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The Rebirth of China's Industrial Real Estate Market

By Nick Carmichael, SIOR

China's industrial real estate market is seeing a strong recovery from the global financial crisis. For example, in China's export-oriented manufacturing hub in Dongguan, Guangzhou, the vacancy rate for industrial properties hit a record high 30 percent in 2008, with rental rates plunging more than 15 percent and driving half of the real estate agencies out of business. As of the Q3 2010, the vacancy rate had dropped to 7.2 percent, with prices rebounding to pre-crisis levels. However, the global crisis might have marked the turning point of China's industrial real estate market. The post-crisis landscape has changed both the public and private sectors' needs and focus for industrial properties.

Public Sector: Market Paradox -- The Higher the Price, the Lower the Vacancy Rate

Local governments have learned from the crisis that not everyone suffered from the global recession. In 2008, while the industrial real estate market hit rock bottom in Guangzhou, the high-end industrial properties in the area, such as the high-tech zones and headquarter zones, witnessed a slight rental increase of 2 percent, with a vacancy rate below 3 percent. This demonstrated a sustained demand from users for higher quality facilities. The return on investment for those properties is estimated to be around 10 percent, significantly higher than the industry average.

Private Sector: Seeking to Cut Costs; Relocating

Although the Chinese economy has emerged from the global crisis relatively unscathed, the global recession's impact on corporate industrial properties is palpable. A survey in 2010 showed that the percentage of companies planning to relocate from high cost areas to second- and third-tier cities doubled from 2009 levels. Many of those who are not planning to relocate are evaluating methods to reduce factory floor space in order to cut operating costs.

In response to these global economic shifts, the market is expected to change in a number of ways:

- Professional developers will play a bigger role in the market as they look to meet the needs of their clients by developing more facilities of higher quality in second- and third-tier cities, reducing government involvement in local real estate development.
- Logistics properties will become a key growth driver, meeting increased industrial demand.
- Developed areas in the coastal region will seek creative ways to restructure their economies. Nevertheless, government will continue to play a central role in the market.

Professional Development and Management

One of the most important trends is the shifting of the industrial real estate development model. For decades, local governments have been the driving force behind Economic Development Zones (EDZs) in China in their role as the primary regulator, promoter, tax collector, service provider, developer, and sometimes even the real estate broker and landlord to the investor.

This government-driven development model has done a good job of increasing the local area's GDP. However, this has proven to not be the most effective or the most sustainable model for industrial real estate development, since it does not encourage efficient land utilization or the formation of industrial clusters (i.e., a concentration of manufacturers in a particular industry providing synergies of vertical integration of suppliers and sub-suppliers supporting the main manufactured product or industry that is "clustered"). In addition, vanity projects built for the prestige of the local governments are often chiefly motivated by GDP output, by foreign direct investment goals, or for face-value reasons, but they lack a long-term synergy with the local economy and the ability to attract blue-chip investors.

Several local governments have realized that a more effective way to build their EDZs is to work with a professional third-party developer. One of the earliest privately developed EDZs in China, Suzhou Industrial Park (SIP), is recognized across the country as one of the best EDZs in China. Strategic planning, sufficient infrastructure, and efficient management are some of the key factors contributing to its success. Many local governments are now trying to introduce similar development models to their EDZs. For example, the Tianjin and Guangdong governments have recently pioneered some successful projects.

These projects demonstrated that professional developers are able to do a much better job of strategic planning, land utilization, and industrial cluster formation. The high-end industrial real estate developed by the private sector often serves as an incubator for the high-tech and high value-added industries, while standard EDZ facilities built by the government work best for traditional lower value-added manufacturing uses. The increased use of professional developers will relieve the government from being the promoter and broker of the local industrial properties, so that they can focus on providing investors with a good investment environment.

Many local developers are becoming more interested in industrial real estate because these investments receive discounted land prices, quotas for commercial development, and increased regulatory support in land-use right transfers (Chinese ownership title). Real estate companies such as Gemdale, Forte, COFCO, Hopson, and R&F, which that used to focus on the development of residential complexes, are becoming more active in the industrial real estate market. After a successful partnership with TCL on a recent project, Vantone, a local developer, announced its plan to become the largest local industrial real estate developer within two years.

Although they have only been operating in China for a short time, foreign real estate developers have been investing heavily and growing rapidly in China. Companies such as Ascendas, Frasers Property, AMB, Shui On Group, CapitaLand, and Goodman Group are expected to play a bigger role in China's industrial real estate market as they increase cooperation with local developers, governments, and their international customers.

After initial development comes daily management. This is where professional real estate companies can add substantial value to their properties. Local developers are trying to transform themselves from traditional real estate developers to sophisticated real estate operators. For example, in Beijing's Hi-Tech Park LDUV, the developer is providing its industrial tenants a set of business services including company registration, government regulatory processing, HR support services, and sourcing assistance. These services are well received by the tenants and serve as a great value-add to the park.

