China Investment Roadmap: the Commercial Real Estate Sector

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China’s urbanization wave is considered by many to be the largest in human history. Following Deng Xiaoping’s reform and open up policy, millions of rural Chinese moved to China’s major coastal cities looking for opportunities in the newly-established factories. As a result, cities like Shanghai and Shenzhen grew into sprawling metropolises practically overnight.

However, much of China’s rural to urban movement has been absorbed by the megacities unknown to most people outside the country. As cities like Beijing and Guangzhou continue to grow and mature, cost of living is rising as well. With economic development now spreading to these lesser known cities, people are beginning to abandon China’s largest cities for the increasingly cosmopolitan regional hubs.

Most of the accompanying construction boom has been exploited by domestic companies, and largely state-owned businesses at that. In 2013, less than 300 construction companies were foreign invested, compared to almost 80,000 domestic ones. Construction and real estate in China is largely a domestic game.

In this issue of China Briefing, we explore the latest trends in commercial real estate in China, and discuss how foreign companies can benefit from China’s massive construction boom. We provide a guide to how firms can sell construction materials in China, and finally detail how foreign architects can most effectively enter and take advantage of China’s rapid urbanization.

Opportunities abound for the discerning company or individual in China’s booming real estate market. With our specialized knowledge of the sector, we at Dezan Shira & Associates look forward to working with interested parties in the future.

With kind regards,

Adam Livermore
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Powering China’s Urbanization:
A Market Overview of the Real Estate Sector

By Dezan Shira & Associates
Editor: Elizabeth Leclaire

The culmination of an enlarging middle class, rising wages, and rapid urbanization has created an immensely profitable real estate sector within China. Each year, 1.8 billion square meters of construction is erected within the nation. China is responsible for more than half of global cement consumption.

Investment in China’s real estate market has skyrocketed in tandem with the development of the country’s middle class and urbanization. China’s middle class is predicted to encompass at least 75 percent of the urban population by 2023. With higher incomes, the demand of new urban citizens will evolve in terms of housing, work and shopping. As the service industry is beginning to make up a larger share of the Chinese economy, the future will see more and more Chinese working in offices. This shift will have important consequences for the market in office space. In 2013, 15 percent of total real estate fell under the commercial category, with six percent as office buildings. By the end of 2015, China’s office real estate industry is anticipated to grow by up to four percent from two years prior.

Foreign investors have been quick to notice this emerging trend. While in 2010, China’s real estate industry was not even among the nation’s top ten most popular sectors for foreign investment, by 2014, it was ranked third on the list. Total investment in commercial real estate investment almost reached RMB 12 trillion in 2013, a 28.3 percent increase from the previous year.

Although China’s tier one cities continue to maintain their dominance in the real estate market, lower tier cities have been gaining ground at a remarkable pace. Much of China’s multiple-decade urbanization movement is in fact taking place in the smaller coastal cities and provincial capitals - megacities most foreigners have never heard of. With stronger economic growth than the traditional major cities, these upcoming destinations offer both job opportunities and a more affordable cost of living.

Nicknamed tier 1.5, locations such as Chengdu, Hangzhou and Nanjing are frontrunners in the transition from tier 2 to tier 1 cities. Commercial real estate development in tier 1.5 cities often enjoy greater government support than in the already overcrowded tier 1 cities. For example, shopping centers covering a ground area larger than 10,000 square meters are prohibited in Beijing’s center, but are encouraged in the developing cities. China’s maturing tier 2 cities are predicted to amass 15 percent of global economic power within the next ten years.

As a subset of commercial real estate, the prospects for shopping malls continues to be promising. Middle class annual disposable income has reached a new high of US$ 3,500, a figure that is expected to increase five-fold by 2030. As a result, China’s demand for large shopping centers has seen steady growth in recent years, especially outside the tier 1 cities. As of 2013, nine of the world’s top 10 largest shopping malls were located within China.
Power Provinces: 2014 Provincial GDP Growth Across China

- **over 7%**
- **between 3-5%**
- **between 1-2%**
- **between 2-3%**
- **less than 1%**

