China Logistics – Riding the Tide of Economic Rebalancing and the Internet Economy
The Chinese economy is still expanding at a rapid pace relative to other major world economies despite slower growth rates in recent years. LaSalle believes that the strong fundamentals and structural changes that are underway in China have the potential to translate into a favorable risk-adjusted return profile for opportunistic investing in the logistics sector.

The followings are the key themes for logistics investment opportunities in China:

1. Government policy support;
2. Macro growth drivers;
3. Undersupply of logistics facilities;
4. Attractive risk-adjusted return profile.

In terms of growth prospects, lower tier cities are expected to benefit more from urbanization and the rapid growth of e-commerce. LaSalle sees different geographic opportunities within this vast and diverse market.
Government Policy Support

In an attempt to minimize the impact of the global financial crisis, the Chinese government introduced a massive stimulus package of RMB 4 trillion in 2008/09, focusing on infrastructure development and social welfare. The resulting surge in debt among local governments and state-owned enterprises proved the investment-led growth model unsustainable.

As a result, in the 12th Five Year Plan, the central government announced a series of reforms aimed at rebalancing the economic structure to facilitate a shift from an export and investment led growth model to a model driven more by domestic consumption. Over the past few years, progress has been made in several areas, such as tighter control of local government debts, household registration reforms and financial reforms. The promotion of e-commerce development also played an important role in boosting consumption demand. In 2015, China’s consumption expenditure grew at 4.6% in real term, compared to 3.7% p.a. in 2013-14, and accounted for a larger share to economic growth than investments.

To accelerate the economic transition and deepen the reforms, the Chinese government stated in the 13th Five Year Plan that it will implement measures to assist industries to move up the value chain and strengthen the growth of the service sector. These objectives should be achieved through the development of a modern information-intensive or internet economy in China. To facilitate the development of the logistics sector, the government introduced a 50 percent tax deduction on land intended for warehouse use and the State Council unveiled its “Mid-to-long Term Development Plan for the Logistics Industry”. Further details are yet to be finalized but it is expected that they will include increased spending on infrastructure development and policies to support the enhancement of logistics information, data analytics and service quality in the logistics sector. Therefore, the slowdown in manufacturing activities is expected to be somewhat offset by solid domestic consumption and the transition to a more service-based economy.

Echoing LaSalle’s Demographic-Technology-Urbanization (DTU) themes, particularly technology and urbanization, we believe that the policy drive would encourage local governments to provide more incentives to 3PL players and e-commerce platforms, and hence lead to a sustainable growth of the sectors.
Macro Growth Drivers

Despite the deceleration from double-digit headline growth rate over the past decade, the Chinese economy today is growing from a much larger base.

Over the past decade, retail sales have been growing faster than the overall economy. This growth is supported by a growth in income and an increased propensity to spend as a result of the burgeoning middle class population. McKinsey have projected that the amount of middle class households will increase from 174 million in 2012 to 271 million in 2022. This segment accounts for a large share of consumer spending and will continue to do so, on the back of the government’s push for urbanization.

Another important driver, i.e. online retail sales, has also been undergoing impressive growth in recent years given the rapid development of the e-commerce sector, rising internet and mobile phone penetration, and people’s increasing willingness to purchase online. Both in terms of the volume of online sales and the proportion of retail sales constituting online sales, China surpassed the U.S. in 2014 and it is now the world largest e-commerce market in the world.

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Undersupply of Logistics Facilities

Among the major economies around the world, China has the largest e-commerce market. However, the modern logistics stock of China severely lags behind its global counterparts and is struggling to keep up with its enormous and expanding consumer market. China’s modern logistics stock per USD 1 million retail sales is only one-fourth of that of the U.S. The gap is even more pronounced in terms of logistics stock per USD 1 million of online retail sales.

