The Case for China Retail: Issues and Opportunities
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Executive Summary

China has enormous potential for investors in all property investment categories. Strong population growth, a large pool of qualified workers, greater integration with the world economy and increasing domestic and foreign investment are fueling demand for office, retail and residential property. Given the strong interest from global investors and the growth in the scale and activity in China, it is worth understanding the fundamental drivers and opportunities of the Chinese retail market in the years ahead.

**Above average economic growth:** Since 1978, when it first opened its economy to foreign direct investment, China’s GDP has grown at a compounded rate of 9.9%.¹ China’s economy has averaged an impressive 11.7%² growth rate since it joined the World Trade Organization (WTO) in 2001.

**Urbanization, growing middle class and creation of wealth:** China is home to 1.35 billion people,³ while an average of 3.8% of the population moves to cities each year. The urbanization and rapid acceleration of wealth is creating a burgeoning middle class. Disposable income per capita of households in China’s Tier 1 cities⁴ has grown 10.6% annually over the past 10 years.⁵

**Rapid growth of retail sales:** Retail sales, which have been increasing at a robust pace over the past decade, are forecast to grow at around 10% per year from 2012 to 2015. Together with the rapid growth of personal wealth, domestic and international retailers are eager to expand their footprint in the country.

**Lack of investment grade stock:** The biggest challenge for many retailers is securing appropriate space. China is noticeably undersupplied in investment-grade retail stock compared to other major economies. Retail supply in China is dominated by old department store formats, and only 16% of the supply pipeline in mature areas of Tier 1 cities is considered grade A.⁶

**Risk Remain:** Property investment in China is not risk-free. Market transparency and institutional legal framework are still behind European and US standards. It is vital for foreign investors to take into account both macroeconomic and institutional risks while investing in China. The lack of liquidity and upward pressure of pricing are the main concerns within the markets.

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¹ DTZ China Insight High-end retail investment – Ranking the Opportunities (May 2011)
² International Monetary Fund – 2010 estimate based on GDP (PPP)
³ Population Division of the United Nations Department of Economic and Social Affairs
⁴ Beijing, Shanghai, Shenzhen, and Guangzhou
⁵ National Bureau of Statistics of China
⁶ CBRE Research and Prudential Real Estate Investors Research
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Part 1: Why China? The Story Behind the Growth

Macroeconomic Indicators - GDP Growth

To fully appreciate the economic strength of China, one needs to understand the macro factors that are driving the country. China’s economy is the second largest in the world, roughly 2.3 times larger than Japan’s and 70% of the world’s largest economy, the US. Since 1978, China has achieved an average 9.9% annual GDP growth, and the International Monetary Fund (IMF) forecasts the Chinese economy to surpass the US by 2016. Although growth projections are less bullish for the next five years, the projected 9% annual growth rate still outpaces other BRIC countries (Chart 1).  

A breakdown of China’s GDP shows that the industrial sector is still the main economic driver, accounting for 46.9% of the overall total, followed by the services sector (43%) and agricultural sector (10.2%). Compared to other mature markets, China’s economy remains oriented toward manufacturing and production, with services trailing behind significantly as a portion of GDP (Chart 2). However, the Chinese government intends to move from labor-intensive industries to more skill-oriented industries. As a result, services will emerge as another key pillar for the economy.

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7. GDP (Purchasing Power Parity) ranked by the IMF
6. Between 2001 and 2016, the IMF projects GDP growth of 8.7% in China. 4.3% in Brazil, 4.2% in Russia and 7.6% India.
9. CIA World Fact Book – The industrial sector is involved with the production of goods (including fuels and fertilizers and the mining and extraction sectors).
10. CIA World Fact Book – The services sector is the non-material equivalent of a good. Service provision is defined as an economic activity that does not result in ownership. The sector includes (but is not limited to) farm and factory related activities.
11. CIA World Fact Book – The agricultural sector is the process of producing food, feed, fiber and other goods by the systematic raising of plants and animals.
China’s reliance on manufacturing leaves it exposed to global demand cycles. For example, the reduction in export demand stemming from the global financial crisis in 2009 caused China’s GDP growth to shrink by 166 bps. However, the government has reacted promptly by implementing a stimulus program in November 2008 that injected RMB4 trillion of capital into the Chinese economy. The stimulus in infrastructure and social welfare is often cited as a critical factor in cushioning China from the impact of the global recession.

