Alpha Investment Partners Limited

Alpha Watch

August 2014

China Retail

Opportunities in a competitive landscape

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Executive summary

There have been some concerns about China's retail market due to the economic slowdown, negative impact of e-commerce, overseas shopping and anti-corruption campaign, and large pipeline supply. However, for those familiar with the China market, the retail market still presents opportunities albeit in a more competitive landscape.

China's economic growth will continue to outperform many countries as it matures and restructures for a more balanced and sustainable growth. China could overtake the US in terms of GDP as early as this year based on Purchasing Power Parities and its retail sales market is expected to be the world's largest by 2016. China's burgeoning middle class will drive consumer spending and reforms will unlock savings and increase spending.

Online retail is the main challenge for physical stores but there is still a need for physical space. Unlike other countries where online retail replaces traditional shopping, e-tailing in China stimulates consumption that would otherwise not take place as some of these online purchases are not available in stores nearby. Low-end mass market retailers are more affected as online consumers are mostly bargain hunters. Physical stores are relevant in cultivating brand awareness, providing the "touch-and-feel" experience and offering things that cannot be purchased online. Retailers are offering multichannel shopping and even partnering up with Tmall and Alipay while mall operators are introducing new retail concepts and mall strategies to generate foot traffic.

The ongoing anti-corruption campaign and increase in overseas travel impact mainly luxury retail which is only a small segment of the retail market. Even then, luxury sales growth remains positive, buoyed by the growth in high net worth individuals and aspirational middle-class. Luxury retailers are still expanding albeit cautiously.

Concerns over China's large pipeline supply could be overstated as effective supply is less if we exclude malls that are non-performing, delayed in construction or planned but not built. China's retail stock is polarized in quality and performance due to the fragmented ownership in strata-titled malls, old-fashioned department stores and inexperienced developers. High average vacancy rates due to some underperforming malls can mask high occupancy rates in successful malls. Furthermore, each city's retail market is at different stages of maturity and their pipeline supply should be seen in the context of their demand and supply dynamics.

Alpha therefore views China's retail outlook as positive, underpinned by wage growth and pro-consumption reform despite a more competitive landscape. There are opportunities especially for experienced developers/owners who can understand the consumer psyche and innovate to create new retail concepts and good mall strategies to rise above many others.

The case for China retail

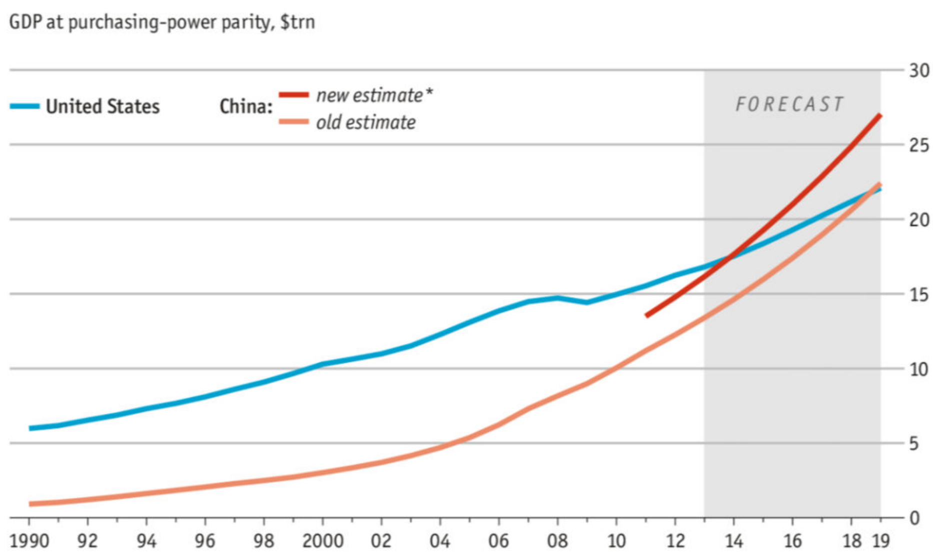
There have been some concerns about China's retail market due to the economic slowdown, the negative impact of e-commerce, anti-corruption campaign and overseas shopping, and the large pipeline supply. However, for those familiar with the China market, the retail market still presents opportunities albeit in a more competitive landscape.

China's economic growth will continue to outperform many countries

China's economic growth will continue to outperform many countries despite a projected slower growth rate in the future as it matures and restructures for a more balanced and sustainable growth. Now the second largest economy in the world, China could overtake the US by this year based on Purchasing Power Parities (PPP)[1] and by 2022 based on value if it grows at 7% CAGR between 2013 and 2020, and 5.3% CAGR between 2021 and 2030[2] (Fig 1).