### Power Provinces

- **$550 Billion**
  - **Sweden**
  - $579.53 Billion

- **$280 Billion**
  - **Chile**
  - $258 Billion

- **$450 Billion**
  - **Iran**
  - $404 Billion

- **$940 Billion**
  - **Indonesia**
  - $889 Billion

- **$380 Billion**
  - **Colombia**
  - $384 Billion

- **$1.08 Trillion**
  - **Mexico**
  - $1.28 Trillion

- **$220 Billion**
  - **Portugal**
  - $224.91 Billion

- **$450 Billion**
  - **Austria**
  - $437 Billion

### Professional Services
Dezan Shira & Associates can provide customized multi-province market research for foreign companies looking to invest in China’s real estate sector. For more information, please contact us at market.research@dezshira.com

EXPLORE DETAILS
Growing incomes have spurred an uptrend in hotels as well, with domestic travel accounting for 4 percent of China’s 2014 GDP. As a whole, domestic travel grew by 14.7 percent in that year, driving demand for hotel rooms.

At the same time, in order to combat China’s heightening pollution crisis, the government is continuously looking for measures to build a more sustainable economy. These initiatives touch upon the commercial real estate sector as well. Buildings currently account for approximately 25 percent of all energy usage in China. As such, the CCP’s twelfth Five Year Plan aims to have one billion square meters of floor space be environmentally sustainable by the end of 2015, a 20 percent increase from 2011 levels. By 2030, China’s government hopes that at least 30 percent of new buildings are constructed and maintained according to green standards, using renewable energy sources and environmentally sustainable construction materials.

Environmentally friendly properties receive benefits which are established nationally but are largely subject to local governmental discretion. For example, while green projects across China receive economic benefits to some degree, Shanghai individually subsidizes RMB 60 per square meter of ‘green’ floor space.

China’s current political, social, and economic dynamics indicate continued development and profitability for the commercial real estate sector. As the government is encouraging the development of China’s inland regions and growth is picking up, many opportunities can be found for investors who dare to venture inward. Coupled with rising living standards, many a promising opportunity awaits the discerning investor.

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**China’s City Tiers Explained**

While China is home to dozens of megacities, they are vastly different in terms of economic and cultural development, modernity and sophistication. As such, Chinese cities are informally classified into tiers. Tier 1 cities are the most highly developed, cosmopolitan cities. Beijing, Shanghai, Guangzhou and Shenzhen are usually thought of as tier 1.

Tier 5 is on the other end of the spectrum: smaller, less developed, less exposed to the outside world.

Tier 2 cities are often either thought of as the provincial capitals, or alternatively the more developed and affluent (coastal) cities.

The tiers are also a useful way to distinguish consumer behavior. A tier 1 consumer would for example buy gourmet coffee beans on a weekly basis, whereas a tier 5 consumer may never have had a cup.

Growing incomes have spurred an uptrend in hotels as well, with domestic travel accounting for 4 percent of China’s 2014 GDP. As a whole, domestic travel grew by 14.7 percent in that year, driving demand for hotel rooms.

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### The Rise of China’s Second Tier Cities

<table>
<thead>
<tr>
<th>City</th>
<th>Floor Space Added for Commercial Use (Million sqm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changsha</td>
<td>3.41</td>
</tr>
<tr>
<td>Chongqing</td>
<td>2.32</td>
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<tr>
<td>Chengdu</td>
<td>1.8</td>
</tr>
<tr>
<td>Harbin</td>
<td>1.48</td>
</tr>
<tr>
<td>Wuhan</td>
<td>1.6</td>
</tr>
<tr>
<td>Dalian</td>
<td>1.46</td>
</tr>
<tr>
<td>Hangzhou</td>
<td>0.8</td>
</tr>
<tr>
<td>Changsha</td>
<td>0.8</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>0.8</td>
</tr>
</tbody>
</table>

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### Real Estate Investment and Construction

- **Changjiang** 3.41
- **Chengdu** 2.32
- **Wuhan** 1.8
- **Harbin** 1.48
- **Dalian** 1.46
- **Changsha** 0.8

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Building for the Future: Selling Construction Materials in China

By Dezan Shira & Associates
Editor: Steven Elsinga and Qian Zhou

For the most part, the construction business in China is run by Chinese parties, and the construction materials sector is no different. China’s rapid urbanization has led to a surge in demand for resources, carrying a variety of economies around the world through a multi-year boom period. The production of construction materials and components from these imports has been largely dominated by local companies, but there are a number of niche markets within that sector where foreign companies have a distinct competitive advantage.