**Household Final Expenditure Consumption**

The high savings rate of Chinese nationals has a profound impact on household expenditures. Comparing private consumption as a percentage of GDP in major economies, China lags significantly behind other major developed nations, and even behind other BRIC countries. It is inevitable that China’s consumer consumption will eventually rise to levels more in line with other developed Asian nations (Chart 3).12

Historically, Chinese families have a tendency to focus on housing rather than consumer goods as their first major purchase.13 While this dampens total household expenditures, private consumption will continue to grow and will likely outpace GDP growth, for reasons that have to do with several fundamental structural shifts in the Chinese economy (Chart 4). These include:

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12 Household consumption expenditure (formerly private consumption) is the market value of all goods and services, including durable products (such as cars, washing machines, and home computers) purchased by households. It excludes purchases of dwellings but includes imputed rent for owner-occupied dwellings. It also includes payments and fees to governments to obtain permits and licenses. Here, household consumption expenditure includes the expenditures of nonprofit institutions serving households, even when reported separately by the country. This item also includes any statistical discrepancy in the use of resources relative to the supply of resources.

13 Chinese families tend to purchase their first house before purchasing cars and other luxury goods. As a result, the general population saves more in order to be able to purchase their first house as soon as possible.
- **Housing**: As the homeownership rate rises, fewer families will need to purchase first homes, which will free personal income for other areas of consumption, most likely in the retail sector.
- **Policy Efforts**: In the wake of the global financial crisis, the Chinese government realized the need for a more-diverse economy to reduce the dependency on foreign exports and increase domestic consumption. Among the measures the government took to increase domestic consumption was to decrease interest rates on savings accounts, which provided less incentive to save and more to spend.
- **Cultural Changes**: China has lagged behind other BRIC countries with similar cultures (such as South Korea and Japan) in terms of household spending rates. Assuming China’s culture shifts in the same direction over time, China still has significant unrealized upside potential. To get in line with its Asian neighbors, household spending as a percentage of GDP could rise roughly to 50%.

### 3: 2009 HOUSEHOLD EXPENDITURES AS A % OF GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>2009 Expenditure as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>71%</td>
</tr>
<tr>
<td>UK</td>
<td>65%</td>
</tr>
<tr>
<td>Brazil</td>
<td>62%</td>
</tr>
<tr>
<td>Russia</td>
<td>53%</td>
</tr>
<tr>
<td>Germany</td>
<td>59%</td>
</tr>
<tr>
<td>Japan</td>
<td>59%</td>
</tr>
<tr>
<td>S. Korea</td>
<td>54%</td>
</tr>
<tr>
<td>India</td>
<td>56%</td>
</tr>
<tr>
<td>China</td>
<td>35%</td>
</tr>
</tbody>
</table>

*Source: World Bank*

### 4: CHINA’S HOUSEHOLD EXPENDITUREs AS A % OF GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditure as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>0%</td>
</tr>
<tr>
<td>2002</td>
<td>0%</td>
</tr>
<tr>
<td>2003</td>
<td>0%</td>
</tr>
<tr>
<td>2004</td>
<td>0%</td>
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<tr>
<td>2008</td>
<td>0%</td>
</tr>
<tr>
<td>2009</td>
<td>0%</td>
</tr>
<tr>
<td>2010</td>
<td>35%</td>
</tr>
</tbody>
</table>

*Source: World Bank*
12th Five-Year Plan - Implication for Real Estate Markets

Planning is a key characteristic of the Chinese economy. China’s five-year plans are a series of economic development initiatives shaped by the Communist Party of China (CPC) through the plenary sessions of the Central Committee and National Congresses. The party plays a leading role in mapping economic development, setting growth targets and launching reforms.