China achieved a GDP growth rate of 7.5% in 2013 and the government looks on target to maintain it for 2014 as it keeps a close tab on the economy with selective stimulus such as increasing infrastructure spending and loosening monetary policy. Recent economic indicators showed that the economy is stabilising after a weak start in the year.

Fig 1: China's economy will overtake US' this year



***Extrapolated from 2011 onwards**
Source: International Comparison Programme, IMF and The Economist

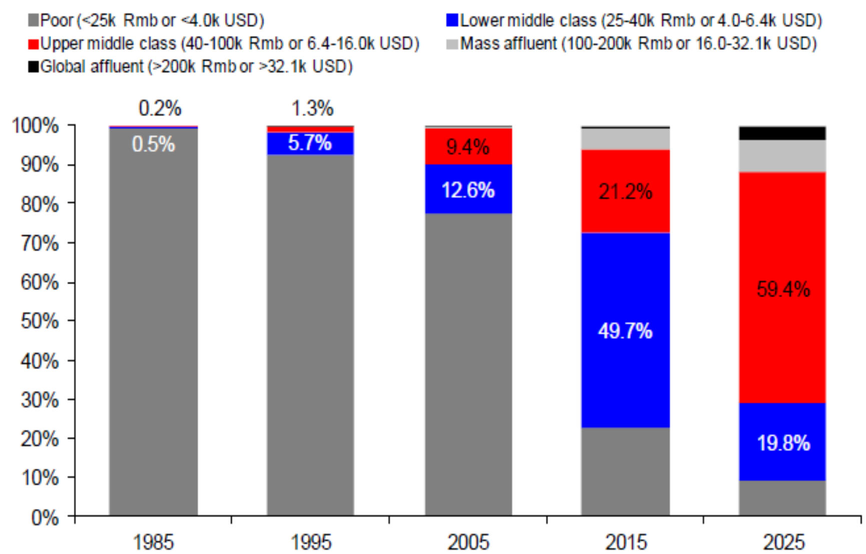
[1] World Bank
[2] Standard Chartered, 2013

Burgeoning middle class to drive consumer spending

China's burgeoning upper middle-class will be the principal engine of consumer spending in the next decade as the government pushes for urbanization and wage growth to move more people into the middle-class group, with the economic goal of rebalancing its economy to increase the contribution of domestic consumption to GDP growth and reduce its reliance on exports and investments.

The middle class is projected to grow from 22% in 2005 to 71% in 2015 and 79% in 2025 (Fig 2). The government targets to increase the urbanization rate to 60% by 2020, from 52% in 2012. Wages have been growing on average around 11% a year in the past ten years and the government's target is to double it by 2020 from the 2010 level.

Fig 2: China's burgeoning upper middle class



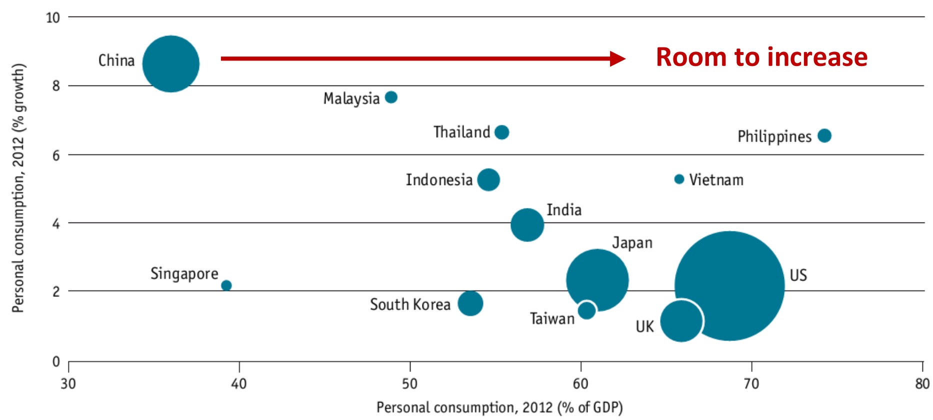
Source: McKinsey Global Institute, Cushman & Wakefield, Macquarie Research, October 2013

Reforms to unlock savings and increase spending

China currently has a high savings rate of 51% compared to the global average of 20% which presents higher consumption potential as they are unlocked. The accelerated pace of reform under the new leadership is expected to progressively reduce the need for precautionary savings in the face of low social welfare spending. Some recent policies to boost consumption include strengthening social safety nets to dislodge savings, relaxation of hukou requirements, increasing minimum wages and extension of land rights to rural areas.

Compared to developed countries and emerging Asian markets where consumption makes up a higher percentage of GDP, there is much room for consumption to grow in China as its people become richer and the restructuring encourages them to spend more (Fig 3). China's consumption-to-disposable income ratio is expected to increase from 76% in 2012 to around 82% by 2020[3]. Private consumption is expected to increase from 36% of its GDP in 2012 to 44% by 2020. This will represent around 70% of the US consumer market size by 2020, compared with 40% in 2012[4].

