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KEYNOTE INTERVIEW

Demographic trends support China's multifamily growth

The sector's fundamentals are strong, says Funlive CEO Keith Chan, and the market is institutionalizing rapidly

The troubles of China rental housing operators such as Danke Apartment, which defaulted on rental payments to its landlords, follow those of firms such as Lejia Apartment, which went bust in 2019 despite being valued at $2 billion at one point. While these recent headlines about the China rental residential sector might spook some investors, they obscure the potential in the sector, argues Keith Chan, chief executive of Funlive, a residential platform which owns and manages 25,000 apartments in some of China's largest cities. He spoke to *PERE*'s Mark Cooper about how China's growing and urbanizing population, coupled with favorable government policies, continue to support investment in multifamily residential, while operators are increasingly turning to more stable models and realistic pricing.

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Q Why are there misconceptions about China's rental residential market?

Most of the operators active in the multifamily sector – I'd estimate 90 percent of them – adopt a master lease model, where they take long-term leases from owners of apartments or buildings. They will usually make some improvements and then sub-lease them to tenants. It is similar to the WeWork model. There are inherent risks to this model, particularly when the rental cycle is falling, which places the baseline rent commitments to the owners at risk. Many operators have been treating the multifamily sector like it's an internet business and trying to add market share as quickly as possible in the hope of market dominance and future profitability. Many of these same groups pay above market rents to landlords in order to build market share, in some cases paying higher rents than they may achieve when letting to residents.

However, this is not an internet business. Every time you add apartments, you need to make capital expenditure, and while the cost per unit may be low, it adds up quickly across a portfolio. It's not like an online platform where you pour in money initially and then have a business which is very scalable. In the past couple of years, especially when WeWork's problems hit the headlines, the master lease model has begun to be questioned and, subsequently, we've seen residential rental companies get into trouble and go bankrupt.

As a result, concerns have grown about China's multifamily sector. The problem, however, is that a particular model was misused, and it got out of hand. There's actually no problem with multifamily residential in China, but it is critical to have the right operating model. The market fundamentals and government policies are very supportive of the multifamily residential business.

Q What are the fundamentals underpinning the market?

There are some key drivers. First, the population of China's first-tier cities – Shanghai, Beijing, Guangzhou and Shenzhen – are massive. So too are the populations of the larger second-tier cities. For example, Shanghai's population is nearly 25 million, and for Hangzhou it is more than 10 million.

Second, these large first- and second-tier cities have big economies, so they attract millions of migrant workers from all over China. Some estimates put the migrant population of Shenzhen at eight million. Apartments in these cities are very expensive to buy, however, and are certainly outside the reach of many young professionals.

Third, we're seeing a change in the way Chinese people view renting a home. Traditionally, home ownership is very important to Chinese people, but a growing number would rather rent and free up cash for other purposes, such as education, especially if they can rent a modern well-managed property.

We estimate there are 200 million people renting apartments in China,

Q How will the multifamily market in China continue to evolve?

There are basically three components in the ongoing institutionalization of this market.

First, we're seeing the government introducing macroeconomic policies, including in finance, law, tax and land supply, which are supporting the whole sector. So, the central government is trying to make sure the industry will grow in the right way and encouraging corporations to take part in this industry in the right way.

Second, there's growing interest from a diversified group of foreign capital coming into this space. We've done a rough calculation and estimate that approximately $5 billion has been invested in the sector. This is small compared with the amount of institutional capital invested in the logistics sector, for example, but there's been interest from big players such as Blackstone Group and GIC. More investment from groups like these encourages more professionalism and greater supply of quality multifamily assets.

Finally, we're seeing consolidation in the wider rental residential market. I expect that over the next few years, we'll see more operators exit the sector as the industry continues to professionalize. We are starting to see that they are less aggressive now in taking on new master lease projects and being more cautious over terms. In the past, operators were willing to pay a fixed rent to landlords, with escalation once every two or three years as well. Now, these operators would rather strike a revenue-sharing deal with landlords. In short, they have adopted a better attitude toward risk.

I predict that the outcome of this institutionalization process will be that in three to five years' time, there will be an active market for trading China's multifamily assets. And I believe in two years' time, there will be a number of major operators becoming increasingly active in this space. Today, Funlive is one of the pioneers trying to create this asset class, but in three to five years' time, as understanding grows that the sector's fundamentals are attractive, that solid returns are available, then more and more investors will be willing to dive into multifamily.

but only one or two percent are renting from professional managers in the type of modern multifamily projects that Funlive manages.

This is because they don't have a choice; I believe most people would rather rent from a professional manager that looks after the whole building and can offer value-added services – such as organizing social activities – rather than the owner of a single apartment, which will not contribute to the upkeep of the building nor be able to offer any extra services. The main constraint on the professionally owned and managed multifamily residential sector today is lack of supply, with only three or four million units across the whole country by our estimate.

We're operating in 15 cities with a focus on the first-tier cities, including Shanghai, Beijing, Shenzhen, Guangzhou and Hangzhou. Favorable land pricing can still be secured in Shanghai, Beijing and Hangzhou, delivering strong returns for our investors. Large second-tier cities we're looking at include Nanjing, Chengdu, Tianjin and Wuhan. However, external investors currently prefer projects in first-tier cities, so in these new cities outside of our investment venture's scope with investors, we will proceed with capital from our sponsor, China SCE. Nevertheless, there will be potential in a broader range of cities across China as the market matures.

Q Are there alternatives to the master lease model?

Funlive operates an asset-heavy model. With capital from China SCE and institutional investors, we acquire land to develop multifamily apartment blocks and purchase purpose-built assets. We're now managing roughly 25,000 rooms across 50 projects with a total value of more than 10 billion yuan ($1.5 billion; €1.2 billion). We have joint ventures with Gaw Capital Partners and with Proprium and with a leading Middle East sovereign fund.

> *"The main constraint on the professionally owned and managed multifamily residential sector today is lack of supply"*

> *"Market fundamentals and government policies are very supportive of the multifamily residential business"*

These are long-term investments with long-term capital which wants to own the real estate. This model works very successfully for multifamily residential in North America and elsewhere. It's proven to be very resilient to market upheaval in the past; multifamily residential performed well in the global financial crisis and also throughout the covid-19 pandemic.

Q Is the Chinese government supportive of multifamily residential?

The Chinese government is supportive of the development of a professional multifamily sector because it recognizes the significant demand to provide good quality accommodation to people who cannot afford to buy.

At the end of 2020, the government held its annual Central Economic Work Conference in Beijing, which outlined eight key priorities for the coming year, one of which is solving the housing problem in big cities and reiterating that housing was for living, not speculation. There will be different policies to support the industry, including on the finance side as well as expected tax breaks, to ensure that institutions support this fast-emerging asset class.

There are also moves to increase land supply for the multifamily sector. Different cities across China will have targets for the amount of multifamily residential and the land they need to zone for this purpose. So, we're seeing parcels of commercial land, which might once have been identified only for hotel developments, for example, now being made available for multifamily residential at a much lower price than if the apartments were being developed for sale.

Making land available at lower prices than for-sale residential land supports long-term ownership by professional investors and managers, by delivering an acceptable yield on their investment. ■