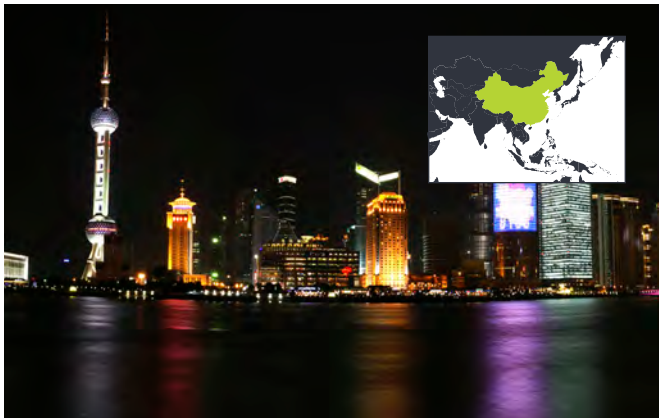


EVEN AS ECONOMY SLOWS, PROPERTY SECTOR EXPECTED TO BECOME STRONGER



For those currently working in the West, China's GDP figures must seem like a different world. Growth has averaged at 7% over the past 20 years and 9% is forecast this year, with a further 8% in 2012. However, while China continues to outstrip most economies, some in China are becoming nervous over the future. Closely integrated global markets and trading networks mean that the financial crisis in the developed economies will inevitably undermine the prosperity of emerging markets. Although China has relatively healthy balance sheets which should protect the country from an economic crisis, it also has a high dependency on foreign trade, so a global recession would create an enormous risk to China's continued prosperity.

“Given the current global economic situation, overseas investors, developers and consultants are likely to continue to target China as an area of growth, focusing primarily on the property development sector. Real estate presents many opportunities for investors, although the building industry faces a number of challenges including skill shortages, funding availability, cost increases, regionality, etc. Over the medium term, the construction and property sectors are expected to become even stronger and more robust and China will remain an exciting and prosperous place for investors.”

Philip Darby - Location Leader, China

Retail inflation in the country has been running at around 6% for much of 2011 due in part to continued rising property prices and increased commodity prices, while food prices have increased significantly. To combat inflation Beijing has raised interest rates and bank reserve requirements, tightening credit to slow the economy and introducing a policy to suppress speculative demand. Transaction volumes have begun to reduce so the policy appears to be beginning to work, although property prices have not yet come down so the controls are likely to remain for some time.

Banks and lending

Even in the best of times it has been difficult for Small and Medium sized Enterprises (SMEs) to get bank loans from the formal financial sector. The legitimate banks, which are mainly state owned, are reluctant to provide credit to privately owned companies and as a result, only around 10% of Chinese SME's finance comes from the banks. In the good years the shortfall has been made up by (illegal) makeshift banks or lenders who fuelled rapid growth through a plentiful supply of credit for all types and sizes of businesses.

With the economy slowing, many businesses are now unable to pay the 20% to 30% interest rates being demanded and some SMEs are now starting to go out of business. The government have stepped up measures to control the 'private lending business' including ordering the legitimate banks to meet a target of issuing 100 billion Yuan (£10 billion) of new loans to small companies this year, although this is dwarfed by the 2.6 trillion Yuan that has been lent through the underground banks.

International investors in development

China attracted a comparatively high level of Foreign Direct Investment (FDI) in the first 9 months of this year. The figure of US\$ 86.7 billion was 16.6% higher than the same period of 2010 with investment in the manufacturing sector slowing while investment in the services sector increased substantially. With labour costs in China rising, the manufacturing sector has become less attractive to foreign investors who are instead looking to invest in Vietnam and Thailand.

