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China

Why we are still positive

December 2015

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Executive summary

Fears of hard landing abound as China deepens its reform and economic growth slows further. China's economy faces huge risks and challenges: excess leverage, overcapacity, eroding comparative advantage, an ageing population, transition to market-based economy and a massive relentless anti-corruption campaign. These will be a drag on the economy but are unlikely to cause a hard landing. Growth will come from industrial modernisation, increased urbanisation, domestic consumption and innovation though not sufficient to match the strong growth driven by the massive investments in the past. We can thus expect a slower GDP growth of 6-6.5% CAGR in 2015-20.

Investment risks have risen but China still has relatively better growth potential than many other countries and can offer new opportunities though the degree will depend on the success of reform. China has more and advanced infrastructure, highly educated people, a large R&D workforce and a large population with high potential to consume. The government remains committed to economic reforms, with a determination and on a scale that are hard to find in many other emerging markets. There will be policy missteps which is unavoidable; slowdown in the pace of reform in order to moderate the economic slowdown; and resistance to the reforms from some quarters like the SOEs. However, the one-party central government has a much higher probability of carrying out many if not all of the reforms to transform the economy, compared to many other nations. The central government also has ample financial reserves to weather short-term volatilities.

As economic growth slows to a more sustainable pace, rising prices and rents are no longer guaranteed in the Chinese real estate market, especially where local fundamentals are weak and oversupply exist. Thus, investors should be more selective in cities and sectors where there are better supply-demand dynamics and growth potential and offer products that meet changing needs. We also need to closely monitor the new opportunities that urbanisation and income growth trends bring given that shifting income elasticity of demand and creation of new demand for goods and services have implications on real estate. Tier-1 and selected Tier-2 cities have stronger growth potential because they have more favourable demand-supply dynamics. For the residential market, these cities are better-positioned in terms of larger migrant inflow, stronger upgrading and investment demand, and lower inventory ratio despite having higher housing price-to-income ratios. The recent housing price recovery has thus been mainly in the Tier-1 and some Tier-2 cities. In the retail and office markets, it will also take a shorter time for these cities to absorb the excess supply with their strong population base and growing tertiary industry.

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Introduction

Fears of hard landing abound as China deepens its reform and economic growth slows further. China's economy faces huge risks and challenges: excess leverage, overcapacity, eroding comparative advantage, an ageing population, transition to market-based economy and a massive relentless anti-corruption campaign. These will be a drag on the economy but our assessment is that they are unlikely to cause a hard landing. Growth will come from industrial modernisation, increased urbanisation, domestic consumption and innovation although it will not be sufficient to match the strong growth driven by massive investments in the past. We can thus expect GDP growth to moderate to 6-6.5% CAGR in 2015-20[1].

As economic growth slows to a more sustainable pace, rising prices and rents are no longer guaranteed in the real estate market, especially where local fundamentals are weak and oversupply exist. This paper discusses China's risks, challenges and growth potential, and assesses if China's real estate is still worthwhile investing in.

Risks & Challenges

1) Ageing demographics

China has a rapidly ageing population which is projected to increase from 9.6% of total population in 2015 to 27.6% and 33.8% in 2050 and 2100 respectively. Although this means that China will take another few decades to reach the current level in Europe (24%) and Japan (36%), the workforce has started to shrink in 2012 and the burden of supporting the aged has increased for the working population as the aged dependency ratio increases from 0.13 in 2010 to 0.25 in 2030[2]. China cannot grow its female labour force participation rate very much as it is already quite high at 64% in 2013; and has to raise taxes and cut public spending to boost its pension fund before it turns into deficit from 2030[3], which will constrain discretionary consumption.

China is however not alone in the demographic challenge. Many countries are also facing shrinking workforce and aged dependency problem. Measures are being introduced to address the shrinking population. China will allow all couples to have two children by March 2016, following the easing of the one-child policy in 2013. Although not sufficient to reverse the aging demographics as not all couples would want to have more children due to time and monetary constraints, it will slow down the population decline to some extent, although some critics have said it is too little and too late. The latest policy change could add three million extra births per year in the initial years and buffer the shrinking workforce to fall by 16% instead of 19%[4] by 2050. The labour force decline will also be further eased in a couple of years as China intends to raise the statutory retirement age from the current 60 years old for men and 50 for women in 2017[5]. The country can also relax its transnational

[1] Based on Organisation for Economic Co-operation and Development (OECD) and International Monetary Fund (IMF) projections in July and October 2015 respectively.
[2] United Nations, 2015. Aged dependency ratio is the ratio of aged dependents on the working-age population. Aged population refers to those aged 65 years old and above while working-age population refers to those aged 15 to 64 years old.
[3] Chinese Academy of Social Studies
[4] Fathom Research, "A Two-Child Policy for China: A Case of Too Little, Too Late?", 12 November 2015.
[5] Wall Street Journal, "China Sets Timeline for First Change to Retirement Age since 1950s", 10 March 2015.

immigration policy which is currently under strict control and further ease its new two-child policy and encourage more births with incentives. China can also raise productivity through technology and urbanisation to counter the economic impact of a declining population (see details in later section).