The twelfth five-year plan, approved in March 2011, seeks to address rising inequality and domestic consumption, and to improve social infrastructure and social safety nets. The plan maps the government’s effort to rebalance the economy. It shifts the emphasis from investment to consumption and from urban and coastal growth to rural and inland development. The plan also continues the prior plan’s effort to enhance environmental protection, accelerate the process of openness and reform, and to emphasize Hong Kong’s role as a center of international finance (Chart 5).

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Sector Affected</th>
<th>Implications for Real Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population controlled below 1.39 billion</td>
<td>Social</td>
<td>Continued need for housing</td>
</tr>
<tr>
<td>Urbanization rate to 51.5%</td>
<td>Social</td>
<td>Increase in urban and housing development</td>
</tr>
<tr>
<td>36 million new affordable apartments</td>
<td>Social</td>
<td>Government-built subsidized housing</td>
</tr>
<tr>
<td>Value-added output of emerging strategic industries to account for 8% of GDP</td>
<td>Economic</td>
<td>Growth in commercial, industrial development leading to an increase in investable stock</td>
</tr>
<tr>
<td>Foreign investment welcomed in agriculture, high-tech and environment protection industries</td>
<td>Economic</td>
<td>Demand in R&amp;D and industrial space</td>
</tr>
<tr>
<td>Coastal regions to turn from “world’s factory” to hubs of R&amp;D, high-end manufacturing and service sector</td>
<td>Economic</td>
<td>Demand in R&amp;D, industrial, and commercial space</td>
</tr>
<tr>
<td>Construction of large-scale hydropower plants in southwest China</td>
<td>Economic</td>
<td>Greater power capacity driving urban growth and creating demand in housing</td>
</tr>
<tr>
<td>Length of high-speed railway to reach 45,000 km</td>
<td>Infrastructure</td>
<td>Second- and third-tier cities to grow faster</td>
</tr>
<tr>
<td>Length of highway network to reach 83,000 km</td>
<td>Infrastructure</td>
<td>Second- and third-tier cities to grow faster</td>
</tr>
<tr>
<td>New airport built in Beijing</td>
<td>Infrastructure</td>
<td>Growth in Beijing real estate, city boundary</td>
</tr>
<tr>
<td>Nuclear power to be developed more efficiently to ensure safety</td>
<td>Environmental</td>
<td>Ensure that power capacity increases in line with the target rate of growth</td>
</tr>
</tbody>
</table>

Source: Prudential Real Estate Investors
Capital Markets

The People’s Bank of China (PBOC) has increased lending rates over the past year to combat soaring inflation, which reached 6.4% in June 2011. The PBOC has raised rates five times since October 2010, but we expect rates to remain at 6.56% through the first half of 2012 (Chart 6).

Although the PBOC has kept lending rates high through stiff bank reserve requirements, they reduced the reserve requirement rate (RRR) by 50 bps each in November 2011 and February 2012 to 20.5%. This high ratio was implemented to deflate the housing market and to shore up banks’ balance sheets in the event of a spike in non-performing loans. However, the recent cut in the reserve requirement ratio could indicate that the government is looking to increase liquidity as the housing market is showing signs of cooling off and to respond the uncertainties of global recovery in the wake of the European debt crisis.

We expect the PBOC to cut interest rates and lower bank reserves in 2012 in an attempt to spur economic activity and cushion the decelerating manufacturing and export sectors. That won’t, however, change the measures enacted to dampen lending in the residential sector in an effort to cool demand, slow the rate of price increases and improve affordability.
Macro Risks

The “country risk” associated with investing in China is higher than for other major economies. For one thing, the economy and political system are centrally controlled, even though China’s government has passed a series of reforms in recent years that permit greater economic flexibility and liberalization. Other issues include the country’s relatively undeveloped regulation of credit, labor and business markets and the uncertainty surrounding legal structures and the security of property rights.14

Transparency, long an issue in China, is highly correlated with regulatory and sovereign risks. Transparent markets should provide clear legal and bureaucratic frameworks that respect property rights and consistently enforce rules and regulations. Hence, China’s risk scores reflect its relatively low but improving transparency.

