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Winning in an oversupplied market

Takeaways from the Chinese commercial real estate industry

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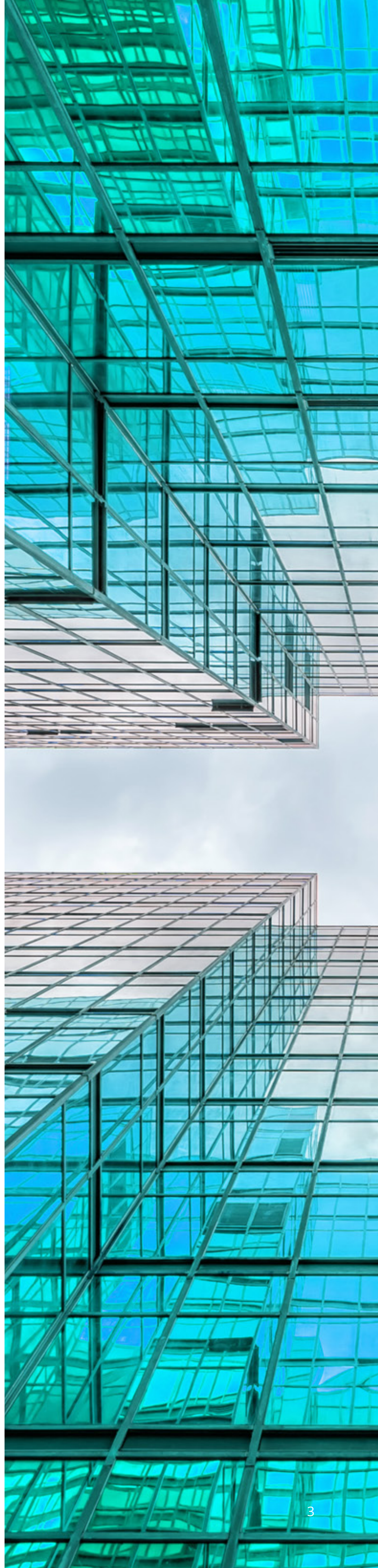
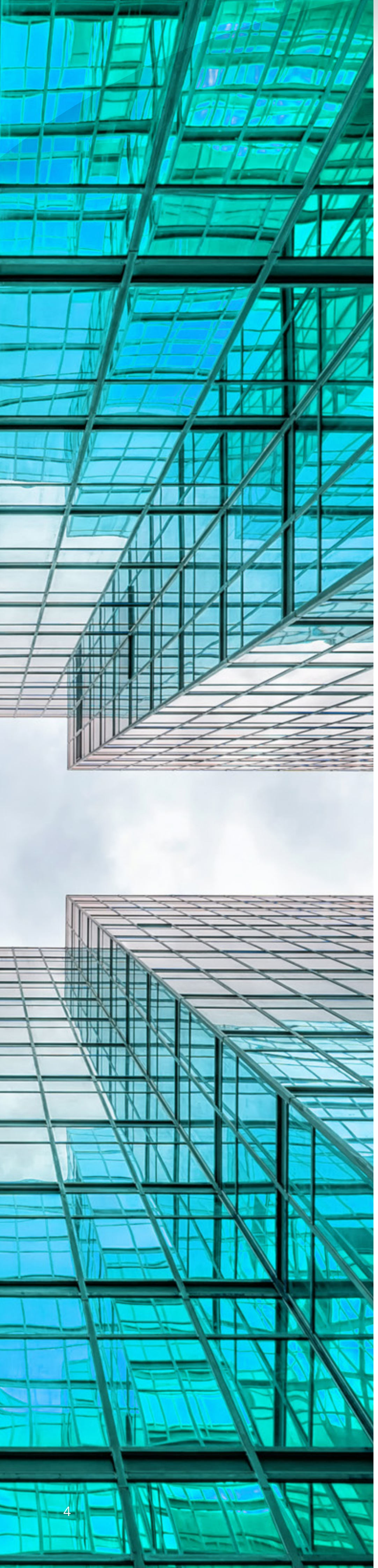




Executive summary

The Chinese real estate industry has experienced remarkable and significant growth over the past three decades, primarily driven by its economic development and the increasing rate of urbanisation. As the largest market in Asia, it has been a focal point for real estate development and investment.

