China's 12th Five-Year Plan and its implications for the real estate market

Since 1953, China has framed its economic and social development initiatives in the context of five-year plans. The content and directives of the plans have shaped the country's rapid rise over the recent decades by defining clear and measurable targets and policy initiatives. Planning is still a key characteristic of the centralized economy, and the government continues to adjust its strategic initiatives every five years to sustain the creation of wealth and welfare, and to maintain social stability.
In the new 12th five-year plan China has clearly signaled its intention to shift from a policy of maximizing growth to balancing growth with social and environmental sustainability. China wants to succeed not just by the scale of its economic growth, but also by the speed with which it can embrace a sustainable future. Further, admonished by memories of turmoil and disintegration, China's leadership places the highest priority on economic and ultimately social stability.
The challenges of keeping economic stability are numerous. To start with, the renminbi's peg to the US dollar induces an "imported" inflation, stemming from the quantitative easing in the US. While the Fed might welcome inflation to reduce real-term US debt, the Chinese government is concerned about rising prices, especially food prices, as they potentially provoke social unrest. If the US dollar peg was eased to let the renminbi appreciate on the other hand, exports would suffer and the resulting unemployment could also create social instability. The Chinese government will likely pursue a further reduction of export dependency by encouraging domestic consumption, before it allows its currency to approximate its fundamental value. Further, China's hunger for energy and its impact on the environment call for the support of renewable energy and, at least as important, of energy efficiency.
In this newsletter we provide a general introduction to China's 12th five-year plan and examine its impact on the real estate market.

The 12th Five-Year Plan

Investors would be well advised to align themselves with the new policy directions the government is charting in the 12th five-year plan. These policies highlight China's key economic challenges that need to be balanced and explain how the government intends to address them.
Three key points of the 12th five-year plan directly impact the real estate industry:

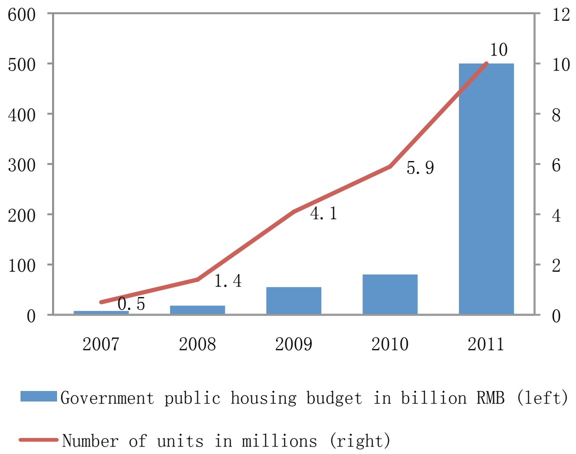
- Improving the living standards by raising the supply of housing for low and medium income households
- Supporting the development of green buildings to reach the ambitious energy conservation targets
- Encouraging domestic consumption, resulting in increasing demand for commercial real estate

While low cost housing is strongly promoted, China maintains its efforts to improve the efficiency of land use by restricting the construction of large apartments (with a floor area lager than 90 square meters) and villas. Real estate policies play a very important role to smooth the widening wealth disparity, at both ends of the scale.

Affordable housing

Rising property prices in China's major cities make it increasingly hard for middle- and low-income households to afford a home. Premier Wen Jiabao indicated in the government report about the 12th five-year plan that 36 million public housing units should be built in the coming five years. These subsidized homes will be sold at a 30% to 50% lower price than private apartments or will be rented out based on income limits. It is the first time that a detailed number of public housing to be constructed is listed in the plan.
Out of the 218'000 hectares of land that the government provides for residential properties this year, more than a third is reserved for the construction of affordable housing. In other words, it is planed that 10 million units of affordable homes are built already in 2011, designed to meet demand from middle- and low- income households.

Figure 1: China's public housing program speeds up



Estimates suggest that government-sponsored public housing investment will likely represent around 8% of this year's real estate investment. Subsidized, social housing is an important angle of wealth distribution, which the government is keen to promote to enhance social stability. Looking at China's efforts to support public housing over the past five years shows that the progress of affordable housing programs is rapidly accelerating.
Besides the central and local governments, state-owned enterprises (SOEs) play a major role in the public housing program. China's central government has ordered SOEs that specialize in architecture or construction to be actively involved in building affordable houses.
The public housing program requires as much as up to RMB 5 trillion over the next five years. For 2011, the central and the local governments provide a budget of RMB 500 billion, while public institutions and businesses must raise another RMB 800 billion. Due to the low margins, developers are not proactive in participating in the development of these homes. However, as the government offers subsidies and tax breaks, and both vacancy and price risk are very low, affordable housing developments can be quite profitable, especially if they are done on a large scale.