China’s government has a higher degree of involvement and greater control over capital investment and economic planning than one might expect in a developing country. Since the “open door” policies enacted in 1978, China has taken slow but measured steps to reform its economy. The reforms have contributed to significant economic growth and improved the institutional investment environment.

Despite the improving transparency, we believe that risks in China should not to be overlooked by foreign investors who are looking to deploy capital in the property sector. It is worth noting that sovereign risks in China are low, given the country’s growth and development prospects and measured centralized economic planning. Other institutional risks, such as political risk, and corruption risk still remain.

<table>
<thead>
<tr>
<th>Country</th>
<th>Country Risk (100=High)15</th>
<th>WEF Financial Development (Country Ranking)16</th>
<th>Sovereign Risk17</th>
<th>Economic and Structure Risk (10 = Transparent)18</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRALIA</td>
<td>35</td>
<td>5</td>
<td>AAA</td>
<td>8.7</td>
</tr>
<tr>
<td>CHINA</td>
<td>42</td>
<td>19</td>
<td>AA-</td>
<td>3.5</td>
</tr>
<tr>
<td>HONG KONG</td>
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<td>1</td>
<td>AAA</td>
<td>8.4</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>42</td>
<td>51</td>
<td>BB+</td>
<td>2.8</td>
</tr>
<tr>
<td>JAPAN</td>
<td>31</td>
<td>8</td>
<td>AA-</td>
<td>7.8</td>
</tr>
<tr>
<td>SOUTH KOREA</td>
<td>35</td>
<td>18</td>
<td>A+</td>
<td>5.4</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>30</td>
<td>16</td>
<td>A</td>
<td>4.4</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>22</td>
<td>4</td>
<td>AAA</td>
<td>9.3</td>
</tr>
<tr>
<td>TAIWAN</td>
<td>26</td>
<td>N/A</td>
<td>AA-</td>
<td>5.8</td>
</tr>
<tr>
<td>THAILAND</td>
<td>42</td>
<td>35</td>
<td>A-</td>
<td>3.5</td>
</tr>
<tr>
<td>US</td>
<td>25</td>
<td>2</td>
<td>AA+</td>
<td>7.1</td>
</tr>
<tr>
<td>GERMANY</td>
<td>21</td>
<td>14</td>
<td>AAA</td>
<td>7.9</td>
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<tr>
<td>FRANCE</td>
<td>29</td>
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<tr>
<td>UK</td>
<td>34</td>
<td>3</td>
<td>AAA</td>
<td>7.6</td>
</tr>
</tbody>
</table>

15 EIU
16 World Economic Forum
17 S&P. Sovereign risk refers to country’s individual credit risk
18 Transparency International
Part 2: The Case for Commercial Real Estate in China

Urbanization on a Massive Scale

China’s urban population, just 83 million in 1955, mushroomed by 2010 to 665 million, or 47% of the total population. The urbanization trend has government’s support, so it should continue, even in cities that already are burgeoning. By 2030, the urbanization rate is projected to top 60%, which means that more than 930 million people will be living in urban areas (Chart 8).19

According to the McKinsey Global Institute,20 by 2025 some 225 of the world’s 600 largest “mega” and “middleweight” cities will be located in the China region,21 More astonishing is that those cities are expected to contribute approximately 30% of global GDP (Chart 9).22

Rapid urbanization means that China now has a bigger urban population than India and North America, and on par with Europe. The demographic change, coupled with economic growth, should create the need for additional infrastructure and better-quality housing and lifestyle amenities in Tier 1, 2 and 3 cities and beyond.

