

Intelligent Investment

Land Tenure Renewal: Implications for Real Estate Pricing and Investment

CHINA VIEWPOINT

The expiration and renewal of land use terms becomes an issue that increasingly needs to be resolved as the tenure of many commercial land sites first leased or granted in the 1990s decreases to less than 20 years.

CBRE RESEARCH
NOVEMBER 2021

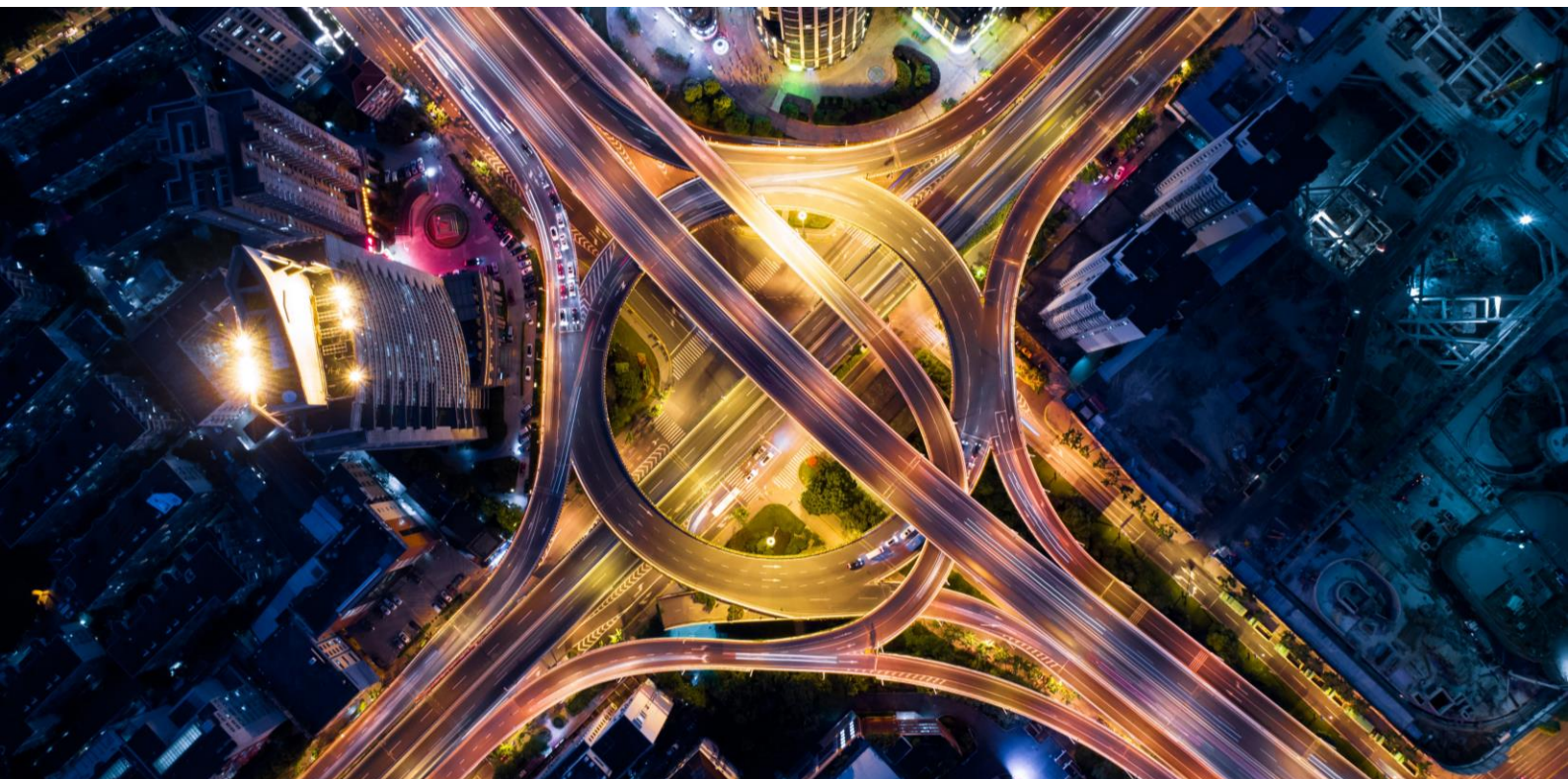


Introduction

Commercial real estate investors in China have long been concerned about the lack of a clear regulatory framework governing the expiration and renewal of land use terms – an issue that increasingly needs to be resolved as the tenure of many commercial land sites first leased or granted in the 1990s decreases to less than 20 years.

