Tianjin Property Insight

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Strata-Title: A danger worse than empty buildings

A wave of supply is coming

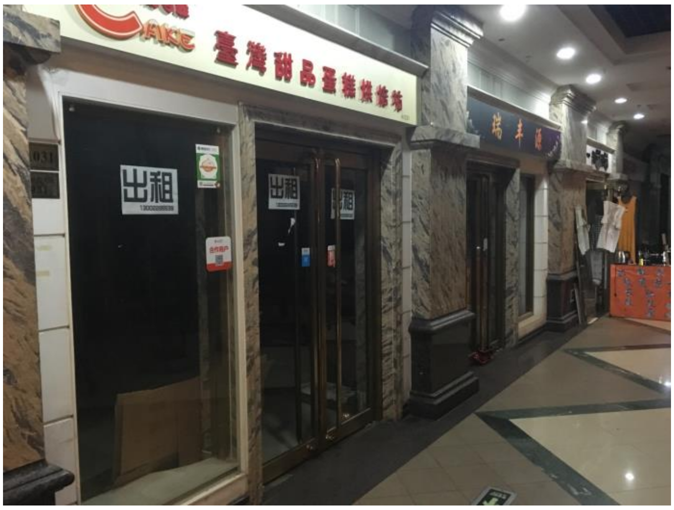
Casual observers have noticed a rapid increase in the construction of large office buildings in Tianjin in recent years and some have raised concerns about where the demand will come from for these buildings. Some, including the media, have cautioned of rising “ghost cities” but there may be a bigger danger than just big, empty buildings lining the skyline.

En-bloc versus strata-titled

If you have ever been impressed when visiting an office building, what was it that made such a good impression? Some buildings stand out because they have clean lobbies, attentive staff at the reception desks, nice landscaping or nice amenities like coffee shops or convenience stores on the ground floor. Other building lobbies are poorly lit, appear to be abandoned, have elevators that do not work well or lobbies that are dirty and full of a variety of advertising and questionable characters. One major reason for the difference may be property management, but a more important factor might be the ownership structure of the building.

Buildings that are well run and maintained often have a single owner who is either the majority user of the space – it could be the corporate headquarters, for example – or it could be owned by an institutional investor such as an insurance company or property investor who may have no physical presence in the building. In both cases, these owners pay to maintain the facilities and staff it, knowing that long-term value comes from a well-operated building with a good image and full of rent-paying tenants.

China’s commercial real estate market is still developing and in addition to these wholly owned or “en-bloc” buildings mentioned above, much of the office and retail space in the country is owned in a form we call “strata-title”. This means the ownership structure has been stratified, or split into layers. It may be that literally a different owner owns each floor or that each floor is split into various units each with a different owner. These investors often have little day-to-day interaction with the property and almost never pay their property management fees.



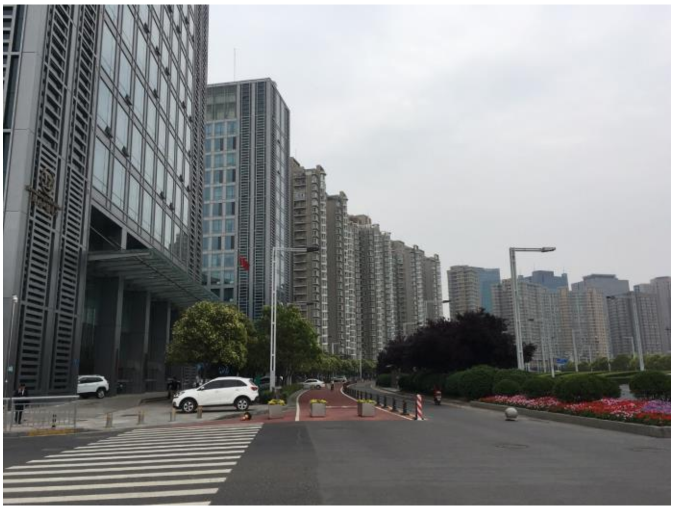
Individually owned shops line the hallways of many of Tianjin’s retail projects, like this one in Chengji Mansion located on Nanjing Road.

It is very common in office buildings, but even more visible in retail strips where, for example, a single street may be fronted by ten different retail units with some open and many others closed, each with a contact number for a different owner or leasing agent. What has happened here is that the developer looking to quickly get back its investment has sold the units to investors and no one, neither the original developer nor the new owners, are working around a common theme to ensure that they all open at the same time or do not overlap in terms of use. This can be seen in several retail areas of Tianjin, where one area might have 100 shops, 25 of which are coffee shops, most of which will not survive for even a year. It is happening in office buildings too, but most people do not see it because it is not at eye level.

