China: Firing Up Twin Propellers

- Policy shift towards quality of growth as opposed to quantity of growth
- "Dual circulation" strategy to shore up medium to long-term economic resilience
- Geopolitical tensions persist, but real asset investment opportunities still attractive

Introduction

China's quick emergence from the COVID-19 setback has allowed the government to refocus on its medium to long-term objectives. In this commentary, we look at the recently announced 14th Five-Year Plan (2021-2025), which marks the next milestone towards the longer-term Vision 2035, and the implications and opportunities it may pose for real estate and infrastructure investors.

Quality over quantity

China bounced back quickly from the COVID-19 pandemic in 2020 to finish the year as the only major global economy to register positive GDP full-year growth at 2.3%.

With the economy back on firmer footing, the government announced a 2021 GDP growth target of "more than 6%" during the Two Sessions held in March 2021. The government is also targeting the creation of more than 11 million new urban jobs and a surveyed urban unemployment rate of 5.5% in 2021, both comparable to pre-COVID-19 levels.

Most economists believe that the 2021 GDP growth target can be quite easily achieved, with the consensus expecting a much higher growth rate of 8.5%[1]. The conservative target is seen as a signal that the government is turning its focus on medium to long-term issues, such as reining in leverage and pivoting to more sustainable modes of growth. After managing to suppress credit growth between 2017 and 2019, overall leverage rose during the pandemic as credit conditions loosened to support the economy, causing total non-financial sector credit-to-GDP ratio to rise rapidly from 262.9% in 4Q2019 to 289.5% in 4Q2020[2].

Looking further afield

At this year's Two Sessions, the government formally unveiled the 14th Five-Year Plan (14FYP) which steers the country's development in 2021 through 2025 to meet the "Long-Range Objectives Through the Year 2035" (Vision 2035), which was also approved at the Two Sessions.

Some of the key targets of the 14FYP are:

i) Keeping GDP growth within a reasonable range based on annual targets set depending on the actual conditions at that time;
ii) Surveyed urban unemployment rate below 5.5%;
iii) Resident urbanisation rate of 65% by 2025;
iv) R&D spending to average more than 7% growth per annum;
v) Strategic emerging industries such as new-generation information technology, biotechnology and new energy (Figure 1) to make up more than 17% of GDP;
vi) Value-added from digital economy's core technologies like Internet of Things (IoT) and cloud computing to exceed 10% of GDP by 2025;
vii) Per capita disposable income of residents to grow in line with GDP; and
viii) Reduce energy consumption per unit of GDP and carbon dioxide emission per unit of GDP by 13.5% and 18% respectively by 2025.

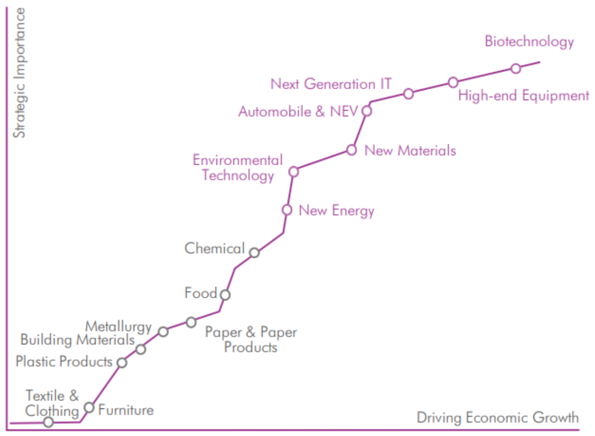
Even though most of the economic targets are non-binding, China has historically strived to meet as many of them as possible. The 14FYP marks the first time a numerical GDP growth target has not been set in a five-year plan. Nonetheless, to achieve Vision 2035's objective of either doubling

[1] Bloomberg consensus as at 5 July 2021

[2] Bank for International Settlements

2020's GDP or GDP per capita by 2035, China will have to grow at an implied average rate of ~4.7% per annum over the next 15 years.

Figure 1: Roadmap of China's key focus industries



Data Source: CBRE Research, August 2020.