CBRE data show that in China's 18 major cities, the total volume of office and retail space under single ownership and with a remaining land tenure of less than 20 years will increase to approximately 30 million sq m by 2030, 70% of which is in tier I cities and a similar volume of which is in core locations.

With the Government Work Report delivered at the fourth session of the 13th National People's Congress in March 2021 highlighting urban renewal for the first time, and the issue also included as a key objective for the 14th Five Year Plan period (2021-2025), the upcoming renovation and redevelopment of a large quantity of aged properties is set to create significant value-added opportunities for investors in China commercial real estate. However, successful urban renewal and the viability of investments associated with this initiative requires the establishment of a clear and actionable land use right renewal mechanism.



Current Land Renewal Regulations

Urban Residential Land Use Rights are Automatically Renewable on Expiry

According to Article 359, Chapter XII, Title Three, Book Two of the Civil Code, “the term of use rights for land used for residential purposes shall be automatically renewed upon expiration. The payment, reduction or exemption of the renewal fee shall be handled in accordance with the provisions of laws and administrative regulations.”

The Renewal of Commercial Land Use Rights Requires a Payable Application Prior to Expiry without Detailed Rules or Guidelines at a National Level

As stated in Article 359, Chapter XII, Title Three, Book Two of the Civil Code, the term of land use rights for non-residential land (including the attribution of buildings and other immovables on the aforesaid land) shall be renewed upon expiration in accordance with the provisions of laws and administrative regulations unless an agreement shall prevail.

Further to this, Article 22 of the Law on Administration of Urban Real Estate (revised in 2019), states that upon the continued use of the land after expiration of the agreed term prescribed by the contract, the land user must apply for extension at least one year before the expiration of the term. When an extension is approved, it is necessary to re-sign a contract for the use of the land and pay the land premium payable (“the Premium”) for further use in accordance with the provisions.

Laws pertaining to land use rights renewal do not stipulate specific terms for the renewal of rights for non-residential land, only indicating that renewal is feasible. The only aspect that can be affirmed is that the renewal of land use rights for non-residential land is subject to the charging of certain premiums and must be applied for at least one year in advance. No details are given regarding the process of renewal or extension, the tenure of the new land use rights, and the amount of the premium to be paid.



Isolated Cases of Commercial land renewal in Shenzhen and Zhejiang Haining

In 2004, Shenzhen authorities issued 'Several Provisions on Renewal of Expired Real Estate' covering the expiry of allocated land in the city. According to the regulation, land tenure is renewable for a maximum term of 40-50 years, with the payable premium set at 35% of the government benchmark commercial land price.

In December 2005 and March 2007, the owners of Huanyu Building and Room 1902, North Block of International Commercial Building, respectively, successfully applied to extend the land tenure for their properties from the original 20 years to the maximum 40 (for retail) or 50 (for office) years. The land premium for an additional 20 or 30 years of renewed land tenure was charged at 35% of the benchmark commercial land price.



Shenzhen



Zhejiang Haining

In September 2018, Haining authorities promulgated a local regulation covering the renewal of expired commercial land use rights in Zhejiang Province. The regulation stipulates that the commercial land renewal period can be for up to 20 years and that the sum of the original tenure and the renewal tenure shall not exceed the stipulated maximum length.

On 30 December 2018, the Haining Municipal Bureau of Land and Resources announced that the land use rights for Longxiang Building, which had a 20-year term for commercial use expiring in 2018, had been transferred on agreement and renewed for another 20 years. The total sum of the premium was RMB 22 million, equivalent to RMB 3,137 per sq m on unit site value, and RMB 377 per sq m on accommodation value (the project's plot ratio is 8.3). With the benchmark commercial land price for 40 years at a 2.0 plot ratio standing at RMB 5,470 per sq m on unit site value, the premium was approximately 57% of the benchmark local land price on unit site value and 15% on accommodation value.