However, the recent debt incidents in the Chinese real estate industry revealed the financial challenges stemming from overleverage in an oversupplied market, highlighting the dual challenges and dynamics within the sector. Particularly in terms of oversupply, it is especially noticeable in the retail segment. This issue became more critical during the COVID-19 pandemic, which further exacerbated the situation by causing low occupancy rates and the closure of nonperforming shopping malls.

In response to these challenges, leading Chinese developers have learned valuable insights. They recognised the importance of prudent financial management, maintaining a healthy debt-to-equity ratio, being cautious in their expansion plans, and timely realisation of expected synergies.

One notable shift has been the adoption of the "3I" model by leading developers. This model emphasises transitioning from merely being developers to mall operators. It also involves diversifying their portfolios and continually enhancing their core capabilities through strategic means, such as leveraging technological advancements and market insights.

These strategies and lessons learned are not only relevant within China but also offer valuable insights for developers in Southeast Asia. As Southeast Asian developers navigate their own challenges in an increasingly competitive market, understanding and implementing similar strategies can help them succeed and thrive.

Ultimately, the experiences and strategies of China's real estate industry serve as a blueprint for achieving sustainable growth and competitiveness, even in the face of adversity and market saturation. The key lies in learning from past experiences, adapting to changing market dynamics, and continuously innovating to stay ahead in the competition.

Winning in an oversupplied market | Takeaways from the Chinese commercial real estate industry

Unveiling the Chinese real estate trends and challenges

Insights into China's economic and demographic development trends

The excess of available properties has become a widespread concern in the developed commercial real estate industry, particularly in more developed countries and economies in Asia. This trend can be traced back to the 1990s in Japan when the burst of its economic bubble resulted in an oversupply of properties. Following this, Tokyo has been constructing residences at a faster rate than they are being occupied. This pattern subsequently spread to other Asian regions, such as China, where the real estate sector has thrived

As of December 2023, the commercial real estate industry in China with a staggering market value of RMB 5578.15 billion represents a substantial portion of Asia's commercial real estate landscape. However, this seemingly vast and vibrant market encountered a crisis with far-reaching economic ramifications, not only within China but also across the broader region, impacting selected Southeast Asian markets. The prolonged downturn in the property sector has directly impacted China's economy, leading to extensive layoffs and creating an atmosphere of financial instability. This impact is particularly significant given that real estate investment contributes approximately 10% to China's GDP and supports over 15% of urban employment, highlighting its critical role in the nation's economic framework.

One of the most pressing challenges facing the Chinese commercial real estate developers was the persistent issue of oversupply, a problem that has been exacerbated by the COVID-19 pandemic. This oversupply issue was not confined to China alone but resonated deeply with many other countries in Southeast Asia, such as Malaysia and Vietnam. These nations also grapple with similar challenges of oversupply, fluctuating demand, and the need to navigate economic uncertainties brought about by common global challenges. Looking ahead to 2024 and beyond, the forecast for the Asia real estate industry indicates a continued supply boom, especially for office space. This projection underscores the ongoing relevance and prominence of China's real estate industry insights within the Southeast Asian regional context. As the region prepares for another wave of development and investment, understanding the learning from China's real estate industry becomes increasingly relevant. Insights gleaned from China's experiences, both successes and challenges, can offer valuable references and perspectives for leading players in Southeast Asia.