Market overview and opportunities for foreign players

Government policy

While hard to penetrate from an economic point of view, the construction materials sector is largely devoid of government restrictions. Every other year, China releases the so-called Catalogue for the Guidance of Foreign Investment, a document that outlines the industries where foreign investment is encouraged, restricted or prohibited. Industries listed as encouraged enjoy beneficial treatment such as tax breaks, while those in the restricted section require additional government approval, or come with caps on the percentage of shares a foreign party may own.

Construction materials, of whatever kind, are not restricted. Some of these are even encouraged, including materials that conserve energy, are used in waste treatment, or replace wood and steel.

As the final months of 2015 draw near, the CCP’s twelfth Five Year Plan (2011-2015) will soon come to an end. A relic from the days of China’s planned economy, the Five Year Plans lay out the government’s major policy goals. Already a concern at the previous session, recent months have seen a host of supportive government measures come out in anticipation of the new Plan. For example, on March 16, 2015, the New Type of Urbanization Plan 2014-2020 was promulgated, mandating the share of ‘green’ buildings in new construction to rise from two percent in 2012 to 50 percent in 2020. As the vast majority of Chinese suppliers are still unfamiliar with green materials, this policy decision offers a lucrative opportunity for foreign investors.

This direction was reiterated in the Opinions on Accelerating the Construction of Ecological Civilization, a policy document released by the State Council on April 25, 2015. Moreover, to promote the development of new types of wall materials such as light partition boards or composite insulating bricks, the Ministry of Finance and the State Administration of Taxation jointly released a Circular on June 12, 2015, offering producers of qualifying products a 50 percent VAT refund. Where the wall materials have been produced with recycled construction waste, 70 percent of VAT is refunded. The release of such stimulating measures is expected to continue after the new Five Year Plan is unveiled.
Niche Markets for Foreign Investors

<table>
<thead>
<tr>
<th>Glass</th>
<th>Waterproof Materials</th>
<th>Indoor Decoration and Fixtures</th>
<th>Advanced Ceramics</th>
<th>New Wall Materials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign companies hold technological advantage</td>
<td>Foreign investment is encouraged</td>
<td>Gypsum plaster boards, wallpaper and suspended ceilings</td>
<td>Electronic, micro-crystal-line and nano-ceramics</td>
<td>Isolative materials, recycled construction waste</td>
</tr>
</tbody>
</table>

**Do-it-yourself**

Foreign investors should be aware that the concept of DIY home renovation is not common in China. When renovating a house, Chinese homeowners tend to hire a builder to do the work. The homeowner either buys the materials from a wholesale market for the builder to use, or has the builder purchase them directly. Several foreign companies have attempted to develop a retail market for building materials, but these efforts so far have failed to materialize.

**Administrative measures in the construction materials industry**

**National licensing requirements**

The production and sale of several construction materials is subject to a licensing regime. Regulations on the matter are issued by the Administration for Quality Supervision, Inspection and Quarantine (AQSIQ), a government body charged, among other things, with commodity inspections. There is no uniform procedure for all categories of construction materials, so regulations differ per product. As an example, we examined the procedure for water-resistant materials.

**Water-resistant materials**

Applications for a water-resistant materials production license need to be addressed to the provincial branch of AQSIQ, and generally follow four steps:

1. Submission of the application materials (reply within 5 days), including:
   a. Business license
   b. Environmental protection valuation report issued by the Environment Protection Bureau
   c. Application documents
2. On-site inspection (1 day)
3. Sampling test (reply within 15 days)
4. Examination of materials and approval (reply within 60 days)

**Local licensing requirements**

Some cities have enacted regulations with more detailed filing requirements for the production or sale of building materials.

For example, Shanghai requires producers and importers of a wide variety of construction materials to file the materials used, submitting a compliance certificate from a testing institution, product warranty, production license (if required), or documents stating that the material has been approved for use abroad.

**Market analysis**

As mentioned before, a large swath of the construction materials industry is serviced by domestic players. Nevertheless, there are a number of niche markets at the top end of the technology and quality spectrum that hold interesting opportunities for foreign investors.

With the Chinese burgeoning middle class becoming increasingly quality-conscious, and with environmental issues remaining a pressing concern, foreign companies can bring technology and know-how to the Chinese market that local providers are unable to offer.

