Hidden Office User Markets And Their Control

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ABSTRACT
This paper addresses one of the unique phenomena in the emerging office market system in China. It identifies and examines the hidden office market and its role in undertaking urban form changes within the process of economic transition. Considering the Chinese commercial property cycles is in the process of economic transition, the central issue is directly related to the time lag related to the physical transition that is behind the change in the socio-economic system. This perspective sheds light on property cycle theory regarding development lags, which will extend the understanding of broader international property markets, especially in transitional economies.

Using semi-structured interviews, the study highlights that the emergence of office markets in China is accompanied with continuous socio-economic and physical changes. This is the main reason for the identified gap between potential and effective office demand. The study confirms the “hidden office market” results from the development and redevelopment lags mainly caused by a much slower turnover of inner-city office stock. In other words, the replacement cycle is longer due to changes occurring in the economic system. Although rapidly expanding, the relatively slow wealth accumulation in the local business sector has also affected effective office demand.
Introduction

The underlying mechanisms of stability and cyclicality of commercial property in mature real estate markets have received considerable interest. Similarly a great deal of attention has been given to emerging markets which are often considered less stable and less mature e.g. the 1980s Japanese property bubble, 1990s Asian real estate crisis. There is emerging research focussing on studying cyclical behaviour and stability in unfamiliar property markets. This paper explores the balance between commercial office market behaviour and the mechanisms of inner-city building stock changes in terms of State and market behaviours and interplays. The methodology was based on a series of interviews involving stakeholders in the Guangzhou office market.

This research concerns the relatively flat office supply and user demand observed since late 1990s, primarily due to the lag in replacing office stock in inner-city area. It examines the economical and physical structural changes in the city’s office user markets, as well as examining and analysing the manner in which the hidden office market impacts upon the supply and demand of the emerging office sector e.g. the apparent gap between potential and effective office user demand. It is not surprising that office supply remained relatively stable until the early 2000s, since over this period the State macro-economic control remained strong. However it appears confusing that the 13%-15% annual economic growth for the past 15 years which was backed by major expansion in the service industry was supported by a usually stable effective office demand. This in turn seems to have delayed the natural up-swing of a new building cycle. This highlights the question: Should the supply level be controlled to boost the office market?

Emerging office market and its behaviour

In mature real estate markets, residential buildings converted for office use do not appear to adversely affect the operation of office markets. This is probably because market structure has been relatively clearly defined according to office supply and demand (Geltner and Miller, 2000, DiPasquale and Wheaton, 1996). Typical rent adjustment and replacement behaviour is captured in office supply models, which reflects equilibrium in a market-led system (Ball et al., 1998). Building replacement and renovation are part of capital investment as building stock increasingly becomes obsoletes. However in mature markets, this process occurs relatively smoothly and has no substantial impact on the property cycle (Ball, 2003).

In China’s transitional economy, building obsolescence in major cities have been severe in the 20th century (Lu et al., 2001). Furthermore, the transition to a market-led system has triggered rapid growth of the service sector. The manner in which the economy runs has created strong demand for buildings to accommodate service-based activities. However, from a building-orientated perspective building stock is costly to be replaced in the short-term, especially when an inner-city area has a high proportion of high-density residential stock. Changes affecting the current urban form will involve land use changes and substantial capital input, thus it is very important that these aspects are fully understood in order to assist development control and policy-makings.
The distinct differences between residential and commercial buildings is partly due to variations in investment, planning control and government policy – for example, zoning law restricts certain building types in defined markets and locations. On the other hand, typical office markets in mature markets have specific structure which contains office of different grades that indicate different quality and cost of capital, as well as meeting the needs of most users. A typical office building system is ‘Prime’, ‘A’, ‘B’, ‘C’ and ‘D’ grade offices with detailed criteria set (Property Council of Australia, 2002). In China, the office market is often less clearly defined with the exception of the ‘Prime’ office market. A review of published media articles suggests the government’s concern regarding lower-grade office markets is clear – since the early 2000s, out of the 32 major Chinese cities, five commercial cities have been directly involved in stopping inner-city residential property from being used as office space; five cities have made a strong response to the issue by showing the interest to introduce similar policy in the near future; thirteen other cities have debated the possibility of using similar approach in when necessary.