2) Waning productivity growth

Productivity growth has been falling, dragged down by the unproductive over-investments and inefficient state-owned enterprises (SOEs). However, China cannot correct the over-investments too quickly or it could lead to an economic crisis. It is however pushing ahead with the SOE reform although this will be a long and difficult process due to resistance. The State Council recently issued guidelines on the partial privatisation of SOEs[6] that would provide a corporate governance structure and steer them towards maximising financial returns and efficiency by 2020. Earlier, Shandong province had tested out the reform by transferring its equity stakes in three SOEs worth RMB 3.3 billion (USD 532 million) to its social security fund which could provide a model for the rest of the China[7].

3) Declining comparative advantage

China has been losing its comparative advantage in low-cost manufacturing due to increasing costs from wage growth and currency appreciation. Average wages have grown by a CAGR of 14% from 2001 to 2014. The yuan has also appreciated against the USD and most other currencies since 2001 up to October 2015. Cost pressures will continue to rise due to minimum wage increases[8] and social security provisions[9]. While some manufacturers will move to lower-cost countries, others will relocate from the coastal cities to inland areas which will develop other parts of China or move into higher-value added manufacturing which will improve productivity. To move up the value chain, the Chinese government has introduced a new economic blueprint to support new growth drivers (details in later section).

4) Overcapacity

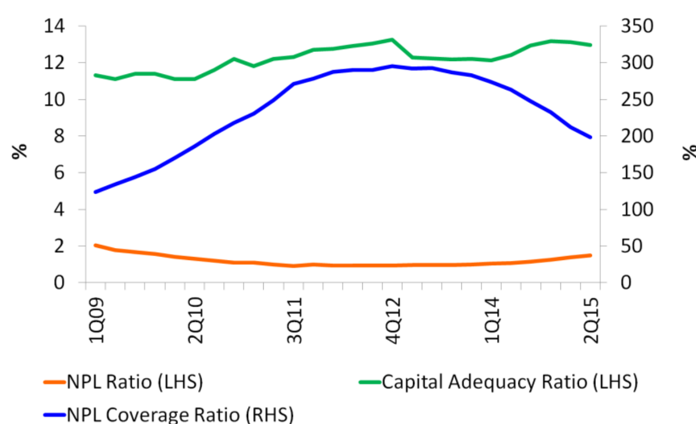
China has large over-investments in capital stock e.g. plant and machinery, rail and infrastructure, and real estate of RMB 19.4 trillion[10] or 31% of GDP. Sectors like the real estate and related industries contribute around 25-30% to China's GDP[11] and owe much of the bank and shadow banking loans; hence too fast a correction may cause bad debts to rise and result in a hard landing. The government has to thus balance growth with reform and sometimes take a step back like stimulating the housing sector to boost economic growth.

[6] Include mergers, public listings, transparency such as declaration of management's salaries, incentive schemes such as employee stock ownership, etc.
[7] Financial Times, "China Tests New Model for State-Owned Enterprise Reform", 19 May 2015.
[8] China requires that the minimum wage of all regions be increased at least once every two years since 2004. The 12th Five-Year Plan has a target to double per capita income by 2020 and stipulates the annual increase to be 13% on average, during the 2011-15 period.
[9] China requires that employers' contribution to employees' social security be assessed on employment income.
[10] Daiwa, 2015.
[11] Fortune, "China's Slowing Economy: The Worst Has Yet to Come", 21 January 2015.

5) Excessive leverage

In our commentary titled "China: Are its debts worrisome?" dated 14 April 2015, we noted that there is a risk of China's surging debt developing into a financial crisis, if credit continues to grow unabated and flows into unsustainable investments. The government is taking steps to curb the excesses and diversify credit risk in the banking system by developing the bond market and allowing local government debt swap, but has to carry out monetary easing in the meantime to support economic growth. Hence, private sector debt-to-GDP continued to grow from 200% at end-2014 to 208% in September 2015. While financial risk indicators are rising, these are still within the acceptable thresholds (Figure 1). China's non-financial sector debt (235% of GDP)[12] is more than backed by assets (900% of GDP)[13]; non-performing loan (NPL) ratio[14] (1.5%) still healthy[15]; NPL coverage ratio (198%) more than adequate[16] and capital adequacy ratio (12.95%) way above Basel III's requirement of 8%. Nevertheless, these warrant close monitoring to ensure debt remains at a manageable level.

Figure 1: China's NPL, NPL Coverage and Capital Adequacy Ratios



Source: Bloomberg, AIP Research

Growth Potential

Reform on track

China's slowdown should not be cause for excessive concern and fear as it is only natural for the economic indicators to show deceleration or decline in growth as they reflect the transition that is taking place. China's growth has been steadily declining from the ~10% level to the current 7%-mark over the past five years on the back of a comprehensive economic reform programme, which was the top agenda under the Chinese government's 12th Five-Year Plan (FYP) spanning 2011 to 2015. The plan spelt out the need to rebalance the economy from exports and investments toward domestic consumption.

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[12] Bank for International Settlements (BIS), "Quarterly Review: International Banking and Financial Market Developments", September 2015.
[13] Bloomberg, 2013.
[14] NPL ratio = NPLs / total gross loans
[15] There is no global standard for "healthy range" but the rule of thumb is a NPL ratio of 10% and below for emerging markets. Source: Golin, J. & Delhaise, P., "The Bank Credit Analysis Handbook: A Guide for Analysts, Banks and Investors", 2013.
[16] A NPL coverage ratio of 25% and above is still acceptable. Source: Golin, J. & Delhaise, P., 2013.

