



The Dragon Code

Urbanization continues to play a key role in China's economy

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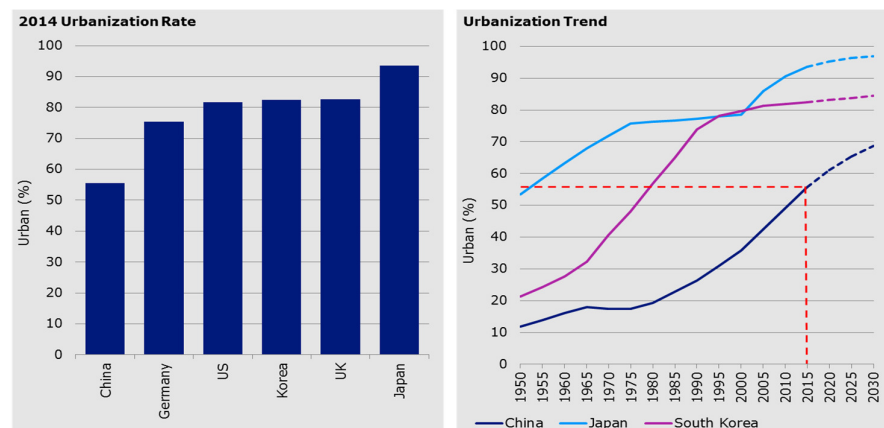
Urbanization and economic growth go hand-in-hand, as no country has reached economic prosperity without a significant population shift into cities. China is no exception. In our view, China's urbanization plays a key role in its economy - in the past and future. In the past, the unprecedented urban growth was supported by the rapid economic transformation, which led to basic infrastructure build-outs. Looking ahead, we believe urbanization will continue to play out in China for decades, supported by promising growth in the service-oriented industries. In the process, urbanization will also create demand for residential properties.

The past

China's economic growth has been intertwined with urbanization. Over the past three decades, China succeeded in transforming its economy from an agriculture-based one to the world's manufacturing hub, growing at an average of 10% per year. In parallel, China's urban population went from less than 23% of the total population in 1985 to over 55%¹ in 2015. In fact, China's cities already accounted for 75% of China's gross domestic product (GDP).² The expansion in the manufacturing base was a magnet for the migration to cities as job opportunities expanded exponentially, while agriculture reforms were in place to ensure higher productivity and less demand for manual labor in rural areas. As the urban communities grew, it brought vast enhancements in the standard of living through infrastructure, such as roads, bridges, power and telephone lines, and water distribution services. At later stages, efficient public transport systems, as well as adequate gas supplies and water treatment services, were introduced.

Looking ahead

Many may think China's urbanization story is history. Yet, at an urbanization rate of 55%, China is still at an early stage of urbanization compared to many developed economies, such as the US, UK, and Japan, where it has reached 80% to 90%. When we look at neighboring countries like Korea and Japan, we see they experienced decades of strong growth, driven in part by urbanization, beyond the level where China currently stands. What this implies is China still has decades before it achieves an urbanization rate near 80%, where progress in urbanization can continue to propel its economy.



Source: United Nations, Department of Economic and Social Affairs, Population Division (2015). World Urbanization Prospects: The 2014 revision. Note (RHS): Data from 2015-2030: Projections

¹ Source: United Nations Department of Economics and Social Affairs, Population Division