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19 United Nations Population Division
21 Includes Hong Kong, Macau, and Taiwan
22 Megacities are defined as metropolitan areas with 10 million or more inhabitants. Middleweights are cities with populations of between 150,000 and 10 million inhabitants.
The dramatic transformation in the urban structure of the Chinese economy is driving strong demand for all forms of real estate. That is especially true in major coastal and Tier I and II cities, but expansion to inland locations is also inevitable. The growing number of cities could create new clusters, forming larger economic hubs and driving real estate development, which should produce investment opportunities. Based on the sheer number of projected mega and middleweight cities alone, China’s investment-grade real estate market will grow faster in absolute and relative terms to the rest of the world.

**Real Estate Market Size**

The vast majority of the real estate in China is not investment-grade stock (suitable for institutional investing). Outside of Tier 1 cities, most properties are considered grade B or lower. The proportion of institutional real estate as a percentage of GDP is significantly lower in China compared to other nations (Chart 10), even though China’s commercial real estate market ranks fifth globally on an absolute basis.
In general, commercial buildings in China have lower standards than developed markets such as the US, Japan, Hong Kong, Singapore and Western Europe. However, the rapid rate of growth and urbanization will create development opportunities and move China up in the global rankings.

The lack of available institutional supply has made the real estate market highly attractive relative to demand from both domestic and foreign investors. That has led property values to increase over the past decade; a trend is likely to continue for a long time. Domestic investors generally are flush with low-cost capital, which enables them to outbid foreign rivals. The dearth of suitable stock limits the number of property trades, as investors do not want to sell without being confident that there is product to buy. The upshot is that most real estate investors are long-term holders. The lack of suitable stock benefits developers who have access to the land bank and have been able to build institutional-quality assets.

Another limitation on investment activity is the high proportion of properties that are owned by occupiers rather than investors. Although China is the second largest real estate market in Asia (behind Japan), its owner-occupation ratio remains high (Chart 11), which is a trademark of an immature market. The percentage of owner-occupied stock should decline because many of these companies are looking to raise capital through sale-leasebacks of their buildings. That should increase the amount of real estate available for investment by domestic institutions (i.e., insurance companies and pension funds).

The tight supply and pent-up demand from investors have led to the continued development of institutional-grade real estate. The growth of institutional stock in China will far outpace that of developed
nations over the next decade or more. However, even with the strong growth, China will still pale in comparison to the US when it comes to the aggregate value of institutional stock. Going forward, the increase in stock should lead to better liquidity in the market and create more investment opportunities.

12: GROWTH IN INSTITUTIONAL-GRADE CRE IN SELECT COUNTRIES (2008-2018)

Source: EIU, IMF, Prudential Real Estate Investors

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23 A Bird’s Eye View of Global RE Markets, Prudential Real Estate Investors, March 2011
Part 3: China Retail Market Overview – Understanding China Retail Investments

The Evolution of the Asset Class

China’s retail market has undergone a transformation over the past two decades, moving away from traditional department stores to large-scale integrated shopping malls.24 Much of this trend can be explained through the transformation of retailing within the country. From the 1980s to early 1990s, the predominant retailers in China were large department stores which were often owned and operated by state-owned enterprises (SOEs). Since the last decade, Chinese shoppers have been gravitating toward more foreign and smaller-format retailers, producing a need for shopping malls to accommodate these stores. Chart 13 illustrates the evolution of retail formats in China through the decades.

Department stores were traditionally a popular way for new brands to establish themselves in China, but in recent years modern shopping centers became mainstream to meet demand. The shopping center format has become the predominant retailing asset of choice in China’s Tier 1 cities (Chart 14), and has begun to take shape in Tier 2 cities as well.

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24 Large-scale integrated shopping centers (GFA from 50,000 to 100,000 sqm) typically contain a variety of retail types, including supermarkets, fashion stores, F&B, department stores, and lifestyle / leisure facilities
Retail Space Per Capita Lags Behind

The overall inventory of commercial retail real estate in China remains low compared to most developed nations. What’s more, a large portion of current stock will become obsolete, largely due to poor property management. Consequently, the supply of quality retail space, and the shortfall of space per capita, might drop even further (Chart 15).