So what is the danger worse than empty buildings?

As some of these retail strips have started to show, the actions or lack of action by one owner can influence that of his neighbour. If buildings are empty, eventually they can be sold or tenants found again when demand grows for retail or office space. The problem is that if these properties are sold strata-title and the individual owners do not pay their property management fees so the building can be maintained or coordinate their efforts to brand and lease the property. Even if there is demand for the space, few tenants will want to lease in a building that is not maintained – and few investors will want to buy into the same scenario. This will leave the initial investors stuck with a property that no one wants to use and that they cannot sell.

We believe that many developers and investors may not be aware of the situation because if the property sells well in its initial launch, small investors appear to have blind faith that the property will be saleable again in the future and the price will increase, because “it always has in the past”.



Over 80% of the total existing office stock in Zhengzhou was sold “strata-title.”

Why has this happened?

One way to understand the development of the market is that Chinese developers, nearly all of whom started in the residential market, have been building and selling office and retail property the way they sold residential property – by the unit. In most cases, they have been doing so with no ongoing interest in how the property is leased or managed longer term.

Government policy might play an indirect role in facilitating the growth in strata-title commercial stock throughout Chinese cities. In Tianjin, for example, in order to establish commercial tax bases, district governments often mandate that land purchased for residential development also include a commercial component. This has given rise to the construction of several mixed-use projects that feature office towers and retail centres by developers who wish to profit from residential sales but lack the experience or know-how to develop commercial real estate and prefer to sell strata-title.

Furthermore, the government has placed restrictions on land banking – the practice of buying land and holding it for future development – meaning that developers must begin developing all land within two years of purchase or face a penalty. While this policy ensures that buildings sprout up at a faster pace, it prohibits property developers from delaying projects until there is a real market need for them. Developers that purchase land in a distressed market may be more motivated to sell quickly commercial projects strata-title for a faster return on their initial investment.

The large market for strata-title sales is made possible by the abundance of individual investors willing to buy commercial space in China. Home purchase restrictions (HPRs), which were released in 2010 across several Chinese cities, limited individuals to the purchase of three residential properties. While HPRs were aimed at curbing speculation to cool down residential prices, one side effect was that demand just spilled over into the commercial market, fuelling the market for strata-title space in commercial buildings purchased by individuals who had already reached the residential limit. However, investment demand for strata-titled commercial space is still strong even in cities that have rolled back HPRs. While there remains a general mistrust in financial assets, such as stocks, commercial real estate can often be purchased at a discount compared to residential.

Unfortunately, the institutional investment demand that typically drives the en-bloc sales market has been comparably small, especially outside of Tier I cities such as Beijing and Shanghai. Nascent service sectors and an oversupply of commercial space make it difficult for institutional investors to achieve reasonable returns in many of China’s Tier II markets. Meanwhile, institutional investors generally are not willing to purchase empty buildings and their expectations on price often differ greatly with developers, which makes it hard to get en-bloc deals done and further incentivises strata-title sales.

Another reason for a lack of institutional investment is that until recently, the market for en-bloc properties was largely dominated by foreign buyers. However, we have noticed that more domestic institutions have become interested in long-term commercial real estate assets.

What are the alternatives?

One positive sign for the market is the participation of big, domestic insurance companies. In other markets, insurance companies have developed property for long-term holding or have bought large blocks of office and retail property with an eye to operating and maintaining it long term. The problem is that insurance companies, like many other investors, prefer to buy property with income, which means developers need to not only build the space but also lease and operate it for a few years before they sell it. The government could also create smaller single-use commercial projects, reducing the financial pressure on developers willing to develop commercial space.

Conclusion

The current land sales system is supposed to encourage developers to build office and retail space, creating a tax base for the local government at the same time as they build the residential space to produce a development profit for themselves. The irony is that when developers who do not have the interest or experience in developing stable commercial property are forced to, they try and exit as early as possible, creating a large pool of strata-title property. This property has proved to be a drag on the economy instead of a boost.

Although the initial intentions of these plans were good, we fear that the continued development and sale of strata-title office space will not only create empty buildings, but empty buildings that, thanks to their stratified ownership structure, will be difficult to lease and operate in the short-term and nearly impossible to rehabilitate later on, leaving the buildings not only empty but unusable. We are encouraged that the government appears to be aware of the situation and efforts in larger cities may provide to officials locally with ideas about how to resolve the issue, but we see this as an issue that needs attention, and soon.

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