbs of other higher-ranking cities. More importantly, most of these county-level cities are relatively under-developed with low per-capita income that has not reached a critical mass of purchasing power that warrants investment attention. We believe that at this stage only the urban areas of the 287 cities at the provincial, sub-provincial and prefecture levels are on the radar screen of international property investors.

Spotting cities with potential

The market consensus is that China's second-tier cities are likely to provide more opportunities for property investors in the country's next phase of development. However, there is no commonly accepted definition of the so-called “second-tier cities”.

Generally speaking, population and per-capita income are the two most important indicators for measuring a city's economic prowess. Among the cities in China, Knight Frank has identified 66 cities with a population of over one million and per-capita GDP above US\$3,000 as of 2006. These 66 cities generated 45% of the national GDP in 2006 from 15% of China's total population. Out of the 66 cities, nine are located in the Pearl River Delta, 13 in the Yangtze River Delta and 18 in the Bohai Rim Region. In some underdeveloped provinces, it is usually only the provincial capitals that have achieved the US\$3,000 per-capita GDP threshold. Examples include Taiyuan, Nanchang and Changsha in the provinces of Shanxi, Jiangxi and Hunan respectively.

Mainland cities with over 1 million people and per-capita GDP over US\$3,000



Source: National Bureau of Statistics of China and Knight Frank

Note: Per-capita GDP and population figures are for the urban areas of cities.

“Provincial capitals enjoy greater people flow, higher concentration of economic activities and better-developed infrastructure.”

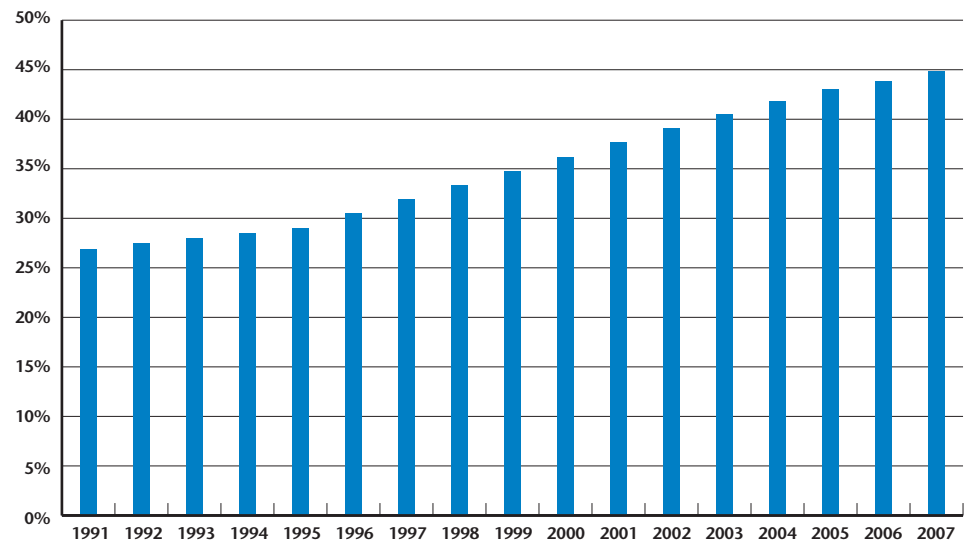
The provincial capitals tend to be hot spots for foreign developers. Compared with other cities, provincial capitals usually enjoy greater people flow, higher concentration of economic activities and better-developed infrastructure. Many provincial cities have also reported a significantly higher proportion of property buyers from other provinces or cities in the country.

Some key cities in inland China, even with rather low per-capita income levels, have attracted the interest of Hong Kong developers. One example is Chongqing, where a number of Hong Kong developers have already gained a foothold. Chongqing’s prospect as an economic hub in western and central China appears bright with a population level of more than 30 million and its designation as a core city by the central government under the Western China Development Strategy.

