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Commercial Real Estate Development in China – Framework and Case Studies

Tobias Just & Xin Lu
(Eds.)

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Introductory remarks on developing commercial real estate in China

It is easy to be impressed by China's size and even more by its growth story over the last forty years. In 1980, GDP per capita in China stood at 300 USD (in current USD). Today, this value is 25 times higher. And if we control for purchasing power, the momentum has been even greater.

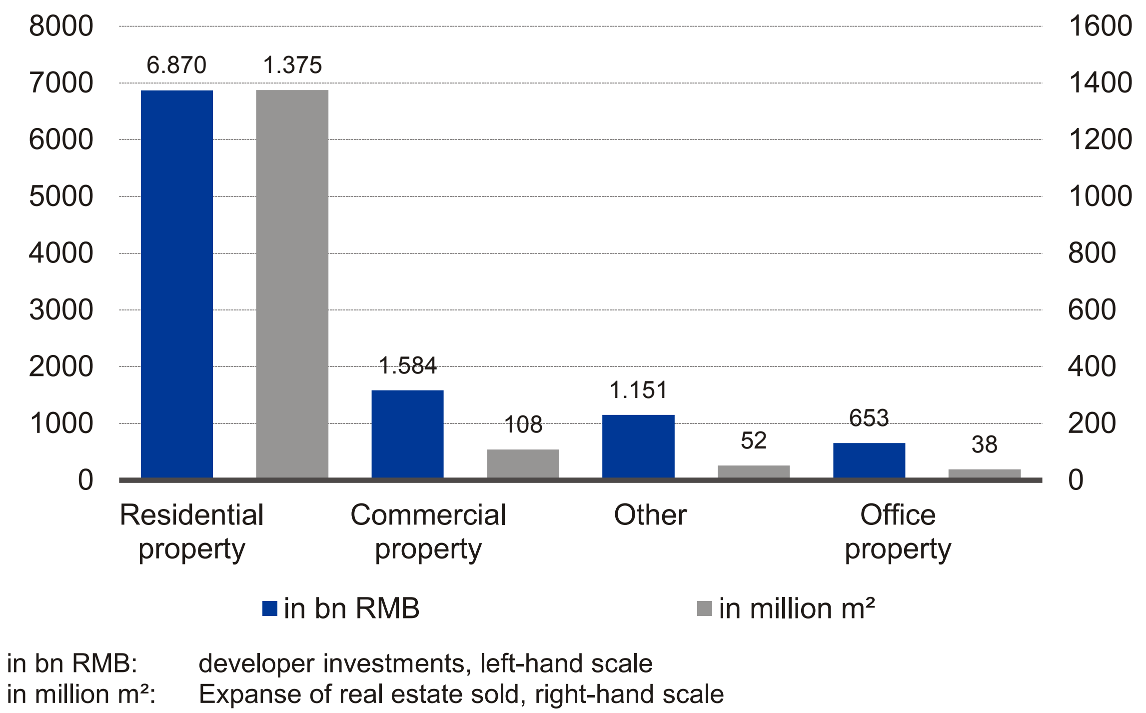
At the same time, the number of inhabitants of China has risen by 500 million, to almost 1.4 billion people today – despite the one-child policy intended to mute population growth in the 1970s. This rising population is living increasingly in cities. Almost 800 million Chinese live in cities, and the number of big cities has been increasing rapidly. According to the latest data published by the UN population division, there are 109 cities in China with more than 1 million inhabitants, totaling an urban population in these larger agglomerations at almost 350 million people. In 1980, there were not more than 18 cities with more than one million inhabitants.

This has resulted in enormous metropolises. According to the UN Population database, there are more than 18 million people living in Beijing, more than 23 million in Shanghai and 12 million in the agglomeration areas of Chongqing or Guangzhou. And even though these cities have more than tripled their number of inhabitants since 1980 – in fact, the number in Guangzhou is now six times higher than 35 years ago – these impressive numbers are dwarfed by the growth momentum of cities that were small at the beginning of the growth story. In more than 100 Chinese cities, the number of inhabitants grew by more than 900% within just 35 years. In Dongguan today, the population has increased by more than 5000% since 1980, and in Shenzhen, of course an extreme outlier, the number has risen by a factor of 190 compared to 1980. A village was transformed into a megacity within just one generation.

Obviously, real estate and the building sector have been a key driver of the Chinese growth story, and even though the growth momentum seems to be tapering off from a very high level, there is still significant room for new developments and improvements. This includes a growing need to refurbish and upgrade existing stock that was built rapidly in earlier decades and is not suitable for the needs and preferences of a wealthier and more urban population.

These urbanization efforts required millions of new residential units. Residential construction has been playing the most prominent role in the last four decades within the China real estate growth story. However, the skylines of Shanghai and Shenzhen are not only shaped by residential buildings, non-residential skyscrapers have also changed the cities' appearance. Similarly, commercial real estate was transformed from mom-and-pop-shops dominating retailing into modern shopping centers that are often bigger than European centers. Figure 1 illustrates the still enormous activity that is taking plece in China's development and investment markets.

Fig. 1 Expanse of real estate in China in 2016



Sources: National Bureau of Statistics in China, Statista

It is impossible to ignore the development in China, as the growth story has many implications for European real estate players; they can benefit as investors, as designers, as technical, legal or financial advisors and of course, it is likely, that Chinese real estate markets will need more asset managers, property managers, portfolio managers and risk managers than today. In that sense, Chinese real estate markets are professionalizing rapidly. Nonethleless, China is not an easy market. Market dynamics and fundamentals are similar to everywhere else in the world, but the framework and mindset remain different and likely to stay so, even though the maturing markets will lead to comparable investment, building and financing standards. This process, however, is not likely to follow a linear path. Therefore, while it is important to be interested in the developments in China, it is equally important to remain prudent and cautious. What is more, China is not only a destination for international capital and know-how, it is turning increasingly into a complex mutual exchange: capital is moving out of China into international real estate projects and Chinese know-how is also moving out. Therefore, even those who are not interested in entering the Chinese real estate market, should have a general understanding of this economic giant.

With this brief reader, we want to raise attention to the various issues and offer a first foothold, by sketching four different aspects of developing commercial real estate in China. First, the article by Boram Yi, Jason Q. Zhang and Qinna Shen provides a brief introduction to Chinese business culture. It is important to note, however, that a new type of international business culture has also emerged, as an increasing number of Chinese managers have been receiving professional training in the US or Europe. Second, the two articles by Xin Lu and Ye Ting detail with a case-orientation, how retail and office developments are conducted in China. While Xin Lu's article deduces current developments for shopping center developments from retail trends and the regulatory framework, Ye Ting's article illustrates a specific case study of a green and modern office building. Third, Philipp Senff's paper focuses on the important aspect of compliance, which is rapidly gaining importance in China. Finally, Chenhui Xia and Tobias Just show it has become equally important to analyze the Chinese capital outflows and inflows. The second largest economy in the planet will increasingly need to diversify its portfolios. There might be cycles in regulatory frameworks, but it is highly likely that European real estate professionals will in the future see more Chinese investors and capital in their own home markets. Thus, one should start learning about these new players as soon as possible, and keep on learning.

Tobias Just and Xin Lu
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Chinese Culture and Its Impact on Today's Consumers and Markets

Boram Yi, Jason Q. Zhang and Qinna Shen

Abstract°° The dynamic Chinese market is attractive to many foreign businesses. In order to successfully interact with the local businesses and consumers, foreign executives need to understand Chinese culture and its impacts on today's Chinese consumers, markets, and business practices. In this chapter, the readers will learn about the roots of Chinese culture and its implications. The chapter highlights a few influential concepts, e.g., *gunaxi* and *feng shui*, and explains their significance in building a successful business venture in China.

Key words: Chinese culture, Chinese market, *feng shui*, *guanxi*

1 Introduction

Since the 1980s, the world has witnessed the meteoric economic growth of China. Today, the size of the Chinese economy is second only to that of the United States. The importance of the Chinese market was spotlighted during the recent global financial crisis. As one example, with prolonged economic contraction, the size of Russia's economy (measured by its 2015 GDP) is about the same to that of Guangdong Province, one southern province in China (the World Bank, 2015; the National Bureau of Statistics of China, 2015). As a response to the sheer size of Chinese economy, foreign businesses increasingly view China as a strategic market. Popular media and business magazines in the United States rushed to assist this trend, publishing numerous articles with eye-catching headlines such as "Doing Business in China: Five Tips for Success" (CNN, 2011), "The Ten Principles for Doing Business in China," (Forbes, 2012) and "10 Subtle Cultural Mistakes You May Make Doing Business in China" (Bloomberg News, 2014). Such publications commonly touch on distinctive characteristics of Chinese culture and business practices, which are often at odds with established practices in the West.

While recurring topics in the popular press touch on the collectivistic and hierarchical nature of Chinese culture and society, they often leave a more fundamental question unanswered: What are the historical, cultural, and social foundations that underlie these phenomena and practices? A clear understanding of their conceptual roots can provide useful insights for and guides to foreign executives and investors and enable them to interact with their Chinese counterparts in an effective manner. This chapter offers an overview of Chinese history, culture, and society, highlighting major differences as well as similarities between China and the West. The aim is to explain how the Chinese ideals of life impact today's customers and markets and how these ideals evolve and adapt to those of the West in a globalized world.

2 History, Society, and Culture that formed Chinese Worldviews

Chinese civilization is one of the oldest living civilizations in the world. Over several millennia, the Chinese have developed prevailing worldviews that shape their cultural values and societal norms. Understanding these views and the ways in which they affect the Chinese understanding of an ideal life—a key motivation for consumer behavior and business practice alike—are a crucial first step for foreign executives and investors seeking to effectively interact with the Chinese. Here we discuss the Chinese vision of an ideal life, that is, harmonious living as it is manifested in three essential human relations—with nature, with gods and with other people—that are influenced by China's two indigenous philosophies, Daoism (or Taoism) and Confucianism.

2.1 Humans and Nature

The Chinese have long believed that living in harmony with nature is one of the three pillars constituting an ideal human life. Influenced by Daoism, ancient Chinese thought that nature runs its own course and should be left alone without much human interference. Daoism informs that humans are a crucial component of the natural world, but not its masters, thus need to follow the flow of nature's rhythms —forming a sharp contrast to the Judeo-Christian belief that humans are the masters of nature. Daoism also teaches that by aligning themselves with nature (i.e., being part of the nature as opposed to being an outsider/master to it), humans can achieve the optimum level of their moral and physical strength. This idea exerts a lasting impact on Chinese aesthetics, shown in art and practiced through *feng shui,* a way to locate, design, and construct an ideal human dwelling according to the flow of nature.

2.1.1 Nature in Chinese Art and Aesthetics

Chinese art, particularly painting and garden design, well illustrates the ideal relationship between humans and nature in Chinese thought. When a Chinese artist portrays a human subject, this subject's individuality is often obscured. The artist often places the individual within a natural setting or in a particular social group. Renowned anthropologist Francis L. K. Hsu notes that a Chinese artist either treats a man as a minute dot in a vast landscape, or dramatizes his external situation in which a viewer can discern the status, rank, prestige, and other social characteristics of the subject (Hsu, 1981). To live harmoniously with nature, thus, means that humans should recognize their place in the natural world and in society, respect the flow of nature and society, and follow it.

The idealized relationship between humans and nature is also expressed in Chinese garden design which aims to "recreate the image of nature while accommodating the sophisticated needs of retreat or habitation" (Tsu, 1987). As a result, curves and studied irregularities—those mimicking nature— characterize Chinese gardens, such as the famous Suzhou Gardens. Landscapers avoid stiff orderliness and geometrical rigidity of a typical French garden style, epitomized in the Gardens of Versailles. Broad central walkways, straight paths, and symmetrical lawns, commonly found in French and Italian gardens, are exotic to China. Structures such as pavilions are deliberately constructed as sheltered parts of the garden, rather than discrete buildings, and thus form an indispensable part of the landscape. This design philosophy reinforces the idea that humans are an important part of the natural world. When seeking an exotic experience, the Chinese could adopt a foreign design, but would still prefer to keep that design separate from the rest as illustrated in the two most famed imperial gardens in Beijing first built in the mid-1700s: *Yihe Yuan* (The Summer Palace Gardens) follows the traditional Chinese style whereas *Yuanming Yuan* (The Perfect Brightness Gardens) follows the Western style.

2.1.2 Nature's Force: *Feng Shui* and Its Impact on the Real Estate Market

The Chinese pursuit of living harmoniously with nature is pronounced in their adherence to *feng shui* principles. Originated in China more than three thousand years ago, *feng shui* exerts an extraordinary influence on architectural designs both inside and outside man-made structures. Literally meaning "wind and water," *feng shui*'s basic principles are to avoid strong winds and to hold water in order to accumulate *qi* (or *chi*), the vital energy that is believed to support all life. The Chinese believe that the residents of the property with positive *qi* would enjoy health and wealth as well as increase their wellness of being and avoid misfortunes. A good *feng shui* site is located in the lee of a mountain or surrounded by hills that provide good protection against winds. It also has ready access to fresh, clean water and is protected from flooding. For maximum heat and light, the front of a building should receive ample sunlight, which means that in the northern hemisphere, where China is located, a home's main rooms should face south or south-east. By linking the placement of objects to human lives, *feng shui* teaches that people are affected by their surroundings and by the layout and orientation of man-made structures. In essence, it maintains that a place is capable of influencing the quality of human life. Thus, finding a way to live in harmony with one's immediate physical surroundings, nature, and the universe is the major pursuit of *feng shui.*

The principles of *feng shui* apply not only to the location and orientation of a dwelling, but also to the arrangement of its interior because the flow of *qi* within a structure is believed to affect its residents. For instance, a direct path from the front door to the back door is avoided because it would allow wind going through these doors to take away *qi*. For the same reason, the Chinese do not like houses that are located at a T-junction because they are more likely to be buffeted by gusts of wind. On the other hand, *feng shui* also offers remedies for structures that are poorly designed. Often a shoji screen is added inside a gate or the door of a house to block the wind and thus to ensure a better hold of *qi*.

The belief that a location affects residents' health and wealth makes *feng shui* a prominent concern in the Chinese residential real estate market. Among the wide range of factors that affect the buying decisions, including physical and environmental concerns, the spiritual significance of a site or the luck a particular location might bring to its residents is considerably important. A study shows that properties judged to have negative *qi* often cost between 30 to 50 percent less than comparable homes with better *feng shui* (Sun, 2006; Wu et al., 2012). A case study of property development in fifteen villages in Hong Kong found that the most significant determinant of the cost of housing is *feng shui* (Tam et al., 1999). Real estate developers in Hong Kong consult *feng shui* masters before they start construction (Stapleton, 2016). A British investigative report revealed that the Hong Kong government had been paying substantial amount of compensations to people living around public construction projects for disturbing their *feng shui* (Moore, 2010). Although some may dismiss *feng shui* as a superstition, recent academic attentions given to the topic recognize its relevancy in the minds of Chinese consumers. In 2012, a prestigious U.S. academic journal, *Psychology & Marketing*, devoted an entire issue to the study of consumer psychology involving *feng shui* and its effects on buying decisions.

Another aspect of *feng shui*, numerology, also helps explain why some properties are valued higher than others with similar specifications. Certain numbers may cue prosperity and thus be favored; others may be the opposite. For instance, number "eight" is well liked because it is pronounced similarly to the Chinese word for fortune, whereas "four" is avoided because it sounds like the word for death. Westerners have similar associations with the numbers seven and thirteen. It was not a coincidence that the Chinese government scheduled the opening ceremony of the 2008 Beijing Summer Olympic Games at eight p.m. on the eighth day of August, the eighth month of 2008, making it a very auspicious occasion. An apartment on the eighth floor or a home that contains eight in the address usually commands higher price. Foreigners considering operating a real estate business in China should take note of *feng shui*. Their awareness of this custom demonstrates their respect for Chinese traditions and sincere interest in doing business in the country, thus making them more attractive business partners as well as reducing the chances of conflict with local population.

In the United States, residential real estate developers in areas with a high concentration of Asian-Americans have adopted some *feng shui* principles, too. For example, they avoid placing the main staircase opposite the front door, as it takes away *qi* (Bryan, 2014). In 2014, a condominium in Washington, D.C., was built in accordance with *feng shui* principles. Well-known American companies like Whole Foods Market, McDonald's, and Disneyland use *feng shui* to help identify optimal building locations and designs, as reported in the *Washington Post* (Chodorov, 2014). Some Asian-American residents in Canada took action to protect the value of their real estate by maintaining good *feng shui*. In 2011, a plan to build a hospice near a luxury condominium in Vancouver was opposed by the condo owners, who were mostly of Chinese heritage. They cited *feng shui* as the reason for their opposition and called the building plan "culturally insensitive" (CBC News, 2011). According to *feng shui*, a place of grief, sadness, sorrow and death generates negative energy that negatively affects the well-being of nearby residents. Thus Chinese avoid living close to funeral homes, cemeteries, hospitals, and hospices. In 2013, Asian-American residents in Atlanta, Georgia, used the same argument when protesting a zoning decision that permitted the construction of a funeral home next to their subdivision (Hurd, 2013). Thus, failure to pay close attention to Chinese ideals could cost investors dearly for their efforts to reach Chinese consumers either in China or beyond its borders.

2.2 Humans and Gods

Just as they seek to live harmoniously with nature, the Chinese seek to do the same with the supernatural world. The Chinese tradition in its pragmatic and secular outlook has long embraced polytheism. To ensure that they maintain harmonious relations with multiple gods, the Chinese would provide material offerings and spiritual reverence to several gods. It is not surprising to find the deities of Confucianism, Daoism, and Buddhism share the same temple. In fact, this is so common that the Chinese language has a term to describe this unique phenomenon: "the Union of Three Religions." A Confucian scholar, for example, would not object to his wife or children making offerings to the Buddha. The Chinese see no contradiction in living with diverse religious traditions and supernatural beings (Koller, 2012).

With the absence of an absolute god and relatively little attention given to the afterlife, the Chinese turn their focus to secular human relationships in their search for the meaning in life.

This explains why Confucianism, among all competing schools of thought, has prevailed in China. It is a system of ethics based not on abstract, supernatural, or absolute doctrines, but on the everyday duties and obligations between individuals that aims to preserve an orderly, harmonious way of living. The Chinese stress strong bonds with family and community which is maintained with the utmost sincerity and almost religious devotion. This strong tie is continued to be honored even after an individual's death in the form of ancestor worship. Traditional Chinese homes usually have a separate room, or a shrine, to commemorate and worship the family's ancestors. In the center of a village is often a shrine or temple that celebrates the ancestry of that village.

2.3 Humans with other Humans

2.3.1 Interpersonal Relationship in Chinese History, Society, and Culture

The last of the three pillars of fundamental human relations is an interpersonal relationship. Confucianism, the foundation of Chinese culture and society, teaches that an ideal life can be attained in an interpersonal relationship when each individual occupies his/her proper place and fulfills the obligations inherent in the five cardinal relationships. These are the relationships between ruler and subject, father and son, husband and wife, between brothers, and between friends. Confucianism emphasizes, in this essentially hierarchical structure, that all individual exist in relationship to one another. This notion works to strengthen an individual's ties to his/her primary group.