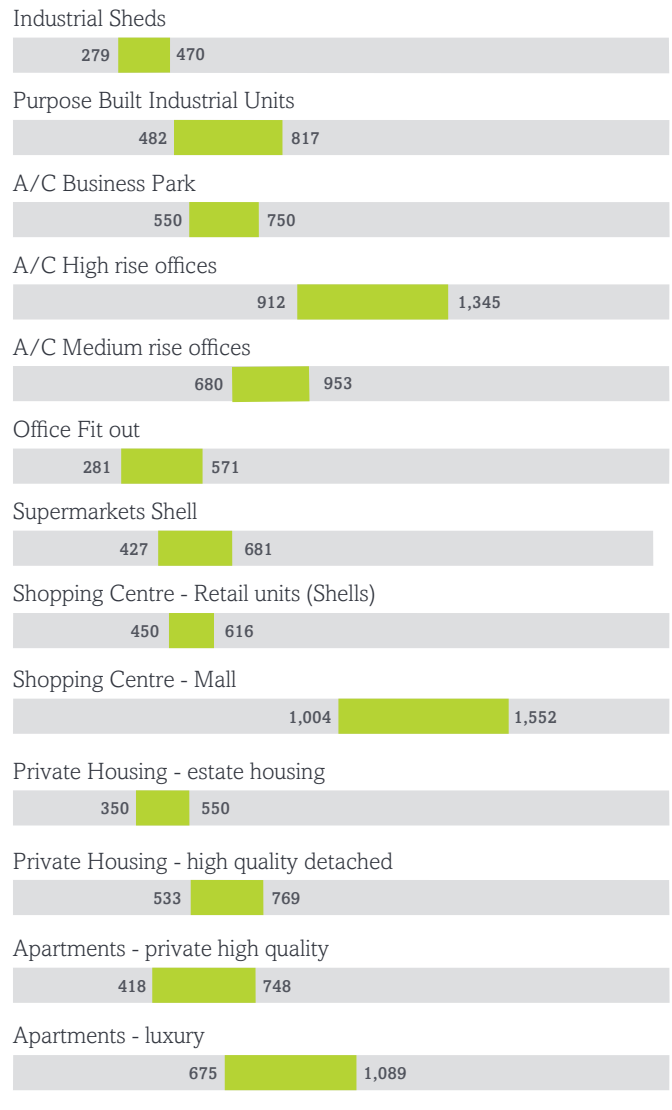
In the years of rapid growth, developers generally secured good returns, especially the large national developers and China has become an attractive country for investors. With the borrowing difficulties noted above, developers have increasingly sought international investors to fund or part fund their projects. This, combined with continued growth in the construction sector, means it is an attractive opportunity and proposition for investors.

The construction market - sectors

All construction sectors have been buoyant for some time. Mixed use developments comprising retail, office, residential and hotels in various permutations are common, while retail mall developments are particularly popular and are expected to continue to be a strong sector.

China has invested hugely in its infrastructure, particularly roads and railways which have been constructed to facilitate growth and development while airport development will be a growth area. Much of the infrastructure is constructed by state owned companies and is funded by the state.

Indicative costs per m² in China (US\$ per m²)



Note: The costs shown above are based on the Study of International Building Costs which EC Harris carried out during the 1st quarter of 2011. The figures represent typical guideline ranges of 'built' costs that a client could expect to pay and are based on cost per m² data provided by EC Harris sources 'on the ground' in China. Note that the figures are based largely on prices payable in Shanghai.

Costs are given in US\$ per m² of gross floor area, measured to the internal face of the external walls.

Note that the figures exclude land costs, professional and legal fees, etc and VAT, which should be added to the costs in this study. VAT is currently 17% on construction projects in China.

“China has a high dependency on foreign trade so the biggest risk to China’s continued prosperity would be global recession.”

The changes of government policy are starting to take effect and although apartments are still being built, there has been a rise in unsold properties and the recently introduced anti-speculation policy is likely to reduce the number of buyers. Developers are not expected to reduce the amount of construction, as there is thought to be an underlying demand especially outside the Tier 1 cities. However, house prices in some areas of China’s key cities are falling as property developers come under increasing cash-flow pressures.

Social housing targets have been set by Beijing, but many of the proposed projects have been slow to commence with construction almost always undertaken by local state-owned construction firms. Historically, health and education projects have been very much government led, but these sectors are now starting to open up for privately funded establishments and are attracting overseas investors and operators, especially in Tier 2 and 3 cities.

Geography

The Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) have seen much development over the past two decades and growth in these cities is now expected to slow. Instead development is now more focused on the twenty Tier 2 cities which will cause developers some challenges in spreading themselves across the country away from their traditional strongholds.

Labour and quality issues

Inflation has been a challenge for a while in China and construction workers’ wages have increased well above inflation. In the last 18 months unskilled labour rates have increased by up to 50% to about RMB 3,000 (£300) per month while skilled labour has increased by up to 100% to around RMB 10,000 (£1,000) per month.

Construction workers are poorly paid compared with those in the West and construction methods are very labour intensive. Many workers have general rather than trade skills and quality control is a problem, exacerbated by the lack of qualified supervision and management. All of this leads to quality issues on site and significant numbers of defects, some of which go undetected.

To overcome these problems, developers need to ensure that they have a robust design and have skilled project managers on their team. In recent months a number of

high profile train crashes and major bridges collapses have been attributed to construction failures. Although the government is concerned about safety issues, progress to improve the quality of construction is slow.

Materials

With many construction materials imported, China is as prone to global price fluctuations as other countries. World commodity prices rose significantly during 2008 and in China this was exacerbated by the completion of the 2008 Olympics venues. Materials’ prices rose substantially up to 2008, suffered a correction subsequently and have since resumed an upwards trend.

