RESEARCH

SPOTLIGHT ON CHINA RETAIL

2011

Knight Frank 萊坊

SORTING THE WHEAT FROM THE CHAFF

Interest in China retail from occupiers, developers and investors continues to grow. Why is retail becoming important as an asset class in China? How many shopping centres are there in China or even just in any one Chinese city? Where are the opportunities for new development and where are the risks?

Confirmation of the existing stock is a basic fundamental in any analysis of a retail market and yet it is almost impossible to answer for China with any degree of certainty. There is no official aggregate stock data published either for the country as a whole or for individual cities, and information on pipeline supply has to be derived from a variety of sources that needs to rely heavily on local knowledge. The lack of concrete baseline data raises key questions of where China lies in terms of the level of retail underdevelopment or overdevelopment. Are certain cities or sub areas close to capacity or are there still many areas where development opportunities clearly abound?

To help address this inadequacy and bring more clarity to China's retail landscape Knight Frank in collaboration with China based consultancy Holdways has collated data on 1,971 retail properties in ten major cities covering shopping centres larger than 10,000 sq m, as well as standalone department stores, hypermarkets, home appliances and home furnishing stores. This paper explores some of the trends that are evident from this extensive database and then focuses on a number of key performance indicators and what this reveals about the retail market.

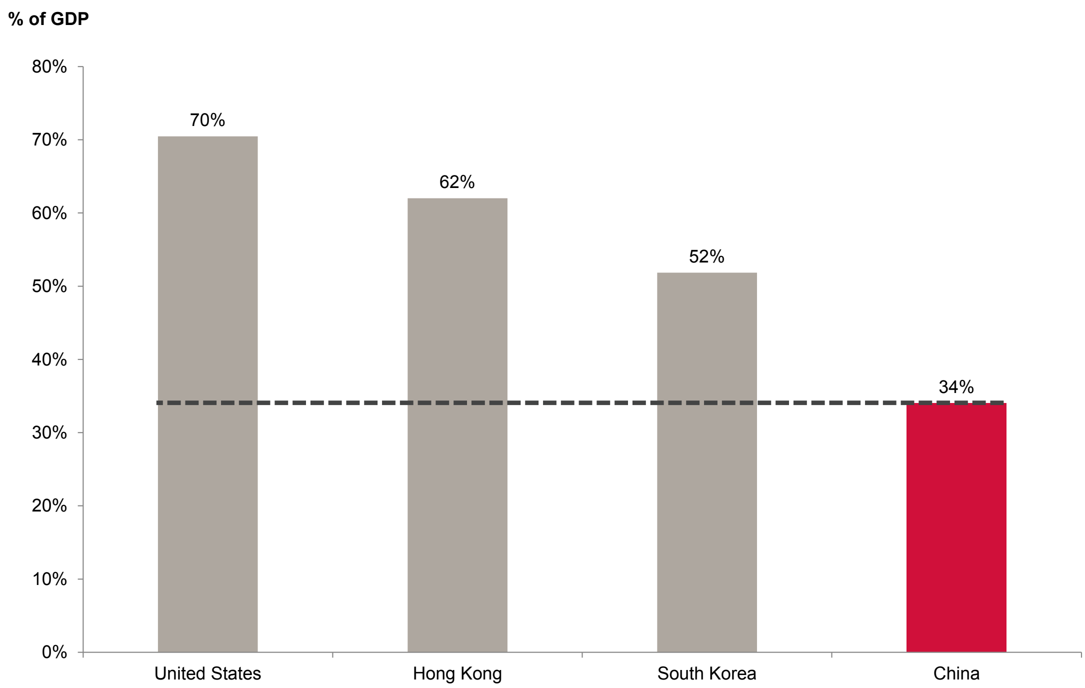
Why China Retail?

Over the past two decades, China's rapid economic rise has been fuelled by growth in exports and fixed domestic investment. Exports have grown twenty-one-fold during the last 20 years. In 1991, China was the world's twelfth largest exporter of goods, but by 2009, it had become the world's largest exporter. China's fixed investment also saw a breathtaking increase, with a fifty-fold growth over the last 20 years.