Key challenges faced by leading commercial mall developers

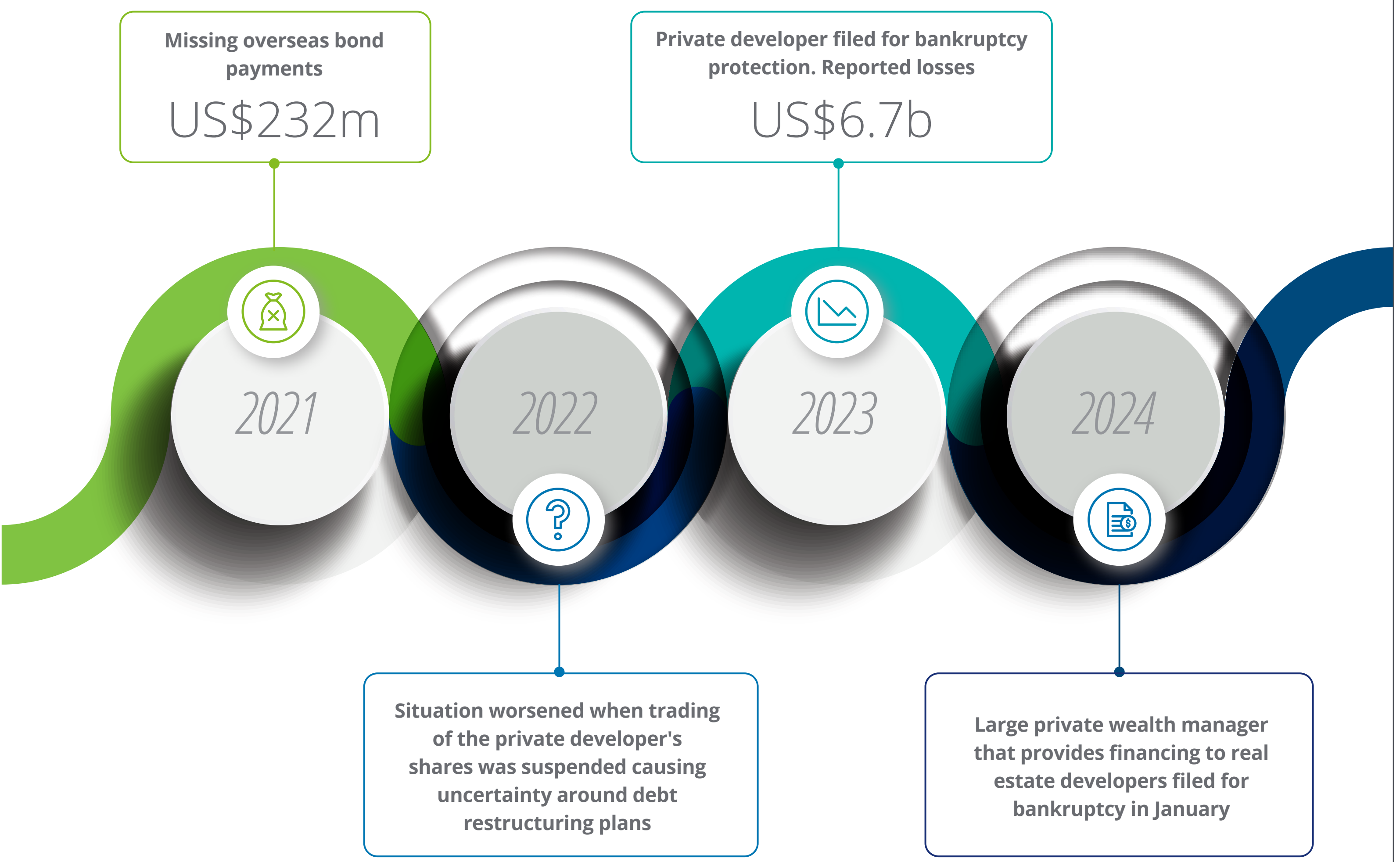
1 Overleverage and the recent debt crisis

A timeline of the recent debt incidents among major players in the Chinese real estate industry provides a comprehensive picture of the challenges the industry has faced in recent years. In 2020, the COVID-19 pandemic and stringent policy reforms increased debt management problems for many developers.

In 2021, one of China's most highly leveraged private developers began missing payments on its overseas bonds, totaling US$232 million, while another property holding company faced similar challenges with bonds worth US$206 million.

The situation worsened in 2022 when trading of the private developer's shares was suspended, causing uncertainty around debt restructuring plans and a court hearing, which was scheduled for 2023 but did not materialise.