In line with the increasing concern over energy efficiency, quality and pollution, demand for a number of related product categories has seen an upsurge. The first area where building quality starts to matter is, of course, safety. As such, there is increased attention to equip buildings with better performing fire- and shock-resistant materials. The scenes of the 2008 earthquake in Sichuan that killed almost 70,000 people are still fresh in many peoples’ memory. As most cities in China are plagued with high levels of air pollution, demand has been strong for air purification systems as well.

Since large parts of China use coal for energy production, any large scale energy savings will positively impact air quality as well. Apart from better isolation materials, solar panels and other energy generating devices will too see strong demand. Lastly, as the use of smart technologies such as intelligent light control and self-adjusting temperature devices begin to find their way into everyday use, foreign investors can expect these trends to be picked up in China as well.

**Glass Waterproof Materials Indoor Decoration and Fixtures Advanced Ceramics New Wall Materials**

Foreign companies hold technological advantage Foreign investment is encouraged Gypsum plaster boards, wallpaper and suspended ceilings Electronic, micro-crystal-line and nano-ceramics Isolative materials, recycled construction waste
Opportunities for a Foreign Architect or Firm in China

By Dezan Shira & Associates
Editor: Steven Elsinga

As China's urbanization continues at a rapid pace, flocks of foreign architects have found their way to the Middle Kingdom. With the Western world still recovering from a crash in real estate prices, construction has obviously slowed down. For many foreign architects, China has therefore proven to be a welcome opportunity.

These opportunities lie mostly in the high-end of the commercial real estate sector. The low to mid-end of the market, along with most of the residential property, is dominated by local architects. While many of the foreign-designed landmarks in cities like Beijing and Shanghai make the newspaper headlines, most opportunities these days are in fact found in the fast-growing lower-tier and inland cities. Many of these cities like to distinguish themselves by erecting extravagant, eye-catching edifices. The international allure of a foreign architect adds even more prestige to the project.

In recent years, this has led to a proliferation of sometimes odd-looking, foreign-designed creations shooting up all over China – apparently much to the scorn of the Chinese central government. Xi Jinping has therefore personally called for a moratorium on the construction of ‘weird buildings’. Rather than a matter of taste, these comments should be viewed in light of the corruption crackdown launched under Xi Jinping. Many of the more outlandish creations are merely prestige projects for city officials, and are financed with taxpayer money. Combined with the popular unrest over ordinary citizens being kicked out of their homes to make room for property development, some aspects of China’s construction frenzy have become politically sensitive.

Despite this recent trend dampening some of the interest in foreign architecture, a ready market remains. Foreign architects are reputed for quality, creativity and – importantly – the use of green technology. As China continues to struggle with pollution, the government is frantically exploring ways to move toward a more environmentally sustainable growth model.

Entering the China market
Dezan Shira & Associates has helped numerous foreign architecture firms get a foothold in China, and as such, has come to understand which approaches tend to work or fail. We will now compare three different models and explain why, in our experience, the third model has the best chance of being successful. The three models are: providing architecture services from abroad, setting up an architecture firm in China, or setting up an ‘architecture consultancy’.

Related Reading
For more information on how to obtain a visa to work in China, please see our related magazine on the subject.
Servicing clients from abroad

Foreign architects do not necessarily have to be in China to do their work; all the drawings and designs can be done from an office in their home country. Apart from finding clients, there is no reason that compels an architect to physically be in the country. The foreign firm could simply open a Representative Office, liaise with clients that way, and receive payment in its home country.

While possible in principle, architects will often find that Chinese clients are reluctant to pay foreign companies directly in foreign currency. There are two reasons for this. Firstly, due to the foreign currency controls that the Chinese government has put in place, paying foreign currency abroad is often either prohibited, or involves a lot of hassle, paperwork and uncertainty for the Chinese party.

The second hurdle has to do with the Chinese tax system. In order to offset VAT and deduct expenses, Chinese companies need to show a special VAT invoice, also called a fapiao. These fapiao need to be printed on a special type of paper that can only be purchased from the Chinese tax office. To purchase these invoices, one needs to have a limited liability company in China. Entities incorporated abroad therefore cannot obtain a fapiao, nor can their Representative Offices in China. If a Chinese company is unable to get a fapiao for its expenses, it is left with a significant and unnecessary tax burden. For this reason, Chinese clients will very likely insist on foreign companies setting up an entity in China. With such an entity, the Chinese client can pay in RMB as well.