Residential sector

The residential sector has been and will continue to be the focus of foreign developers’ interest in second-tier cities. This is understandable given that the risk involved in this sector is relatively small. Rapid urbanization in second-tier cities should translate into steady demand for residential units. It is also relatively easy to assess the residential demand in second-tier cities. In addition, many foreign developers prefer residential projects because of their short payback periods – capital can usually be recovered quickly through the presales of properties.

Urban population (As % of total population)



Source: National Bureau of Statistics of China and Knight Frank

“The quality gap between foreign and locally-developed properties is narrowing.”

However, competition in the residential sector has been intensifying. As China’s construction materials industry is rapidly maturing, the quality gap between foreign and locally-developed properties is narrowing. Local developers have also been catching up fast in acquiring the know-how for developing quality residential schemes, with some having already hired overseas architects, interior designers and landscape designers in an effort to improve standards.

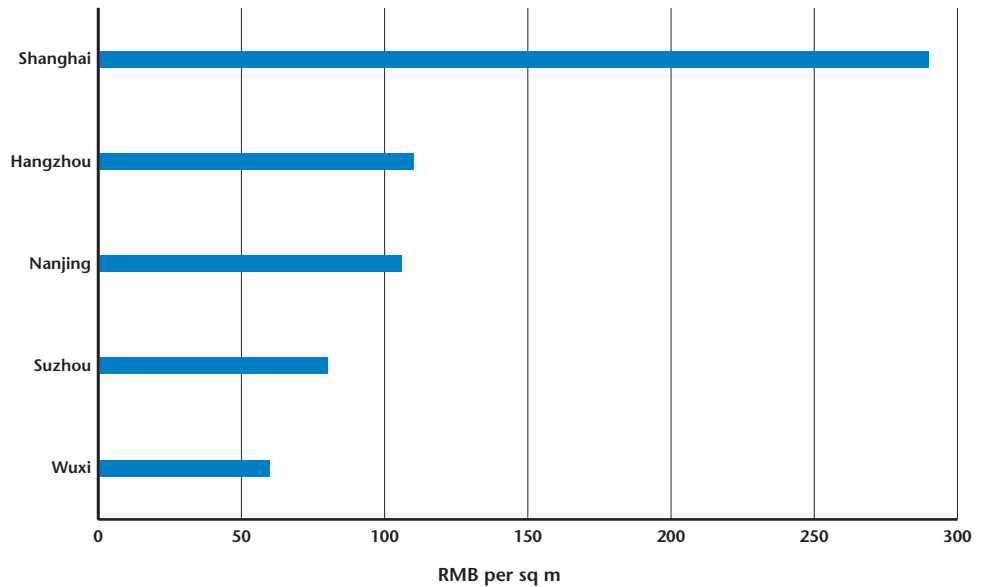
Office sector

“Most enterprises in second-tier cities cannot afford to buy or rent Grade-A offices.”

The office sector has so far taken up only a small proportion of foreign developers’ interest in second-tier cities. Demand for Grade-A office space in China has so far been concentrated in first-tier cities, whilst demand for quality offices in many second-tier cities currently remains relatively weak. Most enterprises in second-tier cities cannot afford to buy or rent Grade-A offices, as construction costs are significantly higher compared with the costs of Grade-B offices or industrial buildings. Nor do these enterprises need the large floor plates offered by Grade-A offices. According to Knight Frank’s survey in Nanjing in 2006, the average office space demanded by a typical local enterprise was only 150 sq m.

Foreign developers are not keen on developing non-Grade A offices as this might have negative impact on their image. Developing office properties will not be the preference for the big name foreign developers unless they intend to keep the development for rent or are confident of selling the building en bloc, as the quality of an office building usually declines if it is sold on strata-title basis.

