

FOCUS ON CHINA

Shanghai Development Takes Off, Transforming the Residential and Commercial Landscape

BY STEVE PRICE, CRE

MY FRIEND CHARLES RAGEN QUOTED ME THE OLD SAW: "Travel to China for a week, and you'll be able to write a book. Travel to China for a month, and you'll be able to write an article. Travel to China for a year, and you won't be able to write anything at all."

I cannot adequately describe the scale of what I saw in Shanghai. Its enormous size and rapid change—and its leaders' ability to make decisions and execute—is amazing. This city is undergoing a massive program of demolition, depopulation, resettlement and redevelopment—a carefully designed strategy to make it a first-class business hub for Asia, beating out Hong Kong and Singapore.

Low-density industrial and housing neighborhoods are coming down, and high-rises with plenty of surrounding green space are going up. This green space and spectacular new architecture appeal to the Chinese elite, foreign corporate workers and domestic Chinese tourists. The city's master plan, as shown in the new four-story Shanghai Planning Museum, calls for 35 percent to 40 percent green space in what was once the most densely settled city in the world. Replacement housing for this depopulation of the central city is going up in massive tracts 10 and 20 kilometers outside the city. The area around urban Shanghai is a broad river delta and floodplain, formerly a huge agricultural area. Suzhou was once the center of the silk industry. I saw an incredible amount of multi-family residential and manufacturing construction during the 90-minute drive between Shanghai and Suzhou. Engineered neighborhoods of six-story apartment buildings go on to the horizon. It's like Le Corbusier on steroids.

Looking at the immense infrastructure and real estate development occurring in China, I cannot fathom how a centralized government can manage the process. Clearly, I don't know enough about how Chinese officials prioritize, organize and carry out their projects, but I can't understand how this much development can occur without contract law, master plans, building codes and infrastructure planning. How do they avoid or limit construction defects? How do they handle construction disputes? How is financing applied to profitable projects, and diverted from poorly designed and unsupported projects?

And the development is more than just new buildings. The Shanghai city government has spent \$160 million in 2005 and will spend another \$200 million in 2006 to support the development and establishment of creative



About the Columnist

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The city's master plan, above, is housed in the new four-story Shanghai Planning Museum. It calls for 35 percent to 40 percent green space in what was once the most densely settled city in the world.

businesses. “We hope to develop the creative industry as we can gain more profit through intellectual property rather than processing or manufacturing,” says Le Jing Peng, deputy director of the Shanghai Economic Commission. According to an article in the *Shanghai Daily* newspaper, 18 newly built creative industrial parks provide space for 800 design companies from 30 countries. Another 18 creative industrial parks are scheduled for completion in 2006.

WHAT TO EXPECT IN THE COMING DECADES

In the next 20 years, China should continue to have an enormous supply of unskilled, semi-skilled and skilled labor. Remember: the surplus Chinese labor supply is larger than the entire U.S. workforce. As the government continues to make massive plant, equipment, and education investments, the overall gross domestic product and productivity per capita will grow. Increased productivity

will partially offset rising labor and materials costs, which will result in continued low pricing on traded and manufactured goods. The definitions of value-add and traded goods will continue to expand, spurred by the efficiency and low cost of digital communications.

The cost of living will escalate rapidly, especially in urban areas. Real estate, transportation, education and medical prices have skyrocketed in the past 10 years, partially because of inflation and partially because the government is withdrawing social support. As growth continues, the government will move farther away from providing and subsidizing housing, education and medical services, and state-owned enterprises will employ fewer people.

For the bottom 80 percent of the income distribution, purchasing power parity between China and the U.S. is probably six to eight to one, or just under the actual

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exchange rate between the yuan/renminbe and U.S. dollar. This huge difference in cost of living and production costs is important because it underlies the major competitive advantage China has with its low production cost environment. This advantage will not disappear any time soon, especially as the U.S. continues to face very high inflation in non-CPI goods and services such as single-family real estate, medical costs and education.

As China grows, changes course, adjusts the way it deals with foreign governments, and tries to support numerous domestic industries that no longer are economically viable, many of today's issues and debates take on added dimensions. U.S. labor groups and manufacturers complain about Chinese workers' low wages and poor working conditions. But huge numbers of Chinese farm workers view factory jobs as a big step up. While visiting the Shanghai offices of a small Seattle-based importer/manufacturer, I was surprised to meet the corporate compliance officer, who inspects all of the company's contract factories to ensure working conditions are acceptable and U.S. corporate customers can buy their products with confidence. The cost advantage of Chinese manufacturing is so large that raising working standards doesn't add much to overall costs.

CHALLENGES INCLUDE MANAGING PUBLIC OPINION AND URBAN GROWTH

Managing public opinion and popular participation is the biggest single issue facing Chinese leaders. Threats range from villagers protesting pollution and growth to organized religions, trade unions and Falun Gong—a quasi-religion, quasi-exercise program. The government (i.e., the party) knows that if enough people get angry and have a common voice, they can create a big problem. And China has a lot of people to get angry.