However, the decline in exports in 2009, which was triggered by the global financial crisis, highlighted China's dependence on the developed economies. In response, the Chinese government stepped up efforts to reduce the economy's dependency on exports by stimulating and developing a sustainable domestic retail market. Boosting domestic demand sits at the top of the 12th Five-year Plan, implying its importance over investment and exports in the coming years. The government aims to develop a long-term mechanism for expanding consumption by stimulating personal income growth, encouraging urbanisation and increasing rural development.

This is a huge task. Domestic private consumption took up a mere 34% of GDP in 2010, a relatively low level by international standards, compared with 52% in South Korea, 62% in Hong Kong and 70% in the US last year. This reflects that Chinese people have over-saved and under-consumed and significant changes in China's development model are yet to be seen. The flip side of this phenomenon is that there is great room for expansion in China's private consumption, which could provide significant opportunities for retailers and retail developers.

Graph 1: Domestic consumption as % of GDP in US, HK, Korea and China



Source: Government sources / Knight Frank

Another driver for the retail market is urbanisation in China, which has been taking place at an unprecedented pace over the last three decades. The urbanisation rate in China rose from 18% in 1978 to 30% in 1995 and continued to rise to about 50% by 2010. The urbanisation rate in Tier 1 cities is typically over 85%, while in Tier 2 cities such as Chongqing, Chengdu and Dalian, the rate ranges from 50-60%. By 2025, it is expected that two-thirds of the Chinese population will be living in urban areas. The growth of urban population has been key to the emergence of a middle class in the country, which will support China's private consumption demands in the coming decades.

Whilst over the long term there are significant opportunities for growth, there remains a risk that certain locations have demand/supply levels that are out of balance and some urban districts are characterised by overdevelopment. The challenge then is to identify those areas where there is clearly too much and those areas where there is still a deficit.

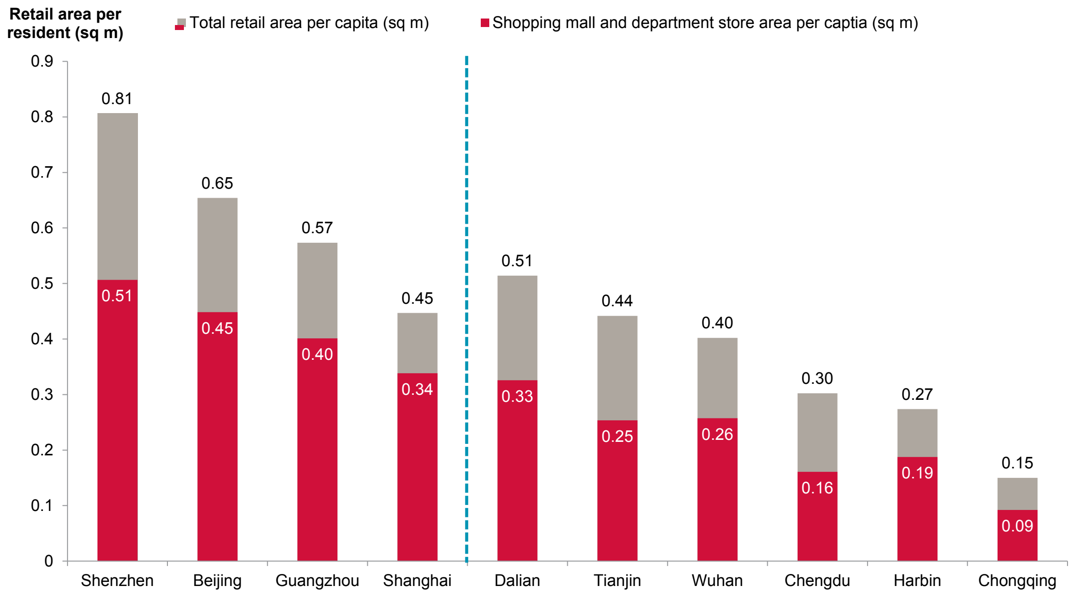
Saturation or Under Supply?