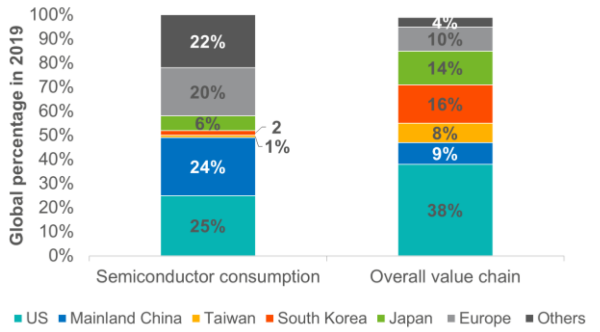
Firing up "dual circulation"

A key concept of the 14FYP is the "dual circulation" strategy (DCS), which was first mentioned by President Xi Jinping at a Politburo meeting in May 2020 and subsequently repeatedly emphasised as China's new development pattern.

The DCS has China's enormous domestic market as the mainstay of development, with domestic and foreign markets reinforcing each other. While the idea of boosting China's domestic consumption is not new, the DCS further stresses the need to unclog bottlenecks to allow for the orderly flow of production factors through China's supply chains. Innovation and technological self-sufficiency are also key pillars of "internal circulation". The latter has become more pertinent in the wake of the US-China trade war when trade sanctions have been imposed by the US.

For instance, the semiconductor industry has become ground zero and one which China is determined to grow in self-sufficiency as it currently imports around USD300 billion of chips annually. Even though China was estimated to have consumed 24% of global semiconductors in 2019[3], its domestic manufacturers only accounted for 9% of global semiconductor industry value-added (Figure 2).

Figure 2: Although a major consumer, China forms a relatively small part of global semicon value chain



Source: BCG, Semiconductor Industry Association

In particular, China's value added from R&D intensive activities like chip design have been significantly lower than from capex intensive activities like wafer fabrication and assembly, packaging & testing, leaving China vulnerable when access to US-based technology and intellectual property becomes restricted through sanctions.

Some of the key action plans under the 14FYP are:

i) Accelerate the development of science and technology toward greater self-reliance and guide the development of seven "frontier technologies", including artificial intelligence (AI), quantum information, integrated circuits and biotechnology;
ii) Upgrade industrial foundations and modernise industrial supply chains;
iii) Expand domestic demand and accelerate the creation of a strong domestic market;
iv) Reform key sectors and promote better interplay between market and government;
v) Promote opening-up and facilitation of foreign trade and investment, foster development of the Belt and Road Initiative and enhance international cooperation;
vi) Promote regional development through a National New Urbanisation Plan (2021-2025) to deepen *hukou* (household registration) reform and coordinated development of Jing-Jin-Ji, Yangtze River Delta (YRD), Greater Bay Area (GBA) and Yangtze Economic Belt;
vii) Accelerate green development and ecological conservation, including emissions reduction and cutting fossil fuels' share of total energy consumption; and

[3] BCG and Semiconductor Industry Association, April 2021

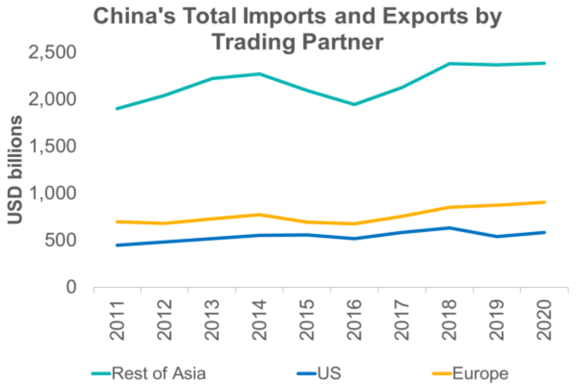
viii) Improve people's lives by raising quality of employment, facilitating social mobility through development of education and strengthening social safety nets like housing, healthcare and elderly care.

US elephant in the room remains

US-China tensions under the Trump administration played a substantial role in influencing the direction of the 14FYP, especially on self-sufficiency. Even though the Trump era has ended, there has been little change in US foreign policy towards China, which has become increasingly bi-partisan. Within the first 100 days of Biden's presidency, the US reinforced its stance that China is its biggest strategic competitor. Trump-era tariffs remain in place, while new sanctions have been imposed on certain Chinese companies.