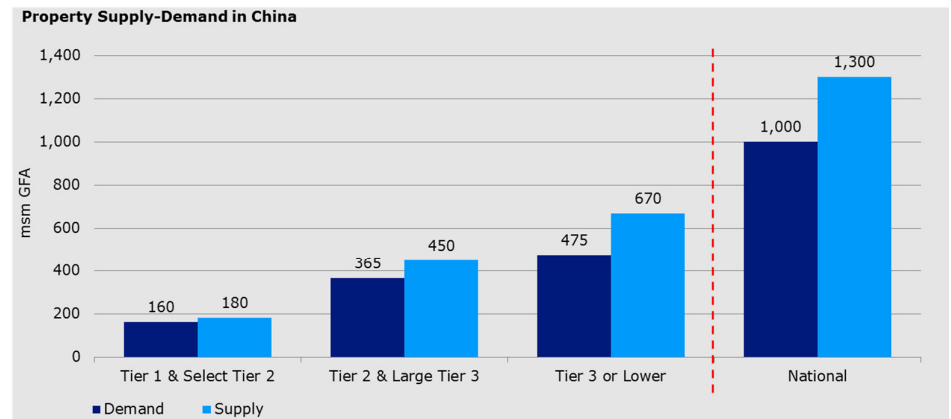
² Source: McKinsey Global Institute (MGI), McKinsey & Company, 2007



Urbanization will continue to sprawl in China, particularly in areas where service-related employment opportunities are robust. In recent years, the services sector has already overtaken industrials as a key contributor of economic growth, accounting for close to half of China's economy. Looking ahead, the expansion of cities will continue to broaden access to social-related services, such as educational and health care facilities. It will create hubs for financials, tourism, insurance, as well as other new industries such as e-commerce.

Creating urban residential demand

With progress in urbanization, urban residential demand will be created, and thereby help absorb a portion of the excess housing inventories in the lower tiered (i.e., Tier 3 and 4) cities, areas that have contributed to the housing oversupply. Over the past 24 years, over 74% of the increase in China's urban population has been in the lower-tiered cities. In 2014, the urban population increased by around 15 million people and close to half, 7 million, chose to reside in Tier 3 and 4 cities.³ In particular, migrants tend to move to the lower-tiered, satellite cities, next to the larger Tier 1 or 2 cities, given the more-affordable housing and greater job opportunities within commuting distance. For example, Dongguan and Huizhou are Tier 3 cities that are satellite cities outside of Shenzhen (a Tier 1 city). Huizhou saw its property inventories drop from a peak of 31 months to clear in June 2014 to only 10 months in July 2016. Dongguan's inventories fell from a peak of 21 months in June 2014 to 9 months⁴ in July 2016. As such, we recognize one of the benefits of urbanization is the narrowing of the imbalances in demand and supply dynamics between tiered cities.



Note: Tier 1 and Select Tier 2 cities - Beijing, Shenzhen, Shanghai, Guangzhou, Hefei, Hangzhou, Xiamen, Nanjing, Wuhan, Suzhou, Tianjin.
 Tier 2 & Large Tier 3 cities - Chengdu, Zhengzhou, Foshan, Sanya, Shenyang, Jinan, Changsha, Xian, Chongqing, Fuzhou, Nanning, Qingdao, Ningbo, Shijiazhuang, Dalian, Kunming, Nanchang, Taiyuan, Guiyang, Haikou, Harbin, Changchun, Hohhot, Lanzhou, Wuxi, Changzhou, Kunshan, Jiaying, Shaoxing, Zhenjiang, Zhuhai, Huizhou, Dongguan, Zhongshan, Langfang, Yanjiao, Xianghe, Guan, Beiding, Quanzhou, Yantai, Wenzhou
 Tier 3 or lower - all other Tier 3 or lower cities not stated above.

Note: msm refers to million square meters

Source: National Bureau of Statistics of China, Citi Research, as at end 2015

Conclusion

For decades, urbanization and China's economic growth have been closely linked. Looking ahead, China's urban centers will continue to play a dominant role in the nation's economy, even more than they do today, stemming from the robust opportunities in the service-related sectors. While we do not favor property stocks from a fundamental bottom-up standpoint due to their tendency to be driven by policy cyclicity, we recognize that urbanization is a secular source of demand for the residential market.

³ Survey of migrant workers by National Bureau of Statistics of China, 2015

⁴ Source: Citi Research as of May 2016

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