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China's property management industry: a major beneficiary from COVID-19

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The property management industry is at an inflection point in China. As it transitions away from a labour-intensive business model and adopts a higher value-added service approach, the industry will offer investors a non-cyclical avenue to tap into the country's growing property demand, as well as the increased demand for better management services triggered by the epidemic.

For the longest time, investors have looked primarily to Chinese property developers to tap into China's property market. This is about to change. Property management – the business of overseeing and managing residential, commercial real estate and/or public facilities – is undergoing a transformation that may well expand the sector's revenue opportunities and profitability.

A NON-CYCLICAL HAVEN

In contrast to property development, property management is an asset-light business, and one which earns stable streams of recurring cash flow. The business is generally labour intensive as the appointed property manager must keep properties in safe and habitable conditions, providing, among other things, security, cleaning and maintenance services. Basic management fees (monthly average RMB 2.25/sqm)[1] – collected from property owners and based on the gross floor area (GFA) managed – are the primary revenue source for most property managers. Such recurring income makes property management less sensitive to macro-economic trends or changes to monetary policy.

In the past, price controls and long-term service contracts have prevented many residential property managers from raising management fees during their first 8–10 years of service. Amid rising labour costs, property management in China has not always been a lucrative business.

This changed at the end of 2014 when the Chinese authorities removed price controls for property management fees[2]. Today, although certain cities still have regulated caps for welfare housing estates (during the first contract period of residential projects), many have been actively reviewing their guidelines, and further deregulation is underway. This relaxation of price controls, the increasing willingness of Chinese households to pay for better

Sources: [1]Citi Research: China Property Management, 1 November 2019. P. 28. [2]National Development and Reform Commission: Circular on the Opinions of Relaxing Price Controls in Certain Services, 17 December 2014.

living standards, plus the sheer scale of space needing management, are strong drivers for the property management sector.

According to the China Real Estate Index System (CREIS), China's GFA under management exceeded 21 billion square metres (sqm) in 2018, of which 66%[3] was from commodity properties (residential, office and commercial spaces). With such a large supply of property space, the total addressable market (TAM) – the revenue opportunity available for property managers – amounted to RMB 1.4 trillion in 2018. As the GFA under management is expected to grow by 1.5 billion sqm annually[3], the TAM will increase to RMB 3.2 trillion in 2030, representing a compound annual growth rate (CAGR) of 7.4% p.a. (see Fig. 1).

NEW REVENUE STREAMS

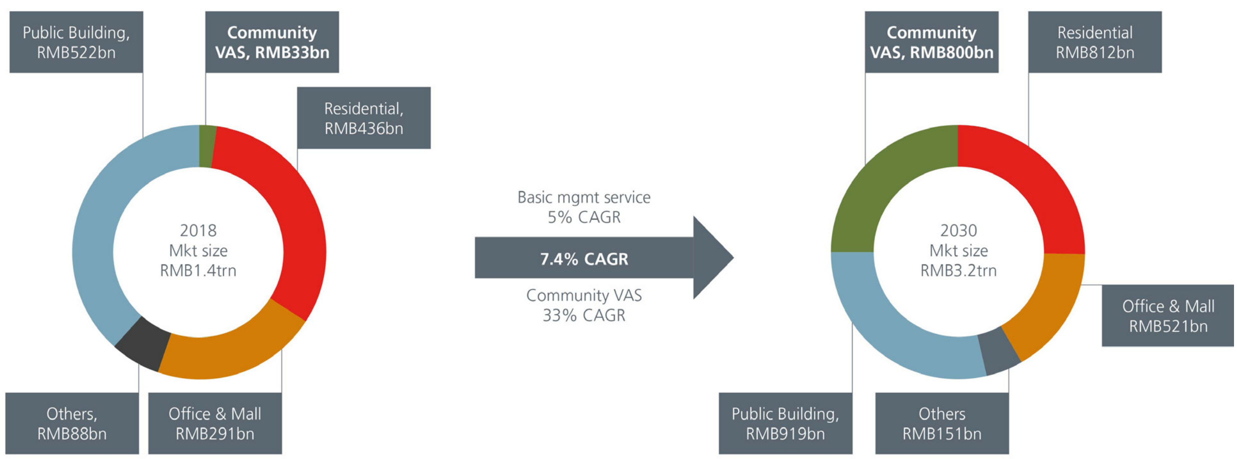
Besides the large amount of space that requires property management, community value-added services are another important driver for the sector. This segment, which is highly lucrative, is expected to have a TAM of RMB33 billion in 2030, up from RMB 8 billion in 2018, representing a CAGR of 33% p.a. (see Fig. 1). While the top 100 players' net profit margins from basic property management services averaged a mere 5-6%, community value-added services can command net margins of more than 18%[4]. Such margins have further room to increase as value-added services enjoy economies of scale given the generally fixed operating expenses. It is therefore not surprising to see in recent years, China's property managers ramping up such services, which typically include:

