Tier I vs tier II

In the game of tiers, second-tier Chinese cities have much to offer property investors

by Terence Loh

Institutional foreign capital has been investing in China real estate for more than 10 years and one of the perennial debates has been over city selection: First-tier versus second-tier, which is better?

It is possible to invest in, successfully exit and generate attractive returns from real estate projects in both first- and second-tier cities.

And while there are many benefits of investing in first-tier cities — such as liquidity, depth of market and greater transparency — over the years, first-tier cities have also become crowded with foreign and local investors bidding for similar projects. For investors who have the ability to source real estate opportunities directly in second-tier cities, the overall market dynamics are favourable compared with the average transaction in a first-tier city.

For instance, second-tier cities, such as provincial capitals and other large, fast-growing cities, offer the following market dynamics:

• More affordable land prices
• Less speculative residential demand
• Wider availability of deals
• Lower sensitivity to macro changes and policies

Fewer restrictive government regulations

A key challenge, though, is performing in-depth due diligence to be able to accurately judge the quality of the project, the developer and the future market growth. Each of these risks is manageable if an investor has a strong local team of experienced real estate investment professionals combined with a disciplined investment approach. With more than US$1 trillion in property sales recorded in 2013, many would agree that the China property market is large, fragmented and liquid. Therefore, with ample investment opportunities throughout
China, one should not be exclusively restricted to first-tier cities.

**Misunderstanding risk/reward**

It is inaccurate to assume that just because second-tier cities have less attractive economic fundamentals than first-tier cities, investments in second-tier cities require higher returns due to perceived higher risks. For example, it is common for institutional investors to assign higher risk premiums for office acquisitions in Boston than New York City. The same risk premium analysis would not be salient when analysing China’s first-tier versus second-tier cities for three reasons:

- **Most investment opportunities are in real estate development, and yield premium analysis is less relevant, especially when analysing for-sale residential development projects.**
- **Housing is generally more affordable and less speculative in second-tier cities, which argues for lower risk premiums.**
- **With China’s ongoing urbanisation, today’s second-tier cities may resemble first-tier cities in five to 10 years. For example, as infrastructure and economic fundamentals have improved in many second-tier cities, several second-tier cities — such as Suzhou, Chengdu, Hangzhou — have moved up closer to first-tier cities.**

**Criteria for selecting second-tier cities**

In analysing second-tier cities in which to invest, consider the following eight factors:

- **Supply and demand fundamentals:** their impact on different submarkets within the city and on various product types such as office and residential

- **Submarket:** directional growth of the city and which submarkets to consider/avoid due to shift in economic drivers and development of future transportation hubs

- **Population:** current and future levels and the reasons for change in future population size

- **Economic drivers:** main industries, higher or lower value-add businesses, future drivers of employment base

- **Average disposable income:** current and future levels

- **Number and quality of tertiary education schools:** key drivers to providing affordable skilled labour force to current and future employers

- **Infrastructure:** current and future high-speed railway, subway, local/regional bus lines and airports

- **Local government and property regulation:** whether the local government is forward thinking and pro-business, and the potential impact from changes in the future

**Supply and demand balance**

Real estate around the world is a very local business, and China is no exception. Even when applying a rigorous city-selection process, it is
unlikely that every city would score excellent in every criteria. Therefore, it is important to adopt a holistic approach and weigh all the above factors before deciding on a project and its location. Not surprisingly, some factors are more important than others.

For example, when CDH Investments considered a mixed-use development in Xi’an, the provincial capital of Shaanxi, one of the most important factors was the supply and demand analysis of the city and its submarkets. In this instance, we focused our analysis on the granular dynamics of each product type and its market positioning. For example, we analysed:

- **Current buyer profile:** What is the current preference for different residential product types (high-rise for-sale residential or low-rise townhomes)?

- **Current supply/demand:** Is there sufficient unmet demand?

- **Future changes:** Will the buyer profile change as the city’s middle-income segment grows? How do we expect future supply/demand characteristics to change?

Similar to most institutional investors, we prefer cities with limited land supply where the government is not releasing excessive land through land auction sales. However, there are several cities in China where the government has flooded its own market with disproportionate supply of land for commercial projects development, including Tianjin, Shenyang and, to some extent, Chengdu. As a result, these cities now face supply/demand imbalances that may take several years to be fully absorbed based on current demand.