Fig 3: China's consumption will grow and contribute more to GDP



Note: Size of bubbles reflect private consumption in US$ bn, 2012.
Source: The Economist Intelligence Unit

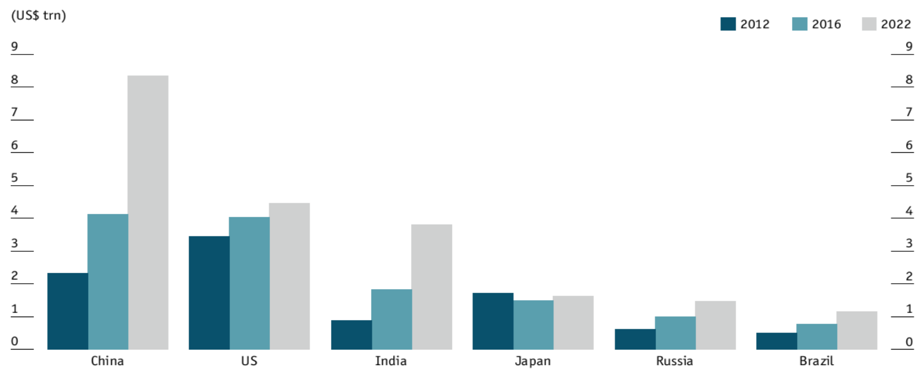
China's retail market will grow to be world's largest by 2016

China is the largest retail market in Asia with USD1.7 trillion sales in 2013 and is projected to overtake the US as the largest in the world by 2016[5] (Fig 4). Its retail sales growth rate is one of the highest globally at double-digits, despite slowing to 12.1% yoy in 7M2014, from 13.1% in 2013, and is forecast to remain at an elevated level of an annual average of 8.4% over the next five years[6] as spending power rises. On the other hand, China's retail sales per capita[7] is low compared to many other countries and there is potential for it to grow given its high retail sales growth rate.

China thus remains the key market in Asia Pacific for retailers to expand into. According to CBRE's survey[8], 64% of international retailers plan to open a new store in China this year, well ahead of Hong Kong, Singapore and Vietnam, which were all second in line with 33%.

[3] ANZ, 2014
[4] ANZ, Emerging Asia Monthly, "Tapping the Impending Consumption Boom in China", 2014
[5] EIU, Retail in China, "Panel Discussion on Potential", 2013
[6] EIU, Retail in China, "As One Store Opens", 2014
[7] China's retail sales per capita of USD 1,194 is just one-tenth of US' USD11,425.
[8] CBRE, "How Active are Retailers in Asia Pacific", May 2014

Fig 4: China to overtake the US as the world's largest retail market



Source: The Economist Intelligence Unit

Retail malls still relevant despite fast growing online retail

The main challenge for physical stores in China is online retail which has expanded almost 14-fold in 2008-13[9]. Online sales made up 7.5% of total retail sales in 2013, up from 6.3% in 2012, and is expected to continue rising as purchases through smartphones and social media become more prevalent. China became the world's largest online retail market in 2013 and its online sales is projected to grow rapidly by 22% CAGR over 2013-17[10].

This does not mean a zero-sum game for traditional shopping. Unlike other countries where online replaces offline retail, e-tailing in China stimulates consumption that would otherwise not take place[11] as some of these online purchases are not available in stores nearby.

Physical stores are also relevant in cultivating brand awareness, providing the "touch-and-feel" experience and offering things that cannot be purchased online such as excellent customer service, restaurants, entertainment and experiential shopping. As online consumers are mostly bargain hunters, the low-end mass market segment are affected to a greater extent compared to other retailers.

Retail stores are rising to the challenge by offering multichannel shopping, i.e. both online and offline purchase. Some retailers such as Uniqlo, GAP and Lacoste have even partnered up with online retail services such as Tmall and Alipay, apart from having their own websites (Fig 5). A Bain survey[12] found that nearly 70% of Chinese shoppers who bought online first still visited a physical store to see the product and make their selection.

[9] iResearch, China-focused internet research and consulting group
[10] iResearch
[11] McKinsey Global Institute, "China's E-tail Revolution: Online Shopping as Catalyst for Growth", 2013
[12] Bain & Company, "China's e-commerce prize", 2013

Mall operators are also innovating to introduce new retail concepts such as lifestyle hubs and intelligent malls. Lifestyle hubs offer a total lifestyle experience by providing local residents a place to hang out and relax over meals, spa treatments or live performances, away from the buzz of the city centre. Increasing the proportion of F&B tenants from 20-25% of total area to more than 30% and promotional activities such as exhibitions are some of the strategies to generate foot traffic (Fig 6). Intelligent malls leverage on online location-based services to provide shoppers with directions to the shopping centre and parking availability, stores' product availability and the best deals.