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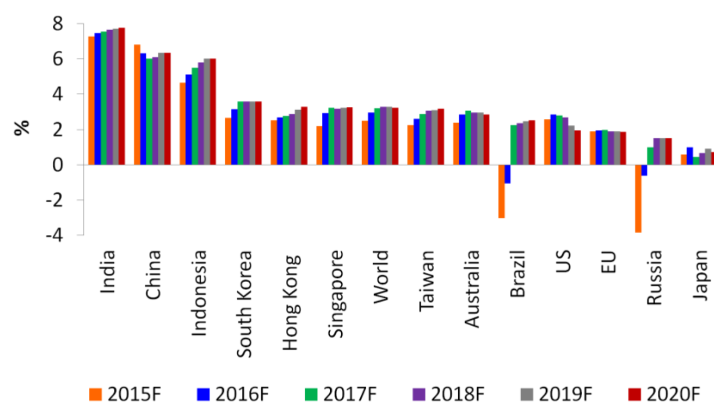
China has met most of its 12th FYP targets, suggesting that reform is on track. The services sector's contribution to GDP has risen from 43.8% in 2011 to 52.1% as of 1H2015. 9.5 million urban jobs were created in the first eight months of 2015 with urban unemployment rate at a healthy 4.0%[17], outperforming the targets of 9 million jobs per annum and unemployment rate of not more than 5%. The average GDP growth for the period is estimated at ~8% per annum (p.a.), exceeding the FYP's target of 7%.

China is continuing with the reform programme even in the face of slowdown fears. According to the draft 13th FYP revealed in October 2015, the GDP target for the next five years could be lowered to ~6.5%. At 6.5% growth p.a., China is still pursuing a medium-high growth rate to achieve a doubling of China's 2010 GDP and per capita income by 2020 and become a "moderately prosperous society"[18]. The intended outcome is to reduce income inequality and expand the middle class.

Pace of growth is still high

China will still be growing considerably faster than many emerging economies even at a slower pace of 6-6.5% (Figure 2). Although China's projected annual growth over the next five years might be second to India, it will still be higher than many other emerging markets including Indonesia, Brazil and Russia (the remaining BRIC countries) and developed markets. Furthermore, two to three years' of incremental growth in China at 6.5% p.a. is equivalent to the whole of India's economic size.

Figure 2: GDP Growth Projections



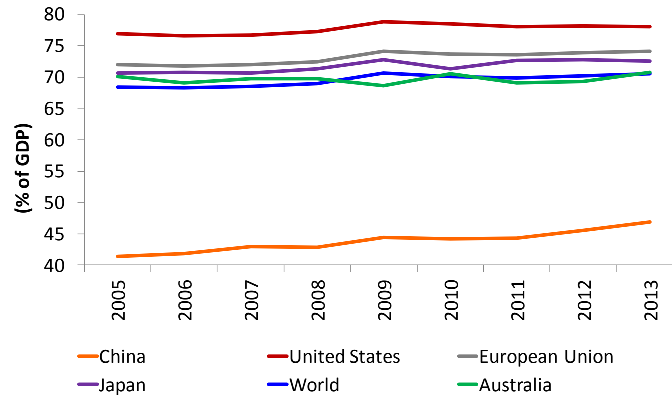
Note: Forecasts dated Oct 2015
Source: IMF, AIP Research

17 Ministry of Human Resources and Social Security of the People's Republic of China
18 The State Council of the People's Republic of China

Potential for services sector to grow

The services sector has overtaken the manufacturing sector in terms of growth rate and now accounts for half of China's GDP growth as compared to 41% in 2005. There is still room for growth since the services sector accounts for more than 65% in each of the major economies like the US, Japan and the European Union (Figure 3).

Figure 3: Services as a % of GDP – China vs. Major Economies

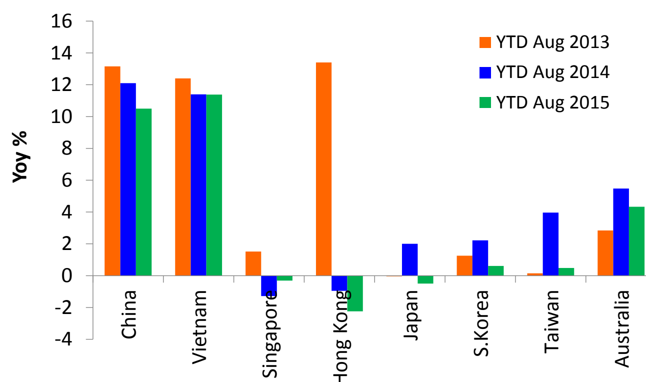


Source: The World Bank; World Development Indicators

Potential for consumption to increase

The potential of the Chinese domestic market is immense with nearly 780 million urban dwellers and a total population of 1.3 billion. Even though the Chinese are well-known for their high savings rate, retail sales growth has been brisk, with total retail sales of consumer goods growing in excess of 10% every year for the last ten years up to 2015 despite the economic slowdown, anti-corruption campaign and leakage in overseas spending. China's retail sales growth is amongst the highest in the region (Figure 4). However, as of 2013, household final consumption expenditure in China was only 36% of its GDP, much lower than 68.5% in the US, 61.1% in Japan and 59.2% in India[19] (Figure 5), suggesting that there is more room to increase consumption to be in line with global trends.