Typical investment analysis focuses on ‘Prime’ or ‘A’ grade office because investment activities typically occur there. However similar rental rates (per $m^2$) may link different office market segments and therefore leasing and investment behaviours will change to also consider the lower end sectors, especially when they form a major part of the market. The relatively flat effective office demand since the late 1990s has resulted in a space market with highly rational office users, which results in higher market stability compared to other major cities. The gap between the potential and the effective office demands has also affected the level of new supply and the rate for absorbing the excess stock created in the 1990s property boom.

Policy concern, in relation to why this exists and persists, is very important. This concept is directly related to the analysis of the role that inner-city apartments play in office supply-demand balance in Guangzhou. Commencing in 2000, Guangzhou is a pioneer in using State regulation to intervene this ‘natural’ market creation. But the question remains: will it be an effective tool, eventually, to facilitate Chinese office market growth?

**Methodology**

Economic systems are continuously evolving as driven by changes in the physical environment and changes of people’s perceptions and beliefs, as well as the actions to change the realities by the changing beliefs (North, 2005). The property development market is closely linked to the investment market, the occupancy market and the urban land market. Any factor that affects one of these markets may vary the pattern of fluctuations in the entire property market. The property market system is highly complex system of interactive markets and stakeholders with no centralised marketplace. When undertaking a study of office market behaviour it is important to integrate the physical world of cause and effect, the social world of human relationships and the inner-world of values and meanings through attempts to integrate insights from natural laws, social principles and cognitive philosophies (Capra, 2002, Neuman, 2003).
Emerging property markets are often identified by the process of rapid yet profound structural change that defines their key characteristics. It is the system itself that requires intensive research to explore its specific operational principles (Chow, 2002). For an increased understanding of the subject matter, features that determine operational character should be identified. To assist the ability of a dynamic office market model to explain office cycles in emerging markets, it is critical to first identify existing knowledge about the mechanisms not satisfactorily explained by current theories. This should be accompanied by careful observations of market settings and first-hand market experience. In other words, it is essential to observe and analyse evidence from inside the system. This includes empirical evidence and descriptive data from experienced market players. For example, people who have been involved in the process in the past 20 years are an invaluable information source. Semi-structured interviews can be designed to capture and explore such insights, where reasons are listed in table 1 to justify this approach.

**Table 1. Justification of the semi-structured interview approach**

1. Lack of comprehensive and good quality time-series data suitable for model building
2. A 5-year delay of data availability by firms due to technical, confidentiality or market transparency reasons
3. A minimum 7-8 year delay in government data for detailed property market activities in relation to the starting time of market activities – early 1990s
4. The lack of the ability of standard data to indicate structural changes

(Source: Author)

Market behaviour is about human behaviour, which makes mature and emerging property similar. The mechanism in both systems are based on extensive exchange activity, specialisation, money and division of labour (Keogh and D'Arcy, 1993). Since there is a common ground for different office markets, there should be a general structure i.e. an interview guide for data collection.

The overall market system changes so rapidly there has to have a flexible approach to examining and re-examining it. Semi-structured interviews provide the required flexibility in dealing with uncertainties in China and yet do not overlook key elements in typical markets. The primary aim of the interviews is to gain insights about market behaviour support observed facts. This requires an exploratory or an open-ended element in the data collection process to identify new evidence under the general framework. The data collection structure also intends to capture special features of the office market not fully reflected in property cycle theory due to China’s structural change.

Given the limitations of the data collection approach (e.g. the logical and technical limitations of the design of the interview guide as well as the practical limitations of conducting interviews), this study makes no attempts to join the debate at the philosophical level on the legitimacy of the approach. The interview guide has been refined based on a pilot test. The emphasis was placed on improving the selection, interviewing and recording process. Limitations include human error, communication difficulties and subjectivity.
Given the complexity of the property markets, one challenge is that interviewees may tend to focus their discussion on areas in which they are more experienced, hence ignore certain key aspects listed in the interview guide. It is also expected that some participants will focus on topics in which they are interested, such as those who are directly affected by a policy shift in the office market tend to emphasise that issue. The semi-structured interview should be able to guide interviewees and allow them to offer information based on their expertise.