Because of such a strong emphasis on primary group cohesion, anthropologists describe the Chinese as "situation-centered" (Hsu, 1981). Similarly, scholars of cross-cultural studies categorize Chinese culture as collectivistic as opposed to individualistic. As such, social status and identity are determined largely by one's relationships, which in turn, determine his/her power and influence as well as his/her feelings of self-esteem and sense of security (Hofstede, 2003; Feldman, 2013). According to an influential researcher Geert Hofstede (2003), Chinese culture is "highly" collectivistic.

The contrast between the Chinese collectivistic view and the American individualistic view was exemplified in a series of highly publicized acquisition attempts made by a Chinese firm to purchase American properties. In spring 2016, the Anbang Group, a Chinese insurance company, which previously acquired the historic Waldorf-Astoria hotel in Manhattan, bid $14 billion to purchase Starwood Hotels & Resorts, one of the largest hotel chains in the world and the owner of St. Regis, Westin, and Sheraton brands. During the process of acquisition negotiation, Western media pointed out the Chinese company's rather unconventional approach to negotiations. They described how Anbang's CEO followed "his own style" and often surprised Starwood negotiation team. For instance, the CEO would call for last minute meetings during peak vacation seasons and even on Easter Sunday (Sender, 2016). Frustrated Starwood executives had to rearrange their vacation and holiday plans. As another example, during business negotiations, when the Anbang CEO was present, his top legal, banking, and negotiation advisors, mostly trained in the U.S., stayed completely silent without offering opinions. This "unusual" approach might be a shock for American executives, but it is fairly common for the Chinese who learned to submit their personal goals to collective/organizational goals and to respect the authority particularly in public (Karmin, et al., 2016).

2.3.2 Centrality of Interpersonal Relationship: *Guanxi* and Its Impact on Business Practices

The primacy of interpersonal relationship over others is a key to understanding the concept of *guanxi,* which literally means a relationship, connection or network, and is variously rendered in English as "Chinese relationships and networks," "interpersonal networking" or the "art of relationship." To the Chinese, *guanxi* is not only the art of networking but a way of life ingrained in their society and culture for several millennia by their belief in the importance of harmonious human relationships. It is a proper moral code: the Confucian emphasis on ethical living through harmonious relations created the elaborate unwritten rules governing the reciprocal exchanges of gifts and favors that unite and expand interpersonal ties. But *guanxi* is also a practical mechanism of self-preservation: the predominantly agricultural Chinese have long relied on *guanxi* to weather the unpredictable forces of nature as well as sudden changes in political power. It is expected that extended family members will assist each other in times of need. An American anthropological economist goes so far as to describe *guanxi* as the "payment of a premium for residential fire insurance" (Bell, 2000). *Guanxi* is so pervasive in Chinese culture and society that the proper practice of its implicit rules is critical for business success in China.

Guanxi enables people to accomplish a common interest through the exchange of favors between trusted individuals. Thus, two key components of the system of *guanxi* are the principle of reciprocity and mutual trust. The principle of reciprocity is a cultural force, "a sort of cultural invisible hand that makes possible group effectiveness and identity over time" (Feldman, 2013). This deeply imbedded cultural element explains why *guanxi* is much more complex than the Western concept of networking, and it also explains why foreign executives who approach *guanxi* solely from a business perspective quickly hit an impasse. For most Chinese, building a close friendship is a prerequisite for discussing business. A potential partner needs to prove himself/herself trustworthy and truthful and to demonstrate that he is willing to take time and effort to gain the trust of others before embarking on a business venture. Shared meals, drinks, and exchanges of gifts are meant to build that trust. In this ritual, a gift is not exchanged to procure a particular favor. Rather, it is a way of developing positive feelings to initiate a relationship (Feldman, 2013). The Chinese often take things slowly and carefully, especially in forming *guanxi*. Thus, in building the typical sales funnel (i.e., closing a business deal from prospecting to making the sale), foreign executives should consider a longer than usual lead time.

Professor Roy Chua of Singapore Management University further clarifies *guanxi* by contrasting the building of trust "from head and heart" (Chua et al., 2009). Trust from the head emanates from the confidence one has in a person's accomplishments, skills, and reliability. However, trust from the heart, or affective trust, arises from feelings of emotional closeness, empathy, and rapport. Most friendships and personal relationships are based on the second type of trust. In general, Western executives draw a fairly clear line between trust from the head (i.e., trust based on competence) and trust from the heart (i.e., trust based on affect) in business relationships. For example, a study by Chua finds that American executives are nearly twice as likely as their Chinese counterparts to separate these two types of trust. They consider mixing the two as an unprofessional behavior that creates the risk of conflict of interest. Among Chinese executives, however, there is a much stronger interplay between trust from the head and trust from the heart; they are quite likely to develop personal ties and affective bonds when there is also a business or financial tie (Chua, 2012). Blurring the boundary between one's personal and professional life often surprises Westerners. During a business banquet, a Chinese manager may ask personal questions about his/her counterpart (e.g., age) as a gesture of courtesy (e.g., an old age is usually associated with elevated social status and position, thus being an important piece of information for the Chinese to properly address them and arrange seating at the table accordingly), which would be considered intrusive in the West.

It needs to be noted that in today's rapidly changing China, a growing number of Chinese companies start to subscribe to Western business norms. As a result, some high profile firms start drawing a clear line between personal and professional relationships and viewing gift-giving as ethically questionable practices, effectively adopting the "trust from the head" approach. As one example, the founder of China Vanke Company, the largest real estate developer in the country, is famously known for his motto, "no bribery of any kind" (Larmer, 2008). Firms like Vanke look more carefully at a potential partner's competence to add value to their business and pay increasingly less attention to building personal/emotional ties with them. In these cases *guanxi* comes to resemble conventional business networking as practiced in the West. The story is told of a Chinese company that rejected an offer from a Western firm that devoted too much energy to providing lavish banquets and gifts, but not enough to demonstrate their competence to its prospective business partners (Chua, 2012).

This observed shift in business culture, however, does not necessarily mean that the Chinese have abandoned the practice of trusting someone from the heart. For instance, the establishment of a business relationship continues to be understood as the start of a personal relationship. Thus, it remains customary to include dinners into business itineraries as an expression to celebrate the start of a new relationship, even when lavish banquets are no longer offered. For another example, it is not uncommon that affective ties often triumph over competence when the two conflict with each other in business decisions (Chua, 2012). Thus, in the Chinese market, although business norms and standards may quickly adapt to those of the global market, human behaviors, including those of business executives, are still anchored deeply in China's cultural roots.

As an interesting note, Chinese thoughts and business practices in *guanxi* find their way into mainstream Western business philosophy. Relationship marketing, a notion and philosophy introduced into business literature in the late 1980s and early 1990s, stresses long-term, relationship-based, and often emotional connections between firms/brands and their customers. In fact, relationship marketing or customer relationship management (CRM) has become one of the most important concepts in recent development of marketing theory and practice. Numerous academic researchers and practitioners examine the relationship between relationship marketing and firm's performance (Samaha et al., 2014). The Chinese may think Westerners are finally appreciating what they have practiced for a very long time.

A good understanding of *guanxi* and the centrality of interpersonal relations is a key to success in China, be it in business, politics, or any other area that requires personal interactions. Although *guanxi* as it is practiced in China is evolving, its deep roots in harmony, reciprocity, and orderly hierarchy continue to be manifested in today's consumer and business behaviors and decisions. Instead of being a barrier to business, when practiced appropriately such as in relationship marketing, *guanxi* may be mutually beneficial to both buyers and sellers. After all, contractual bonds can be legally broken if needed, but emotional and social bonds, once formed, are much harder to break.

3 Conclusions

Throughout their long history, the Chinese have preserved the ideal of living in harmony with their surroundings. They believe in living harmoniously with nature because humans' physical and material conditions are assumed to be susceptible to the flow of nature, as evident in their adherence to the principles of *feng shui*. Belief in living in harmony with the supernatural world led them to comfortably coexist with multiple faith traditions. While the Chinese have been less concerned with seeking an absolute truth in the supernatural world, they have paid more attention to building an ideal, harmonious society in this world, as prescribed by Confucianism. They believe that when individuals identify with their primary groups and fulfill the roles expected of them, a harmonious and orderly society can be achieved. Within the group, cooperation in a wide range of areas, personal and professional, is the norm.

Thus, to build a trustworthy business relationship, in addition to demonstrating competence, business executives and managers are usually expected to be willing to build personal connections with their trading partners. The focus, often times, is more on a long term relationship and its benefits and less on a particular transaction and the resulting one-time gain or loss. Within this context, Chinese entrepreneurs tend to find comfort in the presence of personal trust (a form of social or psychological contracts) whereas their Western counterparts likely to seek security in legal contracts. This process of cultivating personal relationships is broadly called *guanxi.* Once a Chinese partner takes someone in as a friend, the relationship tends to endure. Time to develop *guanxi* is, therefore, a critical investment.

An understanding of the roots of Chinese customs and practices will provide an advantage for foreigners seeking to do business with the Chinese. This understanding, however, must be accompanied by an awareness that dynamic changes are occurring in today's China. Throughout the first two decades since it actively sought to return to the global market in 1979, Chinese business communities and consumers had been eager to adopt many Western systems (e.g., social and business values, norms and standards). As a result, many of today's Chinese business people and consumers have become familiar with wide range of changes (or "reforms" as the Chinese call them) occurred during this period. In fact, today's younger generations of business executives, if trained in Chinese educational institutions, have actually received business education based on the curriculum developed in American/Western institutions. In 2001, when China eventually joined the World Trade Organization, the country celebrated it as a seal of proof for their effort.

For this reason, Westerners may find Chinese culture and its consequences in people's behaviors less distinctive. However, as China's economy has become increasingly successful in recent years, the Chinese began to take more pride in their own cultural and social identities. As a result, many Chinese are re-discovering their cultural roots and preferences. Today, Chinese consumers tend to favor products/services considering local tastes. Multinational firms such as Unilever and BMW all introduce unique products/brands that serve only the Chinese customers. Like any other, Chinese culture and society is live and thus ever changing. Any stationary view on them is less than ideal. At the same time, as shown in the chapter, the roots of culture, or the fundamental worldviews, hold lasting power to inform and to predict the changes in society.

4 Key Takeaways

1) The Chinese vision for an ideal life is anchored in the three pillars of human relationships—living in harmony with nature, gods, and other people. This ideal continues to provide a critical guidance to the Chinese consumer and business behaviors and decisions.

2) Competence matters in a business relationship, but willingness to build personal connections can be equally or more important.

3) Time to build guanxi is a critical investment. The Chinese focus more on long- term reciprocal interests and less on short-term transnational interests.

4) Feng shui is relevant. It is a significant consideration in the real estate market. Simply dismiss it as a superstition may cost relationship and investment.

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China office building development: a case study

Ye Ting

Abstract°° China is the world's second largest economy, and this is reflected directly in a strongly rising demand for office space by Chinese public administrations, as well as both domestic and foreign tenants. As a consequence, investors, real estate developers and financial institutions are paying more attention to the potential of office buildings in Chinese conurbations. In this paper, we present a case study of the development of an office building in Shanghai. Shanghai is China's economic powerhouse, its financial center, trade center and shipping center. Developments in Shanghai therefore provide insight into potential future developments in other Chinese cities. This chapter looks at the Hongqiao Vanke Center in Shanghai, and considers the development process as well as the key success factors for developing office buildings in China.

1 Development Process of Office Buildings in China

1.1 Brief Overview of China's Real Estate Market

Real estate in China can be divided into commercial and residential properties, as in other economies. However, what differs are the different business models that investors and developers typically adopt in residential and commercial property markets in China:

- Residential real estate: Developed primarily for direct sales in order to achieve maximum short-term profits through a rapid turnover of invested equity.
- Commercial real estate: Developed primarily for longer holding periods. The key difference is that the operation of the property is a key element of the development and investment plan. The project management capacity reflects this different value chain accordingly.

1.2 The Development Process of Office Buildings

This process consists of six phases: site selection and acquisition, market research and positioning, confirmation of the project design proposal, project development and construction, investment and operations, and disposal of assets.

For residential developments, the first three phases as well as the sales process are of the utmost importance in China, whereas for commercial developments, the emphasis is more on the middle three phases. Of course, for both asset classes, all six phases are relevant, but developers place a somewhat different emphasis on the respective phases.

- Land selection and acquisition: Prior to the development of commercial real estate, it is necessary to obtain the land-use right from public administrations and organizations, or from previous owners. In China, the land-use right for commercial property is valid for 40 years and for office property, 50 years.

- Market research and positioning: Market research is important both before and after acquiring the piece of land. Before the acquisition the developer needs to know whether he can afford the land price. After the acquisition, a detailed analysis of demand and completion are crucial. As Chinese developers move so rapidly, it is very often necessary to adjust analyses constantly to new developments.

- Project design and engineering: Typically, the development cycle of commercial real estate is longer than that of residential real estate. By and large, it takes 12 to 18 months to develop residential units in China, while developing commercial real estate takes at least three years.

- Project investment and operations: Depending on the early positioning and design proposal of the project, the following two steps are important: for retail properties, attracting capital is fundamental, for office buildings, early lease contracts are most important before or shortly after completion of the project. As commercial properties are typically not directly sold, an asset management team needs to handle the operations after commencing the project.

- Disposal of project assets: For commercial properties, a disposal of assets is usually only initiated after a certain period of effectively operating the project.

Considering the comparatively long-term nature of commercial real estate developments, as well as the dynamics of the Chinese real estate markets, it is important that developers reconsider their strategies and next steps in every single phase of this process. This comprises an analysis of the national and international economic environment, as well as changes in user preferences and requirements.

2 Success Factors for developing Office Buildings in China

These factors can be grouped into three categories:

- Company and team-related factors

- Factors related to the macro environment

- Factors related to the competitiveness of the building itself

2.1 Company and team-related factors

Success prerequisites: The corporate DNA, financial strength and team spirit are the necessities for the success of the project, as they allow for quick and effective action and reaction to market movements.

- **Corporate DNA:** In order to facilitate rapid movements in dynamic markets, what matter is whether a team follows overarching guidelines, or a corporate philosophy, as employees can decide and manoeuver quickly and independently according to these general values. In China, the vast majority of commercial real estate developers want rapid project returns. For many office buildings, priority is given to a pre-sale. For pre-sold office buildings, the overall project quality cannot be ensured. As a result, the DNA of the developers helps to foster a specific project quality. For example, Vanke Group, as a typical real estate developer in China, always develops projects based on the early holding as a whole, and maintains long-term investment with partners rather than pursuing for short-term interest maximization of a single project.

- **Financial strength**: As mentioned above, commercial properties are frequently considered a medium to long-term investment, including a significant holding period. This entails the risk of vacant spaces at the time of opening. Therefore, sound financing, in this case, a strong equity base, is essential for reducing this risk. In China, many projects soon face financial distress, due to a weak equity base if the asset management team cannot ensure a timely pre-letting of the property.

- **Mature team:** The stability of the personnel framework and team flexibility are crucial factors for the success of a project. A mature development team can comprise people with expertise in investment, financial planning, design, engineering, asset management or with a good network for attracting capital.

2.2 Macro environment

Analysing the macro environment consists of two aspects: an analysis of macro economic aspects and of the regional and infrastructural aspects regarding the building. Within the overall positive growth environment of the Chinese economy, the latter are more important for the developer, so as to find a suitable lot of land and investment strategy. This comprises exploring a city's long-term strategy and its planning status, as well as the traffic infrastructure, population trends and sectoral developments.

- City orientation and planning: Office buildings are designed primarily for corporate tenants, and their office space demand is typically driven by the city's economic development. Shanghai, for example, as the economic and financial center of China, reached a nominal GDP of CNY 2.512 trillion (equivalent to USD 358.9 trillion),[1] with the service sector accounting for 67.8 percent of this value (Shanghai Statistical Yearbook 2016). This so-called third sector is increasingly determined by new technology sectors, business services and a finance-oriented service sector. In addition and according to the latest city planning of Shanghai,[2] the city is poised to focus more on its central and some newly emerging business districts, in order to attract more globally active players to the city.

- Traffic convenience: Shanghai is a megacity with more than 20 million inhabitants. Commuting takes a lot of time, so that an efficient traffic infrastructure is important,

[1] According to the Shanghai Statistical Yearbook (2016), the exchange rate between CNY and USD is 7:1.

[2] Further information on this subject can be obtained from the "Outline of the Shanghai Master Plan 2015-2040".

and a good location within the tightly knit public (railroad, subway and urban bus system) and private traffic network is crucial for the success of an office building.

- Radiating population and industrial planning: Offices fulfill representative purposes for private and state-owned corporations. Accordingly, the exact planning of the location and quarter are essential for the future potential of a particular office address. In China, two different business and industrial areas can be identified, with regard to future office locations: the office-oriented business district and the industry-oriented high-tech development area. Either benefits from specific planning, tax and concession policies.

2.3 Characteristics of the building itself

In the last few years, successful office developments have needed a clear strategy with regard to project scale and its design typology, i.e. the specific design proposal, its engineering quality, functional design and environmental efficiency.

- Project scale: The optimal project scale not only depends on benchmark projects in the vicinity, but also on the catchment area for qualified employees and attractive tenants with a good reputation. All this feeds into building a brand for the respective property.

- Landmark building: In Shanghai there are more than 140 skyscrapers that are more than 150 meters high. In such a dense market, it is difficult to brand a building and to develop tenant brand loyalty to a specific building. Developers therefore try to establish unique selling points (USP) for their buildings like ecological efficiency documented by a green certificate, a striking project façade, sufficient parking spaces or other technical hardware elements.

In the next section we show how the Hongqiao Vanke Center was developed according to just these success factors.

3 Case Study of Hongqiao Vanke Center

3.1 Preliminary remarks on Vanke

Vanke is one of the biggest project developers in China and one of the largest 500 companies in the world. Vanke has also turned into a broad and well-diversified development holding.

Vanke Group is Shenzhen-based and was founded in 1984. Group turnover exceeded CNY 360 billion in 2016. Along with the enterprise development, the company has transformed from traditional residential developers into a comprehensive urban support service provider. This has gradually broadened the development portfolio towards commercial, logistics, educational and cultural real estate, as well as to pension real estate and other integrated services. Tab. 1 depicts the development of Vanke's sales volume, and Fig. 1 shows that Vanke's commercial building activity is concentrated in China's south-east. However, Fig. 1 also demonstrates that Vanke has successfully moved out of her original Shenzhen area towards China's center and up north along the coastline.