As consumers move into the higher income brackets and become more sophisticated, there will also be a shift in preference to shopping in modern retail malls with more comprehensive choices, newer designs and comfortable environment instead of at street markets.

Fig 5: Retailers with online presence

Source: Savills Research

Fig 6: Innovative mall strategies

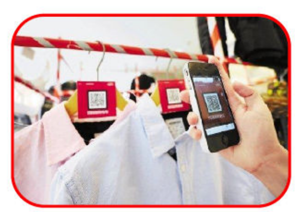
High profile exhibition: K11 (Monet: RMB70 per ticket)

Theatre & performance: Metro City

Landscape (eg seaside): Joy City Yantai, OCT Bay

App guide: Wanda, Intime

WeChat sales: Tianhong, Wangfujing



Partnership with Tmall & Alipay: Xixi Intime City

Source: Savills Research

Luxury brands' expansion in China…

***Hermès** will be opening its fifth Maison Hermès in Shanghai in September, and a new store in Beijing and Chengdu later this year.*

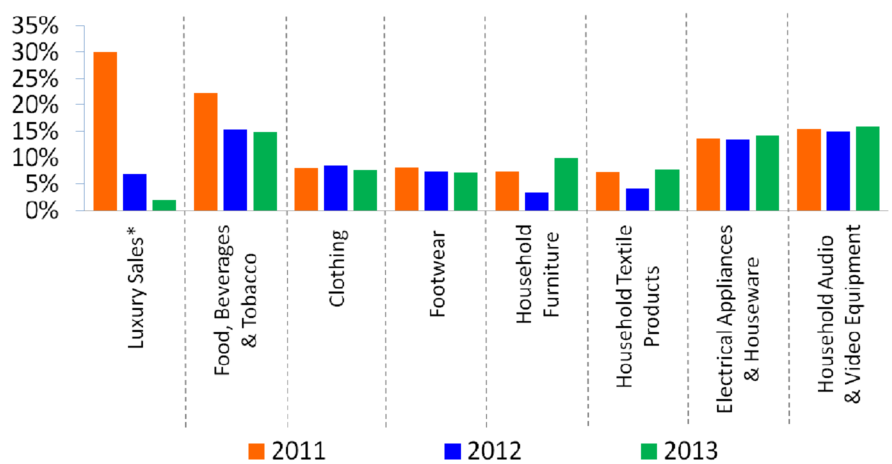
***Prada** opened its fifth store in Shanghai after rolling out its fourth store in Beijing and second store in Xi'an.*

***Jo Malone** will be opening in Shanghai in November, following the launch of its first Chinese shop in Beijing earlier this year.*

Anti-corruption and overseas travel impact luxury retail which is only a small segment

The anti-corruption drive since late 2012 and increase in overseas travel by mainland Chinese affects mainly the luxury retail segment which represents only a small part, i.e. less than 1% of the retail market. Luxury sales growth slowed to 2% in 2013 from 7% in 2012 while other segments maintained or increased their growth rates (Fig 7). Nevertheless, growth remains positive albeit slower, buoyed by the growth in high net worth individuals and aspirational middle-class who cannot wait or travel to take advantage of cheaper luxury items overseas where prices can be lower by 30% or more. Hence, although luxury retailers are more cautious, they are still expanding to reach out to a wider consumer base. Rather than simply increasing the number of outlets, they are more selective and focusing on increasing profitability. Luxury brands that recently announced expansions in China included Hermès, Prada and Jo Malone.

Fig 7: China's retail sales growth by segment, 2011 – 2013



*Luxury sales reflect those of Greater China
Source: Economist Intelligence Unit, AIP Research

Meanwhile, the slack in demand in luxury retail is mitigated with strong demand from fast fashion goods and F&B operators catering to the growing upper middle-income group. Most fast-fashion retailers exceeded their expansion targets in 2013 while 65% of luxury retailers missed theirs[13]. H&M plans to open between 80 and 90 more stores this year while Starbucks is looking at opening 300 new stores by 2015.