Rapid Growth in Logistics Real Estate

The development of logistics facilities lags far behind the development of manufacturing real estate in China. Although there are thousands of warehouses nationwide, most of them are sitting vacant because they are unable meet the sophisticated demands of the industry. The key components of a logistics center, such as a strategic location, truck-high loading docks, adequate space for maneuvering and parking for trucks and trailers, high ceiling clear heights, heavy floor loading, well laid out inventory storage, and other necessary supporting infrastructure, are absent from many traditional humble warehouses in China.

Local governments have realized the importance of logistics facilities for the manufacturing and retail sector, and they have made logistics one of the key encouraged industries for investment promotion, providing additional incentives including discounted land prices and fast-track regulatory approvals for the development of logistics real estate.

Although ProLogis, one of the first foreign developers in China, sold all of its China properties to Singapore-based GIC in 2009, this move is not likely to slow the investment in logistics infrastructure by other international players as China's logistics market continues to grow. China's Q1 2010 exports grew 29 percent while imports jumped 65 percent over the same period last year. Domestic retail sales grew by 18 percent in Q1 2010 compared with same period last year. All together, China's logistics market is valued at approximately US$ 176 billion.

Strong demand and growth in the market are reflected in large investments in logistics facilities. Global Logistics Properties, a GIC subsidiary, increased its total portfolio from 3.76 million square meters (40.47 million sq. ft.) in December

2009 to 4.4 million square meters (47.36 million sq. ft.) in June 2010 after the ProLogis China property acquisition. Yet another driver for increased growth is the large number of logistics facility development projects postponed in 2008 and 2009. This situation is resulting in an undersupply and in increasing prices, a trend forecast to continue throughout 2011.

Moving Inward

The Chinese government has promoted mid-west China as an investment destination for years with its "Go-West" Policy, but for most companies, the incentives offered didn't outweigh the additional logistics costs of moving away from the ports and the coastal markets. With rapid wage inflation and the global recession, many labor-intensive manufacturing operations are experiencing margin erosion and are re-evaluating a possible move inward to reduce costs of labor, real estate, and utilities. Some of the major players that have recently moved west include Foxconn, Intel, and AOC.

Upgrading Existing Industrial Real Estate

Changes are not only happening in second- and third-tier cities. Crowded EDZs in coastal areas are also looking for opportunities to upgrade their industrial clusters. Governments are tightening environmental standards, limiting land supply, and being selective in choosing projects that complement their existing industrial base. However, upgrading industrial clusters has proven very challenging as the industrial development that has occurred since China's opening and reform has hardly left any room for future changes. Local governments have been creative in finding ways to upgrade their EDZs. For instance, some heavily polluting factories were forced out after the implementation of stricter environmental standards; other companies, mostly state owned, have been moved into low-cost areas after negotiation and compensation from the local government.

Earlier this year, the Ministry of Land Resources of China (MOLAR) sent 100 of its officers to conduct a nationwide study. One key issue was to decide how best to manage the limited land supply in developed areas, while supporting the economy as it goes through this restructuring phase. As China does not sell the ownership of industrial land but grants a 50-year land use right, a major topic of discussion is what to do when these land use rights expire. The study suggested local governments use these coming land use right expirations as opportunities to restructure their local industrial base, relocating unfit enterprises and attracting new investors that better fit the existing industrial clusters while allowing the previous owners to benefit from the property appreciation.

A More Regulated Market

Government has always played a central role in China's real estate market. In the past few years, MOLAR has issued an increasing number of regulatory changes in the industrial real estate segment. In 2006, 2007, and 2008 MOLAR issued several circulars to regulate land allocation and usage. It has also been conducting nationwide land audits and enforcing the land auction process to further regulate the industrial land market. Although these regulations showed the government's determination to make the industrial land market more market-driven and adequately supervised, their implementation sometimes remains vague. The project approval processes are still complicated and time consuming. Local officials still have considerable power to delay projects through an unnecessarily complicated regulatory path.

Developing industrial real estate projects in China has never been easy. Finding an ideal piece of land is merely the beginning. Investors must ensure that the land has been transferred to industrial use, the project is in line with local zoning, the land title is properly owned, and the property rights and project completion certificate are in place. With all the due diligence work done, the land use right transfer can be another complicated process, especially given the recent regulatory changes issued by MOLAR, to limit speculation and profiteering in the secondary market. After the transfer is completed, investors need to follow the regulatory steps of project application, environmental assessment, safety assessment, fire protection inspection, occupational hazard assessment, and many other approvals. Failure to fulfill any of the steps will result in trouble obtaining the operation license and delay in operation start-up. An accurate and up-to-date understanding of the often-changing regulations implemented at national, provincial, and local levels is a critical component for the ultimate success of an industrial real estate investment in China.