The crisis deepened in 2023 when the private developer filed for bankruptcy protection in August and a real estate developer reported significant losses of around US$6.7 billion in the first half of the year, only to default on external debt payments in October. Lastly, in 2024, a large private wealth manager that provides financing to real estate developers filed for bankruptcy in January, further exacerbating the industry's financial instability.

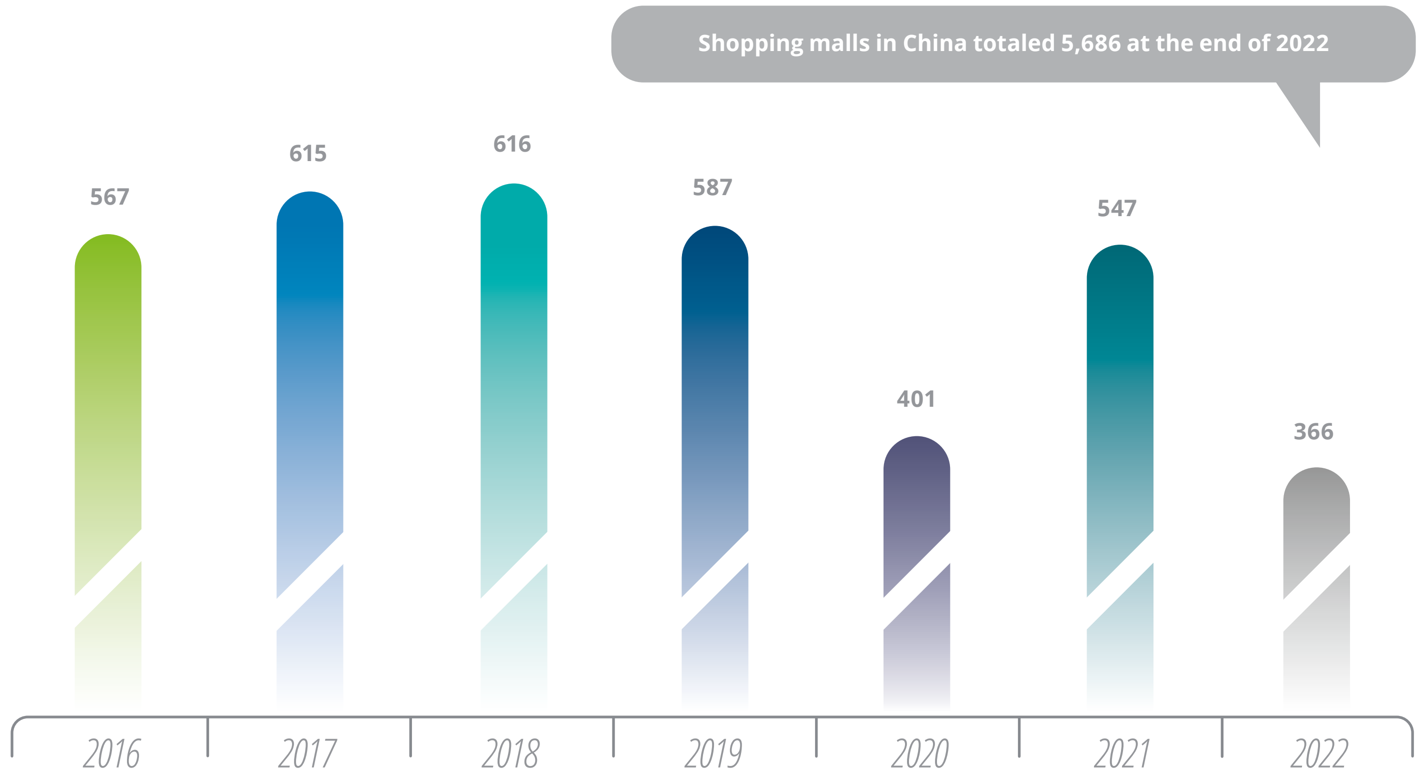


2 Oversupply of the shopping malls

From 2016 to 2022, China experienced a significant surge in the number of new shopping mall openings, peaking with a total of 5,686 shopping malls across the country by the end of 2022. This growth trend reflects a remarkable compound annual growth rate (CAGR) of more than 20% year on year, indicating the rapid expansion of China's retail infrastructure.