Energy-saving buildings

What's notable in the five-year plan is the prominent position of environmental issues such as the reduction of energy consumption and CO_2-emission. Not only is this the first plan that involves green energy issues; they are mentioned as a top priority.
The new and 'greenest' five-year plan in China's history contains a range of targets that are congruent with the Copenhagen announcement that China's CO_2-emissions per unit of GDP would be reduced in 2020 by 40% to 45% with respect to 2005 levels. Clearly defined and distinct targets will help ensure that provincial and local governments actually implement the environmental policies. Promotions for government officials are no longer dictated mostly by how many percent GDP they grew their area but now also by how 'clean' they are.
In the past five years, industrial energy efficiency already improved considerably. The new plan calls for a major push towards energy-saving buildings. Many local governments have set up green building regulations in line with national policies. In first-tier cities, new buildings generally need to comply with a minimum energy saving standard. Local governments have launched ambitious plans to renovate existing buildings to make them more energy-efficient. 25% of the buildings in medium-sized cities and 10% of those in smaller cities will need major refurbishment or reconstruction by 2020. It is also indicated that tax rebates and other financial incentives for the construction and purchase of energy efficient buildings will be announced in the near future. A first tax regulation circular (caishui 2010, #110) providing tax incentives to energy-saving businesses starting from January 1, 2011 was already released.
Beijing is determined to implement building energy saving policies by applying strict energy saving design standards in new building construction, and gradually conducting energy-saving renovations to existing buildings. Shanghai has ambitious plan as it aims to reduce its energy consumption per unit of GDP by 20% by 2015 compared to 2010, with 15% stemming from energy-efficient buildings. In the next five years, the city's planned 180 million square meters of new residential and public buildings shall be 50% more energy efficient, while corresponding renovations account for 30 million square meters. A similar 50% energy saving regulation has become mandatory to all new buildings in Guangdong province.

Highlights of the 12th Five-Year Plan

Economic restructuring
- GDP to grow on average by 7% annually
- Prices to be kept generally stable
- Rise in domestic consumption
- Urbanization rate to reach 51.5%, up 4% from 2010
- Coastal regions to turn from 'the world's factory' to hubs of R&D, high-end manufacturing and services

Infrastructure
- Nuclear power to be developed more efficiently under the precondition of ensuring safety
- Construction of large-scale hydropower plants to gain momentum in southwest China
- Length of high-speed railway to reach 45'000km
- Length of highway network to reach 83'000km

Environment & clean energy:
- Non-fossil fuel to account for 11.4% of primary energy consumption
- Water consumption per unit of value-added industrial output to be cut by 30%
- Energy consumption per unit of GDP to be cut by 16%
- CO_2-emission per unit of GDP to be cut by 17%
- Foreign investment welcomed in modern agriculture, high-tech and environment protection industries

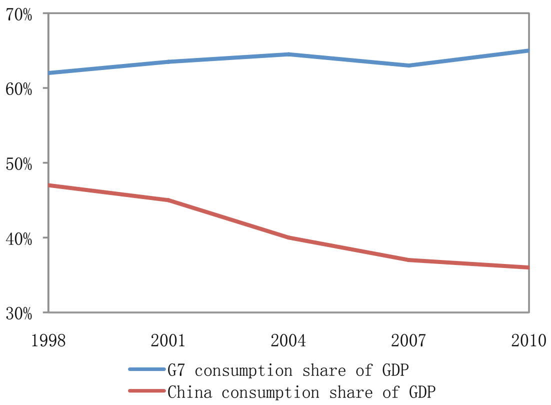
Livelihood
- Population to be no larger than 1.39 billion
- More than 45 million jobs to be created in urban areas
- Construction and renovation of 36 million apartments for low-income families
- Minimum wage standard to increase by no less than 13% on average each year

As it continues to urbanize and to raise its standards of living, China's building footprint gets bigger and bigger. As the government seeks to promote its own green building standards, projects that are certified are becoming increasingly appealing to developers and investors. It is a good time for architects and developers to spread the appeal for green buildings and to move beyond the major Chinese cities.

Consumption and commercial real estate

China plans to double domestic consumption, especially with regard to wholesale, retail, lodging and catering, over the next five years. The government employs different economic tools to orchestrate higher consumer spending, including improvement of the social welfare network (mainly health and pension insurance), rise in wages, and the creation of new jobs.
As a result, the commercial property market has won attention. Amid a series of tightening measures to cool down the residential property market, many property developers have turned their eyes to the opportunities in the commercial sector. Compared to the residential sector, the retail property market is less exposed to the government's macroeconomic control. The development of commercial streets and shopping malls across China has therefore caught the interest of developers and investors.
According to data from real estate service provider Jones Lang LaSalle, property investment in China last year totaled about RMB 5 trillion. Less than 30% of that amount went toward commercial projects – a ratio essentially unchanged from 2006 to 2010. It is expected that the supply of retail space will accelerate in the coming years.
The major concern of commercial developers in China is the lack of critical information needed to set rental and lease rates. The commercial real estate market requires deep involvement of developers to resolve all sorts of issues for tenants. While residential real estate has a short development cycle, allows for a quick turnover and a clear exit, the commercial sector is more sophisticated, is exposed to a longer cycle, involves an active approach regarding the mix and establishment of tenants, and gets very complex for large scale projects.