Retail GFA per capita serves as a proxy for retail density. Graph 2 shows the retail GFA per resident population (including permanent and non-permanent population) for the 10 major cities. It excludes on-street retailing so absolute values should be treated with caution but the relativity between cities is revealing. The level of retail that can be supported in any area also needs to take into account the number of domestic and overseas visitors, local consumer expenditure levels as well as the location, design and management of existing retail offers. Nonetheless, in broad terms, the graph suggests Shenzhen is the closest to oversupply amongst the Tier 1 cities and Dalian is closest to oversupply amongst the Tier 2 cities. The average for first tier cities is 0.62 sq m per capita whilst the average for the selected Tier 2 cities is 0.35 sq m per capita. Comparing retail GFA per capita against disposable income per capita in Graph 3 also highlights these two cities as the furthest outliers from the average ratio amongst the 10 cities.

The graphs also suggest that supply in Shanghai is still underweight, compared with other Tier 1 cities. Whilst major shopping areas are concentrated in core areas such as Nanjing Road and Huaihai Road in the Huangpu, Xuhui and Jing'an districts, suburban areas such as Zhabei still lack new shopping centres. The pattern of retail GFA per capita for different cities can also be seen later in the report in a converse relationship to current rental levels with Shanghai recording the highest rental levels amongst the Tier 1 cities and Shenzhen the lowest. Dalian is also shown to have the lowest rent amongst all the Tier 2 cities.

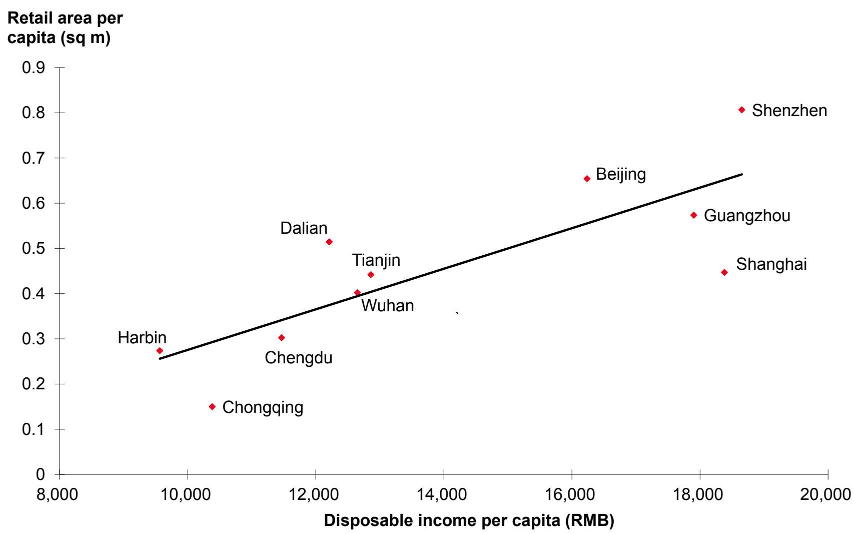
Ultimately retail GFA per capita is insufficient by itself to indicate capacity limits but is still a useful index to track for early warning signs of overdevelopment.

Graph 2: Retail GFA per Capita



Source: Chinese municiple governments / Knight Frank
Note: Resident population includes both permanent and non-permanent population. Total retail area excluded street shops, includes Department Store / Shopping Centre with GFA equal or above 10,000 sq m, Hypermarket with GFA equal or above 5,000 sq m, Home Furnishing Store with GFA equal or above 8,000 sq m and Home Appliance Store with GFA equal or above 3,000 sq m.

Graph 3: Retail GFA per Capita vs Disposable Income per Capita



Source: Chinese municipal governments / Knight Frank

The Declining Role of Stand-Alone Department Stores

As retail continues to evolve in China, it is clear that there are significant transformations that are underway in how the offer is presented. Our database also quantifies the declining role of standalone department centres in the Chinese retail market. Standalone department stores were typically the first attempt at an organized retail format. From a developer view, standalone department stores required less expertise to build and they were positively received by consumers attracted to the offer of everything under one roof and discount marketing promotions. For retailers, taking concession space in standalone department stores represented a relatively easy, low cost option to gain experience of the China market. However, whilst the format is still very evident in Tier 2 cities, their role has significantly shrunk in Tier 1 cities as consumers seek greater choice and variety and retailers move away from the department store cocoon and opt for their own branded stores. Graph 4 shows that the comparison of standalone department store stock vs shopping centre stock. In the Tier 2 cities, standalone department stores account for more than a third of this combined stock whereas the average for Tier 1 cities is just 20%. Wuhan has a profile similar to a Tier 1 city because its retail supply is relatively new coinciding with the development of the Wuchang and Hanyang districts. Guangzhou has the lowest proportion of standalone department stores compared to other first-tier cities, as the city's well-developed street retailing areas reduced the standalone department store opportunities.