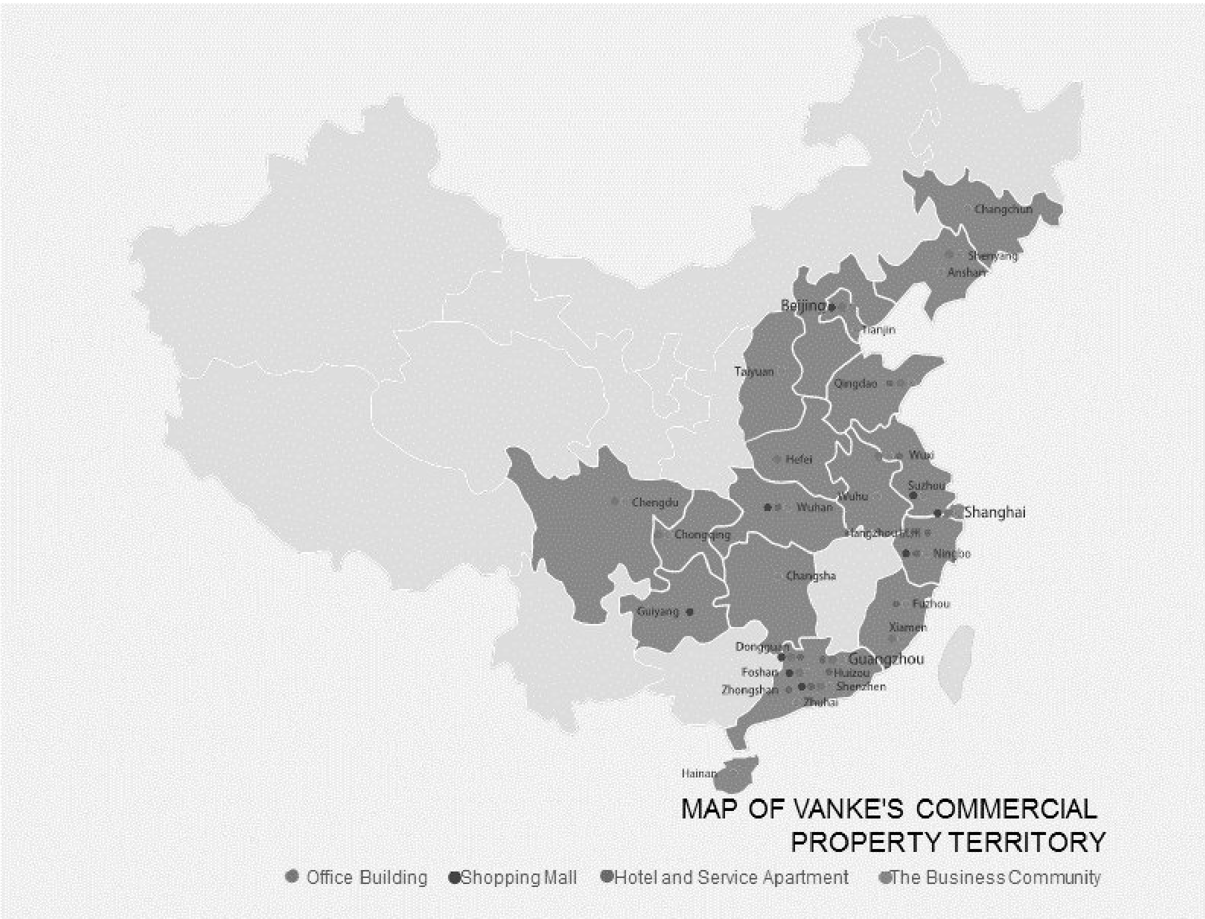
Residential development within the system offers financial support and a favorable reputation for the development of commercial real estate.

Tab. 1: Sales overview of Vanke Group

Year	Sales (CN¥ 00,000,000)
1991	4
1999	29
2001	45
2006	212
2010	1081
2011	1215
2012	1412
2013	1700
2014	2000
2015	2600
2016	3600

Remark: The data has been extracted from the annual reports of Vanke Group.

Fig. 1: Vanke's Commercial Property Territory



Remark: The figure was provided by the project department of Hongqiao Vanke Center.

3.2 The respective macro environment

Vanke's project is situated in Hongqiao Central Business District (Hongqiao CBD) and the Yangtze River Delta Urban Agglomerations. Hongqiao CBD is at the core of the one-hour economic sphere of the Yangtze River, and is considered a new engine of China's financial center.

The strengths of Hongqiao CBD include:

- New gathering place for business activities, and new engine of future urban development of Shanghai, with total investment from the state of up to CNY 20 bn as of 2014.

- Top-notch exhibition center with an exhibition area of 10,000 square meters.

- Excellent transportation infrastructure: Hongqiao offers an integrated transport hub carrying 1,100,000 people daily.

- Strong business center: New headquarters of logistics and service companies have been located here, facing the Yangtze River.

- Ecological efficiency within the area: All buildings within the CBD are up to the standards of the national green buildings.

Fig. 2: Location of Hongqiao CBD

Remark: The figure has been extracted from the introduction to Hongqiao CBD.

Favorable factor for regional planning: comprehensive start of CBD

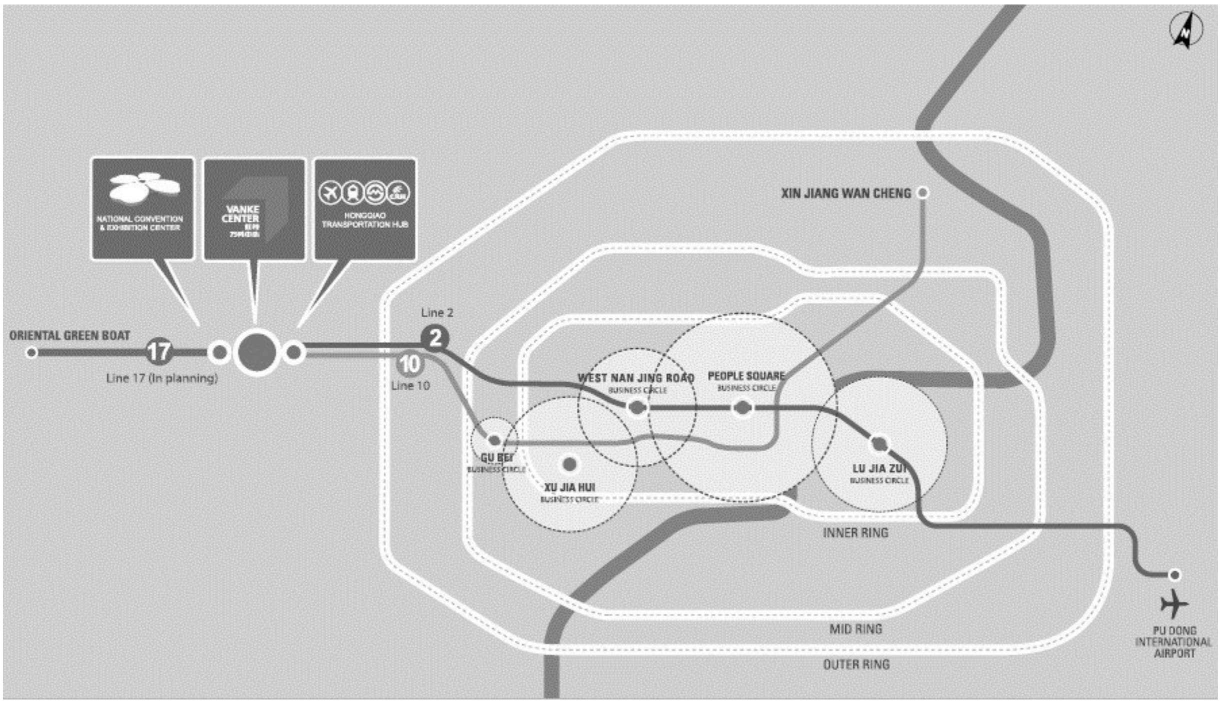
Hongqiao CBD covers an area of 86 square kilometers, including a central area of 26.6 square kilometers, the core area spreads over 4.7 square kilometers, and that of the starting Phase I still amounts to 1.47 square kilometers.

The core area Phase I will be built into the first low-carbon business community in Shanghai, with the overall development size of approximately 2.7 million square meters. Hongqiao Vanke is located in core area Phase I of Hongqiao CBD.

The project benefits from an efficient transport infrastructure, i.e. an all-weather three-dimensional traffic system. The project is located near Shanghai Hongqiao Airport, the Shanghai Hongqiao high-speed rail station is close by and three subways are within walking distance (line 2 line 10 and line 17).

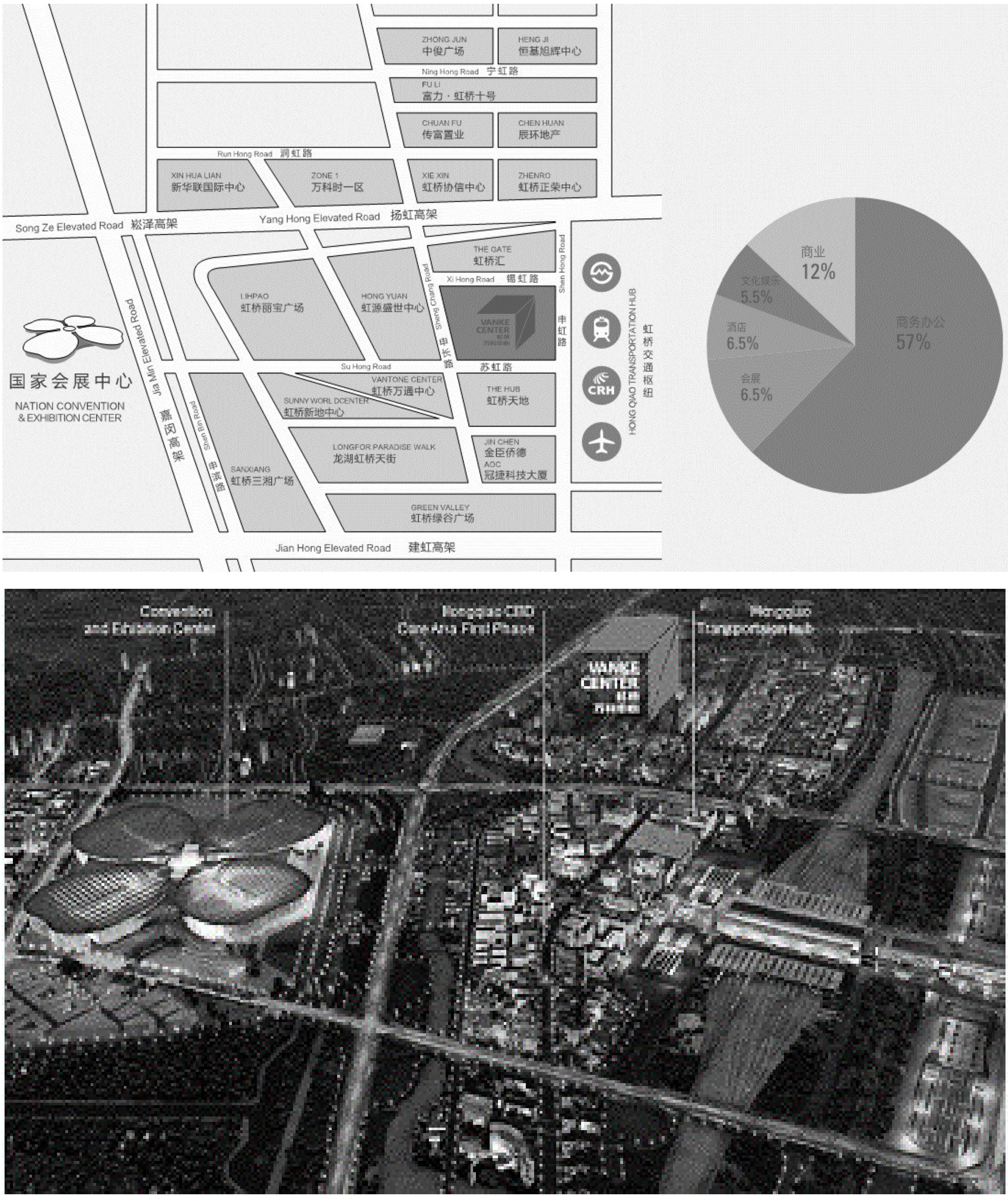
This makes the location only a 2-hour flight from Beijing, a 2-hour high-speed rail trip from Nanjing and a 1-hour subway trip from to Jujiazui. Fig. 3 depicts this connectivity, which makes Hongqiao one of the best multi-modally connected business districts in the world with regard to passenger turnover, and this attracts office tenants.

Fig. 3: Transport connection of Hongqiao



Remark: The figure was provided by the project department of Hongqiao Vanke Center.

Fig. 4: Location of Hongqiao Vanke Center within Phase I development



Remark: The figure is excerpted from the introduction to Hongqiao CBD.

Center for business clients and consumers

The location is designed to attract two different population groups: businesspeople as well as private consumers: With regard to business customers, Hongqiao CBD core area Phase I has become a vibrant district which accommodates more than 85,000 commercial and technical professionals every day. More than one million people use the traffic hub in Hongqiao daily. For these consumers, there are 14 international schools operating for 2,115 residential buildings (including 131 villas) within walking distance. The overall catchment area is estimated to be as large as three million people.

3.3 Advantageous building characteristics

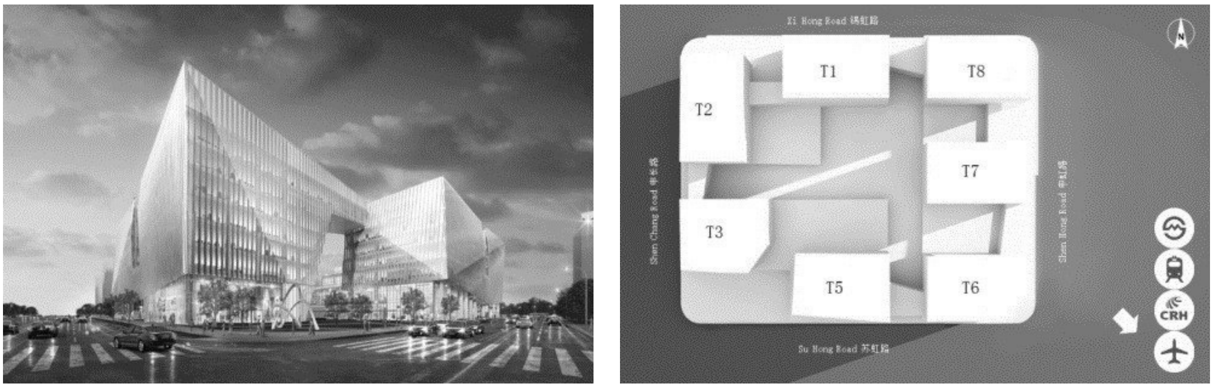
Tab. 2 summarizes the main characteristics of the project.

Tab. 2: Project overview of Hongqiao Vanke Center

Overall building area	197000 m^2
Office building area	101356 m^2
Business building area	34089 m^2
Number of buildings	7 office buildings
Project acquired	In May 2011
Project delivered	Delivered as a whole in April 2016
Parking spaces	1050
Green certification	National AAA Green Building Certification, and LEED Gold Certification

Remarks: The figure was provided by the project department of Hongqiao Vanke Center.

Fig. 5: Rendering of the project: a diamond design



Remark: The figure is provided by the project department of Hongqiao Vanke Center.

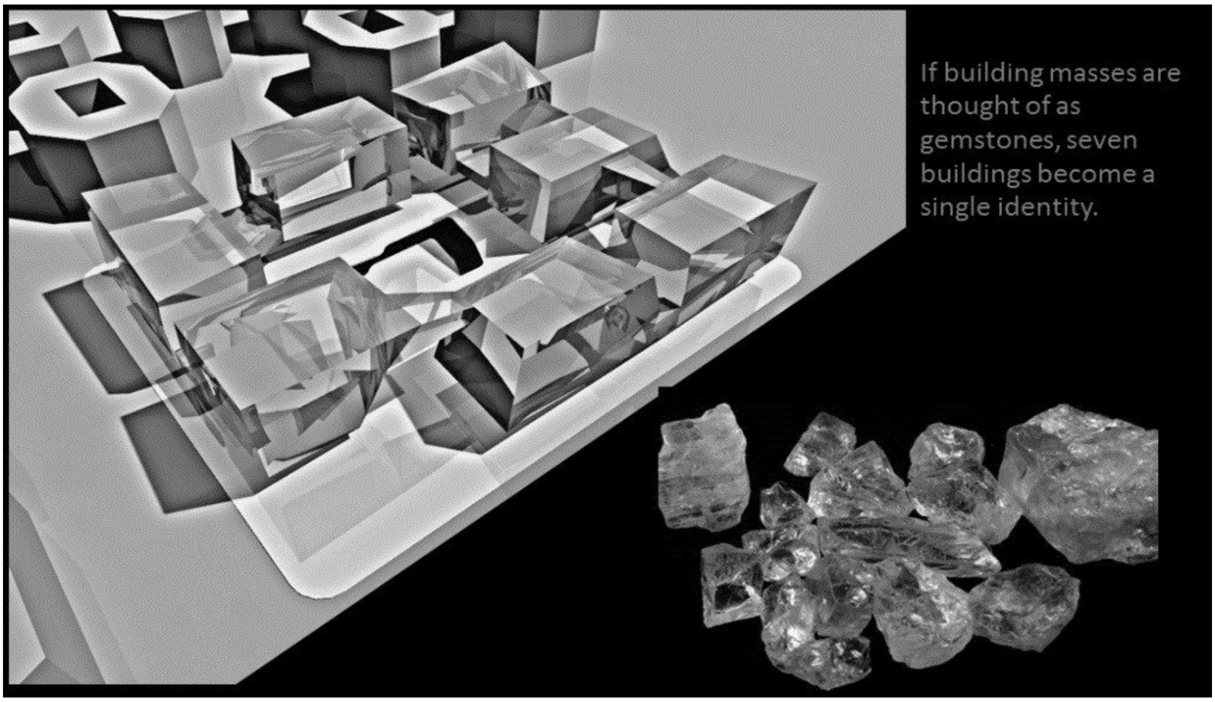
The project benefitted from international cooperation, which enabled the team to achieve international concept and design standards, thus facilitating a high level of functionality. The overall architectural design was laid out by the US-American design company NBBJ, indoor design was from the Australian company WOODS BAGOT, and the landscape design was developed by the Californian company ACLA.