- Public space utilisation;
- Property brokerage;
- Electronic services;
- Lifestyle services;
- Financial services; and
- Housekeeping services

Still at a preliminary stage, some property managers have even started to explore other value-added services in advertising, online retailing, retirement care, and medical services.

A good property manager is important for value preservation or the creation of properties. More recently, Chinese households and authorities have come to recognise the value of property management in light of the coronavirus (COVID-19) outbreak. To contain the spread of the virus, property managers have been rigorously carrying out preventive measures such as temperature

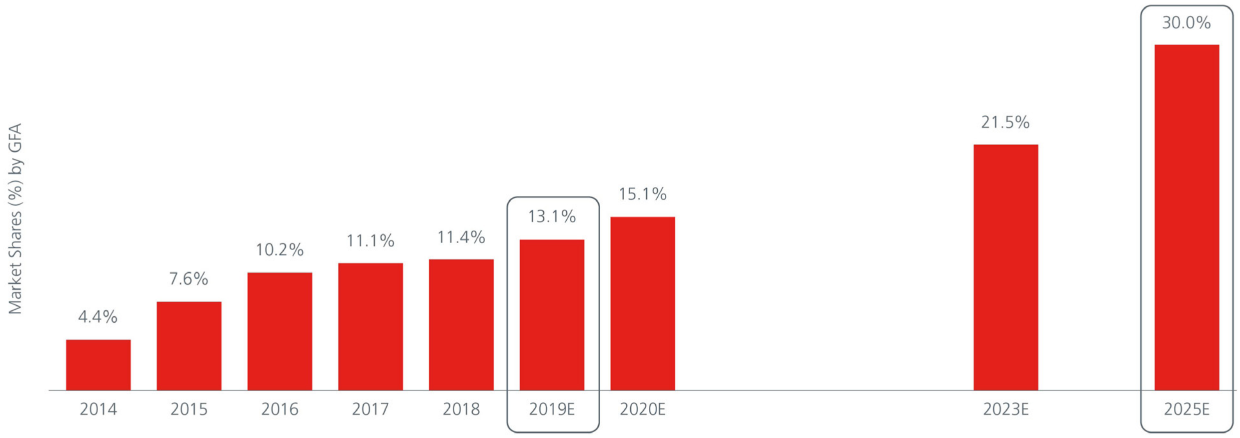
Fig 1: Total addressable market (TAM) size to hit RMB 3.2 trillion by 2030



Source: NBV, MOHURD, Ministry of Commerce, Chinese Academy of Industry Economy Research, Intelligent Research Group, China Index Academy, Citi Research estimates.

Sources: [3]Eastspring Investments' estimates, March 2020. [4]DBS Asian Insights, September 2019, p. 18, citing data from CIA and DBS HK.

Fig 2: Top-10 market shares of property management companies



Source: China Index Academy, Citi Research estimates. Property management companies' market share by Gross Floor Area (GFA) under management, property developers by contracted sales.

taking, record keeping and ensuring that residents as well as tenants wear a mask when leaving the premises. According to anecdotal reports, many community households have voluntarily compensated property management staff as a means of expressing their gratitude for these kinds of services. In addition, a local property management vendor which failed to carry out preventive measures in its property, was reportedly banned by the authorities from expanding its services in Dezhou, Shandong province[5].

Over in Shenzhen and Hangzhou, local governments have announced they will provide a subsidy of RMB 0.5/ sqm for two months to property managers, in recognition of their work and the related costs incurred in helping manage the fallout from the outbreak. We also expect that there is a high likelihood of more supportive policies for the property management business, such as temporary cuts in value-added tax, as property managers are now taking up more social functions (e.g. community-level governance). This shows the important role of property managers in community management for tenants and property owners. It is likely that there will be more government policies aimed at encouraging property managers, with well-established infrastructures and wider coverage, to offer value-added services.