These issues, though, do not mean that the entire China market faces unattractive supply and demand challenges. Because China’s property market is growing rapidly, current demand levels are unlikely to stay flat forever. For example, in the past, few analysts expected that grade A office space net absorption in Chengdu would grow by sixfold from around 50,000 square metres in 2007 to nearly 300,000 square metres in 2013, reflecting an almost 30 percent compounded annual growth rate. However, many analysts did expect supply levels to increase at an even more rapid pace, which resulted in vacancy rates remaining unchanged at 30 percent in both 2007 and 2013.

**Which second-tier cities?**

In our universe of second-tier cities, we clearly have a preference for certain cities such as Xi’an, Hangzhou, Nanjing and Suzhou due to supply constraints in prime locations coupled with stable demand across most sectors.

Let us take one city, Suzhou, as an example, and lay out the criteria that we analyse to form our view on the city’s suitability for investment. Suzhou is a strong second-tier city and benefits from its close proximity to Shanghai, which is 30 minutes away via the current high-speed railway. Suzhou has a significant concentration of higher value-add industries, which supports a large base of white-collar jobs and indirectly provides steady demand for residential and commercial real estate. Furthermore, according to the SouFun-CREIS 100 Cities Index, residential prices in Suzhou rose 3 percent and 4 percent in 2012 and 2013, respectively, which is in line with price increases in mature residential markets. With residential prices growing slower than the local GDP growth rate, it is unlikely that this price appreciation would spark concerns within the central government. Therefore, we believe that the risk of further tightening measures in Suzhou’s residential market is limited. Within Suzhou, we especially like the Suzhou Industrial Park submarket due to its proximity to amenities such as well-operated retail malls, high-quality schools and medical services, as well as access to existing subway lines. However, it is not easy to acquire prime land for residential and/or commercial development due to relatively competitive land prices and compressed profit margins.

**Case study: Tier II investment**

The challenges described above, such as being priced out of the market, are common, but it is possible to find compelling deals with attractive risk/reward potential. One such example is our investment in a mixed-use development project in Xi’an, provincial capital of Shaanxi province. In 2011, we jointly acquired a greenfield site with a Hong Kong-listed developer with whom we had an excellent existing working relationship; investment managers typically prefer working with existing partners in order to reduce execution risk. Xi’an has a population of more than 9 million people, diversified industrial base, growing middle-income population, as well as improving infrastructure from newly-completed subways and airport terminal, so the

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Downtown Suzhou
city’s property market showed great potential. The existing employment industries are well supported by the strength and quality of the city’s education base, which is considered the third largest after Shanghai and Beijing.

Furthermore, according to the SouFun-CREIS 100 Cities Index, residential prices in Xi’an were up only 2.7 percent annually during the past two years, which resulted in an affordable home price to disposable income ratio of between 6:1 and 8:1. This also lowered the risk that the central government would implement new restrictive housing policies in Xi’an because home prices remained affordable for local residents. Furthermore, the supply side of the equation was less of a concern in Xi’an than in many other cities, such as Shenyang and Tianjin. The government had been steadily releasing residential and commercial land, and had not flooded its own market with excessive land sales. However, the local government was less progressive than in first-tier cities, which resulted in a lengthy period of negotiations to get acceptable terms and conditions and close the transaction. Today, this project is under construction and connected to the newly-operational east-west subway line. Considering all the factors described above (ie, supply/demand as well as city dynamics), Xi’an provided many attractive reasons to support an investment in a mixed-use project in this city.

During the past 10 years, opportunistic hurdle rates for China property have been declining from internal rates of return in the mid to high 20 percent range to the low 20 percent range. This has been partially due to improved transparency, market knowledge and comfort from established fund managers that have exited Chinese property investments. Additionally, more realistic pricing of risks and returns for Chinese property should allow for a better understanding of second-tier cities. Considered one of the legends of real estate from the Urban Land Institute, the late James Graaskamp once said, “A successful real estate investment will require four assets — land, knowledge, tenants and capital.”

The eight factors for second-tier city selection provide knowledge, which is only one of the four “assets” espoused by Graaskamp. Nevertheless, there are several other important factors that also determine a project’s success, including location, entry/exit price, product mix/design, understanding of end-users, equity and debt funding, and joint venture development partner. For those investors with the appropriate skill sets and experience, China’s second-tier cities present a challenging but rewarding investment opportunity.

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