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SHANGHAI | LONG-TERM RENTAL APARTMENT

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Long-term Rental Apartment: An Emerging Sector in China's Real Estate Market

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As a long-term mechanism for China's real estate development, the statement "leasing is of the same importance as home purchases" has drawn much attention in recent years. It was reiterated in the government work report on 5 March 2018 to stick to the principle of "housing is for living, not for flipping" and to boost the development of the rental housing market. The long-term rental housing market has developed rapidly due to the population inflow in big cities in China, supported by industry upgrades and preferential policies. In recent years, developers have been the chief source of supply of long-term leasing apartments. As more and more players enter the market, mergers and acquisitions activity is set to increase. IPOs and securitisation have become popular for investors to finance or dispose of their assets.

Background of Long Term Rental Housing Development

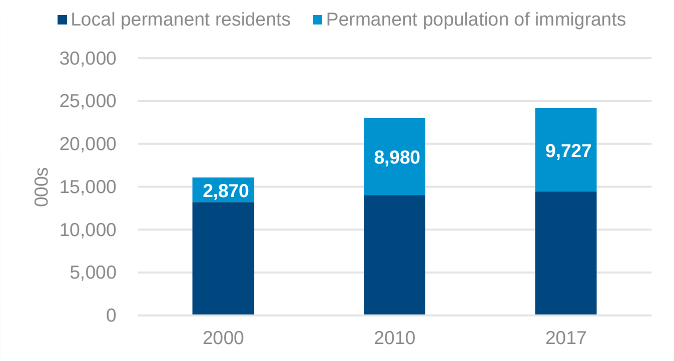
As a long-term mechanism for China's real estate development, the principle "leasing is of the same importance as home purchases" has drawn much attention in recent years. It was reiterated in the government work report on 5 March 2018 to stick to the principle of "housing is for living, not for flipping" and to boost the development of the rental housing market.

The development of long-term rental housing is buoyed by such factors as the population inflow in big cities in East China boosted by the expansion of service industries, robust leasing demand caused by the unaffordability of home purchases in first and second-tier cities, and preferential policies by the Central Government, including the principles "the same right for home leasing and purchases" and "housing is for living, not for flipping".

As a proportion of Shanghai's gross domestic product (GDP), tertiary or service industry has risen from 52% in 2000 to nearly 70% in 2017, buoyed by the increasing industry upgrades. With the development of modern service industry, Shanghai has attracted more and more immigrant workers, especially white-collar talents.

As at the end of 2017, Shanghai's permanent population of immigrants from elsewhere in China reached 9.73 million, having grown at a compound annual rate (CAGR) of 7.4% from 2.87 million in 2000. During the period (2000-2017), the annual net population inflow was about 400,000. The large size of the immigrant population has become a major source of demand in the rental housing market.

Figure 1 Permanent Population of Immigrants in Shanghai (2000, 2010 and 2017)



Source: Shanghai Statistics Bureau

According to statistics from fang.com, the CAGR of Shanghai's secondary housing sales price hit 12% between 2000 and 2017, whereas the CAGR of the secondary housing rental rate was just 5% over the same period. The divergence of sales and rental price growth has forced portions of the immigrant population to suspend home purchase plans and rent homes instead.

From 2016 to the present, various ministries and committees such as China's State Council, the National Development and Reform Commission (NDRC), the

Ministry of Land and Resources (MOLR) and the Ministry of Housing and Urban-Rural Development (MOHURD) have launched policies to support the development of the rental housing market.

Figure 2 Favourable Policies for Rental Housing

Issue Date	Circular	Contents	Issuer
2016/4/27	Schemes on boosting consumption and industry upgrades	Reduce real estate inventory by different cities, establish the rental and sales housing system, boost the development of rental housing market	NDRC
2016/5/17	Opinions on promoting the development of rental housing market	Commercial properties are allowed for rental housing use, utilities charges based on residential criteria	State Council
2017/5/20	Circular on developing the rental housing market in cities with large population inflows	Support institutional and large scaled rental housing operators, establish government rental housing trading service platform, increase rental housing supply	MOHURD, NDRC, MPS, MOF, MOLR, PBOC, SAT, SAIC, CSRC
2017/8/28	Pilot schemes on utilizing collective construction land to develop rental housing	Specify 13 cities as a pilot to use collective construction land for rental housing development	MOLR, MOHURD

Source: Colliers International Research

Market Suppliers and Key Brands

Based on studies of the market suppliers for long-term rental housing in Shanghai and their supply sources, the majority of long-term leasing apartments are typically acquired via redevelopment of non-residential properties such as hotels, commercial or industrial properties. This is because available en-bloc residential properties are limited and acquisition costs are relatively higher.

