

Restoring Hope in the Wake of Calamity (CBRE Research, 4th June 2008)

Given the damage from the earthquake in Sichuan and the consequent lowered appetite for risk, it's easy to predict a slump in the local property market. But a closer look at the region reveals that there are many reasons to be hopeful.

Like the rest of China and the wider world, CBRE mourns the victims of the recent Sichuan earthquake and applauds the bravery of those rescue workers, volunteers and individuals who performed countless heroic acts in the wake of its massive destruction. China has not seen a natural disaster of this magnitude in over 30 years, more than a lifetime for much of the region's young population.

Reports have abounded on the quake's impact on the property market in Chengdu – many striking a pessimistic tone, though the underlying economic strength of this emerging second tier city indicates that the region will continue to flourish.

Residential

Buyers are more risk-averse. Most owner-occupiers will only purchase a home once in a lifetime, and it's usually the largest investment they will ever make. Naturally, they want to eliminate risk as far as possible.

Shortly after the quake, the local government halted all construction, although some sites resumed building on May 23, after passing inspections. While this was necessary to ensure safety during the series of aftershocks following the quake, it has also delayed completions.

Disputes have arisen over cracks in buildings, both existing and under construction; most home buyers had not insured their properties against earthquake risk. While these disputes have yet to be resolved, concern over building quality has naturally become paramount in the region. Prospective home buyers are postponing decisions and assuming a more risk-averse attitude when comparing their choices.

The situation is also straining developers. House sales were already sluggish across the country and, as the Chinese expression says, the quake is "adding frost to snow" to make

things even worse. The luxury properties damaged at the foot of Mount Qingcheng, Dujiangyan, are one prominent example. Furthermore, developers face rising costs for raw materials.

There have been much fewer inquiries and visitors in sales offices, especially for high-rise projects. It is rumoured that developers might cut prices for upper floors, but this has not happened to date. Many upcoming launches previously scheduled before the Olympics were put off until after the games. Major developers are expected to be able to withstand a period of market lows but smaller developers might need to make adjustments – including on pricing – in order to survive the aftermath of the quake.

Though the situation is bleak, there has been an increase in the number of sales in the secondary market as residents from the affected areas are now purchasing abodes in Chengdu city. The leasing market is also witnessing similar activity levels from such affected citizens too.

Office

Following the earthquake, most of the major prime office buildings like Times Plaza and Plaza Central sought professional advice on the structural integrity. After thorough inspections had confirmed that the buildings were safe to re-enter, most of the tenants quickly resumed business. Rents have not yet been affected, including for upper floors as most of the significant commercial buildings are close to full occupancy. In the same token, some prospective tenants are re-evaluating the terms of their leases and investors are also postponing decisions for about a month. Together with the high occupancy rates and the presence of newer buildings which are generally better fitted out, it seems unlikely that office rents will fall.

Hotel

Major hotels have responded quickly to the disaster by slashing rates by about 20%. Occupancy fell significantly as tourists are currently unwilling and unable to travel to Sichuan. This could persist until the affected tourism areas are rebuilt. Apart from the tourism market, the convention industry has also quietened down significantly. One of the more notable events which was supposed to have been held in late May – Western Expo – is now postponed to October. The deferment of this and other seminars that are held in the city would have an impact on the current room and occupancy rates. However, the hotel industry is expected to turn around soon, what with the remaining tourist destinations within Sichuan Province which are unaffected by the earthquake and a resumption in the business confidence level.

Retail

Except for losing tourists temporarily, most shopping areas remain bustling and there have been minimal signs of disruption. Some of the tenants in high-end department stores witnessed zero sales, for the first time ever, in the first week of the earthquake. However, as of the third week after the earthquake, local customers have made a comeback across most of the retail formats – pedestrian street shops, department stores and shopping centres. The appetite for consumption – especially of living necessities – might have actually increased in the wake of the quake. Prime retail is basically not affected because the target customers of this market segment are financially more capable of withstanding such disasters. A quick market survey revealed that current market activity reflects at least 70% that of the norm – quite a quick comeback just within three weeks of the quake.