Complete decoupling of both economies is highly improbable and detrimental; both sides will do well to work together on issues that impact humanity, such as climate change and pandemic response. Meanwhile, China will look to forge greater regional trade integration through platforms such as the Regional Comprehensive Economic Partnership (RCEP) trade agreement, which is targeted to take effect from 1 January 2022 (Figure 3), and possibly the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

Figure 3: China's total merchandise trade with the rest of Asia exceeds that with the US



Source: National Bureau of Statistics, General Administration of Customs PRC

Implications on real estate

The policy directions are generally supportive of commercial real estate demand in China, particularly in the Tier-1 and selective Tier-2 cities in the mega city clusters. China's push to ramp up innovation and R&D spending, accelerate digitalisation and its ambitions of strengthening strategic industries bode well for demand for office and business park spaces (including pharma and life sciences R&D facilities), especially in key tech locations such as Beijing, Shanghai and Shenzhen.

Boosting domestic demand does not mean China will become more insular. The opening-up of sectors such as banking, insurance and wealth management will continue to gather pace and the focused development of city clusters such as Jing-Jin-Ji and YRD will attract investments into the key cities within these clusters, underpinning business expansion demand over the medium to long term. E.g. Shanghai aims to host the regional headquarters of more than 1,000 multinational corporations by 2025, up from 771 in 2020.

Spurring domestic demand through unleashing middle-class consumption, self-reliance on home-grown technology and unclogging of local supply chains will provide tailwinds for well-managed shopping malls and modern logistics warehouses, including cold storage facilities.

The already robust demand for data centres will be further underpinned by the 14FYP's target to grow the digital economy beyond 10% of GDP, but the nation's emissions reduction targets also mean that new data centre developments will have to comply with tighter environmental regulations. E.g. the Beijing municipality has proposed that renewable energy as a proportion of total annual energy consumption for each new data centre approved in 2021 to be at least 10%, with 10% increments for new approvals every year thereafter to 100% by 2030[4].

As China strives towards bettering its people's quality of life as it aims for an urbanisation rate of 65%, policies will be fine-tuned to promote the healthy development of a long-term lease apartment market especially in the core areas of key cities where housing prices are less affordable. E.g. the Beijing municipality will release more land for the development of rental apartments in 2021, comprising 30% of the year's total land supply for residential development, up from 13% in 2020.

[4] Beijing Municipal Commission of Development and Reform

Macroprudential measures targeting the wider housing market are expected to stay in place for some time to minimise speculative investment demand and discourage property developers from overextending their balance sheets. However, end-user housing demand will remain robust in the cities which are “talent magnets” within the mega city clusters, such as Beijing, Shanghai and Shenzhen. Case in point, Shanghai introduced a stringent points system in early 2021 in which those who already own an apartment or had records of apartment purchases in the city within the past five years will find it more difficult to buy a new apartment. As a result, demand for resale high-end and luxury apartments grew, pushing up secondary market prices.

China’s rapidly ageing population is close to peaking and its old-age dependency ratio is projected to rise quickly in tandem. The 14FYP aims to improve the elderly care sector, potentially presenting more opportunities for established senior living operators to provide quality eldercare and senior living products to meet the growing needs of the ageing population.

China recently announced a new three-child policy, but it remains to be seen if it can stem the falling birth rate given the lack of impact when the two-child policy was introduced in 2016. Nonetheless, birth rates in cities where the costs of living are relatively lower (such as Tier-2 and below) may improve, requiring more social infrastructure such as infant care and childcare centres. These could provide another source of leasing demand for office and/or retail space from operators wishing to cater to working parents in the vicinity.

To attract more private capital and promote public-private partnerships (PPP), China has launched the much-awaited pilot batch of nine domestically-listed REITs (C-REITs). Restricted to infrastructure assets (including data centres, logistics warehouses and business parks) for now, the scheme allows sponsors to unlock value from illiquid but income-producing assets. The scheme could help to control macro leverage and over time, may be expanded to include commercial properties.