**Interview guide and sampling**

The interview guide serves as the bridge linking the research questions and the interview data. Designing this ‘instrument’ requires both formation and refinement works. Firstly, clearly defined concepts and the research question were used as the basis for the design of the interview guide and response categories. Secondly, a plan for data recording and pilot testing of the interview guide was developed. The target population and the sampling process were planned before identifying interviewees and conducting the interviews.

The interview guide was developed along with the conceptualisation of the key elements in the research design. As a common framework, the guide covers themes including:

1) General descriptive data on cyclical market behaviour;
2) Key determining factors of office market changes;
3) the relationship between office cycles and structural changes, such as the land reform and urban planning approach, property investment and finance market changes, office user behaviour (i.e. business firm preference), developer behaviour, and state policy impacts;
4) Statistical data or project case to support the claims about cycles; and
5) State policy impacts on office market behaviour.

A validity pilot study was conducted using an interview with a commercial property investment firm in Melbourne prior to the first field trip (Wu, 2005). Nevertheless the uncertainty in the field has required several alterations of the interview structure, primarily due to a different interview culture in China. Note the public sector in China can be somewhat difficult to approach and certain research issues also raise confusion. The pilot study also shows that interviewees tend to shorten their discussion if they are unfamiliar with the questions. At times the anticipated length of the interviews was substantially shortened with some core issues remaining untouched.

Since private office developers and investors tended to be more familiar with the research issues at hand, these interviews were flexible enough to enable ‘data-rich’ results based on interviewees’ expertise. For example, there was a different focus for government, developers, investors, office users, financial institution and court interviewees. Some factors identified during the interviews which are not considered in the original methodology were then integrated either in the refined final version or in the analysis.
The interview targeted individuals or representatives of organisations who were directly related to the Guangzhou office market. The selection was mainly based on business type or administrative duty which was relevant to the structure of the office market. Although not as rigorous as a laboratory experiment, where for example it may overlook or double-count certain aspects affecting market behaviour, it is however derived from the basic supply-demand patterns for commercial office. Interviewees were identified and selected with the intention of covering the core components of the emerging commercial property market. Thus most participants were in the ‘inner circle’ of commercial property markets.

The interviews targeted participants who with expertise in commercial property, and also who understand the dynamic operation of the office market. The sampling process was not completely random since the intention was to source data from specific sectors, as undertake the necessary steps to identify select and arrange interviews. Selected interviewees were mostly ‘insiders’ or ‘elites’ in the field who have knowledge about the research issue at hand. In terms of response rate, out of 50 attempts there were 42 interviews conducted (see table 2). Overall, the approach followed the conceptual model previously adopted for the commercial property market system (Ball et al., 1998).

Table 2. List and number of key players interviewed

<table>
<thead>
<tr>
<th>Key commercial property market player category</th>
<th># per category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office user/occupier (owner or renter)</td>
<td>11</td>
</tr>
<tr>
<td>Property developer,</td>
<td>4</td>
</tr>
<tr>
<td>Builder or construction and property management</td>
<td>3</td>
</tr>
<tr>
<td>Small investor, major investor,</td>
<td>2</td>
</tr>
<tr>
<td>Bank and other financial institution</td>
<td>2</td>
</tr>
<tr>
<td>Land owner (the state) and legal sector</td>
<td>4</td>
</tr>
<tr>
<td>Government property department and data provider</td>
<td>4</td>
</tr>
<tr>
<td>All sorts of consultants who usually act as facilitators and,</td>
<td>6</td>
</tr>
<tr>
<td>Property &amp; construction academics (researcher and adviser)</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total numbers</strong></td>
<td><strong>42</strong></td>
</tr>
</tbody>
</table>

(Source: author)

Overall the interviews were a time-consuming process with high degree of uncertainty. An interview plan was made before each interview, clearly stating the interview theme and key questions, timing, and list of interviewees’ details. Each interview required 30-60 minutes and was originally intended to be fully recorded. However, recording is subject to interviewee’s consent. Various requests regarding audio recording, interview length, confidentiality and sensitivity were raised during the interviews. To varying degrees, fifteen interviews referred to inner-city apartments for office use in Guangzhou.