Although the land parcels in these cases are all originally allocated land, they provide a useful reference point for land tenure renewal practices for commercial land granted on the open market, particularly with regard to the renewal of the stipulated maximum land tenure and the one-off payment of a renewal premium pegged to the benchmark local land price.

Impact of Land Use Rights Expiry on Commercial Real Estate Valuation and Investment

Investors' Concerns about Land Tenure Expiry When Purchasing Older Properties

A SURGE IN AGEING ASSETS

An increasing number of properties in core areas of China's tier I cities have less than 25 years remaining on their land tenure. Depending on their risk appetite, property owners must decide whether to proceed despite undefined land tenure renewal and continue to hold their investments or divest.

LACK OF A CLEAR LEGAL FRAMEWORK

While commercial land tenure can be extended based on the New Civil Code of the People's Republic of China, no clear instructions are given for the procedure of land renewal and the premium to be paid. This situation is creating uncertainty for both domestic and foreign investors.

LIMITED EMPIRICAL DATA FOR MEASURING THE IMPACT OF LAND TENURE ON INVESTMENT PRICING

Due to the upbeat outlook for investing in properties in tier I cities possessing stable cashflow or attractive value-added potential, investors usually consider land tenure with positive assumptions when evaluating such opportunities. While high liquidity in tier I cities also provides investors with strong investment comparables, these attributes do not exist in every market, location and property type. As empirical data for analysing the influence of land tenure on transaction prices remains insufficient, this report by CBRE establishes a robust framework for gauging this impact and provides first-hand evidence for investment market participants.



Remaining Land Tenure and Capital Values: A Quick Calculation

Real estate capital values can be calculated via a simple formula that is widely accepted among investors. Below is an illustration of the impact on value from a mathematical perspective.

Capital Value = Net Operating Income / All-in Cap Rate

Net operating income is dependent upon the performance of the property and leasing market conditions. The all-in cap rate is considered as a blended treatment of the judgement for both the base cap rate and the land tenure factor. The judgement comes from an analysis of sales transactions and investment market conditions.

The all-in cap rate includes the following two breakdown factors.

✓ Base Cap Rate

The base cap rate comes from an investment market analysis and depends on the treatment of the risk premium for factors including macro/micro geographical differences, property type, building conditions and asset performance, and does not consider land tenure.

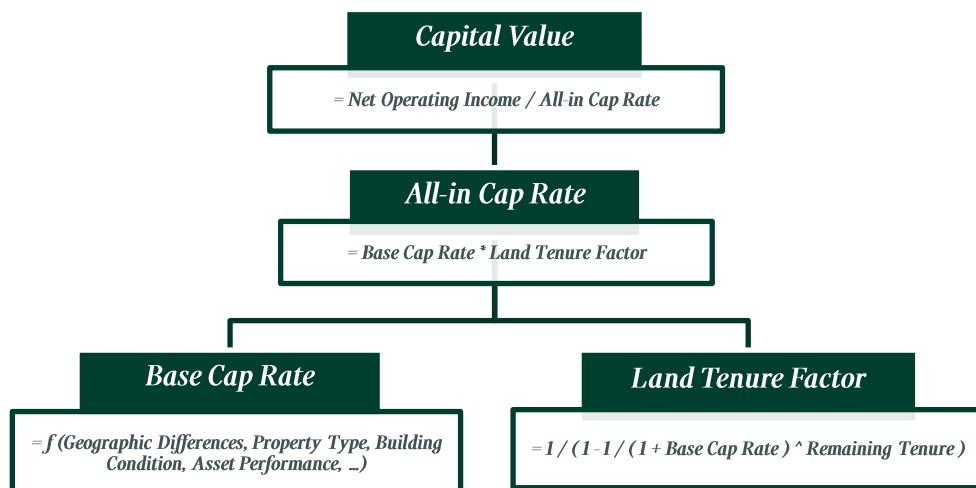
✓ Land Tenure Factor

Given that the possession of land in China is on a land use term basis, the land tenure factor is considered when forming the all-in cap rate judgement. From a methodological perspective, the land tenure factor can be calculated using the formula below, assuming zero residual value:

Land Tenure Factor = 1 / (1 - 1 / (1 + Base Cap Rate) ^ Remaining Tenure)

The land tenure factor is a variable greater than 1.0, indicating that the all-in cap rate is always greater than the base cap rate, which reflects the additional risk premium derived from the often-short period of remaining land tenure.