Graph 4: Proportion of Standalone Department Store Stock and Shopping Centre Stock

Source: Knight Frank

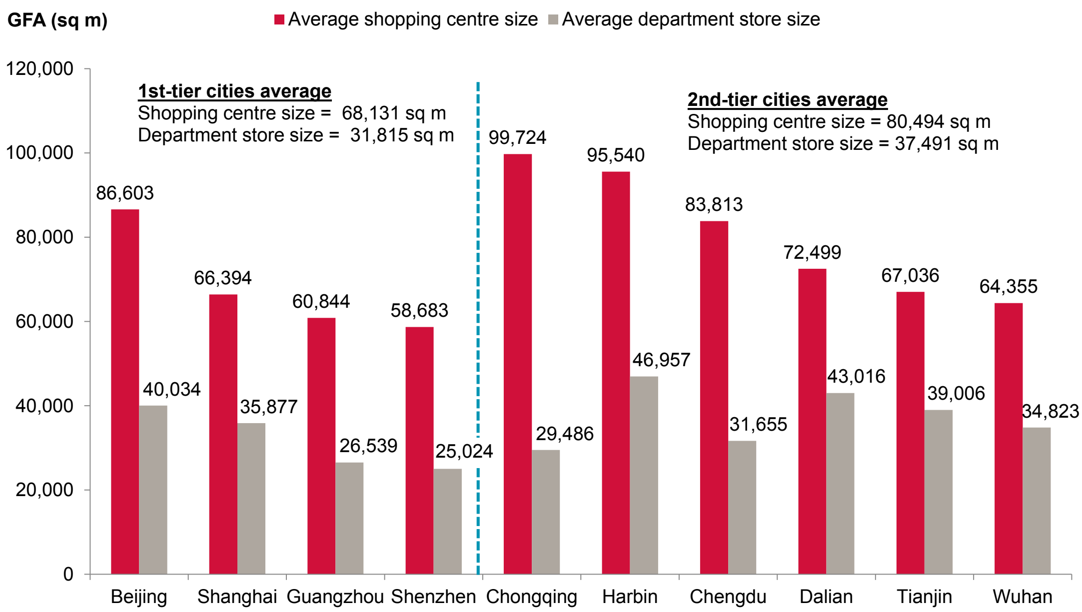
Centres on Steriods

One feature where Tier 2 cities record substantially higher levels than their Tier 1 counterparts is in the size of shopping centres. Whilst the average size of standalone department stores is relatively consistent across the 10 major cities, Graph 5 shows the average size of Tier 2 shopping centres is more than 18% higher than Tier 1 cities at approx 80,000 sq m compared to approx 68,000 sq m. The average size of shopping centres in Harbin and Chongqing is a remarkable 95,540 sq m and 99,724 sq m respectively. As a comparison, only six centres in Hong Kong are larger than 100,000 sq m and most of these represent phased developments.

That oversized shopping centres are a feature of Tier 2 cities is a reflection of many development sites being associated with very large land parcels as well as a lack of comprehensive planning by the municipal government. These sites are usually zoned as mixed use with no distinction on the precise commercial makeup in the amount of non-residential GFA permitted. The tendency by many developers is to default the allocation of this space to retail believing that retail revenue provides for a better balance sheet. Hence, the large average size of Tier 2 shopping centres is a major concern as the gross floor area is typically not a response to perceived demand but a maximum floor space limit that is inappropriate for the location. The failure of municipal government to impose tighter controls on retail planning is compounded by policies which restrict developers from holding onto their land for long periods. One effect of deterring developers from land banking is to reduce the opportunity for phased retail and releasing supply over time as the market gradually matures in a new development area.