Riding on the Coattails of Retailers

Chinese consumer spending has grown dramatically – at a 14.4% compounded annual rate between 1970 and 2010 – due to a myriad of factors including rapid GDP growth, urbanization, the burgeoning middle- and upper-classes and the increasing level of discretionary income (Chart 16).
The Chinese government’s drive to stimulate domestic demand has propelled local retail sales to higher levels. The National Bureau of Statistics announced that retail spending grew 17.1% in 2011, and projected that retail sales will rise rapidly over the next several years due to urbanization and GDP growth (Chart 17).

Despite the strong growth in aggregate retail sales, China still lags significantly behind most countries in sales per capita (Chart 18). China retail sales are about US$2,000 per capita, third among BRIC countries. China remains far behind developed nations, particularly Japan, which tops the category at US$13,463. That leaves room for significant growth in China, which bodes well for real estate investments in the retail sector.
Space Demands Surge to Meet Consumer Needs

Retail sales in China have not yet reached their full potential, as they are projected to grow at a strong 11% annual pace over the next few years, and are forecast to reach nearly US$6.5 trillion by the end of 2015 (Chart 19).²⁵ As retailers continue to expect strong sales, demand for new retail property will grow.

China’s rising household income has induced demand for more organized retail and chain retail stores. At the same time, international retailers are capitalizing on the growing middle- and upper-class population. According to McKinsey, the number of China’s wealthy households,²⁶ which hit 1.6 million in 2008, will climb to more than 4.4 million by 2015, trailing only the US, Japan, and the UK in number. Even allowing for the current economic slowdown, the number of wealthy households in China is likely to expand by about 16% annually for the next five to seven years (Chart 20).

²⁵ EIU Data Services – estimate as of December 2011
²⁶ McKinsey classifies as wealthy Chinese households with annual income of US$ 36,500, which equates to the spending power of a US household earning US$100,000
Future retail growth figures indicate China will account for 36% of global retail sales. 27 Out of the top 10 global cities in retail sales growth, three will be in mainland China. Shanghai and Beijing will be on the top the global cities list, far outpacing that of Tokyo and the New York Metro area. Long-term retail sales projections look bright for consumer goods (Chart 21).

**Expansion in Retail Footprint**

A key to the success of malls is the ability to attract high-quality tenants, and China’s growth is attracting both international and domestic brands. The number of chain stores in China more than tripled between 2003 and 2009 and the amount of space occupied by these stores grew roughly four times (Chart 22). 28

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28 China’s National Bureau of Statistics
This increasing global footprint has generated strong demand in shopping centers and those that are outperforming have been able to generate a sizeable price premium over average malls.

![Graph: Expansion of Chain Retail Stores in China (2003-2009)]

Apart from the growing number of domestic retailers, international retailers have also been moving into China since the 1980s in an effort to capitalize on the growing local market and diversify revenues outside of their home countries. Fast food chains are not the only foreign retailers to benefit from the growth. Hypermarkets, fashion retailers, and high-end retailers have all made significant forays into the China consumer market. With the slumping economy in Europe and North America, many retailers in these consumer sectors have made China a high priority in terms of expansion and market penetration.

**Beyond the First-Tier Cities**

Outside of top-tier cities, delivery of products is a bigger problem for retailers than demand. In these regions, appropriate supply is not available to all retailers. The result is a bifurcation where the best retail projects charge high rents, with a substantial drop in rents for non-prime assets.

With the exception of Beijing (Chart 23), the majority of Chinese cities are not inundated with top retail properties. Rather, the majority of Tier 2 cities have an undersupply of stock in relation to the demand for products.
China’s Retail Supply – Can it be Absorbed?

As the cost of procuring land in Tier 1 cities becomes prohibitive, developers have shifted to Tier 2 and 3 cities. While Beijing and Shanghai have a large amount of retail stock, the vacancy rate remains below 6%, supported by strong demand. However, the rising cost of land has made it difficult to develop new supply. Despite these challenges, given the lower vacancy levels in Tier 1 cities, developments that are financially feasible and have good asset planning should have little difficulty in stabilizing.