Figure 1: The Non-Linear Relation of Land Use Term Change and Capital Value



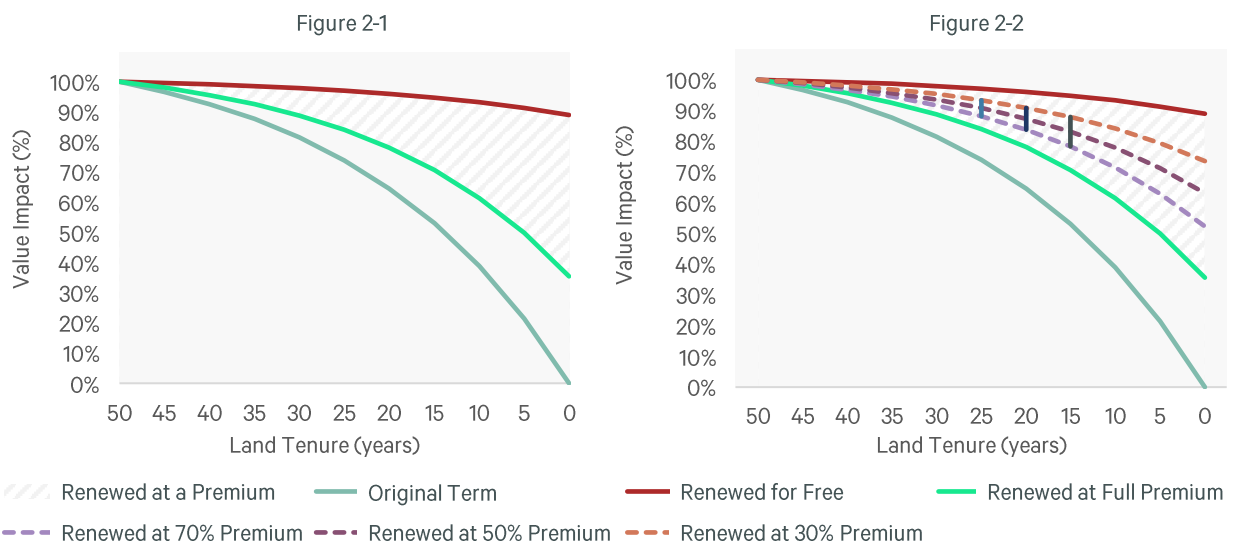
Value Impact in Practice in the China Real Estate Investment Market

The previous section illustrates how the cap rate is the decisive factor influencing fundamental differences in capital value. Also, the shorter the remaining land tenure, the greater the impact on value.

Foreign investors in China tend to adopt a ‘zero residual value upon expiry’ hypothesis in their investment analyses as the country operates under a leasehold land use rights system and has yet to clarify a policy on land tenure renewal. However, in practice, this hypothesis conflicts with investment market transaction prices. In addition, the latest Civil Code (2020) states that that the land tenure of commercial land can be extended through the payment of a certain premium.

Therefore, the curve reflecting the actual land tenure impact on capital value would fall in the shaded area bounded by the curve representing “renewed for free” and “renewed at full premium” (Figure 2-1). This is a smoother slope compared to that for the original land tenure only (see curve “original term” in Figure 2-1), assuming that capital values would be zero upon expiry of the land term.