Some inexperienced developers are all to eager to complete in advance of the market and to maximise the scale of project as they take the view that these mega centres will deter future competition, and being the largest in the area is a strong marketing asset. However, reality continues to demonstrate that bigger is rarely better. This size of centre generally requires significant vertical retailing and whereas most regional centres in Hong Kong are between 4 – 6 levels, these mega centres typically start at 6 levels and go many levels higher. Driving footfall to the upper levels is challenging for any centre and in many cases, the higher floors of these centres prove unsustainable.

Graph 5: Average Size of Shopping Centre and Standalone Department Store

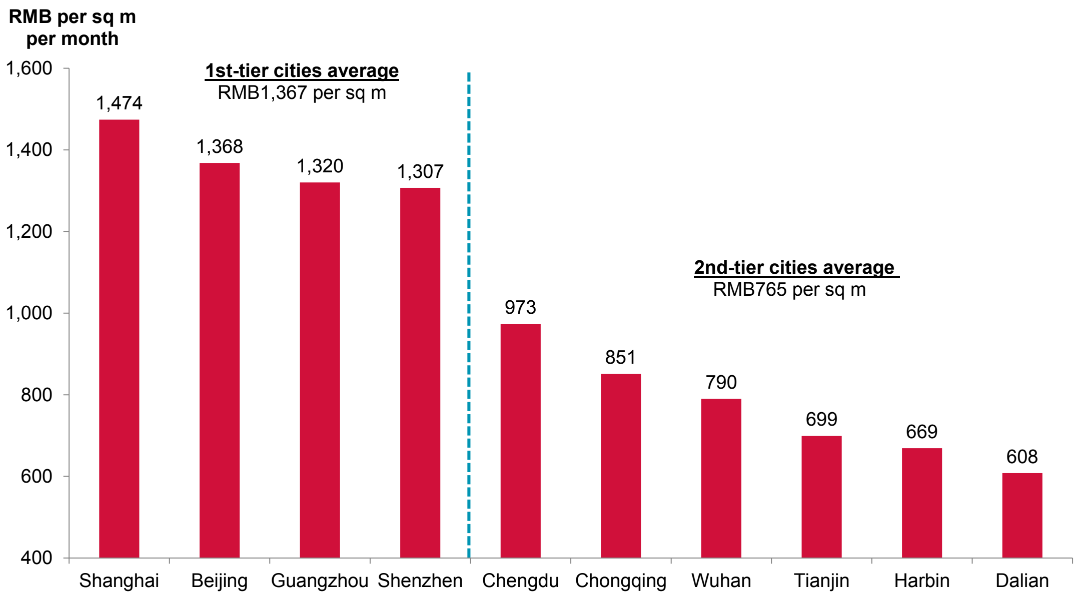


Source: Knight Frank

Prime Shopping Centre Rents – Shanghai still Favoured Most by Retailers

Graph 6 shows the typical monthly rent of prime shopping centres for Level One (ground floor) assuming a unit between 100-250 sq m. With rent levels at around 10% higher, Shanghai continues to outperform the other Tier 1 cities. On this comparison, the average rent for the Tier 1 cities is RMB 1,367 per sq m, whilst average Tier 2 rents are 46% lower at RMB 765 per sq m. However, a comparison of retail sales growth between Tier 1 and Tier 2 cities, which is a proxy for rent, indicates in Graph 7 that the gap should gradually narrow. For all these cities, there is a wide disparity in rents between the performing and non-performing centres.

Graph 6: Monthly Rent of Prime Shopping Centres (based on Typical Level One Unit)



Source: Knight Frank
Note: Based on level one standard fashion retail unit with area between 100 to 250 sq m..