Despite the lowest number of new mall openings in 2022, with just over 300 malls opening in that period, overall development remains strong. The substantial increase in the number of malls from less than 400 malls a decade ago to 5,686 malls by the end of 2022 signals a major transformation in China's retail landscape, with projections showing further growth to reach 7,000 malls by 2025, strengthening China's position as a dynamic country and a growing retail market.

Figure 1: Number of China's new shopping centre openings by year



Strategic shifts adopted by the Chinese leading mall developers: Navigating the 3I model

The impact of retail oversupply in China has manifested in various ways. Firstly, there has been a significant slowdown in the supply or opening of new malls since 2018, indicating an oversupply problem in the market. Additionally, the average national shopping centre occupancy rate has plummeted to an alarming level of around 30% in 2022, exacerbated by lockdowns due to COVID-19 and economic slowdowns. This sharp decline in occupancy rates underscores the severity of the challenges faced by mall operators. Moreover, oversupply issues have led to the closure of 27 malls between 2020 and first quarter of 2022, spanning major cities to tier 3 and 4 cities across the country, with many developers opting out of the market to cut losses. In response to these challenges, Chinese developers are increasingly turning to an 'Integrated Development' model, emphasising mixed-use offerings as a strategic approach to address oversupply and adapt to changing market dynamics.

The evolution of China's urban population and its GDP per capita from 1990 to 2022 illustrates China's economic and demographic shifts, with urbanisation continuing to increase alongside significant and sizable GDP growth, providing valuable insights into China's socio-economic transformation. In parallel, the real estate industry is also facing challenges, as evidenced by the time span of debt incidents among major players from 2020 to today, reflecting the financial instability of the industry. Despite this, China is indicating rapid growth in retail infrastructure shown by the amount of mall openings. However, oversupply problems emerged which led to mall closures and pushed developers to adopt integrated development models to win against competition and retain customers.

Introduction to the 3I model

This model, which focuses on identity, icons, and inflow management, has allowed these developers to differentiate and thrive in an oversupplied market. An important aspect of this approach involves managing the "2Ts" well – tenants and traffic (i.e. customers), ensuring a strategic balance between attracting quality tenants and driving foot traffic to their malls. By prioritising these key elements, these developers are able to navigate the complexities of the oversupply landscape and maintain their position and market shares in a competitive market environment.

Amidst the challenges of oversupply in the retail sector, developers such as Longfor, Joy City and COCO Park have managed to maintain their competitive edge by implementing the innovative '3I model'.

JOY CITY
Revenue grew 26.5% during market slowdown, reaching 2.9bn USD in '22
Consistently **high occupancy rates** of 93-95% betwen '21&'22

LONGFOR
Operating **81 malls** in **100+** locations **No.1** private commercial developer by revenue

COCO PARK
#4 in China's Top 10 commercial property project for **brand value** in '22 **Exceptional occupancy rates** of 96% - 98% between '21 & '22

Longfor case study

Identity

Strong brand presence across China's major cities with two differentiated offerings: (1) urban shopping malls for middle-income families, (2) community shopping centres for selected districts.

Icon

An exemplary mall introduced a unique 'Boundless Wisdom' theme with a 3-meter astronaut model as its icon, targeting young families and students.

Inflow management

Utilises crowd management systems to maximise online-to-offline experiences leveraging its loyalty programmes through mobile applications.