But don't anticipate revolution. Singapore, Hong Kong and Taiwan are all successful examples of authoritarian Confucian governments that have produced massive amounts of growth and moved huge numbers of people from poverty into the middle class.

China also needs to invent a civil legal system. Right now, several old and ineffective systems are in place. The lack of rule of law and the arbitrary use of authority are serious problems. The leaders of China are ruthless and brook no dissent. At the same time, there is more internal discussion of problems in China than we are aware of. As individual



In Shanghai, low-density industrial and housing neighborhoods are coming down, and high-rises with plenty of surrounding green space are going up. This green space and spectacular new architecture appeal to the Chinese elite, foreign corporate workers and domestic Chinese tourists.

wealth and communications grow, the business leaders and public likely will grow impatient with patently indulgent and all-powerful political and business leaders.

Managing the environment of urban growth is another big challenge. This issue doesn't revolve around environmental and green concerns, but infrastructure requirements. Building out infrastructure is clearly a priority and Chinese governments at all levels are certainly outspending the U.S. federal government.

GOVERNMENT'S ROLE UNCERTAIN IN COMMERCIAL REAL ESTATE

In China, appraisers are licensed through the government. After meeting with colleagues from CB Richard Ellis and Colliers International, I learned that the brokerages are required to run all valuation work on the mainland through their Hong Kong offices, where they have an appraisal license. Most of the firms' work in Shanghai is market research and feasibility analysis.

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Shanghai residents gather for a morning Tai Chi session. Managing public opinion and popular participation is one of the biggest issues facing Chinese leaders.

Some of the trends they talked about sounded familiar and others were very unlike the U.S. market. China is experiencing a fairly low-yield real estate investment environment; 10 percent overall rates of return are typical for central business district office investments. Goldman Sachs recently purchased an office building on a 5 percent cash-on-cash return, but planned to make money on rolling over many older leases in the building and pushing them up to market. Second- and third-tier office buildings are being converted to residential condominiums, and capitalization rates for small multi-family and single-family residential structures are around 4 percent to 5 percent.

The land markets are largely government-controlled with most improvements constructed on ground leases from the local government. So from the onset, the local power structure is extremely influential. Fifty-year tenure is normal for office ground leases, and 75-year terms are typical for residential ground leases.

To control massive increases in residential condominium prices in the past several years, the government has tightened residential lending, decreased the loan-to-value ratio, increased transfer taxes on the sale of properties held for short periods of time, and prohibited re-sales and swaps of pre-sale/pre-construction purchase contracts. Recently they put restrictions on foreign ownership of residential units purchased for investment.

I had heard rumors in the U.S. that many of the new projects going up in China had very weak fundamentals. However, experts at CBRE and Colliers disagreed. They said that in Shanghai maybe 10 high-profile foreclosures or bankruptcies occur each year, and the market is more self-disciplined than outside investors might think.

Though the market appears to be fairly orderly on the macro level, it differs from the U.S. in that the number of property transfers is low and the market is not highly liquid. Large and politically well-connected U.S. and European investors such as investment banks would like to buy more in this market, but very few merchant builders or developers construct, lease up, then sell their assets.

Professionals from both brokerage firms said the role of the central government is uncertain in setting economic policies and structuring the environment for commercial real estate development. But they reported the situation is gradually becoming more transparent, especially in the central Shanghai area. But buyers still must be large enough to have political muscle. Neither firm thought nationalization was a big risk anymore, but mentioned numerous other risks. Beyond the lack of good quality available product is the relatively uncertain due diligence process. For instance, when buying a building, making sure the rent roll and the leases are accurate can be a challenge; obtaining financial information about tenants also may be difficult. Some foreign investors find it safer to buy poorly performing class B or vacant class C buildings, then rehab them and find new tenants.

This is a very odd and segregated market. Its major players have diverse views of the future and very different investment objectives. Colliers and CBRE reported vulture/opportunity funds and long-term growth investors shopping in the same markets for the same assets. Both want to purchase, but for opposite reasons and based on opposite long-term assumptions.

WHAT A U.S. BUSINESS AUDIENCE SHOULD ACKNOWLEDGE

- We have to learn how to make good decisions in the U.S. political, private investment, and public investment/infrastructure realms. Once those decisions are finalized, we need to figure out how to execute them efficiently and promptly.

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The Shanghai city government has spent \$160 million in 2005 and will spend another \$200 million in 2006 to support the development and establishment of creative businesses. “We hope to develop the creative industry as we can gain more profit through intellectual property rather than processing or manufacturing,” says Le Jing Peng, deputy director of the Shanghai Economic Commission.

- We must emphasize investment in education and expand the franchise of education as widely as possible because manufactured or traded goods will continue to go to offshore factories with unskilled or semi skilled laborers. Furthermore, more goods and services will become traded goods subject to competition from offshore.
- We must forget our assumptions of innate superiority. Next week, we’ll need something from China that we won’t be able to make or do ourselves, be it software code, a drug patent or financing a deficit.
- Many of the reoccurring U.S. critiques of China are designed to serve U.S. domestic political needs than on substandard business practices. ■