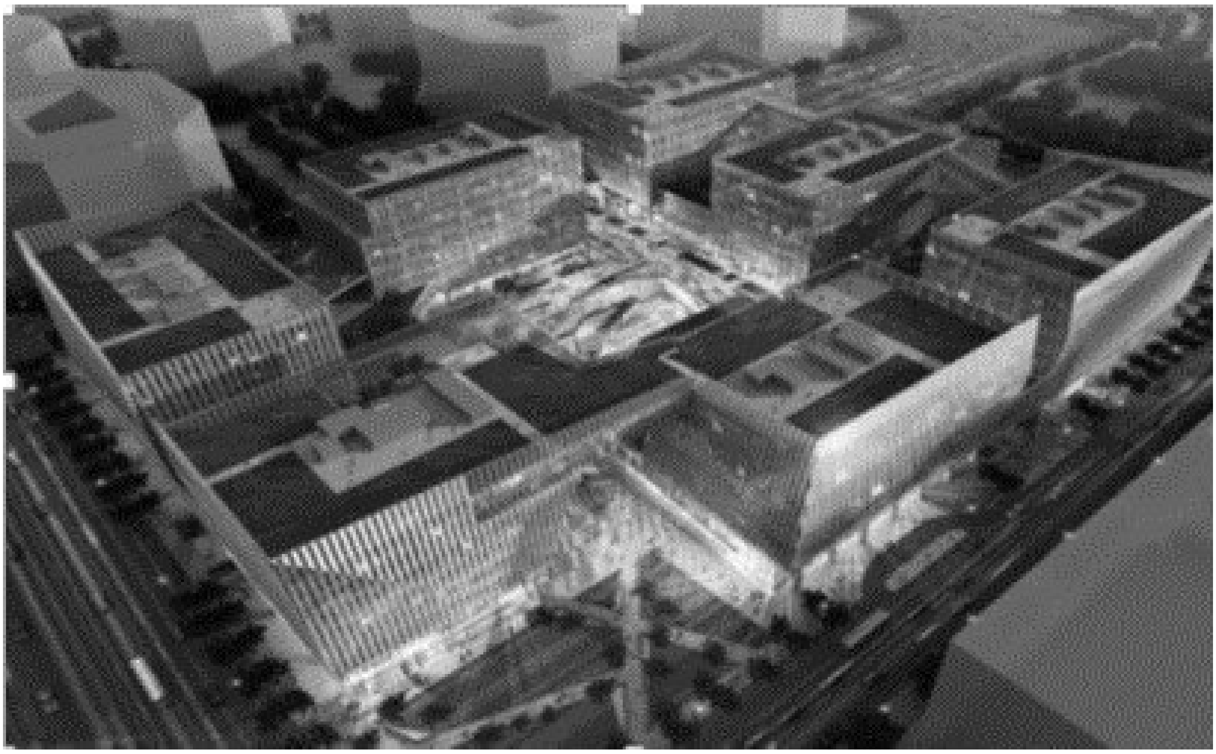
The design targeted a landmark building that resembles a diamond, to reflect both durability and value.

Functional configuration of the project

- The building was – among others - certified by LEED with the Gold standard.
- The project was configured as an international 5A office building, including a standard floor area of 200-2,500 square meters, net height of 3 meters, 150 mm-raised floor settings, central air conditioning with variable air volume, a total of 1,000 parking lots and 24-hour cooling water. Tab. 3 provides more details on essential building parameters.
- Column-free graphic design, high home efficiency rate and improved office comfort
- Removable floor, easy cross-floor office, and flexible space

Fig. 6: A building like a diamond





Remark: The figure was provided by Hongqiao Vanke Center

Tab. 3: Construction Parameters of Hongqiao Vanke Center

Depth of office area	10-13 m
Net height of standard floor	3 m
Raised flooring	150 mm
Floor bearing	300 kg/m^2 for office buildings
Power supply system	80 w/m^2 for office buildings
Air conditioning system	VAV air conditioning
Guest elevator	Hitachi, 4 guest elevators for each building
Curtain wall system	Double hollow Low-E unit glass curtain wall

Remark: The figure was provided by Hongqiao Vanke Center

Qualification of the operation team

Established in 2012, the office development company now maintains a team of 200 people covering investment, design, development, leasing, operations, technology, finance and other professional fields.

The expertise and stability of the team guarantees the accurate early orientation of the project, the high quality of design and construction proposals, precise investment attraction, leasing speed and operational quality.

Fig. 7: Impressions of Hongqiao Vanke Center

Remark: The figure was provided by Hongqiao Vanke Center

3.4 Achievements of the project

Hongqiao Vanke Center has become a regional landmark of an eco-office project in Hongqiao, Shanghai, which is highly regarded by international and domestic enterprises. At present, CJ Corporation, FIAT, and ThyssenKrupp Group have moved their China or Shanghai headquarters to Hongqiao Vanke Center. Meanwhile, Vanke Group has also located its East China and Shanghai regional headquarters in Hongqiao Vanke Center. The project has accommodated five of the world's top 500 enterprises and a number of internationally renowned enterprises, with an overall occupancy rate of up to 90 percent within a few months after opening.

Tenants have indicated that all success factors had an impact on both their decision to rent at Hongqiao Vanke Center and on their satisfaction. The Korea CJ Group leased 9,800 square meters in 2016 for their Greater China headquarters. In a survey, they gave reaons for their entry: They recognized the cultural DNA of Vanke and trusted the track record of the developer to produce a landmark office project. They recognized the macro conditions of the location and highlighted that the excellent transport infrastructure is also relevant. What is more, they preferred a green building to an office building with traditional environmental characteristics and appreciated the professional operations of the management team.

The successful letting of the property enabled a quick exit. Today, GIC, Singapore's Sovereign Wealth Fund holds 90% of the building as an investment.

4 Conclusion

Since the land of Hongqiao Vanke Center was acquired in 2011, the team of Vanke Business Management Company has worked on many challenges in the process and completed a landmark building with very good energetic and financial properties. The three success factors of the office building: development enterprise and team, overall macro environment and the specific building characteristics have been decisive in making this project a success for Vanke. The favorable national and international macroeconomic environment also helped of course.

Chinese shopping center development – today and tomorrow

Xin Lu

Abstract°° This chapter describes the character of Chinese shopping centers, its relationship to urban development in China, as well as its customers and developers. Finally, the chapter elaborates on the outlook and development trends for shopping centers in China.

Keywords: Shopping, mall, tenant, developer, online

Among all real estate typologies, shopping centers have a comparatively short history which raises concerns about their possible outlook. In Europe, the shopping center format is no more than 60 years old, and in China even significantly less. Backed by very strong retail growth and enormous pent-up demand, China is likely to remain the most active market for shopping center development. Yet, shopping centers in China are being challenged by new shopping formats, above all the rising E-commerce.

1 Mall and the City

Shopping malls in China have been developed at an unprecedented speed during the past decade. At the beginning of the 21st century, a shopping mall was still something new in China. Only a few shopping malls were developed during the 1990's, such as the China World Trade Center in Beijing, Hang Lung and the Grand Gateway in Shanghai, and the Teemall in Guangzhou. The business mode familiar to consumers at that time was department stores, commercial streets, and supply and marketing cooperatives.

During the early phase of urban development in China, when large numbers of new cities, residential districts and industrial areas sprang up, shopping malls were neither favored by the government nor by developers. It was not until problems arose from the mono-functional urban development model, with living, working and entertainment being separated, that the mixed-use model gradually evolved.

1.1 Expectations of the government

In China, governmental visions play an important role in business development. But governmental planning can fail, particularly when the plan cannot fulfill the fundamental purpose of commerce serving urban life and creating a dynamic city. The best example of how governmental planning failed by ignoring the relevance of retailing for a city is the satellite city Anting New Town located in the suburban area of Shanghai. Anting New Town benefited from a modern master planning from Germany, but large numbers of stores along the streets, even when designed, built and sold, failed to be rented out. Without retail facilities, the residential buildings also remained vacant even after they were sold; and without residents, it was even harder to find new retailers to move in.

The city government realized that professional developers were needed to develop and operate commercial properties in an integrated manner. China-Singapore Suzhou Industrial Park drew on land development experience from Singapore, that the government should first organize a development company to establish a community commercial service center integrating shopping malls, culture, sports, health and education. This measure added a significant premium to the offered parkland. Similar cases also revealed the great potential of shopping malls in increasing land value to local governments which rely mainly on revenue from land sales.

Therefore, in contrast to Europe, most city governments in China are in favor of shopping mall development and make compromises on land price. The Wanda Group seized the opportunity and quickly received invitations from the governments of major cities in China through its shopping mall chain store brand Wanda Square, and purchased a large amount of comprehensive land, including commercial and hotel land, as well as office and residential. The development of shopping malls was to increase the value of the adjacent residential and office properties.

Then, governments not only realized that shopping malls can help to increase surrounding land and property value in newly developed cities and neighborhoods. The government also began to reap the benefit of reconstructing downtown areas. The opening of the IAPM shopping mall on Huaihai Road in Shanghai was the key factor in the substantial increase in price of residential buildings in the vicinity, on Nanchang Road. There, residential property prices for existing properties soared fastest in the following year across Shanghai.

Beyond the positive stimulus for adjacent land, governments of course also appreciate the rising tax revenue associated with land transactions, and the stabilizing of businesses and residential areas.

1.2 Why are shopping malls integrated into city complexes?

Shopping malls in China are often part of a city complex, which usually consists of a large podium and several high-rise buildings. The FAR (floor area ratio) is typically very high, which even applies to suburban areas.

However, shopping malls becoming part of city complexes is not merely the result of urban planning. In fact, it follows from the need of developers to raise capital: Usually, the IRR (internal rate of return) of shopping malls and hotels is comparatively low. Developers then need a cross-subsidizing cash-cow, i.e. offices or residential units. Thus, a city complex usually consists of three parts: retail, residential and business units. Business units in turn include offices and hotels or serviced apartments. In China, residential properties and offices are primarily for sale, as they bring quick cash returns. With Chinese developers still depending largely on equity financing due to relatively immature debt markets, developers need the sale of offices and residential units to finance other uses. Shopping malls that focus on assets operation need funding from the development and sale of other properties.

At the same time and as indicated above, retail adds value to residential properties, offices and other properties for sale. Creating premium value by joining retail with residential projects has been the development strategy of China Resources Land Limited. This strategy includes, among others, a city complex with Mix City (high-end shopping mall), residential "plus fun" square (mid-range shopping mall) and residential plus district living mall. In 2004, when the Mix City shopping mall of China Resources Center was established in the Luohu District of Shenzhen, Luohu was not a fashionable location. Yet, five years later, when Park Lane Manor, their residential project next to the mall, was sold, its apartment prices were highest among all high-rise buildings in Shenzhen. The Mix City mall changed this location into a sought-after address.

1.3 The missing public open space

The very dense and compact Chinese city structures lead to a conflict of growing importance; urban public space never seems capable of accommodating the developing needs of citizens for public open space. Residential developers have to meticulously design landscaping, children's playgrounds and clubs in their building districts to meet client needs for public space in a limited area.

During rapid expansion, big cities in China are also experiencing additional changes, such as the transition from manufacture-based cities into consumption and services-oriented ones. Export-oriented production is undergoing structural changes, and domestic demand is becoming more important, as disposable incomes have been rising. During the early phase of industrialization, cities had to provide high-efficiency production spaces and supportive living spaces. In that sense, they were focused on providing "first places" (living) and "second places" (work) and did not pay much attention on so-called "third places" that prove to be relevant for community building (social or public places). In the post-industrialization phase, citizens require more space for consumption, and healthier, greener and more livable cities. This is particularly challenging for second-/third-tier cities in China. On the one hand, they are still struggling to attract business and investments in new industrial development areas, but on the other hand, they have to improve the urban environment to attract capital and talent and create a high-quality leisure and consumption environment. The first-tier cities like Beijing or Shanghai have basically moved towards consumption-oriented cities. However, this movement is challenged by continuing inward migration to all cities.

Ray Oldenburg (1999) elaborated on the needs of these third places, "Cafés, Coffee Shops, Bookstores, Bars, Hair Salons and Other Hangouts at the Heart of a Community". Shopping facilities are part of these places, according to Oldenburg's reasoning. The improvement of urban space quality lies in the improvement of all three living places. The improved quality of urban life generally means less time spent in the first and second places and more time in the third. In a consumption-based city, the lack of urban public spaces have, to a large extent, evolved from city squares, green lands into the third places comprising commercial areas. The very dense Chinese cities have shifted parts of the public third places into private commercial (shopping) places. In that sense, commercial areas are partly fulfilling social demands.

For some reason, many architects are not interested in privatized public spaces, as they focus more on the traditional public space. However, not only Chinese developers have sensed these needs and the need to create public spaces in shopping malls. This is not necessarily born from their sense of social responsibility, but rather from rising competition over attracting customers, generating more spontaneous purchases and eventually strengthening the emotional bond between their projects and consumers. Hong Kong IFC has many high-end restaurants in its roof garden, but people can also bring food and have picnics in selected areas. Solana by the riverside of Chaoyang Park in Beijing applied for a 3A national scenic spot in 2013, and in its preliminary commercial design, non-shopping leisure needs were included in its general operational concept.[3] Increasingly, developers have started to use roof gardens, sunken plazas, and atrium spaces to attract customers. The “shopping machines” that merely focus on operational efficiency are less likely to win the now fierce competition. This development is the direct result of limited public space in the cities.

2 The customers

2.1 Spare time in the cities

China has a collective society. During non-working hours, Chinese like to meet people. These meetings can be personal gatherings with friends or a business gathering. Often the meetings are a mix between private and business. Many of these gatherings involve eating, drinking and singing. Eating is a traditional culture with a long history, while karaoke is a means of entertainment from Japan that entered China not more than 20 years ago. For a white-collar worker, there are several occasions to eat out during the week; for a senior manager chances are that he rarely eats at home during the week. Many shopping centers reflect these popular leisure activities; they offer a broad variety of restaurants as well as cinemas and KTVs (karaoke night club).

Shopping has itself become a leisure activity for many Chinese urban dwellers, particularly for families and couples. What is more, as the limited public space in China’s cities; as well as the comparatively low air quality limits the number of outdoor playgrounds for children, shopping centers try to fill the gap in order to attract families, and they provide facilities for children’s amusement and education. In general, professional and leisure-time learning has become as important as physical exercise for young people. In Hubindao, a shopping mall in Shanghai, a Faber-Castell shop offers various drawing classes almost every night. In Frankfurt/Main, similar workshops are held in the Faber-Castell shop only once every few months. In China, such courses are in fact a business, while in Germany they are primarily designed to promote sales. Chinese entrepreneurs and corporate executives are keen to participate in various management training courses. After class, they frequently join in get-togethers. Therefore, shopping centers in China usually offer a triad of leisure time activities: eating, learning and playing/singing.

For the future, it can be expected that sport and travel will become more important, and this will also be reflected in shopping centers. In the recent past, the strong increase in disposable income and the pursuit of a healthy and culturally rich life make sports and travel a new trend, though there is still a large gap between China and western countries in terms of the sports, travel brands and stores in shopping centers.

[3] In China, the National Tourism Administration is issuing a rating of “scenic spots”, where 5A-sights have the highest touristic attraction (like the Forbidden City in Beijing or the Potala Palace in Lhasa), a 3A scenic spot is a touristic attraction of medium quality, still high enough to enter the rating.

2.2 Target groups and competition

In the early years of China's shopping center development phase, many projects were rather based more on developers' visions than on exact market research. Many developers, without studying high-end customers nearby, rushed to open high-end luxury brand shops, as if it were the only way to show their foresight and sagacity.

However, real estate markets are still comparatively intransparent and are moving rapidly, which makes market research challenging. Both in downtown areas and newly developing districts, the number of residents is changing rather unpredictably. Meanwhile, housing prices are soaring, which changes the composition of residents. Potential competitors are even more difficult to predict, as urban planning is directed to a general GFA (gross floor area) and this comprises office, retail and hotels. Thus, looking at the typical urban planning parameters does not yield clear view on potential future competition. A developer can switch quickly between uses.

In recent years, the most important target group for shopping center developers has been families with children. Family life is often organized around the new-born child, and with limited average living space, limited access to nature or museums, and poor air quality. The activities within shopping centers are often the best compromise for young families at the weekends.

Shanghai Vanke Qibao Plaza (see Fig. 1), that was designed by ECE, was clearly defined as a family mall, with bright colours, changing lights and a special dinosaur decoration in the opening phase. The mall opened in November 2016 and quickly became one of the most popular malls in Shanghai. The footfall on the opening day was about 200,000 people, most of whom were families with children.

Another important target group of typical modern shopping malls in China are young, educated people. COFCO Group transformed an old department store in Beijing into the Xidan Joy City for youth and fashion, and that also was a great success. The shopping malls in the Joy City Series were then all targeted at young people. However, it seems that families are a more reliable customer group. Therefore, only few developers followed the Joy City model and target primarily young people. Some developers, like the Longfor group, chose young people as the target group for some of their projects, but only in combination with family facilities within the respective projects.

Fig. 1: Qibao Vanke Plaza (right) with Tree House (left)

Source: own pictures

What is more, shopping center developers need to react to changing habits of the young: similarly to western societies, many prefer to stay at home, in virtual realities online, rather than going out. In order to attract these travelers to virtual reality, shopping malls are presently studying virtual (VR) and augmented reality (AR) technology. In some of the shopping malls in Beijing and Shanghai, VR experience shops have opened.

So far, elderly people are not being targeted particularly by developers, because the savings rate of elderly is usually high and disposable incomes comparatively low. This will change – at best – in the long run.

3 Characteristics of a typical shopping mall in China

3.1 Height

Due to the high population density and intense utilization of land, shopping malls in big Asian cities are often taller than European or US-malls. Shopping malls in most Chinese cities consist of more than five floors, which conflicts with the natural requirement that retailing should stay on the ground level. Some shopping malls are forced to go up to six or seven floors and a few even exceed ten. Sometimes, this is due to the high cost of land on which the mall is located, such as the 15-floor Langham Place located in Mong Kok, Hong Kong, and the Times Square in Causeway Bay, which transformed its partial office area on the 13th, 15th and 18th

floors into retailing in order to increase the commercial area. Sometimes, this is an issue arising from unsuitable land-use requirements. Other times, urban planning departments lack an understanding of retailing. Then, they offer a property with comparatively low coverage and still high GFA. Thus, the developer is forced to build more retail floors. Experienced developers then follow two strategies: First, they negotiate with the government to increase building coverage, as this allows for fewer floors with a given GFA, or they negotiate a higher share of office or hotel within their project.

The challenge created by the building height sometimes turns out to be an opportunity for creativity. Langham Place (see left-hand picture in Fig. 2) and Times Square use express elevators to move customers to an indoor square on an upper floor. From there, the customers are transported to the next stage, the so-called “new ground floor”. In its recent renovation of an 11-floor shopping mall in Beijing Chaoyang Joy City (see right-hand picture in Fig. 2), COFCO Group renovated part of the 5th and 6th floors into a 10,000 square meter area called “Joy Yard”. The public area of this yard was designed like an outdoor pedestrian street in Europe; special tenants provide services such as pottery, a book bar, tea art and casual food & beverage. This creates an interesting experience area for relaxation and social engagement, rather than merely shopping.

A similar approach was followed with the Shanghai Joy City, which opened at the end of 2015. The COFCO Group tried hard to push customer circulation to the upper floors. First, the “More Fun 166”-area on the 8th and 9th floors includes a sky wheel attracting the young customer target group. Second, the bar area within the shopping center, named Weiyang Street, stays open until 4 am. Third, a DIY street offers experiences by letting people make their own necklace and purse, and fourth, Neon Street, consists of a series of neon-lighted restaurants.