Industrial

Industrial properties were least affected because they are mostly structurally sound low-rises. Most factories resumed production soon after the quake. A prime example is Intel, which houses about 1,600 employees in its facility in the northwest of downtown Chengdu and is relatively close to the epicentre.

Businesses remain enthusiastic about the region. Tencent, the instant messaging service provider, was the first firm to venture into Chengdu after the quake by agreeing to buy a

building in the Tianfu Software Park in south Chengdu. Toyota Boshoku, a member of the Toyota group, also agreed to open a factory in east Chengdu.

Recovery in the mid- to long-term

Despite being only 100 km from the epicentre, buildings in downtown Chengdu have barely been damaged. Seismologists attribute this to its unique geological structure, which acted as a sponge in absorbing the shock waves.

Rebuilding the quake zones with increased seismic design offers massive potential for real estate development and services. The government has announced plans to relocate and rebuild affected areas such as Beichuan and Dujiangyan that were devastated in the quake. Opportunities generated by the subsequent reconstruction boom are expected to cover a wide range of services, which should benefit local industry.

Residential demand is likely to increase in the future, especially for mid-market owner-occupied housing built to stringent seismic standards. As downtown Chengdu fared far better than its unfortunate neighbours, it has proven an attractive location for wealthy residents of surrounding areas, driving up demand for this safer location. To cater to this demand, part of the future residential supply is likely to shift focus to low-rises in addition to enhancing seismic design. Developers will need to re-evaluate their project positioning as well as overall marketing strategies to target the new demand. For city planners, they also have to take earthquake risk and future housing demand into consideration, as the current mantra for building the city's skyline encourages height and density.

Office, retail and industrial are unlikely to be affected in the long term as their recent performance indicates.

While the quake might have made investors and developers hesitate about high-rise office buildings at the moment, the burgeoning Sichuan economy in terms of disbursed FDI growing at about 40% y-o-y in the past two years signals the rising demand from an influx of foreign businesses. As the negative market sentiment wears off in the second half of 2008, most of the office supply scheduled for 2009 and 2010 are likely to come on stream unchanged.

Since there is no new supply of prime retail in 2008, the market is all left up to existing retailers as the May 12 quake did not directly take its toll on them. However, consumer psychology towards aftershocks has appeared to influence their shopping behaviours. With a seemingly unpredictable end of aftershocks, residents of Chengdu will keep on spending more on living necessities in order to maintain a stock in case of emergency. But this is unlikely to persist as soon as aftershocks fully die down. Hence the retail landscape will not change much in the mid-to-long term. Demand will only grow larger in accordance with the residential sector, which will draw in housing demand migrated from surrounding areas as previously mentioned.

It is obvious that the government is acting very quickly to the reconstruction. On May 29, the Ministry of Railway and Chengdu agreed to start building the railway between Chengdu and Dujiangyan soon and aim to finish it within two years. On the same day, China National Building Materials (CNBM) decided to invest billions of Renminbi to build manufacturing facilities in Chengdu that produce construction materials, including cement and fiberglass. It is expected that the infrastructure of the affected areas will go through a revamp and kick it up a notch in the future. As more companies related to reconstruction move in, demand for industrial properties will be on the rise.

Sichuan represents only a tiny fraction of the national economy, so the quake will not slow the China's overall growth. Heavy public spending during the subsequent reconstruction boom is very likely to offset some of the losses and even pull up the regional economic growth. Previous earthquakes in major international cities like Los Angeles and Tokyo illustrate that these temporary disruptions produce only minimal long-term effects on the regional economy, and serve to refine risk analysis and improve preparedness for future catastrophes.

The current market 'standoff' is likely to remain for a period of time. However, we expect the Provincial Government, in accordance with Central Government, will grant incentives and/or relax existing restrictions in order to revive the property market. In the mid to long run, the continuing economic growth potential and the Central Government's macro plans such as the Pilot Reform City and the upcoming Metro system, amongst others, for THE gateway to south-western China, cannot be all too readily dismissed by a force majeure.

In a nutshell, there is a silver lining beneath every cloud.

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