[13] Knight Frank, "Experience at the Fore in the New Retail Typology in China", 2014

Concerns over China's pipeline supply overstated

There are concerns about China's pipeline supply which is the largest in the world[14]. In some cities like Hangzhou and Chengdu, retail stock increase in 2014-15 can be as high as 88% and 71% respectively (Fig 8). However, these concerns could be overstated given the following reasons:

1) China's retail space per capita, at both national and city level, is still behind developed countries and has room to grow. At a national level of 1.1 sqm, it is much lower than the US' 4.7 sqm (Figs 9-10);

2) China's retail stock is polarized in quality and performance due to the fragmented ownership in strata-titled malls, old-fashioned department stores and inexperienced developers. Effective supply is much lower if we exclude malls that are non-performing, delayed in construction or planned but not built;

3) China's retail space is not homogenous. High vacancy rates mask the fact that some successful malls have high occupancy just as high vacancy in poorly designed, located or managed malls bring up the average vacancy rate; and,

4) Each city's retail market is at different stages of maturity and has different demand and supply dynamics.

   Demand: Some cities have greater potential to increase consumption as their consumption per income level is lower than others, e.g. Shanghai has higher disposable income than Guangzhou but lower consumption expenditure per income (Fig 11).

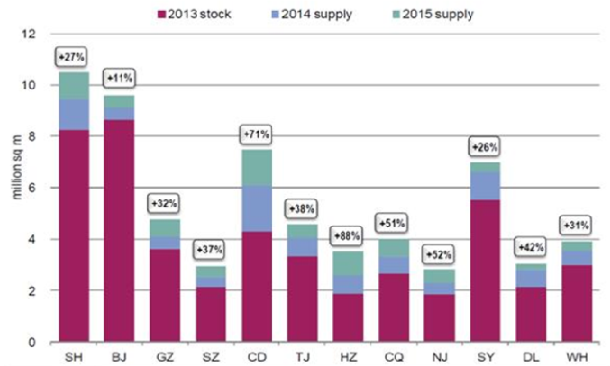
   Supply: Some cities have more room to grow their retail space given their higher disposable income and lower retail space per capita than others, e.g. Shanghai vs. Beijing (Fig 12).

   Vacancy rate: Some cities have lower vacancy rates e.g. Shanghai than others which are still digesting supply from recent large completions (Fig 13).

   Rents: Some cities have rental growth while some are seeing decline. For example, Beijing and Shanghai have the highest growth rate of 2.4% and 1.6% qoq in 1Q2014 respectively while Guangzhou and Chongqing recorded declines because of weak performance of newly completed malls which pulled down the average rents (Fig 14).

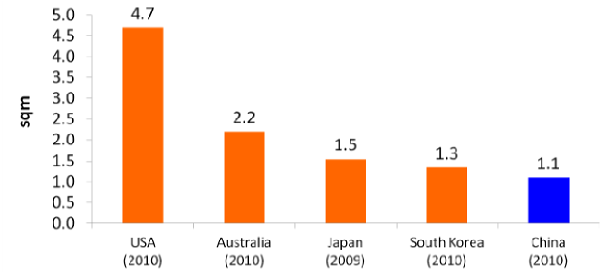
[14] CBRE, "Shopping Centre Development – The Most Active Cities Globally", April 2014

Fig 8: Retail stock increase* in major Chinese cities, 2014-16



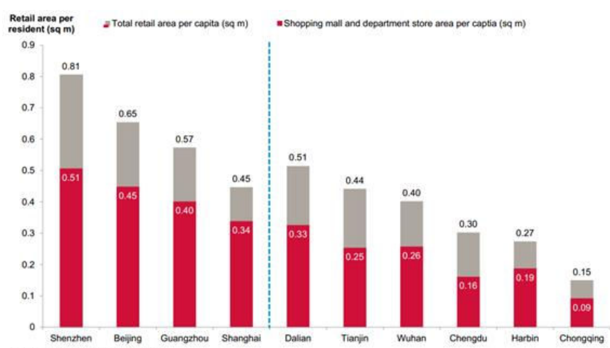
*Includes shopping malls and department stores
^Tier-1: core cities; Tier-2: growth cities
SH: Shanghai; BJ: Beijing; GZ: Guangzhou; SZ: Shenzhen; CD: Chengdu; TJ: Tianjin; HZ: Hangzhou CQ: Chongqing; NJ: Nanjing; SY: Shenyang; DL: Dalian; WH: Wuhan
Source: Savills Research

Fig 9: Retail space per capita – China vs. other countries



Note: Retail space includes shopping malls, department stores and street shops for e.g. fashion and F&B use but excludes standalone cinema
Source: Urbis, February 2012

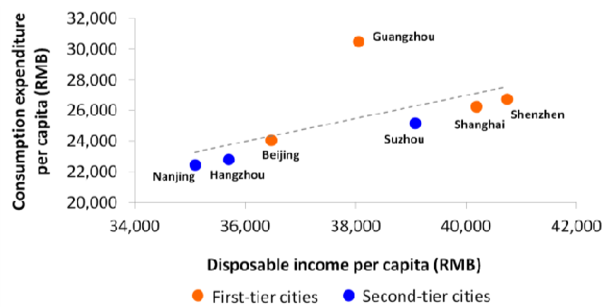
Fig 10: Major Chinese cities' retail space per capita