Fig. 2: Langham Place Hong Kong (left) and Chaoyang Joy City Beijing (right)

Source: own pictures

3.2 Layout of the plan

Many shopping malls are still problematic in their functional planning, even some very well-known projects, such as the Nanjing Aqua City, of which the theme and major spaces are fascinating, but the customer circulation is like a maze. The IAPM on Huaihai Road, Shanghai, with high-end and fairly creative space, is a successful project in a general sense. However, tenants within the secondary customer circulation have not provided the expected sales revenue. It was Mix City in Shenzhen, an early classical project, which was rational and efficient in its functional plan. The functional planning problem is often due to developers' insufficient experience. The earliest shopping malls in China appeared in the 1990's, and massive, unexperienced development continued for nearly ten years.

The increasingly strict city fire code is also exerting a substantial impact on the economic efficiency of layout and the creativity of space use. Numerous fire stairs, wide bridges, and the monotonous atrium from top to bottom may be the result of fire-code compliance. Developers' coordination skills with the fire department can be critical to the project. Shopping malls in China have more escalators than malls in western countries, due to a greater number of floors.

Public spaces in shopping malls are becoming more and more generous, but unfortunately, they are not as diverse as hotel lobbies. The success of Mix City in Shenzhen has initiated many rather unimaginative replicas in shopping malls.

Still, a rising number of malls are achieving innovation in architectural an urban form. Examples with a high quality design are the art-themed Parkview in Beijing, the K11 in Shanghai (see Fig. 4), the high-end and fashionable IAPM and the IFC in Shanghai (see Fig. 3), the Taikoo Hui in Guangzhou and Raffles City and Taikoo Li in Chengdu (see Fig. 4).

Small spaces in public areas are usually nicely designed, such as the restroom and elevator lobby. There is usually more than one restroom on each floor with interior design comparable to that of a five-star hotel. The amenities are also needs-focused, such as a family restroom with squatting pans for children. In general, developers pay great attention to this aspect in the design phase.

Fig. 3: IAPM (left) and IFC (right), both in Shanghai

Source: own pictures

Fig. 4: K11 Shanghai (left top), Taikoo Li (left bottem) and Raffles City (right) Chengdu

Source: own pictures

3.3 Tenant mix

Given that the development of shopping malls in China is much faster than the expansion of brands, many shopping malls have difficulties attracting tenants. The occupancy rate at opening is often less than 70 percent. Especially the upper floors are problematic. Clothing, shoe and bag brands are mostly international, such as H&M and Zara, whilst the F&B businesses are usually local.

F&B in shopping malls in China takes up about 30 percent to 40 percent, much more than in Europe. The percentage of entertainment is also relatively high at about 5 to 15 percent. Besides cinema and KTV, ice skating rinks are popular. If a shopping mall does not attract enough footfall, the first reaction of the owner is usually to increase the share of F&B tenants with relatively low rents. Shanghai Sun Moon Light Center Square, located in the downtown area of the Dapuqiao district, realigned its strategy in less than one year after the opening, so as to increase the F&B area to 60 percent, an increase of 10,000 square meters GLA (gross leasable area).

To compete against e-commerce, tenants of experiential services are gradually taking up a larger proportion in shopping malls. Apart from F&B and entertainment, education is also a choice. As mentioned before, education is in great demand from the main target group of young people and children. Today, rental fees paid by the education tenants is still low. However, some developers have already realized the growth potential of this tenant group. Vanke, the biggest real estate developer in China, is planning to transform an office property in downtown Ningbo into an education mall.

According to fire regulations, children-related tenants are not allowed above the third floor, and the IMAX cinema escape exit is also preferably no higher than the third floor. For this reason, in recently designed shopping malls, we often see children-related business on the third floor, while on the fourth or fifth floor, generally theater entrances as well as F&B and entertainment.

4 The developers

4.1 Mainland developers

Most developers in China have accumulated a fortune from developing residential buildings. Although some Top 10 real estate companies, such as Vanke, Greenland, Wanda, China Resources, Longfor and Gemdale, have also developed commercial real estate, their main revenue is from the sales of residential buildings. Even for the most aggressive commercial real estate developer, the Wanda Group, revenue in 2015 reveals that income from investment property leasing and property management only accounted for 10.94 percent, while sales revenue from saleable properties stood at 82.54 percent. (Dalian Wanda Group Co., Ltd, 2015).

In the 1980's, the Chinese government initiated a housing reform. Housing commercialization started in the 1990's and real estate growth sky-rocketed between 2004 and 2013. Vanke Group, the biggest real estate developer in China, witnessed an increase in sales from 6.38 billion (bn) CNY in 2003 (China Vanke Co., Ltd, 2003) to 242 bn CNY in 2017 (China Vanke Co., Ltd, 2017). The residential market was characterized by strong demand and short development cycles, fast capital return and high profits. In the golden two decades of soaring development, real estate developers became accustomed to earning quick cash. Shopping malls with higher capital precipitation, lower profits, and more operational demands were not their first choice. Thus, most developers are reluctant to develop shopping malls, but they still have to, as most of them are required by the government to develop commercial properties with every lot of residential land they obtain. Urban development is therefore increasingly oriented toward mixed uses.

This situation continued for several years and developers were squeezed internally. On the one hand, they had to establish commercial development and operation teams; on the other hand, they still applied residential development methods to commercial properties. As new ways of financing and suitable withdrawal mechanisms were not yet available, the development of commercial properties became a huge burden. It was difficult for them to accept, that shopping mall development required different management structures, including new concepts with regard to recruitment and remuneration.

In recent years, there have been several changes. A number of competent domestic developers such as Vanke, R&F, Hopson, Greenland, Greentown and Shanghai Shimao have started to become involved in commercial property development. Longfor and China Resources are even proportionately increasing commercial properties in a strategic manner, in order to diversify their investment portfolio. After several rounds of government regulation, residential buildings went through ups and downs with shrinking profitability and available residential land, especially as developers come to realize that the boom-years of the 1990s are over. Alternative business models, such as the development and operation of commercial premises and the refurbishment of old properties, are therefore flourishing today.

4.2 Hong Kong Developers

Most of the developers in China are from the mainland, but for shopping mall developments, Hong Kong developers have played an important role. Hong Kong has a longer tradition of real estate development than the Chinese mainland. In contrast to the mainland developers, who built up their businesses from scratch, Hong Kong developers came with experience in commercial real estate, with the Chinese mainland also offering a very substantial stage.

Hang Lung went to the Chinese Mainland to develop city complexes in 1990. The Plaza66, completed in 2001, is still enjoying high returns on rental fees from both office areas and the shopping mall. The shopping mall integrates many luxury and famous brands, so that Plaza66 remains a top fashion trendsetter. Since the opening of Ganghui Hang Lung Square in 2006, Hang Lung has completed 9 Hang Lung Squares in major cities, each being a landmark project.

Sun Hung Kai's shopping mall brands in Hong Kong landed successively on the Chinese Mainland. The IFC in Shanghai, opened in 2010, witnessed rapid growth in sales volume, making it a high-end brand in Pudong New District that can compete with Plaza66. In 2013, IAPM on Huaihai Road opened and achieved great success as well. This brand, specifically designed for office workers, is open from 10 am to 23 pm, some F&B even until 1 am.

TaiKoo only has a few really successful projects on the Chinese Mainland; examples are the San Li Tun Village in Beijing, the high-end Taikoo Hui shopping mall in Guangzhou or the Taikoo Li, which opened in Chengdu in 2014.

Shuion land achieved fame and success by developing the Xintiandi district. Its business model is to acquire large areas of land in downtown areas for district development. First, they developed Xintiandi, a retail street district, which preserved the old Shanghai architecture and urban form. Xintiandi enhances land value, a key fact in the subsequent development of residential and office buildings, around it by Shuion. This model has also been applied, among others, in Chongqing, Wuhan, Foshan.

4.3 Retailers

Rising rent and the demand for mixed-use commercial properties has forced a number of big-name retailers to enter the shopping-mall business.

Department stores, one of the main retail forms before the emergence of the shopping mall, saw declining sales figures due to competition from shopping malls. Large department stores quickly responded with transformation and expansion. The Beijing Wangfujing Group acquired China Spring Department Store Co. in 2013, and started comprehensive channel construction both online and offline in 2014, while at the same time, rapidly developing shopping malls and outlets. In 2016, the Wangfujing shopping mall was completed in Toronto and started expanding overseas. Shanghai Bailian, apart from owning close to ten shopping malls in Shanghai, also developed malls in major cities including Chongqing, Shenyang, Nanjing and Wuhan. The Dashang Group from Dalian developed the shopping mall brand NEW-MART with at least 100,000 square meters of GFA; so far more than 30 NEW-MARTs have been completed. Regional retailers like Golden Eagle, based in Nanjing, and Grandbuy in Guangzhou, are focusing on developing shopping malls in regional markets.

Professional retailers are moving into real estate as well. Electrical equipment retailer Suning has developed hundreds of real estate projects, including several shopping malls. Furniture retailer Red Star Macalline intends to copy Wanda's model and is planning to complete 100 city complexes by 2020.

IKEA established IKEA Centers specifically for the development of shopping malls, and has opened three shopping malls in China. Supermarket groups including TESCO from UK, Auchan from France, E-Mart from Korea, and Aeon from Japan etc. are competing in the commercial real estate market as well.

4.4 Overseas Developers

CapitaLand from Singapore is presumably the most successful overseas commercial real estate developer. Of the 102 shopping malls in five Asian markets developed and operated by CapitaLand, more than half of its business is in China. Of the 63 shopping malls in 38 cities in China, the total GFA is about 6,500,000 square meters. CapitaLand is more professional than most local developers in the development, operation and financing of commercial real estate. Compared with developers from European countries and America, it is also more localized and financially more successful.

In 2005, Simon Property Group, one of the largest commercial real estate companies in the USA, joined hands with Shenzhen International Trust & Investment Co., Ltd (SITIC) and Morgan Stanley Real Estate Fund, and set up a joint venture for developing shopping malls. However, after the successful development of five Impression City centers, Simon sold all its shares to SITIC.

SM, the largest developer in the Philippines, developed and now operates 58 malls in the Philippines and six in China. Chengdu SM City Square, for example, still maintains a stable footfall, with an average of 50,000 customers daily, and the sales performance of most retailers is on the rise after ten years in operation.

However, retailers still have a long way to go in this new field and most of the overseas developers are moving slowly and carefully. Hong Kong and Singapore developers seem to be the most successful in shopping mall development in China, thanks both to their long-term operational experience and to a sufficient understanding of Chinese culture.

5 Trends

5.1 Asset-light business model

As mentioned above, the asset-heavy development model places a strong asset burden on developers, limiting their speed of expansion. The asset-light model, with capital provided mostly by professional investors, and developers mainly responsible for land acquisition, design, construction, leasing and operation, will be the new business model for pure development companies. This model is mature in western countries, but as the development of financial instruments in China lags behind, the model is still in the process of development.

As chairman Wang Jianlin of Wanda Group explained in his speech at the Shenzhen Stock Exchange in 2015, Wanda is on the road to an asset-light model. Until 2015, the 135 shopping malls developed by Wanda all used the asset-heavy model. In 2016, of the 50 shopping malls scheduled for opening, 20 are asset-light. After 2017, 50 more will be opened every year, of which 40 will be asset-light.

In 2014, Vanke transferred 50 percent of its shares for the Shanghai Vanke Qibao Plaza (pure shopping mall) to the Government of Singapore Investment Corp GIC, and 90 percent of stock equity for the Shanghai Hongqiao Vanke Center (Mixed-use) to GIC. In the same year, Vanke signed the Letter of Intent for a Strategic Cooperation Platform for Commercial Real Estate with Carlyle Investment Group, and planned to establish an asset platform company, Carlyle and Vanke, holding 80 percent and 20 percent stock equity respectively. The asset platform company plans to purchase the nine commercial properties owned by Vanke through acquiring stock equity or assets. It is expected that the asset platform company will hold commercial properties on a long-term basis, and that it will withdraw for the purpose of asset securitization in the future.

5.2 Struggling with or symbiotic with E-commerce

The rapidly growing e-commerce sector is like a dark cloud hanging over physical retail business entities. In 2015, the proportion of e-commerce retail sales reached 12.7 percent of total retail sales in China. Online sales increased 35.7 percent over the previous year. (China E-commerce Research Center, 2016) There are two phases: In the first, the discussion is about whether e-commerce will ultimately terminate physical retail business. The gamble for 100 million CNY between Jack Ma, founder of Alibaba, and Jianlin Wang, founder of Wanda, on whether e-commerce will exceed 50 percent of total retail sales in 2022 is an iconic and dramatic event during this phase. Shopping mall developers have tried to find solutions, as none would like to be the “dressing room” for e-commerce. The simplest measures they took were to decrease the proportion of fashion shops and increase F&B and Entertainment. They toured around the world and collected all types of experience business, from 4D dynamic cinema, indoor seashores, Sega themed museums to city farms. Tenants and themes relating to sports were also gaining popularity, which had something to do with the intensified sports trend. Apart from sports articles, many activities such as horse riding, shooting, diving, skating, kart racing, floating, and flying can now be seen in shopping malls. Sport-themed shopping malls are also emerging. South of Chengdu, Yopindo shopping mall is launching an extreme sports theme for its customers. MH MALL, at Mission Hill in Shenzhen, has introduced the concept of Retailtainment, which integrates a golf theme. Wanda also came up with the skating themed Wanda Plaza. But all this still belongs to phase one.

Soon, the discussion entered phase two, that is “O2O”Online-To-Offline, when the discussion was not about who would win the competition, but about their coexistence in the future, as both had what the other could not replace. The most important question in this phase is about “How”. How to combine both worlds – offline and online in order to build a multi-channel retail business model?

Another round of competition between Jack Ma and Jianlin Wang also took place during the second phase. In March, 2015, Ffan.com established by Wanda jointly with Baidu, and Tencent went online. In April 2014, Alibaba became a shareholder of Yintai, which is an enterprise that started with department stores in Zhejiang province and today operates 9 shopping malls and 35 department stores throughout the country. In 2015, Alibaba launched Meow Street, an APP for local life aimed at helping shopping mall operators to establish basic infrastructures, including iBeacon and WIFI to connect shopping malls with consumers, and provide comprehensive shopping services including discounts, indoor navigation, car parking and payment, queuing, and real-time sharing of shopping experiences. The services provided by both APPs of Ffan.com and Meow Street are similar. Wanda has sufficient offline resources and an adequate understanding of business entities, while Alibaba is quickly expanding cooperation with business entities, with an initial goal of 500 shopping malls.

“Internet plus” has become a buzz word in many industries. At a time when we can pay by mobile phone in taxis and in small shops on the street, the issue of combining online and offline business should be considered by every retail professional.

The All Dragon Business Wisdom Circle set up, with investments from the Ping’an Group, one of the largest insurance companies in China, an O2O platform, a third party service, for shopping malls. Some retail developers have also chosen to establish their own online platforms. In 2014, Hunan Bubugao Group launched its Cloud Monkey Platform. In October of the same year, Beijing Chaoyang Joy City also launched its O2O platform, which focuses not only on service functions like finding cars, but mainly on convenient product sales, such as an all-round F&B solution system integrating take-out, group buying, queueing, ordering, paying etc., establishing a complete transaction loop and service for F&B. Meanwhile, interactive games connecting online and offline were launched, such as 3D dressing rooms and the “future money-robbing Machine”, where customers can get cash coupons through AR interactive games. Through combining the advantage of offline business in shopping malls with online interaction, the platform was a great success.

For the shopping center developers, there are two key tasks. The first is how to use online as a tool and channel as mentioned above. The second is how to maximize the advantage of the offline business. I formed a “3 E” principle for successful offline retail business in the future. The three “E” are experience, exhibition, and emotion. Compared to online, the physical shopping environment can offer experiences, which can only be perceived through physical presence. This refers not only to eating, but also to leisure, play, sport, DIY, etc. The physical shops can exhibit their products, while the online shop can only describe it. Despite this, more and more Brands have rightly started to set up their online and offline channels and are looking for a place to exhibit at the same time. The physical shops will be more like an exhibition and service place, similar to Apple stores. Emotion is the goal to strive towards. Customers are social animals and they like to meet people or be among them in an environment in which they feel comfortable. Both space creation and center management tools help establish this bond.

5.3 Integrated functions

Shopping centers consist of two characters in the Chinese language, namely, shopping and center. Shopping centers in the past were a collection of shops, whilst in the future, they will contain more functions, and be more like a center. A city center can never be without trade, but it is not a mere collection of shops either. Shopping centers in the future will be more like a small center for a certain district, covering part of the basic life service functions such as restaurants, laundry, banking, clinics etc., and the functions of public facilities including culture, art, education, sports, and leisure entertainment. This is comparable with the evolution of smart phones. The original functions of a mobile phone were making phone calls and sending text messages for long-distance communication. Nowadays, mobile phones have integrated the functions of PCs, a camera, purse (mobile phone payment), book, CD player and even sports trainer. Tomorrow's shopping malls will no longer be a mere collection of shops, just like today's smart phone is not just a phone any more.

Not only shopping centers, but shops themselves are undergoing many innovations. After creating fashion brand "exception", Mao Jihong, founder of Fangsuo, created an integrated sales model, which sells fashion clothing as well as books, coffee and small designer commodities, and it also offers lectures and art exhibitions. Its first shop in Taikoo Hui in Guangzhou became the most popular shop in this high-end shopping center. What Fangsuo sells is not a certain product, but a lifestyle, targeting a certain group of people, a place where people like to go. Similar shops are rapidly popping up in China, book bars with music discs and stationery, jewelry shops with training for jewelry making and personal customization, beverage shops with drawing classes etc.

5.4 Customer orientation

The history of shopping mall development in China is very intriguing, as it has condensed decades of development in western countries. A decade ago, in many cities in China, there were no shopping malls. But during the past couple of years, some cities are already facing competition between numerous malls. CBRE's studies in recent years on global shopping center development show that China is the most active market (CBRE, 2015, p. 3). "China continues to dominate the development pipeline with over 60% of construction globally in Chinese cities." (CBRE, 2016, p. 7).

The super-highspeed development has brought a misconception in the timeline that the past seems to coexist with the future. While Chinese developers are still learning the basics of shopping malls, they have to bring out their "inner genius" to make an unexpected move to attract customers and beat the competition. For this reason, huge problems still exist in the functional plan of many shopping malls, and that is why developers in China are researching customer demands, as they have correctly perceived that footfall is fundamental to success.

We participated in the design of Shanghai Vanke Qibao Plaza. In order to compete with the other three competitors within three kilometers, our client's operation department required the design of VIP rooms. Each floor should have multiple nursery rooms and restrooms, in which family restrooms must also be provided for parents with kids. Furthermore, even a “husband nursery room” was provided for those waiting for their shopping spouses (see Fig. 5). This luxury design requirement astonished our German colleagues, as in shopping malls in Germany, generally only one restroom would be provided, and some were like highway supply stations with coin-operated machines.