There are five types of long-term rental housing operators in Shanghai:

> Government platform, i.e. state-owned developers They develop or redevelop their own properties, lease land to develop or acquire existing assets through equity or asset transactions to operate long-term leasing apartments.

> Standard developers They develop their own properties (15% residential space set aside for self-holding as stipulated in most of Shanghai's new residential land supply), acquire existing properties (equity or asset acquisitions) or rent en-bloc properties. Typical examples of this category are Port Apartment (Vanke), Guanyu (Longfor), Youmi International Community (CIFI), Yizhan, Yijian and Yitang (China Merchants Property).

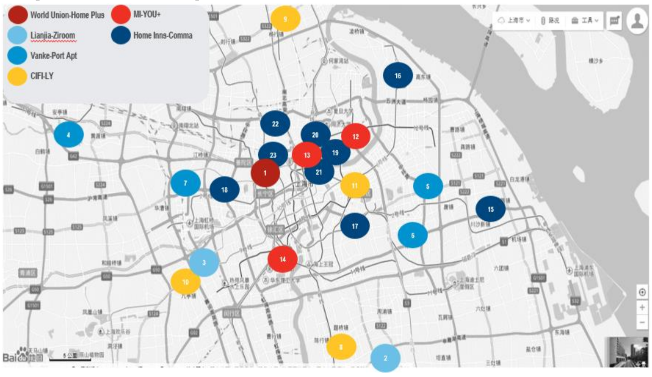
> Agencies These rent en-bloc and/or strata-titled properties, acquire existing properties (equity or asset acquisitions) or operate through asset management. Typical examples are World Union's Home Plus, Lianjia's Ziroom and Weiye Woaiwojia's Xiangyu.

> Hotel management companies These rent en-bloc properties and provide light asset management. Typical examples are Home Inns' Comma, Plateno's Wowqu and Huazhu's CJIA.

> Start-up companies These rent en-bloc properties or acquire properties (through equity or asset acquisitions) with support from financial institutions. Typical examples include YOU+, Mofang, QK365, CYPA.

According to Colliers' research, around 80% of the existing long-term rental apartments are located in the city centre, are close to the Inner or Middle Ring Road, and are near metro line stations. In addition, many projects are close to high-tech parks or innovation and incubation centres. Developer-led long-term rental apartments have become a major source of new supply in recent years.

Figure 3 Shanghai's Major Long-term Rental Apartment Map



Source: Colliers International Research

In Shanghai, the current target consumers for long-term rental apartments are mainly young people aged 25 to 35 such as college graduates and white-collar dwellers. Most of the mid-end long-term rental apartments see a high occupancy rate of 80-90%.

The dominant room plans are studios or small lofts with a size of 25 to 35 sq m (269 to 377 sq ft) and the rental rate ranges mainly from RMB3,600 to RMB6,800 per month (USD568 to USD1,073 per month). The rental rate for the smallest studio sits at RMB1,600-RMB2,600 per month (USD252 to USD410 per month). Service charges (mainly Internet fees) are normally set at RMB280 to RMBB300 per month (USD44 to USD47 per month), and utility fees for water and electricity are additional. Some projects have car parks charged at RMB300-900 per lot per month (USD47 to USD142 per lot per month) although most of the young tenants may not need car parks.

Business Models and Exit Routes of Long-term Rental Apartments

Business models for long-term rental apartments can be classified into “centralised” and “dispersed” models by properties’ concentration level; or “heavy asset” and “light asset” by asset structure. Since developers typically have strong financial positions and start-up companies are normally funded by financial institutions, these two types of operators will acquire centralised properties through the heavy asset model. Conversely, hotel groups and agencies usually acquire dispersed properties through the light asset model. In addition, some developers and investors will also draw on the trust model by introducing the managerial expertise of professional operators to their own properties.

There are four main exit routes from investment in long-term rental apartments. These are asset transfers, equity transfers, launches of asset securitisation such as Asset Backed Securities (ABS)/Commercial Mortgage Back Securities (CMBS) through stock exchanges to secure the liquidity mortgaged by income producing properties and pay back the periodic interest and principal as the finance cost, and launches of REITs of the equity type through stock exchanges to liquidate their properties by various investors.