**Effective office demand and the ‘hidden’ market**

In Guangzhou, the impact of existing building stock within the slow and often costly replacement process of building stock that involves changes of land use has to be fully considered in order to give a fuller view about the office
market. The Guangzhou Land Management Department (GZLMD) data highlighted a fairly stable effective demand (annual absorption) since the mid-1990s (see figure 1). Since the peak in the late 1990s identified by office data and a new up-swing since 2004, the overall office market has not produced the effective user demand that matched the potential office demand reflected by the growing service sector (see figures 1 & 2). Note that underlying office demand is usually associated with economic structure, business output, consumption and market stability. However, effective demand can be affected by the availability and affordability of existing space such as inner-city apartment and office buildings previously owned by State-owned-enterprises (SOEs) or government agencies. As discussed later, without sufficient incentives an office building replacement cycle will take longer period to complete.

**Figure 1. Office user demand and supply in Guangzhou**

(Data source: Guangzhou Land and Property Management Department, 2005)

**Figure 2. A grade office rent and vacancy in Guangzhou**

(Source: DTZ Guangzhou office, 2005)

The analysis of the interview responses identified different behaviours in the Guangzhou office market:

1) User behaviour appears to be relatively rational;  
2) Many firms are still at the early stage of business expansion;  
3) Most office users are particularly sensitive about space efficiency, regardless of the grade of office that is occupied;  
4) At the high-end market, the expansion of foreign firms was delayed by the financial crisis in the late 1990s and their expansion priorities such as Beijing and Shanghai; and
5) The macroeconomic and planning policies also created uncertainties that restricted effective office demand. It seems all these factors have affected actual office absorption.

Compared to typical ratings in mature office markets, we classify the existing office stock in Guangzhou into three general categories:

1) Commercial Prime & A grade (high-end) office, B grade office, C grade (lower-end);
2) Residential office space; and
3) Non-market state-owned-enterprise office space.

The key difference is due to the high proportion of office space that is classified as ‘residential office’ or ‘non-market office’ as opposed to the share of domestic firms in high-end office markets. The circumstances surrounding the hidden office market is a major issue that needs more attention.

**Hidden office market and the inner-city physical transformation**

Major Chinese cities under the planned economic system have relatively high density and their inner-city commercial centres do not completely follow the notion of central business district (CBD) as in commercial cities in mature markets.

In the mid 1990s, the concept of office use was vague. Business could be run in residential or other types of buildings. Thus the low effective demand for office is due to high office prices and management fees, as well as OPEX such as HVAC. Smaller firms prefer operating in apartments: cheaper and 24-hour available. This has reduced the effective demand for office. (A lower-end office developer)

Since the early 1990s the process of building new business districts in major cities has been observed. However social, economical and cultural factors complicate the identification and understanding of inner-city office demand.

High office vacancy rate is due to the large number of small business firms who are at the early stage of their life-cycle. Most operate their business in inner-city apartments. This is supported by the city’s investment culture which focuses on inner-city rental property for stable returns. (Hidden office user 1)

Several interviewees also suggested that office users from the local business community in Guangzhou, such as small trading companies, preferred inner-city apartment space so they could lower the costs of their business operation. For example:

Our place (hidden office), the annual cost is only half of typical office building, but has higher building efficiency and lower management fees. Given its advantages, they said we affect residents...who are they referring to? There are no residential users (in these inner-city apartments); all users in these buildings are companies. There are many more buildings of this type. (Hidden office user 2)

Many local firms are small in size, mainly trade business; many do not need to impress their clients by staying in high-end office; they have established network via informal ways. In the 1990s, many high-rise apartments were built in inner-city area with a much less office supply. Small investors tend to buy property and rent it out; don't care residential or office use. (Guangzhou office market analyst)
The above comment suggests the importance of understanding office user preference and space market conditions in explaining observed behaviours in emerging property markets. Previous urban land uses reflected the former economic structure and the inner-city high-rise apartment building boom since the early 1990s. The substantial impact on the emerging commercial office sector, especially the lower-end office market, was also uncovered in the process of the interviews.