Fig. 5: Qibao Vanke Plaza – Husband nursery

Soure: own pictures

5.5 Innovation

Like customer orientation, innovation is a way of thinking; or in other words, customer orientation is a starting point for thinking, and innovation is a specific tool. For shopping centers in China, the demand for innovation comes not only from the pressure of competition, but also from the Chinese people’s strong interest in new items. Our Chinese customers love novelties, and our developers love new styles, new products and new business models. In the architectureal field, there has been a debate about whether China has become a global laboratory for foreign architects.

Innovation contains many aspects, from space, leasing, and operation through to tenants. Examples include the above mentioned extension of the concept of shopping center to the

Center, themed malls, the creation of a themed district in Joy City, mobile phone applications, the innovation of tenants themselves etc. From the development procedure of shopping centers, innovation can only be made possible through the joint efforts of different departments in many steps, such as product positioning and space design, including mainly architecture and interior design. If a product is envisioned as a mere combination of functions and tenants, it is most likely a regular product. If architects focus only on space creation, the final product might not conform to fit the retail logic. The possibilities and potential created by space design, can inspire product definition. It is indeed an interactive process. Some successful cases including K11 in Shanghai and Taikoo Li in Chengdu are a perfect combination of these two aspects.

Another example is the combination of space design and leasing. The purpose of design is to create highlights and space quality to increase footfall, and to drive traffic to the weak point of leasing in the mall as well. If Joy City only created an internal leisure street without shops providing interactive activities, it would only be a copy of a European street. A third example is the combination of space design with the demand from and trends associated with target customers. The interaction between virtual reality, mobile media, and shopping malls is important for attracting younger customers.

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Managing Real Estate Compliance Risks in China[4]

Philipp Senff[5]

Abstract°° Compliance and risk management belongs to the key challenges of businesses and their executives worldwide. This also applies to China,[6] no matter whether business is Chinese or foreign-invested. Foreign businesses will likely face additional challenges in China given that they are less familiar with the regulatory, business and cultural environment than local players. The same applies to Chinese investors doing business abroad.

This article provides a brief overview of tools of transparency and prevention as an embedded part of a compliance and risk management strategy from the perspective of a foreign company operating in the real estate industry in China.[7]

Keywords: real estate, compliance, risk management, transparency tools, prevention tools, China

Introduction

There are three key drivers, which show that compliance and risk management is getting more important in the real estate industry in China. First, the Chinese regulator pays high attention that companies and management comply strictly with the local laws and regulations, which includes also the real estate industry. Both companies and management can face significant liability risks in case of non-compliance. Investigation and liability risks are increasing due to a rise of whistle-blower activities, which actually does not apply only to China, but also to many other countries. Second, the real estate exposure of foreign companies in China is rather high. Many foreign industrial companies have invested significantly in the Chinese market through the acquisition of land, construction of factories and R&D operations, or through the takeover of Chinese companies, which have a real estate exposure. Third, real estate business is often local business where third parties will be involved, and the involvement

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[4] This article does not intend to provide legal, tax or any other advice. The content of this article has been simplified for understanding purposes and does not contain a full analysis of the matters described herein. Statements of the author in this article reflect his personal view only, and not necessarily the view from any firm, company or organization. Chinese laws and regulations - as it applies to all laws and regulations worldwide - could be subject to dynamic changes and developments by the regulator. Continuous follow-up on the latest regulatory developments is important for assessing the legal and tax situation. Please take specific legal and tax advice on any particular matter which concerns you.

[5] This article is based on the author's previous article "Corporate Risk Management in China through Transparency and Prevention - Legal and Management Hints for Foreign Businesses and Executives in China", published in the book: "Governance, Risk and Compliance Management in China: Practical Guidance for Executives" (eds. Senff/Zhang).

[6] "China" stands for the People's Republic of China.

[7] This article shall not lead to the wrong conclusion that other countries have no compliance risks. Compliance is a global challenge, which affects businesses and their executives worldwide.

of third parties can lead to less transparency and trigger additional liability risks. This is a global risk, which does also exist in China.

The following shows a selection of typical liability risks of foreign companies doing real estate business in China, and strategies for the mitigation of those liability risks.

1 Selection of Liability Risks

1.1 Corruption Risks

Corruption belongs to one of the key liability risks in real estate transactions and construction projects. Liability risks in conjunction with corruption payments in China can be triggered by the Chinese regulator and also by foreign regulators.

1.1.1 Chinese and Foreign Regulators

1.1.1.1 Chinese Regulator

Corruption payments often stand in connection with the involvement of third parties, who shall facilitate real estate transactions or construction projects. There are a number of different scenarios, which could apply. One typical scenario is that the acquirer and seller of the real estate in China agree on the involvement of a third party, which is a service company based on a service agreement (to be concluded between the acquirer and the service company) which shall disguise an illegal payment to the service company. The acquirer pays the service fees to the service company, which is however not providing the services under the service agreement, and held by a shareholder, who belongs to the employees of the seller. Therefore, this service agreement is a fake service agreement.

The overall corruption scenarios in the Chinese real estate market are not very different from the situation of other countries' real estate markets. The following shows a selection of the corporate and personal liability risks in conjunction with the above scenario with the fake service arrangement.

<u>Liability Risks of the Acquirer</u>

The acquirer can face a number of liability risks, which include the following:

- The acquirer can face a fine under the Chinese Criminal Law. It shall be noted that the Chinese Criminal Law provides explicitly sanctions against companies. This is different from other jurisdictions (e.g. the German Criminal Law), where the offender shall be the responsible individual, but not the entity.

- Both the sales and purchase agreement (SPA) between the acquirer and the seller for the acquisition of real estate, and the fake service agreement between the acquirer and the service company could be regarded as void from the Chinese Civil Law perspective. This will trigger the risk that the transfer of the real estate will fail.

- Corruption payments which have been booked internally under shadow accounts will likely lead to tax liability risks. As a rule of thumb, the Chinese regulator could impose the sanction of 50% to 500% of the non-paid taxes.

- Involved business partners (shareholders, banks, etc) could ask for compensation from the acquirer in relation to their financial losses due to the failed real estate transaction.

- The business license of the acquirer could be revoked in China, so that the legal status of the acquirer ceases to exist.

- Media coverage about the compliance case could damage the reputation of the acquirer.

Personal Liability Risks of the Executives

The involved executives can face personal liability risks, which are mainly the following:

- Key personal liability risks are imprisonment, fines and the confiscation of property.

- Further, the involved executive can face a personal blacklisting risk. The personal blacklisting provides that the executive won’t be entitled to hold a leading manager position of 5 years.

- Both the shareholder abroad, e.g. the foreign parent company, and the subsidiary in China can claim compensation from the involved manager for the incurred losses under Chinese Company Laws. The risk of compensation claims - under Chinese laws - by the foreign parent company against the involved executive is in practice often unknown. Given that such compensation claims are not capped under Chinese laws, it could affect significantly the involved manager and may hit its financial existence.

- The involved executive could lose his/her job given to a unilateral termination of his/her employment contract.

- Media coverage will certainly damage the personal reputation.

1.1.1.2 Foreign Regulators

Corruption payments in China - no matter whether these payments stand in connection with real estate transactions or construction projects - can also trigger liability risks under other jurisdictions. There are a number of foreign regulators, which have released anti-bribery laws with exterritorial effect. Examples are the *US Foreign Corrupt Practices* Act ("FCPA"), the *UK Bribery Act* ("UKBA") and to a certain extent the *German Criminal Act*.[8] Those foreign regulators are entitled to investigate within their jurisdictions against bribery and other misconducts and impose sanctions on the offenders. Some foreign regulators provide personal supervisory duties for the management at the headquarters level abroad in conjunction with their business operations in China, and non-compliance with these personal supervisory duties could trigger high personal compensation liability risks of the affected management towards the parent company abroad. Investigations and sanctions of misconducts is getting international. Recent cases show that this is not a theoretical risk anymore.

Risk of High Personal Compensation Liabilities under German Laws

German laws could also trigger liability risks in conjunction with misconducts in real estate and construction projects in China. German company laws provide that the board of the German parent company has under certain requirements personal compliance duties with regard to the business operations in Germany and abroad. Breaching this personal compliance duty can lead to high personal compensation claims, which can be raised by the German parent company against its own board in Germany.

The decision of the Munich Regional Court from 2013[9] demonstrates that this personal liability risk is not theoretical. In that case, a large company filed successfully a lawsuit against its former CFO claiming for personal compensation of EUR 15 million in conjunction with corruption payments abroad. The company has alleged that the former CFO breached its compliance duties in conjunction with corruption payments abroad. At a later stage the company and the former CFO agreed on a settlement agreement out of court in the amount of EUR 2.5 million. The decision of the Munich Regional Court is not connected to a real estate transaction in China. However, it is irrelevant from the German law perspective to which country and in which industry sector corruption payments have been conducted. Therefore, such a liability scenario can also arise in conjunction with corruption payments for real estate and construction projects in China.

[8] The *Chinese Criminal Law* contains also anti-bribery provisions with exterritorial effect. Article 164 of the Chinese Criminal Law prohibits, providing benefits to foreign officials or to officials of international public organization for the purpose of illegitimate commercial benefits.

[9] See the decision of Munich Regional Court (Landgericht München I) dated 10 December 2013 (5 HK O 1387/10).

Key Considerations of the Decision of the Munich Regional Court[10]

The decision of the Munich Regional Court states inter alia the following: *"[...] der Beklagte habe trotz wiederholter in zur Kenntnis gebrachter Gesetzesverletzungen keine bzw. jedenfalls keine ausreichenden Maßnahmen zur Aufklärung und Untersuchung von Verstößen, deren Abstellen und der Ahndung der betroffenen Mitarbeiter eingeleitet." [...] "Gerade das wiederholte Auftreten von Gesetzesverstößen oder zumindest gravierender Verdachtsmomente im Zusammenhang mit Korruptionsfällen im Ausland zeigt, dass das bisherige System nicht ausreicht. Dann aber ist es Aufgabe jedes einzelnen Vorstandsmitglieds und damit auch des Beklagten, im Rahmen seiner Überwachungspflicht darauf hinzuwirken, dass innerhalb des Vorstands ein funktionierendes Compliance-System beschlossen wird." [...] "Demgemäß bedeuten grenzüberschreitende Schmiergeldzahlungen eine Gesetzesverletzung, die sich auch nicht aus der Erwägung heraus rechtfertigen läßt, anderenfalls seien wirtschaftliche Erfolge auf korruptiven Auslandsmärkten nicht mehr möglich." [...] "Einer derartigen Organisationspflicht genügt der Vorstand bei entsprechender Gefährdungslage nur dann, wenn er eine auf Schadensprävention und Risikokontrolle angelegte Compliance-Organisation einrichtet [...]."*

Sitting on a board in Germany can therefore not exempt from personal liability risks in conjunction with misconducts in foreign countries (e.g. in real estate transactions or construction projects China). Executives in Germany having business exposure in China need to develop personal risk management strategies in order to mitigate potential liability risks under German laws.

1.1.1.3 Whistle-Blower

The liability risks by the Chinese regulator and foreign regulators have been increased due to the rise of whistle-blower activities worldwide. Whistle-blowing is getting easier given that companies are increasingly setting up whistle-blower lines, also called speak-up lines, and ask staff and business partners to use it. Further, the Chinese regulator provides rewards to whistle-blowers. Rewards can reach up to RMB 500,000, and under certain requirements even exceed this amount.

Foreign businesses operating in China need to get familiar with the ongoing regulatory development in conjunction with whistle-blowing. CEO's and CFO's, no matter whether they are running the business in China or abroad, face an increasing level of personal liability risks in conjunction with disclosure, reporting and risk prevention obligations under Chinese laws and the applicable foreign laws.

[10] See the decision of Munich Regional Court (Landgericht München I) dated 10 December 2013 (5 HK O 1387/10).

1.1.2 Risk Management Considerations

The mitigation of corruption related risks must be part of the overall compliance and risk management strategy. The following shows key thoughts for the development of a business partner check on third parties given that corruption risks are often connected with third parties. However, additional compliance and risk management tools will be required in order to mitigate corruption related risks in the real estate business.

Business partner checks can create a higher level of transparency over the potential liability risks when involving (or not involving) the new business partner. In practice, business partner checks are also sometimes part of the financial risk management, in order to assess the creditworthiness of the business partner. This applies especially to distributors or other business partners, who shall pay the company. Business partner checks may apply to any business partner of the company, which includes e.g. suppliers, service and logistic companies (due to potential fraud risks) and distributors, marketing, agents (due to potential corruption risks). The individual business partner check must be designed to the business needs of the company, and fit to the individual risk scenario. The following shows some practical thoughts for the development of a business partner check.

Step 1: Pre-Qualification Form

- The business partner candidate shall fill out the Pre-Qualification Form so that the company can get more information (full contact details, reference projects, etc) from this business partner candidate.
- The Pre-Qualification Form will request the business partner candidate to provide certain supporting documents (copy of business license, etc).
- The Pre-Qualification Form must be signed and affixed with the company seal of the business partner candidate.

Step 2: Risk Assessment

Once the company has received the Pre-Qualification Form, the company can usually review:

- The legal status of the business partner candidate;
- The shareholder, corporate governance and key corporate and management information of the business partner candidate;
- The business scope of the business partner candidate, in order to assess whether the business partner candidate is entitled to do what shall be agreed upon under the agreement between the company and the business partner candidate;

- Any sanctions and blacklisting history of the business partner candidate;
- Review those topics, which are related to the results of the Pre-Qualification Form;
- Other aspects.

Step 3: Decision Making Process

The management of the company makes the decision to accept the business partner candidate or not. If the management goes ahead with the business partner, solid legal documents (agreements, etc) must be drafted.

The business partner check must be exercised in compliance with Chinese laws.

1.2 Risks Related to Land-Use Rights

Additional legal risks could arise from the legal position of the Chinese granted land-use rights. The Chinese granted land-use rights are the most important real estate rights for foreign investors given that they are marketable.[11]

1.2.1 Differentiation between Allocated and Granted Land-Use Rights

In China, there is no private ownership of land. However, both domestic and foreign investors may hold, acquire and sell land-use rights for different purposes. Chinese property laws differentiate between allocated and granted land-use rights.

The allocated land-use right will be acquired by allocation without payment and is not subject to any limitation in time. However, the acquisition of such a land-use right is subject to stringent approval procedures and is only possible for a few specific types of use, such as:

- Land for government agencies and military units;
- Land for urban infrastructure and social welfare;
- Key energy, transportation projects supported by the state;
- Other land-use purposes as provided by Chinese laws.

[11] Foreign real estate investors shall comply with additional legal requirements in China.· Key legal restriction for foreign investors is the so-called “onshore acquisition structure”. Foreign investors, which intend to invest in Chinese real estate are required to have a corporate presence in China, which is usually a Wholly Foreign-owned Enterprise or a Joint Venture Company having usually the legal form of a limited liability company under Chinese laws. This company holds then the real estate. Therefore, the foreign investor is not allowed to invest directly in Chinese real estate without having interposed a subsidiary in China. This legal structuring requirement has a significant impact on foreign real estate funds, foreign private equity investors and foreign family offices, which prefer to have a more straightforward structure. Foreign industrial investors will be less impacted given that they usually have a corporate presence in China due to business reasons.

Foreign investors are not entitled to hold allocated land-use rights given that they are rather meant for Chinese domestic investors subject to a strict supervision by the Chinese regulator. Further, allocated land-use rights can't be mortgaged. If the investor intends to invest in land where an allocated land-use right, but no granted land-use right, exists, the investor can apply for the conversion of the land-use right from allocated to granted which, however, requires the prior approval by the Chinese land administration authorities.

1.2.2 Granted Land-Use Right

Granted land-use rights may be acquired, transferred, leased and mortgaged.[12] The holder of the granted land-use right may use the land for the construction of buildings and facilities in accordance with Chinese laws. Granted land-use rights may be only hold for a limited period of time, and this term depends on the purpose of use.[13]

1.2.2.1 Registration Risks

The name of the holder and all key information (e.g. location of land, size of land, purpose of use and term of use) of the granted land-use right are stated in the granted land-use right certificate. If there is a discrepancy between the content of the granted land-use right certificate and the content of the land register book at the Chinese land administration authority, the entry in the land register book shall prevail.

Therefore, there are potential fraud risks in relation to the provided granted land-use right certificate, if the acquirer relies on the land-use right certificate only. It could be possible that the land-use right certificate is not reflecting the updated legal status (e.g. the purpose of use has been changed), or has been forged.

From a risk management perspective, it is advisable to double-check the real content at the land register entry at the Chinese land administration authority.

1.2.2.2 Term of Use Risks

The term of use of the granted land-use right depends on the respective purpose of use. As a rule of thumb the following maximum terms of use apply, which could be however subject to different local regulations.

- For residential purposes: 70 years
- For industrial purposes: 50 years (in Shanghai: 20 years)

[12] The Chinese mortgage is generally comparable with the German "Hypothek". Chinese laws don't acknowledge the German "Grundschuld".

[13] German investors will perceive that some characteristics of the Chinese granted land-use right are comparable with the German hereditary building right, called "Erbbaurecht".

- For trade and tourism purposes (including hotels, offices and shopping malls): 40 years
- For mixed use purposes (combination of different types of use): 50 years

In 2014, the Shanghai government has issued new rules in conjunction with granted land-use rights for industrial purposes. According to these rules the term for industrial related granted land-use rights has been shortened from 50 to 20 years. The Shanghai rules will have a significant impact on the acquisition and financing of this type of granted land-use rights. Shenzhen, Foshan, the Beijing Economic and Technical Development Zone (and likely other cities) have adopted the Shanghai rules. Therefore, it is important to assess also the local regulations.

The purpose of use of the granted land-use right can be changed after prior approval by the Chinese land administration authority.

Chinese laws provide the following mechanism for the extension of the terms of the granted land-use rights:

- Granted land-use rights for residential purposes shall be extended automatically after expiration of the term of use. An application for the extension of the term of use is not required.
- Granted land-use rights for other purposes than residential require an application for the extension of the term. The application for the extension shall be granted unless there are public interests.

Foreign investors need to be aware that the terms of their granted land-use rights will expire. Consequently, they need to understand whether and under which requirements the terms may be extended. The earliest terms commenced in the 1990s so that there are currently no practical experiences with regard to the extension of terms of granted land-use rights. Extension and compensation issues are affecting both Chinese and foreign investors, and there is no difference whether an industrial company or an institutional investor holds the real estate. “Compensation experiences“ exist with regard to expropriations, which relate however to a different situation. Expropriation means that the term of the granted land-use right is running, but that the term shall be terminated earlier. It is expected that the Chinese regulator will release more guidance rules on the extension of the terms of the granted land-use rights.

Both institutional investors and industrial companies need to develop a compliance and risk management strategy, which can mitigate their liability and business risks in relation to the extension of the term of use.

Key thoughts will include the following:

- It will be important to keep monitoring the national and local legal situation with regard to the extension of the term of use of the granted land-use right. The Chinese regulator could release new regulations soon given that the terms of some land-use rights will likely expire in a few years. Key focus must be whether the extension of the term of use will trigger an extension fee, and if yes, it will be essential to understand the calculation basis of this extension fee.