Figure 2: Consumption share of GDP to grow again



However, more and more residential property developers in China are expanding into commercial projects. To limit complexity, they typically outsource tasks such as the elaboration of the business model and rental rates, the portioning of space for offices and shops, the supervision of design and management of the leases. However, there are still too many commercial real estate projects that are badly developed, due to developers' lack of experience or an overdone "cost-optimization".
In the current climate of tight credit in China, developers are finding it relatively difficult to get loans even for commercial development. Residential-retail combinations may be the most suitable projects for many developers, as the proceeds from residential sales can be used to finance the retail part in the same complex.

Implications for investors

According to the Central Bank, Chinese banks lent RMB 509.5 billion in new loans to the real estate sector in the first quarter of 2011, including those to developers and homebuyers. This amount is considerably lower than the RMB 843.3 billion in the same period in 2010, reflecting China's ongoing credit tightening. Property developers increasingly shift towards equity financing, as the government will continue to curb lending to the real estate industry.
With regard to the residential sector, the increased supply of affordable housing should have little impact on the price level of the non-subsidized housing market, but is expected to ease tension among first-home buyers. Private developers generally target mid- to high-end customers, delivering higher quality properties and looking for higher profit margins. In other words, it is not expected that developers will be willing to actively be involved in developing pure public housing projects, which generate net margin of only a fourth compared to those from normal property development projects, unless they can negotiate a package deal or enhance their standing with the government.
Further, under the 'green' guidelines of the new five-year plan, it can be expected that investors ever more appreciate investments in sustainable real estate. An increasing number of encouraging policies will be formulated to favor green building development projects. More and more developers try to comply with sustainability standards to receive government support, but there is still a considerable lack of green building know how. Green buildings will be a major topic of the Chinese real estate market, and the distinction between true and pseudo green construction will become more and more apparent over time.
Finally, the central government has made clear in its 12th five-year plan that it wants to promote economic development by raising domestic consumption levels. Real estate developers, property funds and investors generally welcome the support of China's consumption growth, with retail developments and shopping malls being the main beneficiaries

of this move.

Investment activities in the real estate sector are still dominated by domestic investors. As first-tier cities such as Beijing and Shanghai experience limited availability and are costly, investors increasingly look for more distant frontiers to achieve higher yields. In second- and third-tier cities, the most promising areas appear to be retail and residential developments, followed by office space, logistic hubs and hotels. A major advantage of second- and third-tier city investments is that these cities have higher demand growth and lower acquisition costs than first-tier cities.

In response to the government's tightening of the capital markets, real estate developers are looking to establish relationships with alternative and foreign funding sources. The issuance of corporate bonds, private equity investments and Sino-foreign joint ventures are an increasingly important source of funding. However, foreign investors need to be selective in their China investment strategies, aiming to identify investment opportunities that follow a clear and distinctive rationale, rather than relying on the market as a whole.

In sum, residential real estate investments will continue to face government scrutiny and projects that comply with green and social goals will be favored. In light of a consumption boost, the commercial sector offers attractive opportunities but remains challenging as quality requirements and complexity rise. Long-term investment strategies inevitably need to be aligned with the new five-year plan. ■

Diener Syz Real Estate

Diener Syz Real Estate is an investment company offering specialized expertise in Asia's real estate markets. Our strong local presence allows direct access to the most attractive investment opportunities. We strongly believe that sustainable development provides both financial and environmental benefits.

Our investment approach takes advantage of a broad range of investment instruments to optimally address prevailing market cycles in Asia's very dynamic market environment. We invest both capital and knowhow into sustainable real estate development projects in China, sourced through our strong network of local developers in cooperation with government agencies.

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Sources

CB Richard Ellis; CEIC; Centaline; Credit Suisse Research; Cushman & Wakefield; Deloitte; Diener Syz Real Estate; DTZ Research; Economist Intelligence Unit; IMF; Jones Lang LaSalle; Knight Frank; KPMG; LaSalle Investment Management; McKinsey Global Institute; Morgan Stanley Research; National, Provincial, and Municipal Bureaus of Statistics; People's Bank of China; Political & Economic Risk Consultancy Ltd; PricewaterhouseCoopers; Reuters Real Estate; Savills; UBS Research; Xinhuanet; China Daily; Shanghai Daily

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