Note: Resident population includes both permanent and non-permanent population. Total rental area excludes street shops but includes Department Store/Shopping Centre with GFA equal or above 10,000 sqm, Hypermarket with GFA equal or above 5,000 sqm, Home Furnishing Store with GFA equal or above 8,000 sqm and Home Appliance Store with GFA equal or above 3,000 sqm

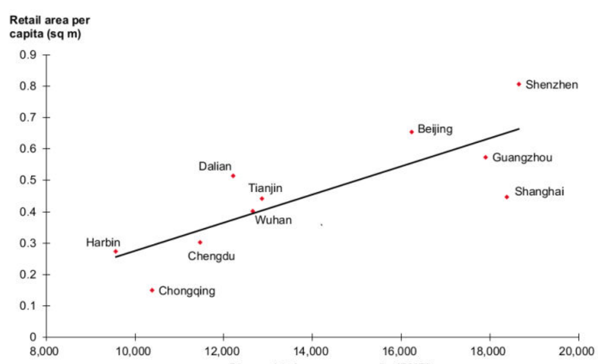
Source: Chinese municipal governments, Knight Frank

Fig 11: Income vs. consumption in China's major cities



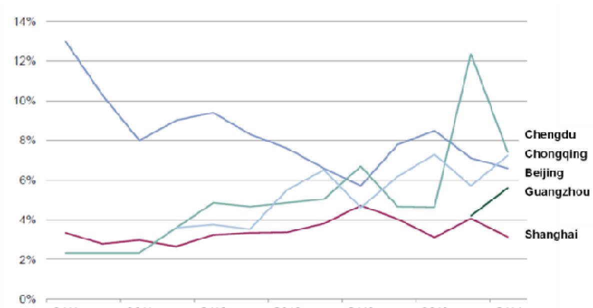
Source: CEIC, AIP Research

Fig 12: Retail space per capita vs. disposable income per capita in China



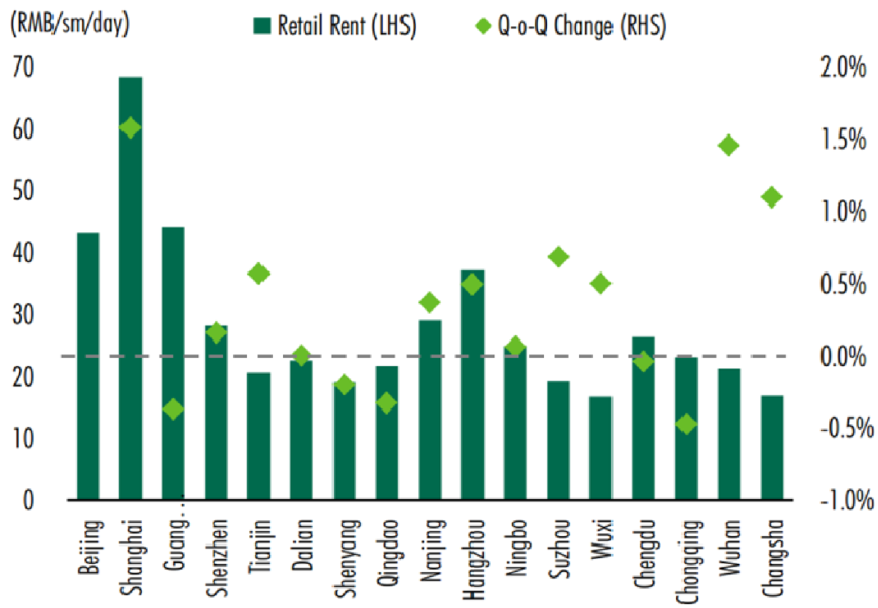
Source: Chinese municipal governments, Knight Frank

Fig 13: Vacancy rates in China's prime retail markets



Source: Savills Research

Fig 14: Rental performance in China's prime retail markets, 1Q2014



Note: Beijing posted 2.4% qoq growth in 1Q2014
Source: CBRE Research

Where are the opportunities?

Given the size and different stages of maturity in China's retail sector, there are opportunities at various levels:

By region: Central and western China provide growth from a low base as the government shifts its focus to developing these inner regions. The eastern part of China is however usually more favoured with three key economic regions, Bohai Rim (Bohai), Yangtze River Delta (YRD) and Pearl River Delta (PRD) (Fig 15) where consumption power is higher and growth potential is strong. The eastern economic regions are the wealthiest, with YRD's Shanghai, and Zhejiang and Jiangsu provinces taking the first, third and fifth spots in China's top ten regions by disposable income. Bohai's Beijing, Tianjin, Shandong and Liaoning are at the second, sixth, eighth and ninth spots. Guangdong (PRD) is at the fourth spot. Several major cities[15] in these regions are projected to have the largest increases in disposable income and consumer spending in Asia Pacific from 2013 to 2030.