Figure 2: The Value Impact from Various Options of Land Tenure Renewal



Source: CBRE, November 2021

Note: The above analysis is based on following assumptions: 1) land tenure renewed upon its expiry; 2) one-off payment of renewal land premium; 3) land tenure renewed to its maximum as stipulated by the law

Figure 2-2 illustrates the different curves of land tenure impact when the premium for renewal is assumed at 30, 50% or 70% of the market land price. This shows how the variance of value impact between the various assumptions accelerates to widen with the decrease in the remaining land tenure. Although this gap is relatively insignificant at an early stage, this emphasises how critical it is for owners to act quickly to mitigate uncertainty related to land tenure renewal before capital values fall sharply. This trend is reflected by investors’ prudent appetite towards assets with a remaining tenure of 20-25 years.

The persistent uncertainty related to land renewal means some foreign investors may hesitate to purchase assets with a short remaining tenure, particularly those possessing less than 20 years. Seasoned domestic players may also adopt a more cautious attitude towards acquiring such properties. Furthermore, current owners of these buildings may be reluctant to allocate additional capital expenditure for maintenance or improvements, leading to the downgrading of quality and operational performance, and even lenders’ attitude.

Other factors including the amount of the land premium to be paid for renewal, payment procedures and processes, and the growth in market land prices to be used when calculating this premium all impact the slope of the curve reflecting the equation of land tenure and capital value.

Figure 3: Factors Influencing Land Tenure Renewal and Their Impact on Capital Value

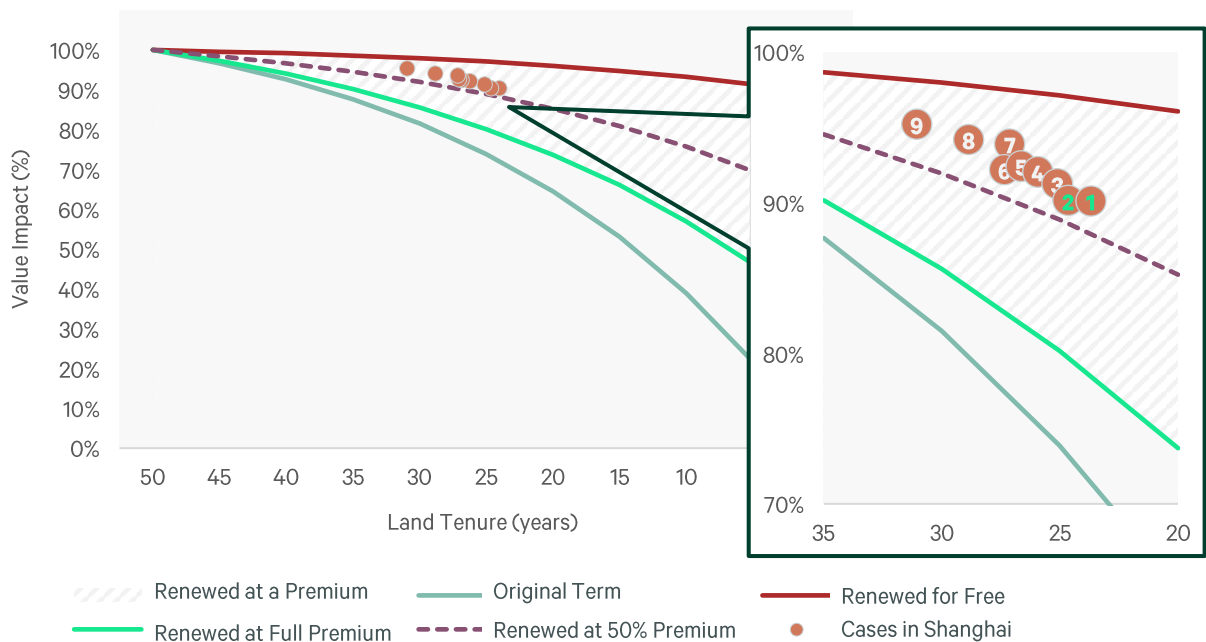
Land Tenure Renewal Factors	Impact on Capital Value	
	Movement of Factors	Movement of Capital Value
Market Land Price	▲	▼
% of Additional Land Premium	▲	▼
Land Price Payment Arrangement	One-off	▼
	Annually	▲
Future Land Price Growth Rate	▲	▼
Discount Rate on Land Premium Payable	▲	▲

As summarised in Figure 3, the higher the land price; greater proportion of additional premium; one-off payment; higher future land price growth rate; and lower discount rate on land premium payable is, the lower the current capital value reaches, and vice versa.