The lack of quality supply contributes to the single-digit vacancy rates currently in Tier One city logistics markets such as Beijing and Shanghai. This phenomenon is expected to persist in the medium term and some of the demand may be spill over to the satellite cities surrounding the Tier One cities. The significant demand-supply mismatch of logistics facilities represents an attractive opportunity for developing new stock.

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In comparison to other property sectors which started two to three decades ago, the logistics sector in China has a rather short history and modern logistics facilities were only built over the past ten years or so. Because of its short history, limited market transactions and relatively low level of transparency, the logistics sector currently offers compelling yields with an average premium of 150-200bps over office assets and with an even wider spread over the risk free rate. When comparing across countries, the yield spread in China’s Tier One cities is much wider than other gateway cities such as Tokyo and New York. As the market develops and transparency improves over time, we believe the risk premium of China’s logistics sector may narrow and this will lead to yield compression in the medium term.

Compared to other property sectors in China, logistics developments have smaller investment sizes and shorter construction periods, which allow for a potentially quicker and more diversified portfolio construction. Logistics land prices in China have increased in the last eight to ten years as China’s economy has grown. Prices for first-hand land, or land acquired directly from local governments, have increased but not at levels that mirror rental growth and capital appreciation in most markets. For this reason, we still see attractive development margins through first-hand land acquisition. Second-hand land prices, which are sales from one owner directly to another, move more in tune with fundamentals, but still offer attractive opportunities for development. Generally speaking, logistics developments in Tier One and Two cities generate around 8-9 percent yield-on-costs, offering a spread of about 250-300bps over completed properties.

LaSalle believes the development margins for China logistics remain attractive. Although land prices have risen, LaSalle still sees opportunities to earn development margins of 25-40 percent and above with the lower margins coming from second-hand land in Tier One markets and higher margins coming from first-hand land in Tier One satellite markets.

Figure 8: Yield by asset type in major world gateway cities

Note: the property yields presented are LaSalle estimates of NOI yields; risk free rates refer to local 10-year government bonds
Source: LaSalle Investment Management (April 2016)
Market Selection

China is a diverse country with cities at different development stages. Development in Tier One cities is more advanced than the lower tier cities. However, in terms of growth prospects, lower tier cities are expected to benefit more from urbanization and the rapid growth of e-commerce. Hence, LaSalle sees different geographic opportunities within this vast and diverse market.

LaSalle has developed an in-house China Logistics Target Market Analysis (TMA) to evaluate the attractiveness of 66 major cities in China. The analysis has come up with five primary targets and eleven secondary targets. Primary target cities are mostly Tier One cities and are regional economic and transportation centres. They all have deep consumer base and mature manufacturing clusters. Secondary target cities are mostly Tier One and a half and Two cities. These cities fare well in at least one of the aspects of economic size, growth and policy support. They demonstrate the necessary macro foundations to support the growth of logistics demand in the future.

Figure 10: China Logistics Target Market Analysis – primary and secondary target cities

Source: LaSalle Investment Management (July 2015)

Since the market is diverse with cities of different maturity and their real estate fundamentals vary, a top-down market analysis combined with bottom-up asset evaluation will ensure a right selection of investments that matches with the appropriate risk and return profile.

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Notes:
1 A master plan of social and economic development initiatives covering the period 2011-15.
2 Financial reforms such as progressive interest rate and capital account liberalization, lowering IPO barriers, development of corporate bond market and making exchange rate system more market-based.
3 Such as enactment of policies supporting cross-border e-commerce.
4 A master plan of social and economic development initiatives covering the period 2016-20.
5 Mapping China’s Middle Class, McKinsey Quarterly (2013)
6 LaSalle evaluated 66 cities by measuring the size and growth potential of domestic consumption and manufacturing activities, connectivity, government policy support, logistics efficiency and market depth. Last updated in July 2015.

Contacts

Catherine Chen
Head of Research & Strategy, Greater China
catherine.chen@lasalle.com

Elton Li
Analyst, Research & Strategy
elton.li@lasalle.com

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