Fig 15: China's key economic regions

Note: PRD also includes Hong Kong and Macau
Source: Savills

[15] Oxford Economics, 2014. These major cities are Shanghai, Beijing, Tianjin, Guangzhou, Shenzhen and Dongguan.

Retailers' trend

New brands in prime market

*UK luxury footwear brand **Rupert Sanderson** opened its first Chinese flagship – and the largest in Asia – at the Shanghai IFC Mall in May.*

*American fast moving consumer goods (FMCG) retailer **Mars** opened its first Asian M&M Chocolate World along Shanghai's Nanjing Road in June.*

Expansion into decentralised market

*American fashion brand **Hollister** opened its second store in Shanghai at Global Harbor in June.*

Expansion into Tier-2 cities

*American designer fashion brand **Tory Burch** opened a 200-sqm store in Suzhou Tower, its ninth in China.*

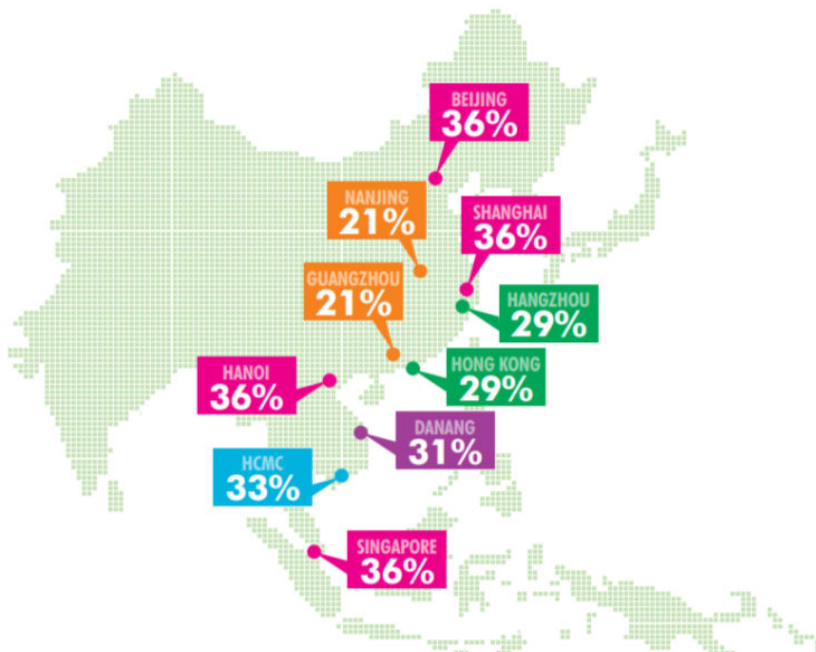
*American consumer electronics giant **Apple** is planning to open retail stores in six more cities – all second-tier – to achieve its goal of opening 25 retail stores across China.*

Expansion into lower-tier cities

*Japanese retail brand **MUJI** plans to accelerate its expansion in China by opening 35 new stores per year in Tier-3 cities. It currently has 105 stores in 34 cities.*

By city tier: First-tier cities attract first-time international retailers before they expand into the second, third and lower-tier cities. Retailers are still looking at most Tier-1 and advanced Tier-2 cities for new store openings in Asia Pacific in 2014, with Beijing, Shanghai, Hangzhou, Nanjing, Guangzhou taking up half of the top 10 spots according to CBRE's survey[16] (Fig 16). Some retailers are shifting their focus back to these cities with strong spending power from the emerging Tier-2 and -3 cities as risk appetites come down amid China's economic and retail sales growth slowdown. Nevertheless, lower-tier cities with growing or high disposable income and low retail stock can offer growth potential. Selection is key with many lower-tier cities to choose from.

Fig 16: Top 10 cities in Asia Pacific for retailers' new stores in 2014



Note: % refers to percentage of respondents
Source: CBRE Survey, "How Active are Retailers in Asia Pacific", 2014

By segment: Retailers usually start with the prime retail area in a city before expanding into the decentralized or suburban areas. Extensive metro line expansion is essential to helping retailers' move into the decentralized markets to tap on the residential catchment.

Shanghai stands out as a favourite destination among retailers given its huge consumption growth potential and more developed transport system and retail scene. See case study.

