Horwath HTL

Hotel, Tourism and Leisure

Special Market Reports

Issue 1 - China

CHINA - COUNTRY FACTS & FIGURES - 2010		
Population		1,336,718,015
Urban population		47%
Rate of urbanization		2.3%
Major Cities	Shanghai	16.5 million
	Beijing	12.2 million
	Chongqing Shenzhen	9 million
	Guangzhou	8.8 million
GDP		$5.87 trillion
GDP Growth		10.3%
Consumer Price Index growth		6.5%
Real Estate Inflation		11.7%

CHINA - HOTEL FACTS & FIGURES - 2010	
Total Hotels	14,237
Total Rooms	1,673,475
Beds	3,064,684
Occupancy	57.88%

CHINA

If you are a real estate developer looking to enter the China hotel market, when packing your bags be sure to leave behind the traditional tools used in assessing a development's potential.

You may also want to leave behind those principals of the real estate market you have learned over time. China doesn't work the same way. If you persist with a traditional approach, you will most likely go home empty handed.

From afar, China appears to most western businesses as an immense pot of gold just waiting to be tapped into – a vast source of future wealth.

Many westerners unfamiliar with China view the country as an unstoppable economic powerhouse surging toward domination through its own version of a market economy.

While in many respects this may be true, there are many business people that will tell you it can be extremely difficult to even gain a presence in the market, let alone a successful one. This is particularly true in real estate investment. For a country as large as China, one story does not tell the entire tale.

Look at the international coverage the annual International Student Assessment (PISA) received when Shanghai students topped the world in mathematics, science and reading and the resultant handwringing in many corners of the world. However, anyone with some knowledge of the country would know that its education system still has a very long way to go and that the students that took part in this test in Shanghai are almost as far removed from their peers in rural China than the students taking the test in New York.

A similar lack of understanding also occurs within the hospitality industry in China. For the international hospitality community, one thing that is clear is that the development pipeline of hotels in China is huge and that all the major players are aggressively signing new deals. This gives an impression that the hotel market is booming and that there is plenty of money to be made by all. This is far from the truth in many hotel markets across the country.

So what are the tools needed in order to successfully enter the hotel real estate market in China?

GUANXI

The term guanxi means the relationships or connections that you have in China and it is particularly important to have strong guanxi (particularly with government) if you want to succeed in real estate development. Most new development land parcels are released by the government, and to succeed in obtaining land, it is important to work with the government well in advance.

In fact, local government in many instances is the one pushing for hotel developments and often targets the development companies that they would like to work with, particularly large national developers (and the big Hong Kong developers) that have successful projects in other parts of China, and offers them the pick of new development sites available.

Many new developers to China do not have sufficient (or any) guanxi and so must find a local partner that is able to bring access to development sites to the table. Finding a local partner is another issue.

LOCAL PARTNER

Finding a local partner whose business interests are aligned with your own, who has the same strategic outlook and approach to management, and who actually has good guanxi and access to land is not as easy as you might think. But if you have no guanxi, then it is crucial.

The above two points might help a foreign developer access the market, but many hotel projects will likely not make a lot of financial success.

To improve the prospects of a potential hotel project, the following factors are required:

MIXED-USE DEVELOPMENTS

Many hotel projects in China tend to be a part of a larger mixed-use development, which is one of the reasons why so many hotels are being developed.

There are a number of reasons why this works:

- Any mixed-use development that includes a residential component is typically a winner in China. Developers are more than prepared to risk poor returns on the commercial component as it will typically be more than offset by the large profits to be made on the residential sales.

- Other commercial components can also offer developers the chance to cash out early through strata sales of office and retail components.

- Should a developer be looking to retain ownership of all commercial space within a development, it is widely considered that a good mix of office, retail and hotel will be worth more than the sum of the individual parts.

- For the above three points, the hotel component is often highly valued as adding crucial branding and recognition to the overall project, thus encouraging the developer to seek a 5-star brand. Lower returns on the hotel are offset by the perception of the value added to other components.

STRATEGIC DEVELOPMENTS

Some standalone hotel developments might not seem to make much sense, but will be pursued by developers for their longer-term strategic value. Taking on a hotel development pushed by the local government builds guanxi, which will help the developer to be successful in future land acquisitions. In some instances, a hotel site will be developed as part of a deal that provides the developer an additional development site, typically residential, where real profits can be made.

LONG-TERM OUTLOOK

When large Chinese companies, particularly government-linked or state owned enterprises (SOEs) look to acquire a hotel asset, they do not take into account the future value of existing cash flows as much as they do general real estate prices and land values. The result is that the estimation of value tends to be much higher and potential international investors are typically unwilling or unable to match such bids.

Most foreign developers (other than overseas Chinese developers) have been unsuccessful in negotiating through the points above and have gone home empty handed. Successful institutional investors in China have stayed away from investing into single assets and have rather focused on investing into platforms. Many examples can be seen in the budget hotel sector as well as investments into emerging full service domestic hotel companies. The obvious exit strategy here is taking the company public.

Other western investors have also injected capital into development companies themselves, which is not really a play on the hospitality sector as much as the residential market although there is often some overlap.

In China, the traditional western methods of doing business bump up against an economy that is controlled by a single-party state, which is particularly the case when it comes to real estate development.

To quote Dorothy in the Wizard of Oz:
"Toto, I've a feeling we're not in Kansas anymore."

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