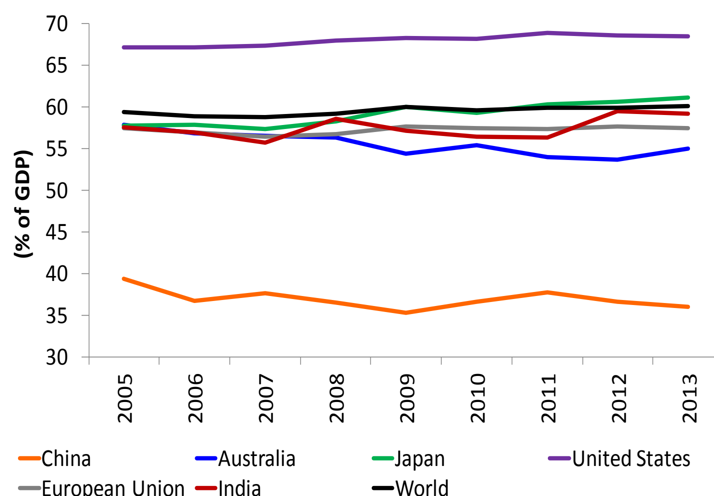
Figure 4: Retail Sales Growth – China vs Asia Pacific Countries



Source: Bloomberg, AIP Research

[19] World Bank data

Figure 5: Household Final Consumption Expenditure – China vs Major Economies

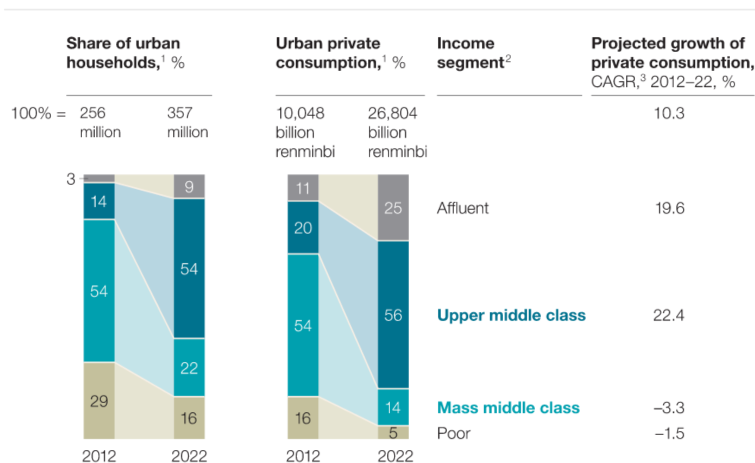


Source: The World Bank, AIP Research

In the new economy, greater private sector participation and competition will help to improve productivity and raise household incomes and private wealth, therefore increasing demand for income-elastic products such as consumer durables, housing, health and education services, leisure activities and financial services. The average annual wage of urban employed persons had grown at a significant CAGR of 13.5% between 2004 and 2014 to RMB 56,339 (USD 9,102 in 2014 terms). Individuals' net wealth also rose by a CAGR of 12% to USD 21,330 per adult from 2006 to 2014[20]. This has led to a rapid growth in the mass middle class which could quickly be replaced by (or promoted to) the upper middle class, characterised by greater propensity to consume higher-value goods and services. According to McKinsey's estimates, continued market liberalisation, greater innovation and growing private sector influence will underpin household income growth which may even outpace GDP growth. Eventually, the upper middle class is projected to account for 54% of urban households by 2022 from 14% in 2012, and account for 56% of urban private consumption by 2022 from 20% in 2012 (Figure 6).

[20] Credit Suisse, "Global Wealth Databook", October 2014.

Figure 6: Transformation of China's Middle Class



Source: McKinsey & Co, June 2013

Growth strategies

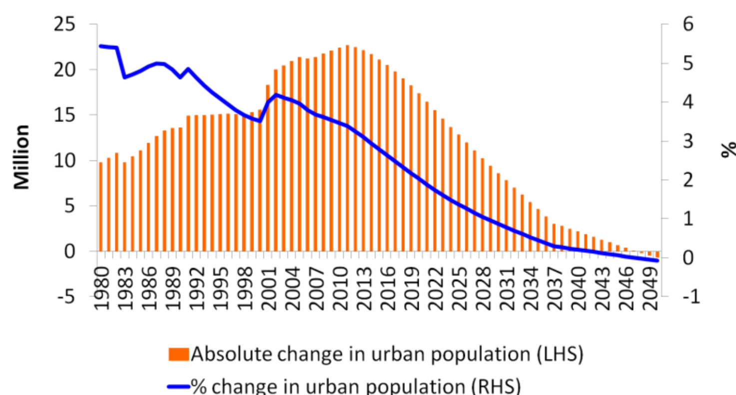
The Chinese government has many levers and action plans to achieve its economic reforms, many of which potentially overlap and complement one another. Some of them are just guidelines or broad plans and require more implementation details, which will determine their success. The central government would also have to ensure resolute execution of these policies across the various provinces, which will require extensive coordination. Nevertheless, this reflects the medium- and long-term strategies that the government is putting in to sustain future economic growth.

1) Urbanisation

China can still grow its productivity through urbanisation as it transfers workers from agriculture to the more productive industrial and services sectors. According to the UN, China's urbanisation rate is projected to increase from 54% in 2014 to 76% in 2050. Although the pace will not be as fast as before given that urban population growth is projected to slow from a CAGR of 3.5% in 2005-14 to CAGR 2.1% in 2015-24, the increase is still high, averaging 18 million per year over the next decade (Figure 7). It will still take another few decades before urbanisation tapers off. Urban working-age population will also not peak for another 16 years according to the Economist Intelligence Unit (EIU)[21].