Structural steel prices and rebar prices peaked in 2008 but by the end of that year with the Olympics over and the crash in other economies the price had halved. Steel and rebar prices showed a substantial recovery up to only a couple of months ago but the market has changed in recent weeks. With commodity prices across the world now falling, Chinese steel mills have cut their production by around 5%. In the Shanghai Futures Exchange the price of steel rebar has fallen by 18% since September and these price cuts will soon filter down to site rates.

Cement prices increased by around 20% in the last year and this, together with the increases in reinforcement prices, has resulted in the costs of concrete framed buildings increasing significantly. However demand is expected to fall in 2012 and cement prices may reduce next year.

Tender prices

With labour cheap, the cost of construction in China is significantly lower than the UK and is also lower than in other parts of Asia. The cheap labour rates mean that labour typically forms around 25% of construction costs; as a result tender price rises are driven more by material, plant and preliminaries cost increases.

Tender prices have increased by around 20% over the last year, although there are regional variations and it should be noted that official government figures indicate a rise of just 10%. On projects lasting a number of years, tenderers are adding a considerable amount for the risk of future increase in materials and labour costs and this is inflating tender prices.

While land prices were on the rise, sales and rentals increasing rapidly and borrowing easy and cheap, cost inflation did not trouble developers. Now, however, with returns down, borrowing more expensive and margins being squeezed, the success of developers may depend on their ability to maintain margins, manage costs, and ensure efficient designs. The management of costs by developers is therefore likely to be higher on the agenda than has historically been the case.

Regional variations

China has a landmass similar to that of Europe and there are significant regional variations in prices. Since contractors tend to be based in the major cities, projects within the cities have lower management costs, better labour availability and easier transportation, resulting in city costs being lower than the rest of the country. Recent tenders indicate that compared to Beijing and Shanghai provinces, prices in the surrounding provinces were up to 10% higher while mark-ups in the more western, rural and less developed provinces such as Xinjiang, Qinghai and Xizang were 15 - 30% higher.

The future

Although some slow down of the Chinese economy is expected, a 'soft landing' seems the most likely outcome. With the growing wealth of its population, China is now less dependent on its exports and can focus on meeting the needs of its domestic market of 1.2 billion people resulting in a significant demand for real estate across all sectors.

Major and mega infrastructure projects will continue to push ahead and the social housing sector will develop as the government continues to invest. This will be especially apparent in the second and third tier cities as the population continues to move from rural areas to the cities. The short to medium term challenge will be how best to overcome the physical distances between the developing cities and ensure a supply of skilled labour.

Given the current global economic situation, overseas investors, developers and consultants are likely to continue to target China as an area of growth, although they will need to focus on property development as opposed to infrastructure which is dominated by State Owned Enterprises. As more overseas investment is permitted, the health and education sectors may become increasingly attractive propositions to outside investors.

Labour costs in the construction sector are likely to continue to rise in the short to medium term, due to the continued shortage of skilled labour, an aging population and less young people entering the industry. Looking further ahead, however we may see less workers on site as China upskills

Economy and construction - China at a glance

	2010	2011	2012
Economy generally			
GDP growth (%)	10.4%	9.0%	8.6%
Consumer price inflation	3.3%	5.4%	3.2%
Unemployment rates %		6.1%	
Exports (annual variation %)	32.0%	19.6%	10.4%
Imports (annual variation %)	39.7%	22.7%	13.4%
Industrial Production		14.0%	10.8%
Interest rates	5.5%	6.5%	
Construction Industry			
Labour rates (annual variation %) - skilled workers nationally	8%	7.9%	
Labour rates (annual variation %) - Shanghai minimum wage	17%	4.8%	

the labour force, uses it more efficiently, drives up quality and adopts a 'right first time' approach.

In the medium to longer term we may also see changes to working practices. Chinese contractors are in a strong position to acquire Western contractors with weakened balance sheets. If they can then combine their own experience of mega projects with the knowledge from their western counterparts, they will be able to bring this knowledge back to China.

Large national developers with significant land banks and a geographical and sector spread with access to off-shore debt are likely to perform the best in the more challenging Chinese environment; smaller to medium sized developers may need to remain focused on particular cities. The liquidity of developers is generally good due to the previous boom and liquidity is likely to be an important factor for developers; since sales are unlikely to pick up significantly in the short term those with weak liquidity may struggle with increased cost of servicing debt.

Although growth is slowing, it is slowing from a very high base. There are some challenges ahead including skill shortages, funding problems, cost increases, regionality and the like, but they also bring opportunities. It is likely that over the medium term, the construction and property sector will become even stronger and more robust and China will remain an exciting and prosperous place for investors.

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