It doesn’t surprise me that 40% of the small businesses have their office in inner-city apartment buildings. It is so popular, especially in Tian-he district (the current CBD). Most apartments are for office use; good location and low management fees. Government policy was introduced in 2000 to restrict such use, which was however cancelled in 2003. (Guangzhou office investor)

I think government published figure regarding small business apartment office users is conservative. We felt it is likely to be 50%-60%, based on the transaction rates. (Guangzhou office analyst)

I think the estimate of 40% small business in inner-city apartment stock is a bit high. Office grades in Guangzhou are classified by us, and are not defined by the government…it is considered a user group, which is policy sensitive. For a very short period, this property type was defined as "commercial & residential", mainly due to the lack of deep understanding of commercial property in the early years. Later on, government realised that it is hard to manage property with the two components co-existing and so eliminated the concept of “commercial” from the “commercial & residential” category. As existing office stock is not able to meet the small businesses' needs, the policy couldn’t be properly enforced. But overall, it is a government attempt to regulate the office market. (Property investment consultant)

The hidden office sector shows its likely substantial impact on the overall office market, which is itself a symbol of market immaturity. Due to the time-consuming nature and the lags associated with building replacement cycles, the role of government policy for deliberate push of the separation of office use from residential buildings has become an important issue, especially when it implies a 40% increase of lower-end office demand.

Can government policy and regulations work?

Government policies in relation to the Guangzhou office market indicated the government’s belief of a strong link between the relatively low effective office demand and the highly popular market of inner-city apartments for office use. It also highlighted its intention to change the current market structure. However, there are a few government ‘targets’ suggested by interviewees:

   Government policy restricts office use in residential buildings is due to: 1) banks and developers face finance pressure; 2) enforcing taxation duty in residential property (private) is difficult, which affects government revenue; 3) supporting office supply in the new CBD development; 4) restoring property market order. It hopes the attempts will assist in the growth of the office market. (Property agent and analyst)

As many buildings start to experience physical and economical obsolescence for residential use, when considering the relatively stable office rental returns then inner-city apartment investors are willing to sustain their property investments to provide service to the local business sector. This implies, in
the context of the Chinese economic transition in relation to property cycles, a key feature differentiating between mature and emerging property markets.

Smaller firms, concerning business expenses, if residential property is ok, service office or lower-grade office may also be preferred. Government's policy requires them to find office spaces...most do not have choice; they have to move out from their apartment offices. (Local office developer)

The actual result or the response of the hidden office market to government policy and regulations was suggested by an interviewee:

We've checked, those who moved out are 40-50% of total residential office users. But they have various ways to 'bypass' the regulation and stay in their inner-city apartments. So the actual impact (of the policy and regulations) is only half of what we initially expected. (Property market agency)

Given the lag in replacement that underpins office cycles in Guangzhou, this pressure has forced the market to adapt cost effective approaches (e.g. convert inner-city residential space to office use), based on the existing structure. Overall this intensifies space use. Through the decision-making process, developers and investors both agreed a less expensive option would be to start new development projects, jointly with State-led commercial district development process. Government, too, considers it a very costly exercise to redevelop existing inner-city districts for office buildings, which involves massive demolition and relocation work, given unclear property rights issues. Based on these limited perception, the government has made strategic plans such as the new CBD development. Therefore, with reference to the policy and regulations for inner-city apartments, the implementation or policy effect may not be as promising as initially envisaged. As suggested:

There have been three actions in discouraging CBD apartment office and I think the latest (2005) government policy stopping residential office is for boosting the office market. The ground of making the policy is: first, it affects local residents' life, second, it changes land/building use. To me, the 2nd reason does not make any sense, and I've not heard it from anywhere around the world. If initially built as residential and later changed to other use, the state can treat it as a taxation issue. I consider self-regulation via body cooperate is a much more effective way for the stated problem. (Local property lawyer)

Government policy prohibits office use since May 2005 will not have major impact on the market (its nominal prices), given the current source of office users. The impact will be mainly on lower-end office markets. (Property analyst)

In early 2007, the passing of the Chinese Property Rights Law highlighted one of the major government moves in clarifying property ownership, namely to restore and maintain property market orders. The rapidly increasing number of legal disputes associated to property occupancy, land and building development as well as demolition and relocation processes (please refer to appendix 1), have strongly evidenced the high cost of transaction which is an important feature of office building or redevelopment lag.