- Companies who intend to extend their land-use right terms need to enter in a pre-coordination process with the Chinese regulator in order to clarify the following:
    - Can the Chinese regulator provide an indication whether the term can be extended or not?
    - If yes, which deadlines will apply for the extension of the term of the granted land-use right?
    - If Chinese laws are still silent on the extension fee question, can the Chinese regulator provide an indication for a possible extension fee?
- It is advisable to have a valuation report in relation to the land, buildings and fixtures ready, which will comply with the regulatory requirements.
- It will be important to develop a worst case scenario for the situation that the term of use won't be extended or that the extension fee is too high from the perspective of the holder of the land-use right.

1.3 Risks during the Construction

Further, liability risks could arise in conjunction with the construction of the property.

1.3.1 Approvals and Certificates

Construction projects require usually the following approvals and certificates in China.[14]

- **Construction Land-Use Planning Permit**
- **Land-Use Right Certificate:** The granted land-use right certificate - regarding the land which shall be subject to the development project - has been released by the competent land administration authority and shows the legal owner status.
- **Project Proposal and Feasibility Study Report:** Approval of the Project Proposal and Feasibility Study Report by the responsible Development and Reform Commission. If this approval has not been issued, the construction project may not be started.
- **Environmental Impact Assessment:** The Environmental Impact Assessment shall be approved by the Environmental Protection Bureau.

[14] The list of the required approvals and certificates above has been simplified.

- **Conceptual Design:** The conceptual design for the construction project shall be approved by the responsible Planning Bureau.

- **Preliminary Design:** The preliminary design shall be approved by the competent Planning Bureau.

- **Construction Design Drawings and Plans:** Afterwards the construction design drawings and plans shall be submitted to a number of Chinese authorities for approval which include the following: Environmental Protection Bureau, Firefighting Bureau, Landscaping Bureau, Electrical Supply Bureau.

- **Construction Permit:** As soon as the Construction Land Use Planning Permit has been issued the Construction Permit may be applied for.

- **Commencement of Works Permit:** As soon as the responsible construction bureau has issued the Commencement of Works Permit, the construction works can start.

The required approvals and certificates for the construction project could lead to compliance risks, such as corruption, fraud and kickbacks, if the internal control is weak. Fraud risks could arise if forged documents will be submitted. Corruption risks could arise if third parties have been involved who arrange the required approvals and certificates, although the legal requirements for these approvals and certificates have not been fulfilled.[15] The latter especially applies to facilitation payments, also called "speed-up money", in order to accelerate the approval process, which will not exempt from corruption related liabilities under Chinese laws.

Typical red flags for such misconducts are the dates of the relevant approvals, if approvals have been issued in the wrong order from a timing perspective. For example: the construction permit has been issued before the land-use right certificate has been issued, this will imply a red flag.

It will be important from a risk management perspective to monitor that all required approvals and certificates are in place. Companies, which want to mitigate their liability risks, usually conduct an annual check whether all required approvals, certificates, licenses and registrations are in place in China, and wherever they operate globally. This check will include the above mentioned approvals and certificates, but will also cover the important business license in China. Companies in China may only operate within the business scope as stated in its business license. The business license will be issued by the Chinese Administration of Industry and Commerce.

1.3.2 Supplier Management

Further, liability risks, such as kickbacks, could come up in the supplier chain for the construction project.

[15] These compliance risks could also arise in conjunction with required environmental, product safety, or industry specific approvals (such as for chemical operations).

Such risks usually refer to suppliers which

- are owned or managed by staff of the constructor, or
- don't deliver (fully) the supplies given to the weak internal control of the constructor, or
- sell the supplies with overpriced fees to the constructor.

These scenarios can significantly harm the company. It will be important from a risk management perspective to focus primarily on the following:

- Increasing overall the internal control in conjunction with the construction project;
- Implementing a procurement policy, which is binding on the company (the constructor) and its key management;
- Exercising business partner checks on the suppliers;
- Clarifying whether construction related services may be sub-contracted or not;
- Developing standard supplier contracts provided that these contracts may be really executed given to the strong negotiation power of the company;
- Developing negotiation guidelines towards those suppliers, which have a stronger negotiation power than the company; and
- Compliance Statements and Undertaking Letter to be signed by the supplier.

1.3.3 Construction Contracts

Construction projects in China are governed usually either by FIDIC contracts or Chinese construction contracts. FIDIC contracts are globally acknowledged constructions contracts, which are also often used by foreign invested-enterprises in China. Chinese construction contracts are based on the template construction contract, which has been developed by the Chinese regulator. Risk management must ensure that the selected type of contract complies with Chinese laws, and still reflects those provisions, which are important for the involved parties under the construction contract.

1.3.4 Managing Investigations by Authorities in Construction Projects

It is very important to keep a proper documentation of the construction contracts, business contracts and any other documents (approvals, registrations, licenses, etc) in relation to the construction project as line of defense against investigations by authorities into the construction project. If third parties have been involved into the construction project, there must be evidence that the services have been actually fully conducted. Otherwise, there is a risk that the agreements could be regarded as fake agreements, which have the purpose to cover corruption payments. The documentation must also show that the business partner check has been duly conducted. Additional strategies of defense will apply.

2 Strategies for the Mitigation of Liability Risks

The chapter above shows that non-compliance can trigger serious liability risks for the involved businesses and their executives in the real estate business. Foreign businesses and executives wanting to mitigate their potential liability risks in China, need to develop a compliance and risk management strategy, which reflects their individual risk profile[16].

The following shows a selection of transparency, corporate governance and prevention tools, which are usually part of a solid compliance and risk management strategy in China.

2.1 Transparency

2.1.1 Business Reviews and Compliance Audits

Tools of transparency refer particularly to regular business reviews. Business reviews, also called compliance audits, are legal risk assessments on all or certain operations of the company, and can create a basis for the development of an action plan for the mitigation of the identified liability risks in China. Business reviews refer usually to procurement, logistics, sales, marketing, construction, environmental, recruitment, or other conducts and operations of the company.

2.1.1.1 Cleaning Out for Upcoming Real Estate Transactions

Business reviews can also help to clean out certain liability risks before the due diligence on the real estate commences, and even before the acquirer has been identified. The likelihood of uncertainties and risks in the due diligence process can be then mitigated significantly. "Cleaning Out" is usually driven by the seller of the target, who intends to lower the risk profile of the target.

2.1.1.2 Safe Business Closure

Downsizing real estate business in China can quickly lead to dynamic scenarios, where hidden legal, tax, customs, environmental, product safety or other risks could arise, and are getting difficult to manage. The actual risk profile of the company could be unclear given that the previous local management was less interested in mitigating the company's liability risks, and the headquarter's management did not realize that certain hidden risks actually exist. This particularly applies to those companies, who have a weak internal control. Hidden risks are

[16] China's Criminal Law does not provide that the establishment of a compliance management system may lower the liability risks of the involved company. However, companies having established a solid compliance management system will be able to detect earlier potential compliance risks and respond to those risks at an early stage. Further, they will be in a better position to show that the misconduct from one employee is not a misconduct by the company.

usually connected to non-transparent procurement and sales practices of the company. Additional typical risk drivers are a high involvement of third parties and a low retention rate. Restructuring plans are getting hit or even fail once hidden risks arise. These negative scenarios can be avoided by an early risk audit or business review. Risk audits can help to screen first the actual risk profile of the operation in China, and will be then used as a solid basis for the mitigation of the identified risks and the development of a safe and realistic restructuring plan, before staff, business partners and authorities are involved.

2.1.1.3 Risk Assessments for Local D&O Coverage

Business reviews can support to identify the personal risk exposure in conjunction with D&O insurances for the protection of the management of the subsidiary in China.[17]

2.1.2 Business Partner Checks

Business Partner Checks on certain companies, especially third parties (property managers, agents, service companies, suppliers, etc) can create transparency over the potential liability risks when involving (or not involving) the new business partner. Code of conducts usually require to exercise a business partner check on companies based on certain requirements and criteria.

2.2 Corporate Governance[18]

Corporate governance is an important tool in order to strengthen the company's compliance and risk management strategy in China. Well-developed corporate governance will be the company's first line of defense against business and compliance risks. Good governance can demonstrate to staff and business partners the values of the company. Values shall prevent from conducting non-compliant business, which could put the company at risk. Good governance can maximize the protection against future business and compliance risks. Disregarding governance can lead to weakness of leadership. Weak leadership is a risk given that it can't defend the company anymore against business and compliance risks.

Chinese company laws provide a number of tools in order to design the corporate governance for getting stronger protection against business and compliance risks. The following shows a brief overview of the corporate governance structure of a WFOE, which applies also to the real estate industry.

<u>Governance Organs</u>

The key governance organs are the following:

[17] Master D&O covers are not acknowledged in China. Chinese laws require mandatorily to conclude a D&O insurance with a qualified insurance company located in China.

[18] The following refers to the corporate governance of a Wholly Foreign-owned Enterprise ("WFOE"), which is structured as a limited liability company under Chinese laws.

- Shareholder’s meeting (or sole shareholder)[19]
- Legal representative
- Members of the board of directors or executive director[20]
- General manager
- Supervisory board or supervisor(s)

Legal Representative

The WFOE shall have one legal representative. The legal representative may be the chairman of the board of directors (or the executive director, if there is no board of directors) or the general manager. In practice, it is usually (but not necessarily always) the chairman of the board of directors, who serves as the legal representative. The legal representative may be either a Chinese or foreign citizen. In contrast to other jurisdictions, the general manager is not automatically the legal representative, unless the general manager has been registered as legal representative at the Chinese Administration of Industry and Commerce.

The legal representative is legally accountable for the activities of the company. It is still unclear under Chinese laws whether this personal risk exposure mirrors a personal risk prevention obligation. The personal risk prevention obligation would lead to the obligation to establish a compliance management system in the WFOE in China.

The legal representative stands for the highest level in the management hierarchy (but is not the highest organ, which is the shareholder’s meeting or the sole shareholder), which is often comparable with the CEO under other jurisdictions. Therefore, the legal representative is essential for leadership and the Tone from the Top. Foreign businesses are carefully selecting the person for the role of the legal representative.

Board of Directors

The board of directors shall be appointed by the shareholder(s), and the board shall consist of between 3 and 13 directors. There are no nationality requirements for the directors. The directors shall be registered at the Chinese Administration of Industry and Commerce. The chairman of the board of directors is usually the legal representative. The directors play an important role in the corporate governance of the company, given to their broad scope of responsibilities. The following shows a selection of the board’s responsibilities:

- Convening the shareholder meeting;
- Reporting to the shareholder meeting;

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[19] The shareholder’s meeting (or sole shareholder) is the highest organ of the WFOE. In joint ventures, the highest organ is the board of directors.

[20] WFOE’s having a relatively small number of shareholders or rather small business may have one executive director instead of the board of directors.

- Implementing the resolutions of the shareholder meeting;
- Preparing the business and investment plans of the company, including yearly budget, annual reports, profit distribution, and plans for increase or decrease of the registered capital;
- Preparing the plans for merger, split, dissolution or change of company form;
- Preparing the internal management departments of the company;
- Preparing the hiring or dismissing of the general manager;
- Developing the basic management structure; and
- Other matters as provided under the articles of association of the company.

General Manager

The general manager is responsible for the daily operation of the company. There are no nationality requirements of the general manager. The general manager may be a member of the board of directors, but is not obliged to be. If the general manager is not a member of the board of directors, he/she is entitled to attend the board meetings without voting rights. In practice, the articles of association or company rules provide precise rules for the obligations and rights of the general manager.

Supervisor

The company shall have a supervisory board, which consists of three members. Companies with small business may have 1-2 supervisors instead of a supervisory board. The supervisors' role is getting more important from the overall compliance and risk management perspective. The supervisor's responsibilities include the following:

- Supervising the financial matters of the company;
- Supervising the action of the directors and senior managers. If directors or senior managers breach their obligations, the supervisor may impose a warning letter and ask for their dismissal;
- Convening and chairing extraordinary shareholder meetings, if the board does not follow its obligations to do so;
- Initiating legal actions against the directors and the senior management in case of breach of obligations;
- Attending the meetings of the board of directors without voting rights;
- And other matters.

Foreign companies contemplate “upgrading” their supervisors to compliance or risk management officers given to their monitoring and supervising role. Side letters with the supervisor can specify the compliance and risk management tasks, which shall be conducted by the supervisor. Example: The supervisor is entitled or obliged (depending on the wording) to exercise a yearly business review on the company’s operation in China. If it is intended to upgrade the supervisor, it is recommended assessing whether this approach fits with the overall compliance management system and corporate governance (code of conduct, etc.). The overall strategic role of the supervisor may also be reflected in the articles of association of the company.

2.3 Prevention

Prevention refers usually to the development and execution of a compliance management system for the preventive protection against future liability risks.

Prevention tools include usually the following:

Procurement

- Business Partner Check and Procurement Screening
- Standard Contracts
- Negotiation Guidelines
- Reporting and Approval System
- Guidelines (Do’s and Don’ts)

Sales

- Sales structure combined with performance and fee controls (direct sales, distributors, third parties)
- Standard Contracts
- Negotiation Guidelines
- Reporting and Approval System
- Protection against Product Liability Risks

Third Party Management

Developing compliance tools in relation to third parties, such as logistics, property management, leasing, and other service providers

Code of Conduct

- Developing a China focused Code of Conduct
- Gift Policy
- Reporting and Sanctions

Employment

- Standard Employee Handbook containing compliance duties
- Standard Employment Contracts for senior and non-senior staff containing compliance duties
- Improvement of the retention rate given that a low retention rate could trigger additional liability risks
- Trainings and Education

Whistle-Blowing

Assessing whether or not a whistle-blower line shall be implemented in China

D&O Insurance

Local D&O insurance policy is necessary in China given that a foreign global master cover would not be acknowledged in China.

3 Protection against Personal Liability Risks of Real Estate Executives in China

Foreign C-suite and senior executives running business in China face a number of personal liability risks. Personal liability risks stand usually in connection with non-compliance conducts at the level of the company. The personal risk management of foreign executives in China is getting more difficult given that they operate in a foreign regulatory, business and culture environment.

Defending the Company

The strongest line of defense is to focus on the company's risk profile, given that the company's risk level mirror's often the executive's personal risk level. If executives defend their businesses against compliance risks, they will also defend themselves against personal liability risks. If the risks are known, they can be mitigated. If the risks are hidden, transparency tools are getting more important. The starting point would be the business review over certain business operations. For example: looking at the fraud risks in procurement or at the bribery risks in sales. Regular business reviews can be also combined with irregular controlling points. In addition, the prevention tools, which have been stated above, can be developed. This approach is especially important for those senior executives, who serve as legal representatives in China. They have higher personal liability risks, but they have usually also more possibilities to implement changes in the operation (e.g. the termination of the business relation with corrupt business partners), in order to mitigate the company's liability risks.

Cockpit Checks

Further, personal risk assessments, also called "Cockpit Checks", can help to identify the individual risk profile of the executive, and show how identified compliance risks may be mitigated or insured. One of the essential points will be whether the executive faces a personal risk prevention obligation under Chinese laws or under foreign laws (if applicable). It is highly recommended to refresh Cockpit Checks annualy.

No one-way street

Tobias Just, Chenhui Xia

Abstract This paper focuses on the development of real estate markets in China, specifically on regulatory and tax issues and market movements. In this final chapter, we draw attention to a related topic, that is, the rapid development of cross-border capital flows from China to western real estate markets. Three factors are decisive for this counter movement. First, rising incomes in China and a still high savings rate induce investment. Second, real estate yields in China have been declining rapidly over the last few years. This has put cash-yielding investors like insurance companies and pension funds at risk, if they cluster their real estate portfolio in a volatile real estate market like China. They are thus searching for assets with higher and more stable rental income outside China. Third, institutional investors in China wish to diversify their portfolios. Because the correlation between domestic markets is higher than that between international markets, institutional investors can benefit from going abroad, even if total returns in Europe are lower than in an emerging market like China.

Keywords: cross-border investments, diversification, institutional investors

1 Introduction

China's economy has been growing by roughly 10% p.a. for almost 40 years, and even after correcting for per-capita-growth and the purchasing power of the local currency, this momentum still implies that China's GDP per capita is now approximately 15 times higher than in the early 1990s (World Bank, 2017). Not surprisingly, this has translated into significant demand growth for all real estate asset classes, as has been demonstrated throughout this book. Additionally, the economic momentum has stimulated massive migration to metro-areas, and this has reinforced the demand for real estate. What is more, income growth not only calls for quantitative growth, but also for qualitative improvements of the real estate stock. Buildings that were put on the market in the 1980s and 1990s already require massive investment in refurbishment, and often complete redevelopment. Therefore, it is likely that all real estate asset classes will remain on a long-term growth path for years. However, this does not rule out short-term fluctuations of real estate rents and yields in China's conurbations.

Despite the generally positive long-term outlook for real estate demand in China, it is also likely that the outflow of Chinese investment into foreign real estate will continue to rise in the next few decades, and for three main reasons. First, net initial yields have been compressed by strong liquidity growth in many cities. Given comparatively high inflation rates, these low yields imply that capital gains are the main driver of total real estate returns. Accordingly, investors with a need for sufficiently high cash returns (such as insurance companies or pension funds) will either have to search for riskier submarkets within China, or seek assets outside China. Since 2010, it became easier for Chinese insurance companies, as well as for sovereign wealth funds, to invest in foreign real estate. However, since very recently, this momentum reverted, as we will show. Second, considering the high volatility of Chinese real estate markets, risk-averse market players will rationally pursue risk-diversifying strategies, by attempting to invest a growing share of their real estate portfolio outside China. Third, with more Chinese capital targeting non-real-estate assets, this can lead to follow-up investments in order to facilitate such investments. Sometimes, the motivation to invest could also be that of a long-term learning strategy for application to the home market.