The securitisation of long-term rental apartments has apparently accelerated since 2017. Many securitisation schemes have been launched including Mofang’s ABS (RMB350 million), CYPA’s REITs (RMB270 million), Poly’s REITs (RMB5 billion), CIFI’s REITs (RMB3 billion) and Country Garden’s REITs (RMB10 billion). The transaction structure is typically in the form of “equity plus debt” with underlying assets of rental income or property interest, and the estimated yields of senior tranches range roughly from 4.8% to 5.8%.

Outlook for Long-Term Rental Apartments

Target consumers positioning: Looking ahead, long-term rental apartments will mainly serve the young millennials group particularly designers, technical entrepreneurs and freelancers. Also, target consumers will be segmented further and consumer portraits will become much more specific, i.e. consumers targeted at white-collar female group.

Product characteristics: We expect that long-term rental apartments will contain more elements of co-living. In terms of internal layout design, more sizable, multifunctional, sociable, sharable and interactive social spaces will be offered. Creative and modern living spaces will be provided in the future.

As opposed to developers’ traditional “develop and sell” model, the business model of long-term rental apartments focuses more on asset management. It is crucial for rental apartment operators to achieve capital gains by increasing rental income and reducing cost through effective asset management approaches. For example, additional service cost for breakfast and housekeeping which has become less popular with the tenants can be reduced while the proportion of common area be enhanced. Also, online-to-offline social platforms are required to increase the tenants’ cohesiveness.

Mergers and acquisitions are likely to intensify in the future with the increasing market players. Light asset models such as launches of REITs and asset securitisation will be the preferred financing and exit vehicles for investors.

Study Cases for Overseas Long-Term Rental Apartment Operators

In view of the long history of long-term rental housing in mature markets such as the US and Japan, domestic developers, investors and operators should make reference to foreign examples.

Figure 7 Operational Statistics for US and Japan's Long-term Rental Housing

Country	Opera-tor	Year of Founding	Total Cap （USD billion）	Operational model	Apartments under Management (units)	Annual Gross Rev （USD billion）	Occupancy rate
U.S.A	Avalon Bay	1978	22.1[1]	Self-owned (centralized)	84,158[2]	2.16[3]	96%[4]
U.S.A	EQR	1966	21[5]		77,458[6]	2.43[7]	96%[8]
U.S.A	American Homes 4 Rent	2012	5.6[9]	Self-owned (dispersed)	51,239[10]	0.96[11]	96%[12]
Japan	DAITO	1974[17]	16.6[13]	Light asset	1,022,322[14]	7.7[15]	96%[16]

[1] [5] [9] as of 26 Feb 2018；[2]-[4] [10]-[12] [14] [16] as of end of 2017;

[6]-[8] as of end of 2016；[13] as of 27 Feb 2018；[15] as of FY2017 ended 31 March; [17] Japan's DAITO was founded in 1974 and engaged in factory letting at its early stage and transformed to home leasing since 1980.

Source: Consolidated by Colliers International Research

Glancing at the two largest rental housing operators in the USA, namely AVALONBAY (USD22.1 billion) and EQR (USD21 billion), together with Japan's largest rental housing service provider, DAITO, the development of long-term rental housing has a history of nearly 40 years in both markets. The heavy asset model represented by America and the light asset model represented by Japan are the two prevailing operational models in the market.

Pros and cons for both models:

The heavy asset model requires higher capital at its early stage and a longer pay-back period. However, except for the benefits from steady rental income streams, capital gains will also be obtained for the holding properties by optimising the asset allocations strategies. This serves to enhance the overall Internal Rate of Return (IRR) for the investment. This model is suitable for established operators with a recognised reputation and for mature phases in the development of long-term rental apartments.

The light asset model will not tie up too much liquidity and has a shorter pay-back period. It is conducive to expansion of market share and enhancement of brand awareness. Due to the dispersed distribution of the leased properties, it is not easy for operators to exert general control over the properties, and so this model has a weaker cost advantage. As a result, the IRR is basically lower than for the heavy asset model with centralised properties.

The development of China's long-term rental apartment is still in its expansion and branding phase. We recommend new entrants to adopt the asset-light model with the heavy asset model as a supplement. This is because new entrants need to accumulate abundant asset management expertise, expand their market share and raise brand awareness. After that, they can exploit product differentiation and cost saving strategies to increase operating profits.

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