Longfor has pioneered the implementation of digital solutions to redefine cross-selling strategies and continually improve the customer experience. Their innovative approach, exemplified by the 'Smart Delivery System' launched in 2022, includes three service scenarios aimed at improving customers' living experience, hence the quality of life. Starting with residential property sales as the initial point of contact, Longfor expanded its offerings to comprehensive property management services, fostering a sense of "home" while providing value-added services from commercial properties to enrich home buyers; lifestyles. Additionally, Longfor has implemented a digital loyalty programme for tenant and shopping centre management via their mobile app, offering convenience and efficiency. Longfor's primary goal is to maximise mall financial performance through proactive tenant and customer traffic management initiatives. They actively manage tenant partnerships, ensuring alignment with its brand identity while hosting promotional events to continually attract visitors. Leveraging its brand equity, Longfor effectively promotes its malls and converts visitors into loyalty programme members, offering targeted promotional messages through digital channels. Additionally, Longfor uses digital tools such as the Paradise Walk One Stop Interface to provide seamless one-stop service, catering to customers' diverse needs while shopping.

Joy City case study

Identity

Joy City shopping malls are perceived as the most convinent one-stop shopping and leisure platform and the customer go-to place.

Icon

Joy City creates spaces to increase social interaction and fun, e.g. its Shanghai mall features a Ferris wheel which has become an iconic structure in the city.

Inflow management

Joy City leverages digital marketing tools to attract and manage influx of customer, working closely with vendors.

With the application of digital initiatives at various stages of the customers' shopping journey, Joy City effectively attracts, converts and retains a strong customer base, focusing on enhancing customers' shopping experiences. To attract customers, emphasis is placed on delivering a differentiated shopping experience, including proximity marketing through automated digital messaging tools targeting mobile users within a 5km radius and creating inclusive malls with 'pet-friendly' environments and dedicated areas for children's activities such as skating rinks and indoor/outdoor mini amusement parks. In the conversion phase, online-to-offline initiatives are paramount, with approximately 30% of mall space dedicated to special events and experiential stores, thereby driving engagement with flagship brand events. Promotions and benefits are offered to attract new members, such as free parking and exclusive member discounts for popular brands. For customer retention, data-driven analytics play an important role, leveraging big data analytics to track customers' shopping carts, purchase history, and their preferences, which then further drive targeted product promotions. In addition, insight-driven tenant selection based on big data analysis of customer shopping preferences ensures an optimised mix of mall tenants to effectively meet evolving consumer demands and preferences.

COCO Park case study

Identity

COCO Park's shopping malls are perceived as fun and modern for young adults.

Icon

COCO Park's flagship mall is located in the heart of the Futian District, Shenzhen, and has become one of the icons of Shenzhen.

Inflow management

To attract and maintain influx, the mall also used digital tools to provide promotional information and continually phase out low performing vendors.

While developing its own malls, parent company COCO Park has significantly expanded its service offerings through a "management services model." In this model, the parent company offers value-added "light" management services through three different approaches. First, the "entrusted management services model" gives COCO Park the full authority to manage the assigned commercial properties, making its own strategic hiring and staffing decisions, which led to improved operational performance and reduced credit risk. Second, the "brand output and management services model" refers to managing commercial properties using the COCO Park brand by other mall owners who retain their autonomy in selecting its own operations team. Lastly, the "sublease service model" refers to leasing commercial properties from owners and subletting commercial space to tenants without operating under the COCO Park brand. Picking on the "entrustment management service model", services offered include market positioning, construction consultancy, tenant sourcing, mall operations management and a variety of value-added services targeting property owners, tenants and other customers. Revenue sources for this model include a fixed fee for services from the property owner, a percentage of revenue or profit from operational management, and a management fee from the tenant. In 2022, revenue from the entrusted management model amounted to $53.2 million USD, increasing 8.5% year-on-year and accounting for 67.9% of the group's total revenue.

Key insights and learning for SEA commercial real estate developers

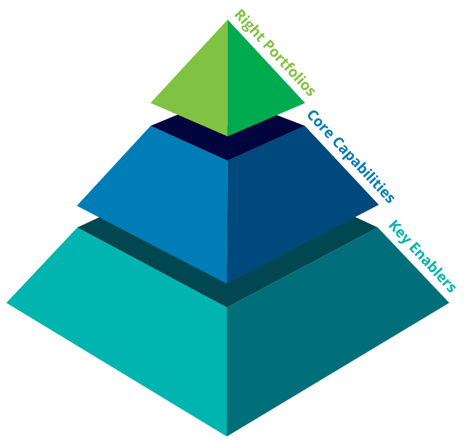
Insights from 3 decades of the Chinese market development

Lessons from the Chinese market development over the past few decades underscore the dangers of excessive leverage, which can eventually result in liquidity problems, as well as the risks associated with irrational diversification, particularly into capital-intensive opportunities that strain developers' financial resources. In addition, implementing a developer strategy that is passive with no differentiation in products and services can weaken developers' competitiveness in the market. The key lesson that can be taken from this study is the importance of prudent financial management as a foundation for sustainable growth.