Although many Tier 2 cities have been the darlings of international investors, it is critical to understand that not all of these cities are equal. Cities like Shenyang – a city known as the financial center of northeast China – and Chengdu – known to be the Silicon Valley of western China – have been more popular destinations for retail developers in recent years. However, this has created a significant amount of supply over recent years. As a result, it is important to understand that some of these Tier 2 cities are still in a transition phase. Although the shopping center concept has caught on well in Shanghai, Beijing, Guangzhou, and Shenzhen, many Tier 2 cities are still adapting to this new concept.

Also, as mentioned earlier, in many Tier 2 cities inexperienced developers have maximized the size of malls without factoring the actual demand. This has also been a key issue in driving up vacancy rates (Chart 24). However, despite the short-term learning curve issues in a few Tier 2 cities, the long-term outlook is still highly positive given the growth potential.

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CBRE Research and Prudential Real Estate Investors Asia-Pacific Research
In most cities, supply will be an area of concern for investors going forward. Cities such as Shenyang, Chengdu, and Tianjin will feature very little new development after 2013, which should alleviate some of the current short-term vacancy issues. Development is still burgeoning in cities such as Dalian, Hangzhou, and Xian, which will see a significant amount of new supply through 2015 (Chart 25). However, vacancy rates remain low in these Tier 2 cities due to growing demand for space, so the development pipeline should be readily absorbed.

Even with new stock expected to rise sharply over the next several years, rental rates should be minimally impacted (Chart 26). Strong rent growth is forecast for most cities, especially those in Tier 1 cities, over the next few years. Selected Tier 2 cities (such as Xiamen, Suzhou and Tianjin) that are not overdeveloped are also likely to experience healthy rental growth.

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CBRE Research August 2011
While a view of the development pipeline might give investors inhibitions about retail investments in China, the big picture is rather misleading. A breakdown of future supply by tiers and locations tells a different story regarding the retail market (Chart 27). A limited number of projects in Tier 1 and Tier 2 cities are considered as class A.31 Most projects in both tiers are located outside of core areas, with the vast majority poorly planned32 and lacking in sophistication. Thus, developers who are able to deliver top-quality assets in prime locations should continue to benefit a long sustainable basis from the growing need for space.

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31 CBRE defines grade A or B retail shopping mall based on location, developer, trade mix, management/operation, and rental performance.
32 Asset planning refers to project design, floor layout, tenant mix and sophistication of operation.
Part 4: China Retail Market Assessment

Key Criterions for Market Forecast

Given China’s enormous market size and the large number of cities, it is important to focus effectively on locations that have meaningful upside potential. With the expansion of China’s high-speed rail and freeway systems, cities that are transportation hubs and economic clusters make the most appealing investment opportunities. According to McKinsey, China in 2010 had 22 economic clusters, representing 92% of the country’s GDP (Chart 28). Out of these 22 clusters, seven are classified as mega clusters and, they represent nearly 54% of China’s total GDP. As infrastructure continues to improve, it is expected that the economic strength of these clusters will continue to grow exponentially.33

The expansion of high-speed rail has benefited Tier 2 cities, as it cuts down the commute time to major Tier 1 regions. For example, a high-speed train can cover the 1,300 kilometers between Beijing and Shanghai in less than five hours. Commuters can get to Beijing in 30 minutes from Tianjin, a Tier 2 city some 120 kilometers away. This more efficient form of transportation has benefited real estate development in many Tier 2 cities as people can choose to live in more affordable areas, yet still be able to efficiently commute to Tier 1 cities.