2 Cross-border investments

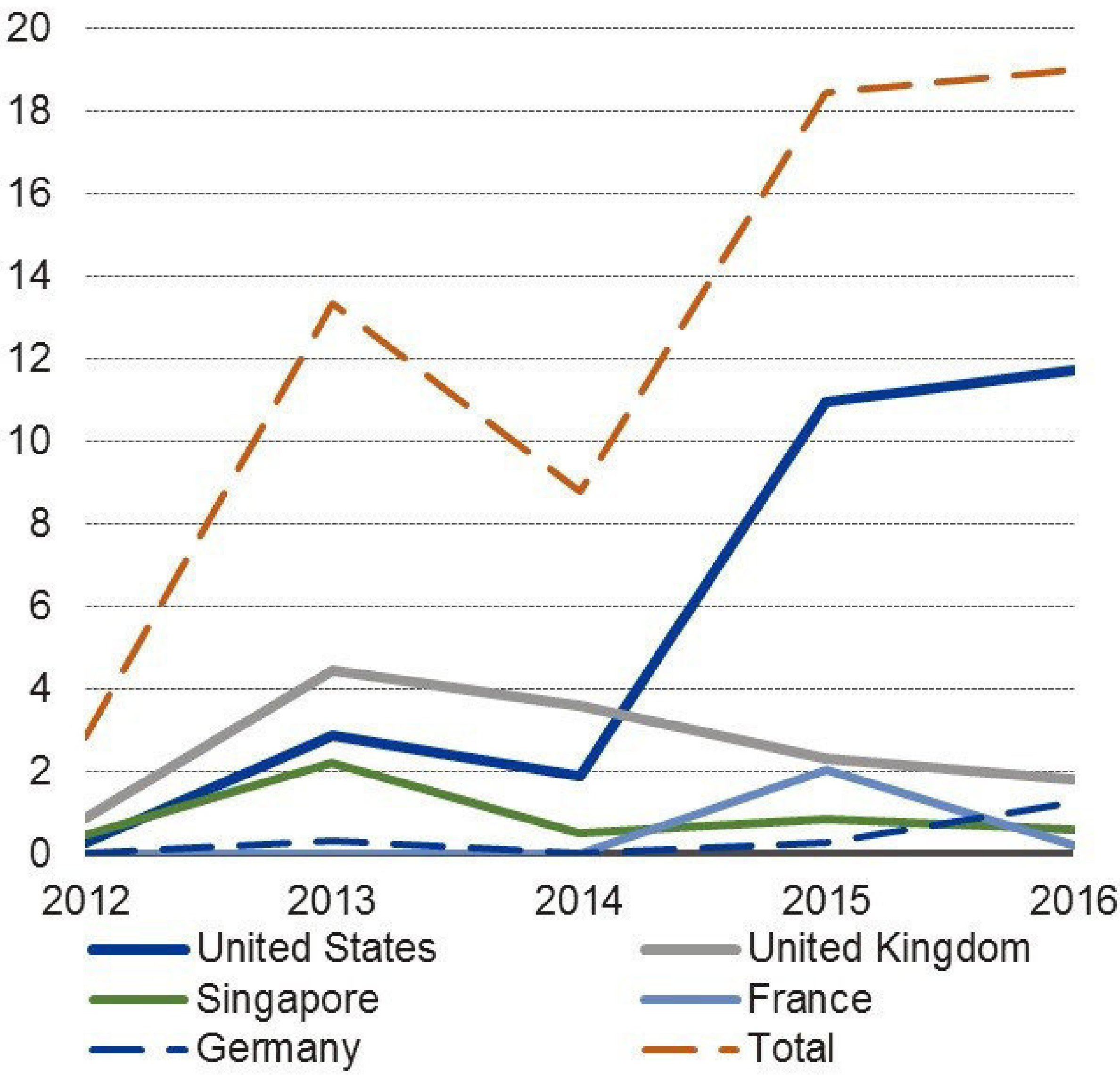
2.1 Volume of in- and outflows

Chinese cross-border investments have been growing rapidly over the last few years. According to the private research company RCA Analytics (2017), there were roughly 56 billion USD of real estate investments from foreign investors in China in 2016, double the volume just four years earlier. Three aspects of this scenario are remarkable. First, the vast majority of these cross-border inbound investments are channelled through Hong Kong or Singapore (in 2016, this share was 94%, according to RCA). Second, the volatility of these inflows is striking; the transaction volume of foreign investors in China was 35 billion USD in 2007, less than 19 billion in 2008 and almost 33 billion in 2011. Third, the average ticket size has been oscillating around 120 million USD per transaction with no clear trend.

With regard to outbound transactions, the picture is somewhat different. At a significantly lower level, the volume of cross-border transactions from (mainland) Chinese investors in foreign real estate has been rising sharply since 2012. Before 2012, outbound institutional real estate transactions were largely restricted. According to RCA, Chinese institutional investors invested approximately 19 billion USD in foreign commercial real estate in 2016 alone (according to JLL, the overall volume may be almost double, and this still does not capture the volume of private home-buyers (Financial Times 2017)). The outbound volume is also strongly concentrated in a few countries, with more than 90% of the overall transaction volume flowing into just six. The US is catching the lion's share at more than 60%, and this share has been rising over the last few years. The average deal size has been oscillating around a significantly smaller average, compared to the inflows. However, particularly in Germany, the number of transactions and the average deal size seem to be trending up from very low levels in the last few years.

When going abroad, Chinese investors are still on a learning curve. They focus on buying in large and liquid markets (New York or London) and they often buy larger portfolios, in order to reduce their investment risk. There are a few very large transactions; according to CBRE Research, with almost 50% of the whole outbound transaction volume of Chinese investors being concentrated in just seven deals in the first six months of 2016 (Zhao, 2016). This stems partly from the important role that insurance companies, sovereign wealth funds and large conglomerates played at that time in the market, as these investors had a very substantial need to invest. Almost 50% of the total outbound investment volume in the first half of 2016 was undertaken by insurance companies alone.

Fig. 1: Chinese real estate investments abroad, billion US$[21]

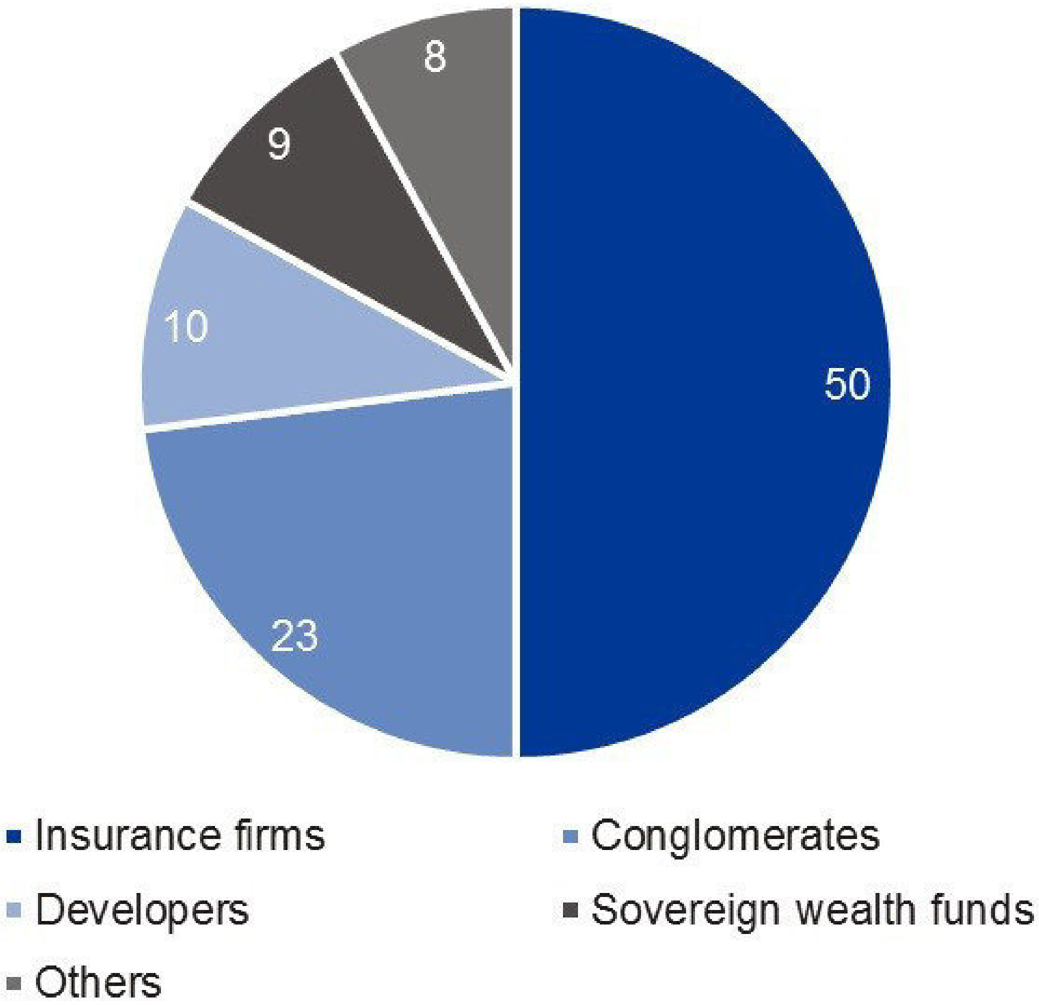


Source: RCA

The Chinese regulators have started to cast an eye on the rising interest of institutional investors in investing abroad, and the debate surrounding capital controls on real estate investments abroad is ongoing. The regulator's main worry is that a further outflow of capital might weaken the country's currency. We will return to this aspect later.

[21] Hong Kong not included in the in- and outflow matrix.

Fig. 2: Outbound capital flows in H1 2016, in %



Source: CBRE (quoted by Zhao, 2016)

2.2 Chinese investors and their strategies

Chinese insurance companies, pension funds, Sovereign Wealth Funds (SWF), developers, real estate companies, family offices as well as private equity investors have become more active on European real estate markets. However, very rarely have they succeeded in securing and transacting a deal. According to brokers, lawyers and fund managers, the success ratio for Chinese investors has been fairly low, despite their willingness to pay a price premium. Potential reasons for the lack of success are manifold, but the common reasons include capital chasing yields, a strong "buying appetite" on German markets from investors all over the world, and specifically for Chinese investors, the lengthy approval processes they have to undergo (and the final "say" in China). Moreover, Chinese investors often prefer to act flexibly, which increases the execution risk for the seller. Lastly, it is probably also their strategy to act carefully and walk away from unconvincing deals.

To be more precise, the likely investor strategy is to simply acquire trophy assets or prime office towers in major cities such as Frankfurt, Munich and Berlin in Germany, or London in the UK. Usually, these parties would be seeking transactions from roughly EUR 100 Mio. upwards. Given the relatively smaller size of office markets in Germany and historically high demand for these assets, it has been a challenge for Chinese investors to find suitable assets in Germany. There are very few properties that could rival some of the more prominent assets that have changed hands in London, such as the Cheese Crater (bought by a HK-CHN Property Company), Walkie Talkie (bought by a HK-Conglomerate) or the Two Place (bought by a Chinese insurance company). British market players also seem to be more open to foreign investors and the market is by far the most transparent in Europe. Additionally, Chinese investors have been generally targeting an IRR (internal rate of return) of about 8% for core assets in Europe, which is very difficult to achieve in the current market environment.

Nevertheless, Chinese investors have had some success in acquiring assets in Germany. Table 1 shows some examples.

Furthermore, at least one transaction in Germany was completed by a Chinese Sovereign Wealth Fund, but the company discloses very little information on its activities. Some insurance companies have tried hard to close deals, such as the Potsdamer Platz in Berlin, but so far without success.

When looking at the deals that have been closed successfully, it appears that a number of investors have successfully adapted their strategy. Fosun Property has purchased its asset through their newly acquired property platform in London. Their decision-making process is also much faster than those of Chinese insurance companies. CIC bought its residential portfolio through Morgan Stanley, whereas the New Century Group has had a team on the ground in Germany when it bought the Golden Tulip hotel. The experienced developer Greenland Group has, for instance, teamed up with the Spanish hotel group Meliá and opened its first hotel "The Qube Hotel" in Frankfurt in 2013. One of the key changes in strategy is to have an experienced team in the target region or country. Although the strategies of the various investors differ, what they all have in common is that the purchasers had people or partners on the ground and in the market, facilitating the transaction. Particularly in markets like Germany, where real estate markets are more fragmented than in the UK or France, local expertise is essential for dealing with the complicated local frameworks in terms of planning processes, regulatory requirements, as well as taxation, to name just a few.

Table 1: Examples of Chinese investors in Germany

Investor	**Classification**	**Asset**	**Year**
Fosun Property	Private Equity	Office Building (Estrella) in Frankfurt	2017
CIC	SWF	Residential portfolio spread over Germany	2016
CCB	Bank	Office Building in Frankfurt (for own use)	2015
Junson Capital	Family Office	Lanxess-Arena in Cologne	2015
New Century Group	Hotel Operator	Hotel in Offenbach (Kaiserlei)	2013
Greenland	Developer	The Qube Hotel Frankfurt	2013

Source: own compilation

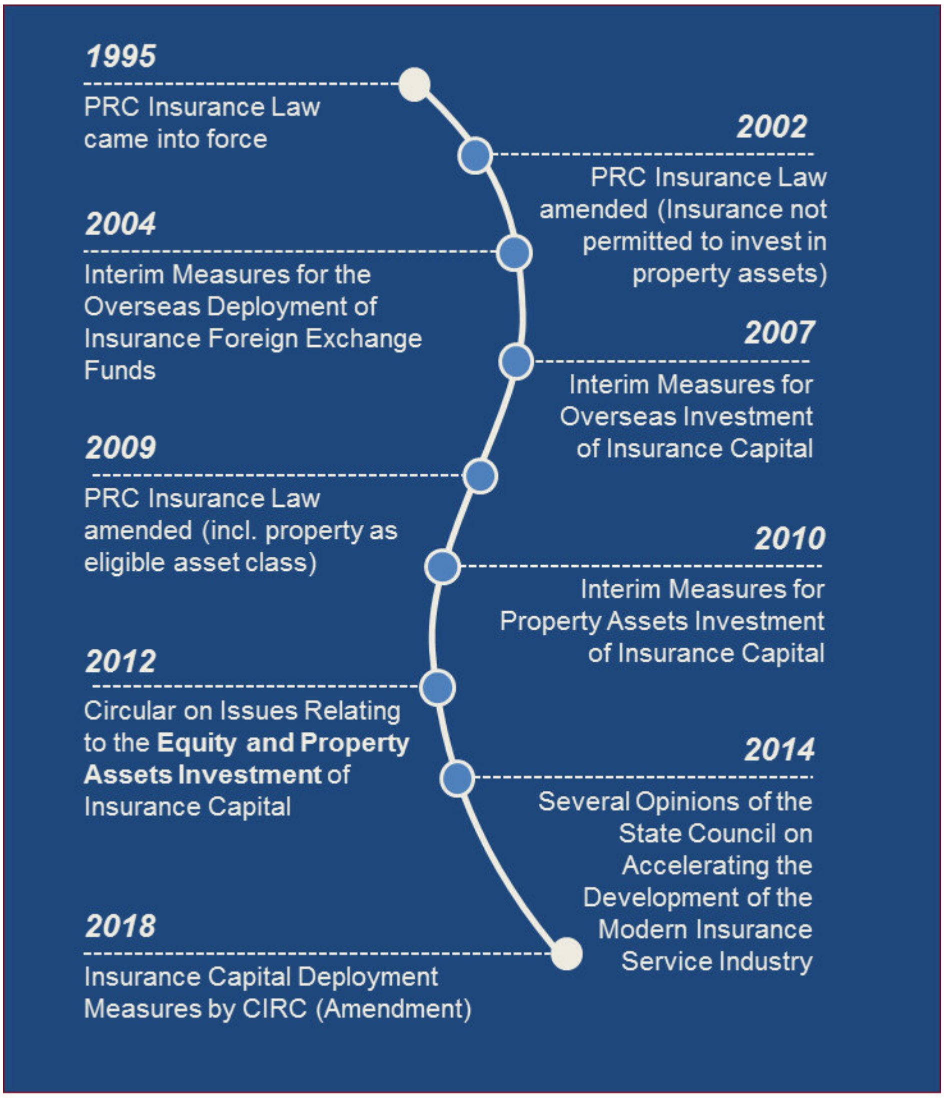
2.3 Retrospective view of regulatory frameworks for Chinese Insurance Companies

Over recent months in 2018, Chinese investors have not been particularly active in the German market, as a result of stricter capital-control policies implemented by the Chinese authorities. In particular, insurance companies seem to be struggling to conduct transactions outside China under the new policy framework.

Looking back, Chinese *insurance* companies have been among the most heavily regulated among Chinese investors. It was not before 2010 that insurance companies were allowed to invest in real estate domestically, and only as of 2014 have they started to invest in this asset class internationally. Over the last decade, the China Insurance Regulatory Commission ("CIRC") has come a long way in relaxing the regulatory framework as summarized in

In summary, Chinese insurance companies have had a relatively brief exposure to investing in non-domestic real estate, because of the constantly changing regulatory framework. With most companies investing in overseas property for five years or less, they are still in an early phase of the learning curve.

Fig. 3: Major regulatory changes for Chinese insurance companies



Source: CIRC, Clifford Chance, Grandway Law and own compilation

2.4 Newcomer with potential

According to CIRC, the total assets of Chinese insurance companies amount to roughly USD 2,658.6 billion (CNY 16,738.94 billion) as at the end of 2017. Roughly 15% of these assets are overseas investments, leaving a further 5% which could be invested in overseas property assets. Hence, funds for further overseas property investments are clearly substantial.

Furthermore, the other major capital pool, comprising the National Social Security Fund (SSF) or the state pension fund, has not been allowed to invest in (overseas) property assets. And its assets under management volume of roughly CNY 2,042.3 billion as per the end of 2016 can be considered substantial as well.

Although they are under strict control and supervision regarding their overseas investment, especially property assets, it is inevitable they need to diversify their portfolio and expand their allocation to overseas markets. It is only a question of time until they will meet the requirements (expertise in risk management, investment management and also transparency). At this point, the diversification of the portfolio to international markets will very likely again be the focus of their attention.

3 Concluding remarks

Real estate capital flows from and to China are volatile, not only because of economic cycles, but particularly because of regulatory changes (Clemens et al., 2011). This will certainly not end in the next few years. However, it is also unlikely that these cycles will prevent the longer-term trend towards a greater integration of Chinese real estate markets into global real estate markets. China's wealth has been rising strongly over the last four decades and economic growth has declined, thus also reducing potential capital gains from Chinese assets. Both these developments have increased the domestic pressure to chase returns globally.

What is more, as China's real estate cycles are not perfectly correlated with the real estate cycles in Europe or the US, investors can benefit from this form of diversification. For two reasons, this diversification potential should remain intact for many years. First, there is still significant backlog demand in China. Second, China has experienced a very different investment history over more than a hundred years, compared to Europe and the US, and this will also produce a series of differently timed echo effects for replacement demand. Therefore, it is important for western real estate investors to understand China's real estate markets, not only in order to identify potential investment opportunities there, but also to understand potential buyers and competitors in their own domestic markets. Real estate professionals in Europe and the US are no longer able to ignore China. They do not need to be active on the Asian markets, but sooner or later, they will have to develop a strategy to cope with Chinese real estate professionals. Therefore, it is important to understand not only Chinese real estate *markets*, but also Chinese real estate *players*.

So far, the stake of Chinese investors in real estate markets outside a few pockets in global cities like New York or London is small. But this is likely to change, as Chinese investors are still at an early stage of the learning curve. Zhao (2016) reports that only one of five big real estate companies has some cross-border experience, and she also argues that merely 15% of the transactions started by Chinese investors were indeed closed after submitting a non-binding offer. So far, Chinese investors are still paying a significant premium for a transaction in Europe or the US. This premium is likely to decline over time, as Chinese investors continue their relentless path along the learning curve.

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