Graph 7: Average Retail Sales Growth

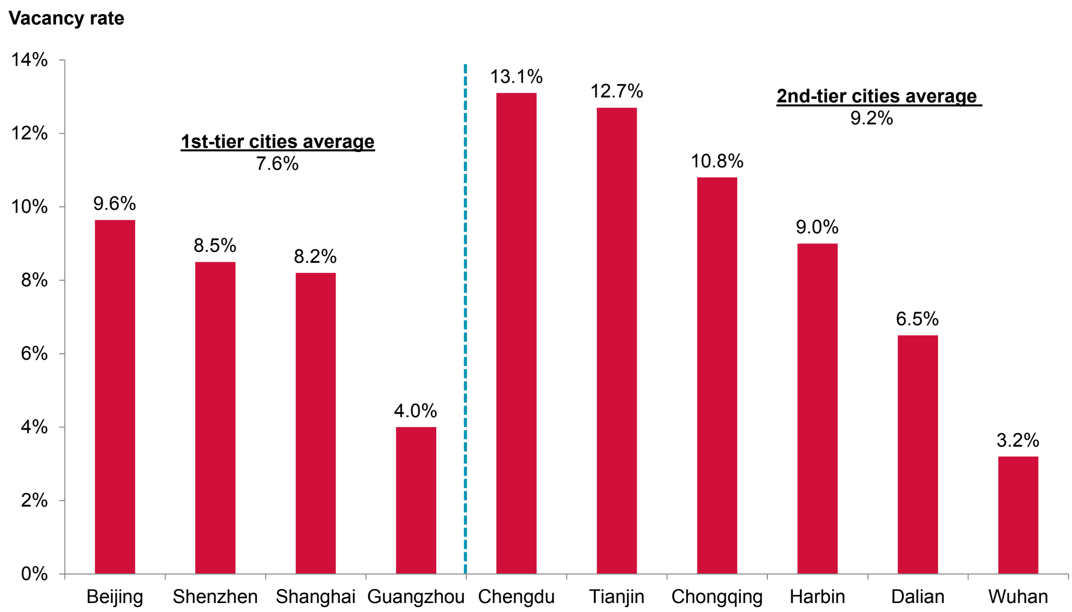
Source: Municipal governments / Knight Frank

Average Vacancy Levels – Voids More Evident in Tier 2 Centres

Graph 8 shows the average vacancy level of prime shopping centres in the 10 cities. The average vacancy level for Tier 1 cities is 7.6% compared to 9.2% for the Tier 2 cities. Guangzhou has lowest vacancy rate among 1st-tier cities, but it's expected to increase as a number of new projects in the Tianhe Sports Center CBD and the Zhujiang New Town CBD are coming on stream, providing some 400,000 sq m of new stock.

For Tier 2 cities such as Chengdu, Tianjin and Chongqing, average vacancy levels are generally higher due to larger average mall size as well as a smaller pool of retail brands looking for space compared to Tier 1 cities. A number of local retail developers also lack experience in maintaining an optimum trade-mix in their shopping centres, thus their occupancy levels are not maximised. The graph only shows rates for prime shopping centres but some poorly conceived, designed or mis-managed centres can have significant problems attracting tenants.

Graph 8: Prime Shopping Centre Vacancy Rate



Source: Knight Frank

As well as looking at the macro level of the market, an insight into occupiers' plans also helps indicate where future opportunities may lie. Some tenants in their trade class tend to act as pathfinders and the establishment of a foothold by one installs greater confidence encouraging similar brands to quickly follow behind.

Brand Penetration – Mass Market Retailers Later to the Party but Quicker to Work the Room

Table 1 shows the total number of stores in the 10 cities for selected retailers (excluding concession stores and sister brands) and their first year of entry. Nearly all of the luxury fashion and jewelry brands established their first standalone store well over 10 years ago starting with Louis Vuitton in 1992, followed by Cartier in 1997 and Chanel in 1999. By contrast, fast fashion operators H&M and Zara only established a foothold around 5 years ago or less but have been much more aggressive in their expansion plans and now have portfolios 3-4 times larger in less than half the time. Undoubtedly, the fast fashion operators have been able to benefit from looser restrictions in the regulatory environment. Clearly China's entry into the WTO in 2001 heralded a new era but it was not until December 2004 that key elements of the Measures for the Administration of Foreign Investment in the Commercial Sector (Commercial Measures) came into play removing the requirement for a local joint-venture partner and allowing foreign retailers to open stores via Wholly Foreign Owned Enterprises (WFOEs). Geographical restrictions and capital restrictions were also relaxed. The challenge for an aggressively expanding mass market retailer is finding well designed and well managed spaces and that these have been, until fairly recently in relatively scarce supply has often resulted in these operators co-locating in the same centre.