Monthly rental levels of typical prime offices in Yangtze River Delta



Source: Knight Frank

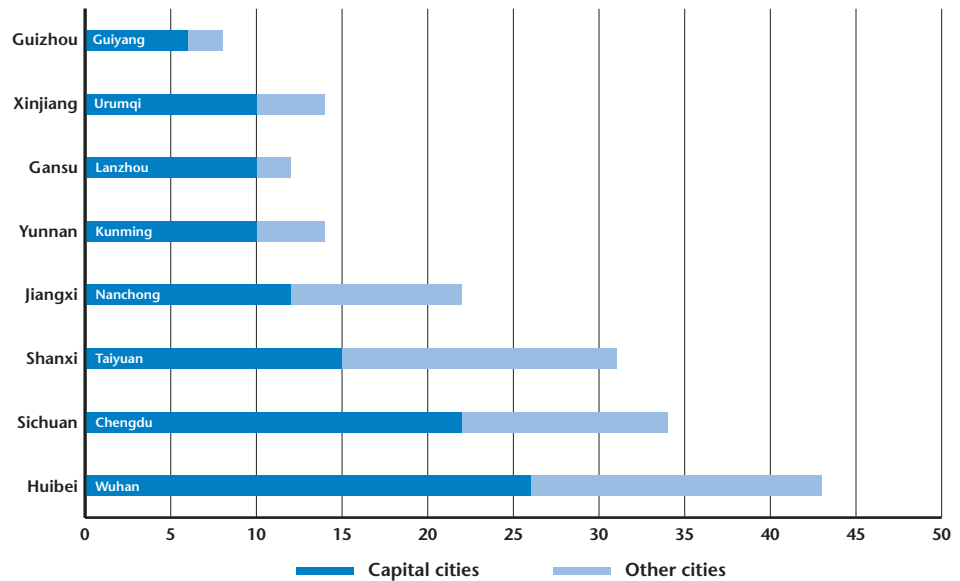
“Demand for Grade-A offices will emerge in cities that have the potential to become a regional service centre.”

China is on track to become a more service-oriented economy, with production-supporting services playing a more important role in the value-added chain. These pre-manufacturing and post-manufacturing services include research and development, product design, market research, branding and positioning, marketing and advertising as well as distribution and logistics. Coupled with the continual influx of multinational corporations, this will stimulate the demand for quality offices, in particular in cities that have the potential to become a regional service centre. Cities with this potential include Tianjin, Nanjing, Wuhan, Qingdao, Dalian, Chongqing and Chengdu. Over time, the emergence of these regional service centres will create more business opportunities for foreign developers.

Retail sector

Foreign developers have an edge in China’s retail sector, as their local counterparts are still lagging far behind in their ability to design and manage shopping centres. Quality retail space in prime locations is expected to enjoy strong capital appreciation over the long term on the back of surging purchasing power and liberalization of restrictions on foreign retailers entering the country. These factors have encouraged foreign developers to keep an increasing number of prime retail properties for long-term investment.

Distribution of KFC in China's inland provinces



Source: Knight Frank

“Usually, a shopping mall cannot be sold at a good price until its success is proved.”

However, purchasing power in most second-tier cities remains heavily concentrated in the provincial capitals. The branch distribution of a foreign fast food chain as of the third quarter of 2007 provides a good indication of this: of the twelve outlets of KFC in Gansu province, ten were situated in its capital city, Lanzhou; 26 out of the 43 KFC outlets in Hubei were in Wuhan, whilst six out of the eight outlets in Guizhou were located in Guiyang.

Significant resources are required to make a shopping mall successful. Huge investment is needed to buy a site in a prime location, to launch a series of marketing campaigns and to hire a team of professionals to manage the premises. Usually a shopping mall cannot be sold at a good price until its success is proved and this can take several years after project completion.

Closing comment

Second-tier cities will offer more opportunities for foreign property investors in China's next phase of development. It is easier to find local partners in second-tier cities and their governments are generally more supportive of foreign property investors. Local developers are more affected by credit tightening, giving the financially-strong foreign investors a competitive edge. However, the challenges of operating in a second-tier city in the areas of market transparency, policy stability and manpower availability should not be under-estimated. Foreign players might not be able to replicate their overseas successful experiences if they do not have good relationships with the local government and do not have the right people on the ground.

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