Beyond China, the likelihood of increased trade regionalisation through platforms such as RCEP and CPTPP could benefit many ASEAN nations. Lower-cost manufacturing hubs such as Vietnam and Indonesia will see more investments into production capacities, leading to increased demand for industrial and logistics facilities. Advanced economies like Singapore could see further establishments of regional headquarters and additional demand for professional services such as trade financing and litigation, underpinning office demand.

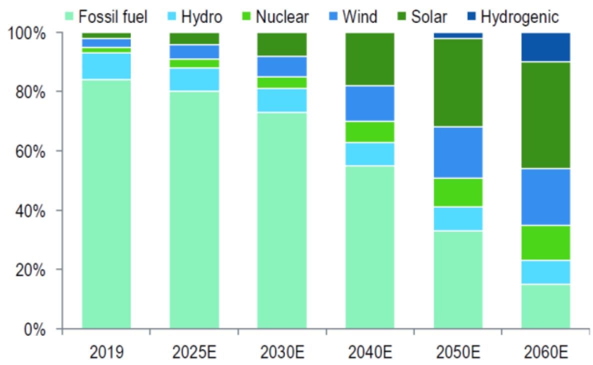
Implications on infrastructure

China is aiming to achieve peak emissions before 2030 and carbon neutrality before 2060[5], ahead of its original pledges under the Paris Agreement. The 14FYP’s targets to reduce carbon emissions and increased consumption of non-fossil fuels dovetail with these longer-term goals.

To do so, China will ramp up power generation from renewable and low carbon sources. We believe infrastructure investors will have opportunities to gain exposure in wind and photovoltaic energy farms as wind and solar energy consumption grows in the coming decades (Figure 4).

Figure 4: China’s use of clean energy could exceed 60% by 2050

Forecast shares of energy consumption, %



Sources: Standard Chartered Research

The green hydrogen industry is still nascent, but China is initiating a four-year programme to support R&D and develop an industry chain with local governments[6]. As the technology matures, the industry will require huge capex into infrastructure like transportation pipelines and filling stations for hydrogen fuel-cell vehicles.

[5] climateactiontracker.org

[6] https://asia.nikkei.com/Spotlight/Caixin/China-s-hydrogen-roadmap-4-things-to-know

Apart from power generation, vast investment opportunities may be present in ultra-high voltage transmission lines, smart electricity grids and electric vehicle (EV) charging stations. On the latter, China's new energy vehicles (NEV) sales is projected to jump from 5% of overall new car sales in 2020 to 20% in 2025 and 50% by 2035, according to the China Society of Automotive Engineers. The association also expects 95% of NEV sales in 2035 to be battery-powered EVs, underscoring the need for more charging stations.

Germane to the 14FYP's dual circulation strategy, China will continue to build out its internal transportation networks, including extending its high-speed rail system, 25,000 km of new highways and 30 more civil airports over the next five years, while airport hubs like Shanghai, Guangzhou and Shenzhen will also be expanded. Foreign capital participation in these traditional infrastructure classes have been limited thus far, but we expect further opening-up of these sectors to allow for more funding options.

For instance, two out of the nine recently-listed C-REITs focus on toll roads. Future C-REITs could possibly include asset classes such as airports and railroads. The Civil Aviation Administration of China also repealed regulations capping foreign investment in the civil aviation industry in February 2021[7], paving the way to attract more foreign investments into China's civil airports.

Conclusion

China has now turned its focus to delivering more sustainable medium-term growth via the 14FYP, which charts its course towards Vision 2035. The 14FYP's action plans suggest policy support will be further extended to promote the growth of key industries through R&D and innovation, boost domestic consumption and improve peoples' lives, mostly targeted at the major city clusters such as Jing-Jin-Ji, YRD and GBA.

We expect positive spill-over effect on demand for most commercial real estate asset classes in these regions. Nonetheless, investors should continue to pay attention to the unique supply and demand dynamics of the asset classes within each micro-location. There will also be growing opportunities in infrastructure, especially in renewable energy generation and transmission and transport networks.

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[7] https://www.globaltimes.cn/page/202102/1215446.shtml