Table 1
Brand Penetration & Year of Entry (Excluding concessions and sister brands)

		Luxury fashion retailer			Luxury jewellery and watch retailer			Mid-range fast fashion retailer		
Brand / Group		Louis Vuitton	Gucci	Chanel	Vacheron Constantin	Cartier	Tiffany & Co	Zara	H&M	Uniqlo
First entry to China		1992	2001	1999	2000	1997	2001	2006	2007	2002
No. of shops in 1st-tier cities	Beijing	3	6	2	2	6	3	7	8	14
	Shanghai	3	5	5	2	4	4	13	11	26
	Shenzhen	1	1	0	1	2	1	4	2	7
	Guangzhou	2	0	1	0	1	1	2	2	4
No. of shops in 2nd-tier cities	Chengdu	1	2	0	1	1	1	2	3	6
	Dalian	1	1	0	1	1	0	3	2	2
	Tianjin	1	1	0	0	1	1	1	2	3
	Harbin	1	2	0	0	1	0	1	1	0
	Chongqing	1	1	0	0	1	0	1	2	2
	Wuhan	1	1	0	0	1	0	1	1	4
	Total	15	20	8	7	19	11	35	34	68

Source: Retailers websites / News sources
Note: Figures include retailers' standalone shops in China only, concession areas and sister brands are excluded
- One of the major observations are luxury brands epxand in China much earlier than mid-range brands.
- Some luxury brands entered the China market as early as 1997.
- Though mid-range brands entered the Mainland market much later than luxury brands, they expanded at a much faster rate.
- For instance, Uniqlo have opened 25 more shops in Shanghai after it opened the first in 2009.
- Shops of luxury and mid-range retailers are rarely located in the same shopping centre. Only 30% of then ten cities with shopping centres having both luxury and mid-range brands.

Summary

The retail market in China continues to be impacted by a lack of transparency and obtaining reliable data remains challenging. Official aggregate figures, where available, need to be treated with a high degree of caution. Trends in data are generally more illustrative than values but the clarity required for decision makers can remain elusive. However, diligent market research combined with on-site consumer and operator demand surveys can help demonstrate the case for new retail development.

Over the last ten years, the rate of new retail supply coming onto the market in these major cities has been phenomenal. There are still plenty of opportunities for new shopping centres but the capacity for the market to absorb additional supply will be impacted by the ability of the earlier, poorly conceived and poorly executed, developments to transform into better stock. Some projects will prove too difficult or too costly to correct. Going forward, local government also need to ensure that building limits are more appropriate to the location to ensure retail offers correlate to the areas of demand.

Greater education is required in what constitutes sustainable levels of retail development, what form it should take and where it should be located. Developers need to derive more rigorous assessments for determining the optimum level of retail development on individual sites whilst local government needs to set out their long term retail planning strategy for their respective urban areas. This will give confidence to developers that their carefully planned retail development is not immediately duplicated on the next site down the street. Better controls and transparency will improve decision-making, which can help grow the market further.

Appendix: The Seven Deadly Sins of Retail Development

Knight Frank has valued more than 2.95 million sq m of retail space in China with a total capital value of RMB44.8 billion. On our frequent travels through China, we see the same errors in retail development repeated again and again.

1. Failure to recognize the importance of convenience. Locate next to public transport facilities – bring retail to the people, don't expect people to go to the retail.

2. Overbuilding: Bigger is rarely better. If a centre is judged by its worst tenant, then leasing to poor quality operators to fill up the space is damning for the rest of the offer.

3. Ownership Stratification: The death knell for any shopping centre. The lack of liquidity has driven many developers to strata and sell. China's maturing capital markets now mean that developers can become landlords!

4. Vertigo retailing: Stacking more levels on a centre doesn't mean shoppers will still both to visit them

5. Misunderstanding your trade area. Failure to understand who your future consumers will be, who your future operators will be and designing accordingly. Shop units need to be the right size and specification for the anticipated positioning and trade mix.

6. Retail mis-management. The software is as important as the hardware. Requires attention to detail and co-ordination in all aspects of the retail offer.

7. Viewing retail as static not organic. The capacity to refresh and stay relevant requires flexibility in the design and the management.