[21] International Business Times, "India and ASEAN Economies to Become the Next China for FDI," 25 January 2013.

Figure 7: China's Urban Population Growth



Note: Forecasts dated 2014
Source: United Nations, AIP Research

2) Shifting foreign direct investments (FDIs) to inland areas

China's ongoing "Go West" strategy encourages FDIs to locate inland which still has comparative advantage in low-cost manufacturing and free up the coastal areas for higher-value activities. Together with the Belt and Road Initiative (BRI) which plans for the Silk Road Economic Belt to start from Xi'an and pass through Urumqi, they provide the driver for urbanisation within China's interior and western provinces. The GDP per capita for inland cities/provinces was at RMB 32,508 in 2014, just half of that in the coastal cities[22] at RMB 66,172 and below the national level of RMB 47,483.

3) Encouraging outbound investments

China also has a "go-global" strategy which encourages outbound investment to leverage on overseas markets and acquire new technologies to help companies restructure and upgrade while continuing to attract inbound investment given its large market size and new opportunities especially in the services sector. To this end, the government is offering financial incentives and easing the approval process for overseas investment. Foreign direct investments recorded a net outflow of USD 209 billion in 2014 and Chinese companies, the like of Alibaba and Huawei, continue to grow in number and size. By end-2014, 18,500 Chinese domestic investors had established close to 30,000 enterprises overseas, with 77% of them posting profits during the year[23]. China is now home to the world's four largest companies in 2015's Forbes Global 2000.

[22] Coastal cities include Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Guangxi and Hainan.
[23] CNBC, "China On Track to Book $1 Trillion in Total Offshore Investment by End-2015", 17 September 2015.

4) Belt and Road Initiative (BRI)

The BRI, a China-led strategy that enhances connectivity within Eurasia through infrastructure network development along the proposed Silk Road Economic Belt and Maritime Silk Road, can open up foreign markets for China's exports particularly in the over-invested steel and construction sectors and help grow some of the targeted industries such as rail transport. BRI is in progress, but execution will take time as it involves regional cooperation. To this end, China has established the Asian Infrastructure Investment Bank (AIIB) which will provide the financial support.

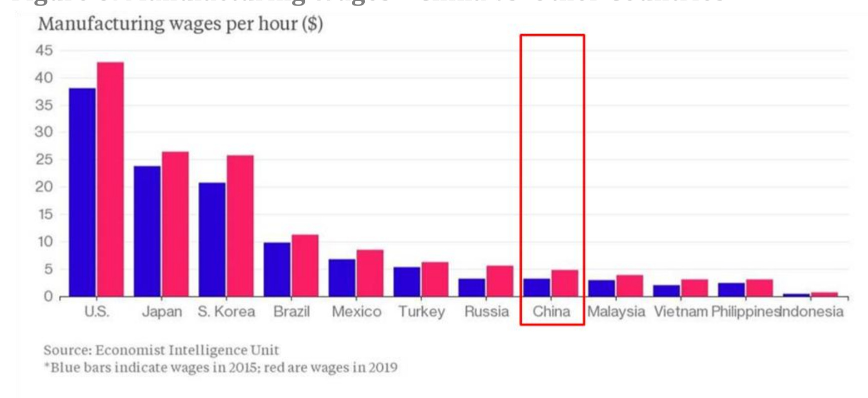
5) Growing modern services

Growing modern services such as information and communication, finance, professional and business services will also provide jobs with higher productivity and wages compared with the traditional ones like wholesale and retail, and hotels and restaurants, and diversify foreign trade[24]. "Made in China 2025" and "Internet Plus" are strategies that will support the services sector's growth. The financial and information technology sectors grew by 9.7% and 8.0% respectively in 2014[25], above the national GDP growth rate of 7.3%.

"Made in China 2025"

"Made in China 2025" is a blueprint that aims to transform the low-cost manufacturing sector to high-end industries[26] through automation, smart technologies and innovation, to offset falling productivity and shrinking workforce and keep China competitive. China's plan to invest USD 1.3 trillion in 10 years may look ambitious. However, China is under a central government and can move things much faster than others. China has also built up capability in some of these industries, in which it still has cost advantage. For example, China has one of the world's largest rail transport networks with more than 76,000 km of track, just behind US and Russia, but manufacturing wages are just a fraction of the US' (Figure 8).

Figure 8: Manufacturing Wages – China vs. Other Countries



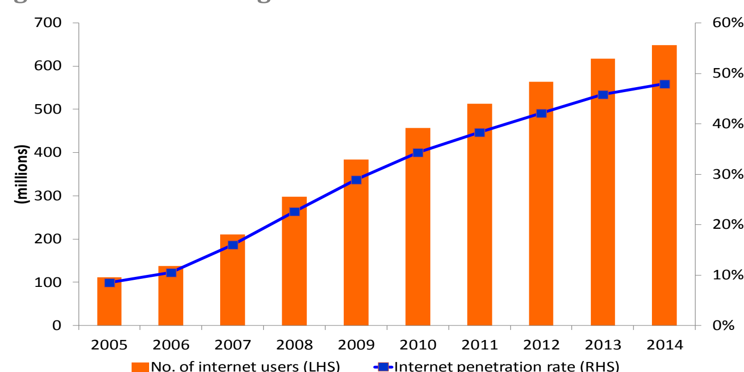
[24] Peterson Institute for International Economics, "Asia's Service Sector Imperative", December 2012.
[25] Forrester Research. Source: South China Morning Post, "IT Sector to Defy China Slowdown with 8 Pct Growth in 2015", 9 January 2015.
[26] The ten key targeted sectors are robotics, agricultural, aerospace, and electrical power equipment, maritime engineering, rail transport, new energy vehicles, new materials, biomedicine and biomedical devices and new generation information technology.