One may find that some clients are capable and willing to pay in foreign currency to an account outside China, in which case setting up a Representative Office for practical reasons would suffice. However, such clients are likely to be the only exception.

Setting up an Architecture WFOE in China

China’s corporate laws are relatively rigid in that they require a company to define what activities it intends to engage in, and demands the company to stay within that scope. When the company is first created, it needs to describe what the business scope is, and apply for a new business license if the business scope is to be changed. Companies in China cannot issue fapiao for activities that lie outside their stated business scope. A company simply incorporated to ‘receive payments’ is unlikely to be approved. Chinese corporate law also requires entities to have a physical office, independently accessible with its own door and desk. Creating a letterbox company solely for the purpose of receiving payments is therefore not an option.

If a company in China wants to bill for architectural services, it needs to have architecture in its business scope. In other words, an architecture firm would need to be set up in China. In our experience, however, the licensing requirements for foreign-invested architecture firms are so prohibitively stringent that most firms are unable or unwilling to meet the standards.

One of the major obstacles is the staff requirement. One fourth of the staff in a foreign-invested architecture firms needs to consist of foreign architects or engineers that have both foreign and Chinese certifications. This means that the company would need to have a large part of its staff take the Chinese architecture or engineering exams. In addition, one fourth of the firm’s “core technical staff” should consist of foreigners with relevant technical design experience. The regulation does not clarify what this specifically means.

If the foreign invested firm is a JV with a Chinese equity partner, these requirements both drop to one eighth. Furthermore, the regulation requires that these foreign architects, engineers and core technical staff remain in China each year for over six months.

The foreign company or individuals (including Chinese partners, if any) need to already be engaged in architecture, and provide two examples of their work. Of these, one project needs to have been completed in the applicant’s home country.
Apart from the license to set up an architecture firm, the company needs to acquire additional licenses depending on the type of projects it seeks to engage in. These are divided into three categories: Comprehensive Qualification, Sector Qualification and Specialized Qualification. The Comprehensive and Sector Qualifications are subdivided into different applications with grades. As a result, there are several dozen different licenses for different projects, each with their own requirements. These requirements range from prior experience, staff types and count and registered capital – often running into several million RMB.

For this reason, most foreign architects resort to the third alternative.

**Setting up an Architecture ‘Consulting’ WFOE in China**

The work-around for this problem is to set up a WFOE that provides architecture consultancy services, i.e. advising Chinese architects. Its business scope would typically cover matters like architecture consulting, real estate information advisory, market research, landscaping advisory, indoor architecture consulting and project management consulting. Which exact services such a company is allowed to perform is at times ambiguous. What is clear is that a Consulting WFOE may review third-party drawings and do conceptual design. However, such a company may not explicitly bid for or sign contracts for architectural design or project management.

In practice, the foreign architecture consulting firm often does most of the work, but goes through a licensed Chinese architect that places its signature on the final product. This way, the foreign architecture firm can still provide its services, without having to meet the stringent licensing requirements under Chinese law. Over the years, Dezan Shira & Associates has helped numerous foreign architecture firms set up such arrangements, and ensured that these firms remained in compliance with Chinese regulations.

As clients pay their fees to the WFOE in China, a common issue is how to take this money out of China in a tax-efficient way. Companies in China are subject to 25 percent corporate income tax. When the profits are subsequently repatriated by issuing dividends, another 10 percent dividend withholding tax is levied. This leaves the company with a significant tax burden, especially considering that most of the work may in fact be done overseas.

One way to bring taxable income down is to hire foreign architects through the WFOE and have them work in China. The firm can also send its architects to China on short-term projects of several months, and then have the head office abroad charge the WFOE. This arrangement of having the WFOE pay the parent company is a form of transfer pricing; a means to both reduce its taxable income in China and take money out of the country without paying dividend tax. The overseas head office can charge the WFOE for other services as well, such as use of royalties and back-office services. To be considered legal, these transactions would have to be at market prices. Inflating the prices to get more money out and save more on taxes is strictly forbidden, and the Chinese tax authorities heavily scrutinize these practices.

Such an approach would require including a stipulation in the WFOE’s articles of association, as well as a framework of contracts covering the arrangement.
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