In regard to the third office type (i.e. State-owned-enterprise (SOE) occupied office stock) one of the interviewees suggest the potential need for more detailed study. However this will require the government’s more proactive involvement and support.

Due to structural change, SOE office stock results in large amount of office space which are cheap and in good locations. SOEs are happy to earn extra income through leasing them to the market without rendering (them) to the State. We
have seen many cases like this. However, the government has not considered it, thus not account them in office supply or existing stock. So it is a hidden one too. The actual amount is hard to be assessed; or, it is too costly to be assessed. Government probably realised the difficulty involved and does not consider it as a very urgent issue. However, statistics based on commercial property such as planning, registration and transaction may only count 60% of Guangzhou's office market. The other 40% is what I mentioned (the hidden market). (Property agent)

This highlights a second section of the hidden office market in major Chinese cities, which would not be discussed in detailed in this paper. Further research and associated data are both needed to address this important issue.

Conclusion

A substantial amount of building stock in Chinese cities is being replaced or currently under 'transition', which includes the emerging office market system. This is mainly related to the lag of urban (inner-city) physical building stock used as office space, given the rapid economic change and especially the growth of the service-based industry. The future of this ‘hidden’ office market and the rate of its transformation, presumably physically, into typical office stocks to meet the increasing standard of the market has and should continuously draw policy attention. In other words, the property market is directly influenced and has to be actively involved in the process. This is likely to continuously provide development opportunities, as long as the market and the government are able to work more effectively together towards stability and a sustained future growth.

The results confirmed that the basic driver of office user markets remains is continuous and substantial structural change occurring under the economic transition. Structural change in the socio-economic sphere is, however, a much more rapid process than change of physical building stock to accommodate the new pattern of market behaviour. This becomes an important consideration for the observed market settings i.e. the ‘hidden office user market’ in major commercial cities, which also explains the low vacancy and relatively low office supply. A detailed understanding about this mechanism requires good-quality market data, which in turn is likely to further the study into theory building using econometric modelling. From the analysis and results, this paper highlighted possible future research agendas in order to better understand commercial property cycles in emerging markets. It is essential that large-scale property investment decisions should be made based on a fine understanding of commercial property market behaviour from a structural change perspective.

References

Appendix 1 Evolution of category of property legal case in Guangzhou

<table>
<thead>
<tr>
<th>Category</th>
<th>1990 - 1991</th>
<th>Average number</th>
<th>1992 - 2001</th>
<th>Average number</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Building</strong></td>
<td>Total number</td>
<td>2878</td>
<td></td>
<td>8352</td>
</tr>
<tr>
<td>Homestead</td>
<td></td>
<td>20</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>Other disputes on land</td>
<td></td>
<td>18</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td><strong>Land</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Homestead user rights</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other disputes on land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2002 - 2004</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Sales of land use rights contract</td>
<td></td>
<td>18</td>
<td></td>
<td></td>
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<tr>
<td>Land use rights transfer contract</td>
<td></td>
<td>87</td>
<td></td>
<td></td>
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<tr>
<td>Lease contract of state-owned land</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Pre-sale contract of commercial house</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Joint venture and cooperative development contract</td>
<td></td>
<td>95</td>
<td></td>
<td></td>
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<tr>
<td>Project transfer contract</td>
<td></td>
<td>7</td>
<td></td>
<td></td>
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<tr>
<td>House demolition and/or relocation contract</td>
<td></td>
<td>2032</td>
<td></td>
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<tr>
<td>Others</td>
<td></td>
<td>300</td>
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<tr>
<td><strong>Total number</strong></td>
<td></td>
<td>8247</td>
<td></td>
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</tr>
</tbody>
</table>

(Source: Guangzhou Intermediate Court, 2005)