Internet Plus

First revealed by Premier Li Keqiang in March 2015, the Internet Plus strategy is a grand plan to modernise the Chinese industries using information technology and will run alongside the "Made in China 2025" strategy. The plan aims to *"integrate mobile Internet, cloud computing, big data and the Internet of Things (IoT) with modern manufacturing, to encourage the healthy development of e-commerce, industrial networks, and Internet banking, and to help Internet companies increase their international presence[27]."*

The government plans to invest RMB1.2 trillion (USD188 billion) over the next three years to further develop its web infrastructure to facilitate the action plan. Considering the fact that China had 649 million Internet users, of which 557 million access the Internet via their mobile phones as of 2014 (Figure 9), it is clear that the idea is not without merit. In addition, China already has some of the largest technology companies in the world, such as Alibaba, Tencent, Baidu and Xiaomi, and more could follow.

Figure 9: Internet Usage in China



Source: China Internet Network Information Center, AIP Research

These efforts will build on the wave of innovation and entrepreneurship that has already hit China. Its version of Silicon Valley, Beijing's Zhongguancun, witnessed the birth of 49 startups daily in 2014. Across China, 1.6 million new businesses were set up in 2014, nearly three times as many as in the US. Along with new companies, there has also been a surge in technological innovation, with more than 660,000 effective invention patents last year, up 12% from 2013. That was more than double the 300,678 patents awarded by the U.S. Patent and Trademark Office in 2014.

The Chinese government hopes that Internet Plus can be a new economic model and important driving force by 2025. McKinsey estimated that the Internet could potentially add 0.3 to 1.0 percentage points to China's GDP growth rate between now and 2025. If executed well, the strategy could turn out to be the next Industrial Revolution, bringing about higher consumption of new products and services and generating higher-skilled jobs while improving productivity.

[27] www.english.gov.cn

Real Estate Investment Strategy

As China's economic growth slows and many Chinese cities face oversupply with no strong local demand drivers in the property market, rising prices and rents are no longer guaranteed. Investors thus need to be selective as each city has different economic growth drivers and real estate demand-supply dynamics.

Residential

China still has massive housing needs despite a large inventory. According to IMF's estimates, the inventory was around 24 months as of mid-2014[28] although this is likely to have declined given the increase in sales volume since late last year when the housing purchase restrictions and borrowing limits were relaxed. UN estimated that China would require housing for its 293 million new urbanites from 2015 to 2047[29]. This is however not evenly spread across the Chinese cities. Tier-1 and selected Tier-2 cities are better-positioned because of their ability to attract migrants and investments. Housing demand is therefore much stronger and they have lower inventory ratio (Figure 10) despite higher housing price-to-income ratios. Beijing and Shanghai are projected by McKinsey to have the largest housing needs among the world's 20 largest cities by 2025. Their current inventory levels of around 85,000 units[30] each are still much lower than the annual 418,000 and 362,000 units respectively required from McKinsey's projected household formation. The recent price recovery following relaxations in the home purchase restrictions and reduction in mortgage rates is mainly in the Tier-1 and some Tier-2 cities (Figure 11).

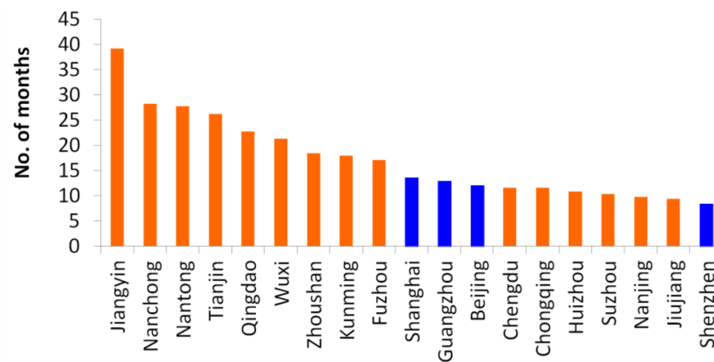
The easing of the one-child policy, though not expected to reverse the aging population, will to some extent boost the housing market as demand for bigger homes will increase in the near future, and more so in the long-term as these extra babies grow up, get married or move to stay on their own. Wealth creation will also continue to support housing demand as families upgrade to bigger and higher quality homes and high net worth individuals preserve their wealth through property investment although more of them are also investing overseas.

Indeed, price increases are expected to be more moderate than before, given the slower economic growth, housing curbs in Tier-1 cities, high price levels and increasing supply of affordable housing by the government.

Changing trends also present new opportunities. The high affordability gap suggests the need for smaller and more affordable homes. There is a growing trend of millennials preferring small units with communal space. Ageing population increases the need for active ageing homes.