Table 2
Major real estate market policies

City	Overview
Beijing	The Wangfujing and Chaoyang Districts are two major retail areas in Beijing, with Wangfujing Street being a famous shopping street. Recently, Hongkong Land acquired a retail site in Wangfujing for RMB2.9 billion. RMB5.8 billion will be invested in developing Wangfujing International Brand Center on the site, which will include a shopping centre, offices and a premier hotel. With inadequate land available in Beijing's city centre, more shopping centres are expected to be developed in the city's fringe areas.
Shanghai	Retail activity is robust in Shanghai, with many luxury brands opening stores in Xujiahui and Lujiazhui. Shanghai's infrastructure and international image have been enhanced after holding the World Expo 2010 successfully, benefiting the development of its tourism industry and boosting retail demand. The opening of the first phase of Shanghai Disney Resort in 2015 will further boost the city's tourism and retail businesses.
Guangzhou	Tianhe and Pearl River New City are the two major commercial areas of Guangzhou. Huacheng Square in Pearl River New City will be the biggest underground development in the world when it opens at the end of 2011. Development will continue in Pearl River New City and with the completions of major new shopping malls and auxiliary facilities, the area is expected to become Guangzhou's leading commercial hub.

Table 2 (Continue)

Major real estate market policies

City	Overview
Shenzhen	Universiade Shenzhen 2011 has greatly improved the city's infrastructure, facilities and international status and will also benefit its retail sector. International retailers are increasing their presence in the city. Futian District now houses a number of international retailers, such as European fashion brand Lightness, which recently opened its first store in Futian's Citic City Plaza.
Tianjin	The construction of the second phase of Jinwan Plaza has just commenced in Heping District, a major retail area in Tianjin. Premier offices, apartments, serviced apartments, a hotel and a department store will be included in the project. With the development of the Tianjin Binhai New Area, more shopping facilities will be built and retail demand will continue to grow as offices and homes are completed.
Chengdu	The city continues to recover from the earthquake in 2008 and a number of new shopping centres are scheduled for completion. Retailers show their confidence towards Chengdu by entering its retail market. For example, French Jewellery Brand Chaumet has just opened its first shop in Sichuan in Maison Mode Lessin Department Store.
Wuhan	Major prime retail areas are concentrated in Jiang'an and Jianghan districts of Wuhan, with Jianghan Road being a famous street for shopping. The rapid development of Hanyang district have drawn many developers such as Vanke to the district, building another major development in the district. The rapid development of emerging districts in the city have pushed up retail supply in a large extend. However, being the regional transportation hub of Central China, the long term outlook of the city's retail market remains bright.
Chongqing	The direct-controlled municipality is a retail and wholesale center of south western China, with the establishment of a number of local and foreign retail enterprises including Carrefour, Gome and local department store chains locating at core retail areas such as Jiefangbei and Nan Ping. With strong retail sales growth in the mountainous city, the new retail supply is expected to concentrate in the sub-urban areas as land available for major developments.
Dalian	As a software engineering and financial centre of North-east China, as well as a popular vacation destination, Dalian attracts many large retailers such as Zara, lending support to retail demand. Traditional shopping areas located in Renmin Road and Qingniwa Qiao. One of the major retail development focus of the city will be in Shahekou District, with major emerging luxury residential and prime office areas concentrated in Xinghai Bay.
Harbin	Harbin is the gateway to Russia for nearby countries such as Japan and South Korea and an important bridgehead to Russia for China's provinces. The financial centre of Northeast China has attracted foreign brands such as Gucci, Dior and recently Hermès to its traditional shopping districts such as Daoli District. The growing income of local residents set to boost consumption and lead to an expansion of more foreign retail brands in its retail market.

Table 3

Outlook for retail property prices and rents in major Mainland cities

	Beijing	Shanghai	Guangzhou	Shenzhen	Tianjin
Retail property prices	↔	↗	↔	↗	↔
Retail property rents	↗	↗	↗	↗	↔
	Chengdu	**Wuhan**	**Chongqing**	**Dalian**	**Harbin**
Retail property prices	↔	↔	↔	↗	↔
Retail property rents	↔	↔	↗	↗	↔

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