RIPE FOR CONSOLIDATION

The property management sector is highly fragmented with more than 127,000 property managers currently in China[6]. In 2019, the top 100 of these companies managed 44.5% of the GFA across the country, whilst the market share of the top 10 managers was only 13.1% (see Fig. 2). As sizeable property managers look to solidify their positions and mid-size players rush to catch up with the rising demand for premium services after the coronavirus outbreak, Citi Research believes that the industry is poised for rapid consolidation, with the top 10 players expected to double their GFA market share to 30.0% by 2025.

The financial resources required for M&A have driven more privately-owned property managers to list on the stock exchanges. Additionally, more developers may also look to list their property management operations in order to unlock the

Sources: [5]Bank of American Global Research: Beyond the outbreak, 7 implications for China property, 4 March 2020. P. 2. [6]CGS-CIMB Research, 27 November 2019, citing end-2018 data from the CRIC (克而瑞).

potential value in the capital markets. Investors can expect about 10-15 Chinese property managers to be listed on the Hong Kong stock exchange over the next three years, according to a 2019 study by CGS-CIMB[7].

COMING OUT STRONGER AFTER THE COVID-19 OUTBREAK

Relative to other service businesses, the property management sector has seen less disruption and decrease in demand during the pandemic. In the short term, despite the increased preventative/ hygiene measures now included in management processes, the core business of property managers has seen only slight cost increases, and these have largely been offset by government subsidies and support measures. Furthermore, as virus control measures are gradually relaxed, the demand for non-essential value-added services – property agency, property sales office management and decoration services halted during the lockdown – will likely recover in Q2 2020.

In the mid-to-long term, quality property managers who can safeguard households' health and well-being, fulfil daily demands, offer transparent communications and ensure a higher level of convenience, will be in high demand. Such premium services, however, are currently in limited supply. Only by offering such premium services can property managers stand out from others when they pitch for third-party contracts for both new and second-hand projects in the future, which, in turn, will help them gain greater market shares, raise management fees and improve profit margins.

IDENTIFYING GENUINE OPPORTUNITIES

The Chinese property management stocks which we track are expected to register robust earnings growth of 34.4% p.a. from 2019 to 2021 as revenues from business expansion and value-added services add to the industry's stable income stream (see Fig. 3). The sector is trading at reasonable valuations considering its stronger growth potential in comparison with global peers.

Nevertheless, after a strong rally in 2019, we prefer to be selective and look for companies with the following attributes:

Developer-backed. Developer-backed property managers can leverage their parents' large reserves of planned or under-construction GFA, as well as a recognised brand name. This also helps them when bidding for third party and secondary market projects amid industry consolidation, as well as when raising funds from the capital markets.

Execution capabilities. Detail oriented and efficient execution is critical to improve management fee collection rates, renewal rates and residents' commitment/stickiness. All these are key drivers of organic growth in GFA and improved margins.

Fig 3: China's property management companies versus international peers

Average	China	International peers
Forward P/E 2021E	**28.0x**	19.9x
EPS CAGR (2019-2021E)	**34.4%**	-2.7%

Source: Bloomberg and Eastspring Investments. Shares prices of China's 8 property management stocks (listed in Hong Kong) and 9 international players (listed in the US and UK), data as at 10 May 2020.

Sources: [7]CGSCIMB: Property Management, 27 November 2019.

Fig 4: Smart technologies that help improve property management quality and lower staff costs

Smart parking + Mobile payment	Door access via mobile + Visitor authorisation	Unmanned store + Smart retail terminal	Patrol robot + IoT
Smart video surveillance + Remote inspection	App coverage + Home living offline services	Electronic building automation & control	Centralised customer service + Smart payment/ticket system

Source: Citi Research: China Property Management, 1 November 2019. P. 13. Companies, Citi Research, 1 November 2019.

Technology. Given the high labour costs involved in property management, managers that make use of technology in daily management – such as smart video surveillance and parking systems (see Fig. 4) – will be able to reduce labour costs significantly and improve profitability.

Diversification. Property managers need to be on the lookout for more space to manage, not only in respect of residential projects, but also commercial spaces and public amenities. The latter segments tend to have higher entry barriers and require a track record in property management but come with higher profit margins.

We believe that China's property management industry is at an inflection point from which it will reinvent its labour-intensive business model and adopt a higher value-added service approach. This will offer investors another viable avenue to tap into China's growing property demand and the rising trend towards urbanisation, as well as the increased demand for quality property management services triggered by the COVID-19 outbreak.

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