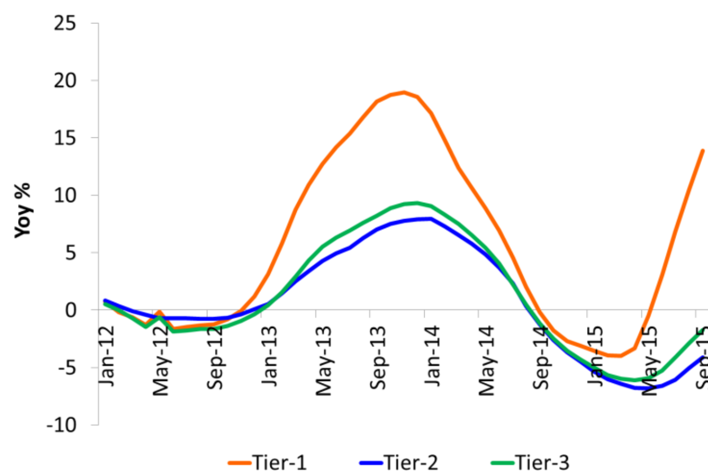
[28] Inventory ratio = floor space unsold / floor space sold. Source: IMF, "Understanding Residential Real Estate in China", April 2015.
[29] Urban population is projected to peak in 2047 and shrink thereafter as population ages.
[30] Based on commercial residential units for sale as of September 2015. Beijing's data includes social housing. Source: CREIS.

Figure 10: Inventory Ratio of Chinese Cities



Note: Tier-1 cities are represented by blue bars
Source: CREIS, CRIC, AIP Research

Figure 11: Price Growth in Chinese Cities



Source: Bloomberg, AIP Research

Retail

China is still at an early stage of retail space development with the potential to grow. Compared with other countries, China has a low retail space per capita of 0.7 (Figure 12). Although more than 40 million sqm of retail mall space is expected to enter the market from 2015-17[31], retail space per capita is projected to maintain at 0.7 by 2017. Income growth, middle class expansion, consumption-oriented reforms and shifting consumer preferences from street shops to comfortable shopping malls will provide the demand drivers. Reduction in import taxes and retail prices will also boost domestic spending and reduce overseas spending. China cut the import duties by around half across 14 types of consumer goods in June 2015[32] but we can expect the list to continue expanding. Luxury brands in China have also slashed prices to close the price gaps with other countries.

[31] Jones Lang LaSalle. Source: Forbes, "How China Will Handle The World's Biggest Supply Of Malls", 8 November 2015.
[32] These include clothes, shoes and skincare products which are often purchased in Hong Kong or overseas instead of domestically due to high import taxes.

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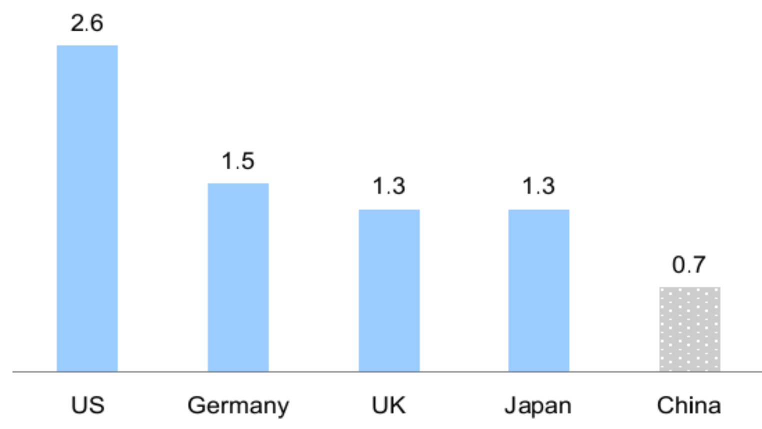
Similar to housing, the bigger cities have better demand-supply dynamics. It will also take a shorter time in cities with a strong population base for the excess supply to be absorbed. Among the Tier-1 cities, Shanghai has the highest growth potential given its low retail space per capita (Figure 13), high disposable income per capita, dense population and metro network, and being the gateway for most international retailers.

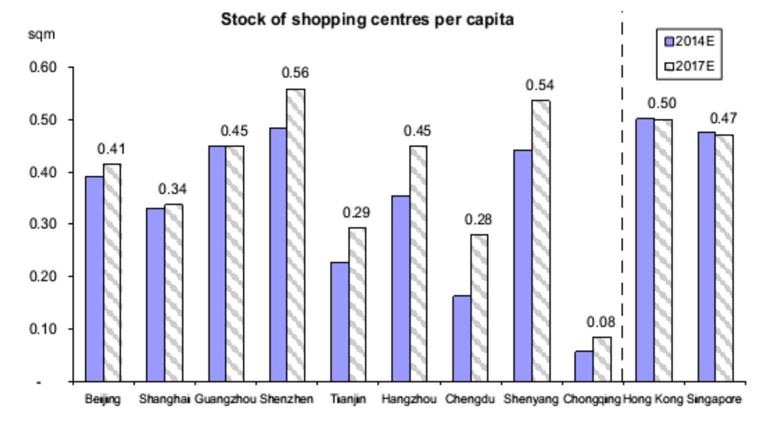
The heterogeneity of retail malls also means the retail stock is polarised in quality and performance. With online retail reshaping retail malls into social spaces and tenants adopting an omni-channel strategy, China's retail scene presents opportunities for experienced developers/owners who can innovate to create new retail concepts and adopt new strategies to compete against other malls and online shopping.