[16] CBRE, "How Active are Retailers in Asia Pacific?", 2014

Case Study: Opportunities in Shanghai

Tapping Shanghai's consumption growth potential, the strongest in China

Shanghai is China's largest market by GDP at RMB 2.16 billion in 2013 with the highest disposable income in the country and the largest city population in the world. Its GDP is projected to increase the most in Asia Pacific by 2030 and overtake other cities to become the world's 5th largest metropolitan area by economic size[a]. Shanghai is China's headquarter economy, financial and commercial centre and the world's busiest port.

Shanghai has the greatest potential to increase consumption compared to other Tier-1 cities. Its household disposable income and consumer spending between 2013 and 2030 are forecast to increase the most by 7.6% and 8.4% CAGR respectively, compared to other Chinese cities.

Continued retail sector expansion, driven by new brands and expansions

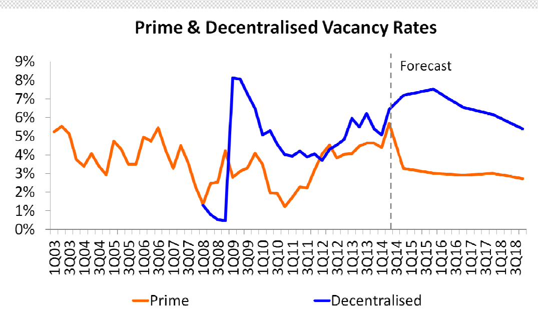
Shanghai is still a high growth market in spite of its large market size. Shanghai is the second largest retail market in China after Beijing and double the size of Hong Kong's retail market, with RMB802 billion of retail sales in 2013. Retail sales are projected to increase 8% per annum up to 2020 based on official estimates, higher than many other countries.

Shanghai thus ranks as one of the top markets for retailers' new stores in Asia Pacific in 2014 (Fig 16). New brands making their debut prefer to open stores in Shanghai, being the gateway to China, while existing brands continue expanding into the decentralised areas. Fashion brand Hollister's second store in Shanghai is in the decentralised area. The opening of the first phase of Shanghai Disney Resort in 2015 will further boost Shanghai's tourism and retail businesses.

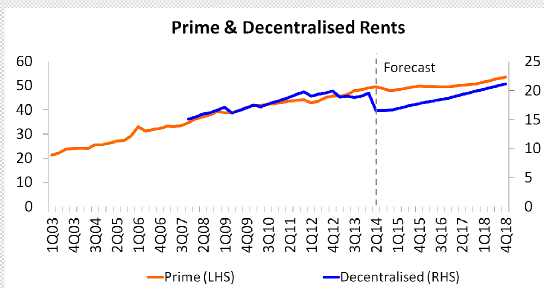
Prime retail space is highly sought after by retailers looking to establish or strengthen their presence. The strong competition for space will likely see vacancy rate fall to below 3% by 2018 (Fig 17). Rents are expected to continue rising on retail sales growth supported by wages increases and the government's implementation of more pro-consumption measures.

Retailers are expanding into the decentralised areas which are growing rapidly, helped by the metro network expansion. Shanghai now has the longest metro line in the world, ahead of Beijing and Tokyo. The decentralized stock at 4.8 million sqm is also larger than the prime stock of 3.9 million sqm at end-2013[b]. While there is a strong pipeline supply in the decentralised areas, a large proportion is expected to be built by developers with limited retail experience. Well-managed retail projects which cater to consumer needs will enjoy high occupancy and good rental growth despite the overall vacancy rate increasing in the next two years.

Fig 17: Shanghai Retail Rents & Vacancy Rates



Note: Decentralised data series starts in 1Q2008. Forecasts as of July 2014.
Source: JLL REIS, AIP Research



Note: Rents reflect ground floor net effective rents, RMB psm per day. Decentralised data series starts in 4Q2007. Forecasts as of July 2014.
Source: JLL REIS, AIP Research

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a Source: Oxford Economics
b Comprises shopping malls and department stores in the prime and decentralized areas. Source: JLL REIS

Conclusion

China’s retail outlook remains positive, underpinned by wage growth and pro-consumption reform, even though the landscape now looks more competitive against maturing slower economic growth, negative impact of e-commerce, anti-corruption campaign and overseas shopping, and large pipeline supply.

In a highly differentiated and fragmented market where retail stock is polarized in quality and performance, and the trend is towards large mixed-used projects blending office, residential and retail/entertainment elements (“work, live, play”), China’s retail scene presents opportunities especially for experienced developers/owners who can understand the consumer psyche and innovate to create new retail concepts and good mall strategies to rise above many others.

Alpha Investment Partners

Alpha Investment Partners ("Alpha") is a real estate investment advisory firm managed by a team of established professionals with proven fiduciary experience.

Equipped with a strong business network, our team of professionals aims to achieve superior investment performance by capitalizing on our unique insights into the region's property markets offering investors the competitive advantage akin to a local player.

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