Additionally, strengthening core businesses through continuous improvement and strategic diversification is critical to overall competitiveness. Becoming a differentiated and active operator is critical, achieved through differentiation using the "3I model" in positioning and design, and by proactively managing the "2Ts", namely tenant and customer traffic, and mobilising digital tools for effective market management.

Key success factors on the corporate level

To make the "3I" model effective, there are requirements at the corporate level as well. The requirements are summarised as key success factors, which are developing the right business portfolio and building strong core capabilities, as well as leveraging key enablers. These are the critical success factors in achieving sustainable market success for the conglomerates.



What's the right strategy?

- Review business portfolio-where to play: construct the right portfolio of properties;
- Set SMART Goals and be ready to adjust growth targets & new developments, reflecting market development cycles

What core capabilities are required to fulfill the winning strategy requirements?

- Re-examine core capabilities, against what it takes to win the competition
- Continue to drive operational excellence to improve operating performance and operational efficiencies

What enablers are required to execute the winning strategy?

- Set customer-centric, collaborative and continuous improvement corporate values
- Hire and train professional managers who uphold the corporate values
- Leverage technologies and tools

Building the right portfolio and determining the right strategy involves two key steps: reviewing the business portfolio to ensure alignment with corporate ambitions, and establishing SMART goals that allow for flexibility and adjustment in response to market cycles. By building a balanced property portfolio and maintaining adaptable goals, companies can effectively navigate market dynamics and achieve long-term success.

Being able to execute the superior strategy effectively requires continual reviewing the core capabilities to ensure that they are aligned to meet the demands. Additionally, maintaining an effort to drive operational excellence remains critical to improving operational performance and operational efficiency.

The right enablers involve establishing company values centered on customer-centricity, collaboration, and continuous improvement. To strengthen these values, it is important to hire aligned professional managers and uphold them in practices and decision making.

In addition, utilising the right technology and tools can increase the effectiveness of managers and facilitate the implementation of established company values.

Planning forward, when considering current operations and future expansions, Southeast Asian real estate conglomerates must answer the following key questions in their strategic planning to ensure sustainable growth. Key questions to consider include:

- How could new approaches, e.g. 3I model/ tools, be applied to enhance financial performance of the existing projects?
- What additional/updated value propositions can be introduced to attract new customers and partners to existing projects?
- Where are the strategic locations for potential new commercial projects and how many projects should be planned for, and when to roll them out?
- What additional businesses could be considered?

Conclusion

In conclusion, navigating an oversupplied commercial real estate industry requires a deep understanding of market dynamics, as well as strategic foresight. Southeast Asian real estate developers can gain valuable insights from the Chinese real estate industry, especially having seen how some of the leading developers dealt debt issues and how they remained competitive in an oversupplied market. These insights highlight the importance of maintaining financial stability, implementing innovative operating models, and adapting to changing consumer behaviours.

Developers seeking sustainable growth amidst stiff competition can benefit from strategies like the '3I' model. This model focuses on identity, icon, and inflow management, which are increasingly important in today's market.

Prioritising tenant and customer traffic management, leveraging digital solutions, and adopting an integrated development approach can help developers thrive in challenging market conditions.

Looking ahead, it is highly recommended for Southeast Asian real estate developers to conduct health checks and define key initiatives for continued success. By focusing on key success factors such as portfolio diversification, core capability development, and strategic partnerships, commercial real estate developers can better position themselves for long-term competitiveness and sustainable growth in an ever-evolving commercial real estate landscape.

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