Figure 12: Retail Space per Capita of World's Major Economies



Source: NBS, UN, US Census, CEIC, Morgan Stanley Research

Figure 13: Retail Space per Capita of Chinese Cities



Source: Knight Frank, Holdways, JLL, Savills, DTZ, Colliers, Morgan Stanley Research

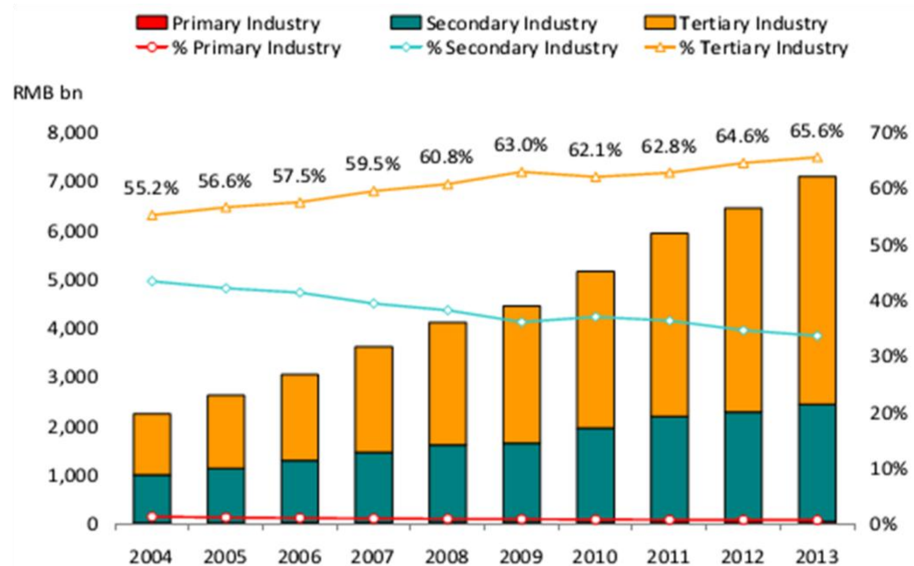
Office

The office sector still has growth potential coming from the services sector expansion and financial liberalisation despite a large pipeline supply. Close to 20 million sqm of office space or 57% of office stock is scheduled for completion in 2015-17[33].

Tier-1 cities, where a growing tertiary industry is driving strong demand fundamentals and lower vacancy rates (Figures 14-15), will digest the large supply at a much faster pace than lower-tier cities where the main economic driver is mainly the secondary industry. Being the political centre, Beijing has strong office fundamental demand from companies that want to take advantage of proximity to policymakers although some government offices may be under the central government's directive to relocate to Tianjin. Being the gateway to China, Shanghai enjoys strong demand from multi-national companies and private local companies that want to set up their HQs and businesses in the financial and commercial hub. Given China's financial deregulation in recent years, Shanghai has seen and is expected to see more office demand expansion from financial institutions and supporting business services in future.

Opportunities in the office sector can include greater availability of investment-grade offices as more high-quality supply completes, providing co-working space as local start-ups grow, offering green buildings useful building features and good management to enhance branding, tenant satisfaction and loyalty.

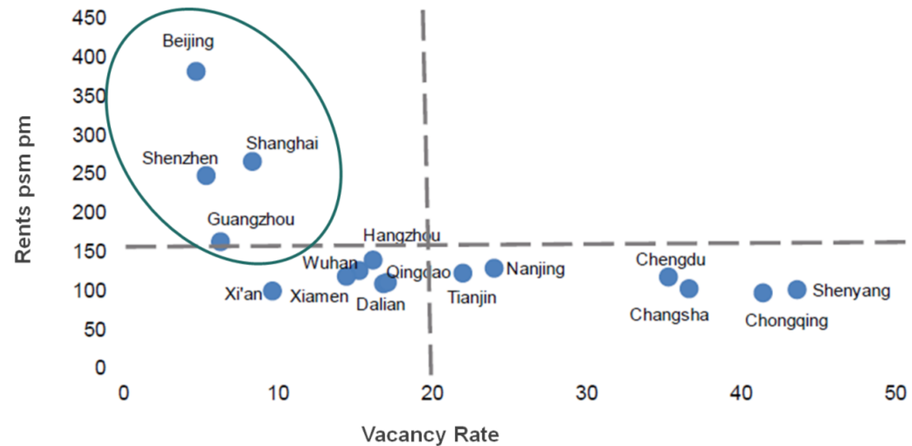
Figure 14: China Tier-1 Cities' GDP Breakdown by Industries



Source: CEIC, NBS, Morgan Stanley Research

[33] DTZ, "Asia Pacific Office Property Times", 1Q2015.

Figure 15: China's Office Vacancy Rates



Source: DTZ Research, 2Q2015

Conclusion

Investment risks have risen in China but we believe China still has relatively better growth potential than many other countries and can offer new opportunities. Compared to many other countries, China has more and advanced infrastructure, highly educated people, a large R&D workforce and a large population with high potential to consume. The government remains committed to economic reforms, with a determination and on a scale that are hard to find in many other emerging markets. There will be policy missteps and unintended consequences along the way, like the stock market turmoil. There will be slowdown in the pace of reform to moderate the economic slowdown. There will be resistance to the reforms from some quarters like the SOEs. However, the one-party central government has a much higher probability of carrying out many if not all of the reforms to transform the economy, compared to many other nations. The central government also has ample financial reserves to weather short-term volatilities. Investors should thus not be put off by the slower growth and risks and instead be more selective in cities and sectors where there are better supply-demand dynamics and growth potential and offer products that meet changing needs. In terms of investing, we need to closely monitor the new opportunities that urbanisation and income growth trends bring given that shifting income elasticity of demand and creation of new demand for goods and services have implications on real estate.

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