28: TIER 1 AND TIER 2 CITY CLUSTERS IN MAJOR ECONOMIC REGIONS BACK WITH GOVT SUPPORT

Source: China Ministry of Railway, JP Morgan, Prudential Real Estate Investors

33 China Consumer Spending Survey – McKinsey 2011
We compiled for closer analysis a list of 19 Tier 1 and 2 cities that will benefit from transportation linkages and interconnectedness with regional economic hubs. Eight variables were taken into consideration, including (Chart 29):

- Population growth
- Disposable income growth
- Future wealth creation
- Amount of current supply
- Historical retail sales growth
- The level of infrastructure
- Future development pipeline
- Rental outlook

Out of these 19 cities, 9 were identified as having an attractive outlook for retail investments. We found selective opportunities in all 10 Tier 2 cities. Nonetheless, there are opportunities in the retail sector in each of the 19 cities due to the positive growth outlook (Chart 30).
Lessons Learned

Over the past decade, there has been a surge of interest from both foreign and domestic investors in China retail real estate market. However, hard lessons have been learned by some of these investors, and these lessons include poor asset planning and management, the lack of local knowledge and various issues with partners (such as lack of alignment of interests).

A number of foreign investors entered China retail real estate markets by replicating the Western retail mall’s concept, but many have failed. Main reasons are conflicts with their local partners, and the lack of local knowledge and professionals, such as misunderstanding the local culture and consumer behavior, mismatching product offerings and poor asset planning and management.

When it comes to asset planning and management, some retail assets in China have been plagued by poor property management. Notable trends that tend to occur especially with local owners are:

- Leasing space to the highest bidder without much regard on the overall tenant mix.
- Strata-titled mall for sale for a quick profit, but inhibiting any future value growth for the property.
- No concept for layout and circulation planning leading to inefficient designs.
- Max out the leasable space allowed by local zoning without regard for demand, leading to excess space, especially on higher floors.
Lack of proper market analysis and due diligence during the design phase often lead to the wrong product and tenant mix.

Interestingly, the average size of retail projects in Tier 1 and Tier 2 cities reflects the lack of proper planning. The average size of both shopping malls and department stores tend to be significantly larger in Tier 2 cities where demand is arguably much lower (Chart 31). By contrast, Hong Kong has only six projects larger than 100,000 sqm, and they were phased developments. Overbuilding often results in the developer’s eagerness to maximize floor area without taking actual demand into consideration.

The lack of sophistication and local knowledge that are often associated with both local and foreign investors has led to numerous failed projects. With the exception of a handful of players, the majority of developers continue to build assets without the proper planning.

34 Knight Frank – Spotlight on China Retail, 2011
Part 5: Conclusion

China’s retail sector has enormous potential. Strong urbanization, macroeconomic growth, projected higher personal spending, expansion of retail chains, greater integration with the world economy, and increasing domestic and foreign investments are fueling demand for quality retail properties. Retail investors in China are looking to capitalize on two major developing trends.

First, more robust consumer spending must materialize for stronger retail sales. The current level of retail spending as a percentage of disposable income is the lowest among other advanced economies and even other BRIC countries, implying that there is room for China for stronger retail sales going forward.

Second, urbanization in Tier 2 cities needs to be followed with transportation and infrastructure developments. McKinsey projects that cities in China will comprise 30% of the world’s GDP over the next several decades, and as such, urbanization will undoubtedly be a major driver for retail investment.

On balance, the real estate investment market in China is still in its nascent stages and various risks exist in the real estate market.

- **Liquidity Risks:** The investment market is still in its early stages. Investors face challenges in finding the appropriate investment-grade product and given the competitive environment, some local investors are willing to pay a premium for these assets.
- **Regulatory Risks:** Foreign investors need to obtain approvals from the Ministry of Commerce (MOFCOM) and the State Administration of Foreign Exchange (SAFE) in order to purchase property in China. The amount of regulation tends to fluctuate depending on government’s views at any given time, and there are times when moving capital in and out of China is difficult.
- **Development & Counterparty Risks:** Given China’s lack of transparency and relatively high corruption index,35 domestic developers and sellers are known to have at times circumvented regulations. Local officials, especially in second and third tier cities, are more prone to corruption and may not always comply with the legal system.
- **Title Risks:** Title to new development projects are often not handed over upon the completion of construction. The developer must apply for title from the local government and, depending on location, the process can take up to two years to complete. Thus, proper title may not transfer upon project delivery.

These risk factors are not likely to disappear in the near future and should be taken into account.

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35 Transparency International Country Index
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