The Impact of Land Tenure on Asset Prices in Investment Transactions

To ascertain how remaining land tenure impacts actual transaction prices, CBRE analysed numerous investment transactions completed over the past three years for standard office properties in core areas of Shanghai (Figure 4). The remaining land tenure on these properties ranged from 24 to 30 years.

Figure 4: Figure 4: An Empirical Study of The Land Tenure Impact on Asset Prices



No.	①	②	③	④	⑤	⑥	⑦	⑧	⑨
Remaining Land Tenure (years)	24.0	24.5	25.0	26.0	27.0	27.0	27.0	29.0	31.0
Transaction Date	Q2 2021	Q4 2020	Q1 2019	Q4 2018	Q1 2019	Q1 2018	Q1 2018	Q3 2020	Q1 2018

Source: CBRE, November 2021

Note: The above analysis is based on following assumptions: 1) land tenure renewed upon its expiry; 2) one-off payment of renewal land premium; 3) land tenure renewed to its maximum as stipulated by the law

This analysis reflects investors' current understanding of the relationship between remaining land tenure and asset price, which is summarised below:

- 1. When the remaining land tenure ranges between 25-30 years, its impact on asset pricing is generally insignificant. (The scattered dots in Figure 4 are closer to the curve “Renewed for Free”).**
- 2. The shorter the remaining land tenure, the greater the impact on the transaction price.**
- 3. When the remaining land tenure is less than 25 years, it exerts a stronger impact on the transaction price to reflect the payment of an additional premium to renew the land tenure.**

Investors in general demonstrate a proactive attitude towards opportunities possessing relatively short land tenure. When factoring land tenure into asset pricing, investors are inclined to adopt the assumption that **commercial land tenure is renewable upon expiry at a certain discount to the market land price**. This reflects their optimism towards the outlook for commercial real estate investment in China and expectation that relevant land renewal policies will be further clarified in future, which is further evidenced by several recently concluded transactions with a land tenure shorter than 20 years.

However, the above analysis is based on a select number of cases and hence have their limitations. Other transactions will be subject to variables such as city, location, property type and timing. Therefore, creating a regulatory framework with both nationwide guidelines and local flexibility to clarify land tenure-related uncertainty is required to ensure the further development and stability of China's commercial real estate investment market.



Conclusion and Recommendations

For Owners and Investors: Certainty Among the Uncertainty

CBRE's analysis has uncovered several key reasons for investors to be optimistic about the renewal of land use terms:

- ✓ Existing regulations, occasional renewal cases and investors' assumptions in their investment analysis demonstrates that commercial land tenure is renewable by paying a premium upon expiry.
- ✓ Both sellers and buyers accept land tenure as a key variable influencing asset pricing in commercial real estate transactions. Generally, the shorter the remaining land tenure, the greater the diminishing impact on value;
- ✓ Existing renewal cases and local pilot regulations illustrate that local flexibility will be built into a future regulatory framework, rather than a one-size-fits-all approach.

Advice to regulators

- ✓ As China's inventory of commercial real estate with less than 20 years of land tenure will increase significantly over the next decade, land tenure renewal should be a key consideration when pursuing urban regeneration.
- ✓ A clear and enforceable land tenure renewal regulatory framework is needed to clarify details of application procedures including the length of renewal, the basis of assessment of the payable premium, and whether this should be a one-off or periodic payment. This will enhance market confidence by creating an environment in which commercial real estate transactions can be more accurately priced, while also mitigating speculative opinions and decisions by market stakeholders.
- ✓ In view of the significant variances across different cities, nationwide guidance should allow for flexibility in local implementation. The Ministry of Natural Resources has already instructed Shenzhen to take the lead in exploring approaches to state-owned land use rights renewal.

To conclude, CBRE believes that a national framework of guidelines providing flexibility for execution at a local level is the optimal solution to the land tenure renewal issue.

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