**The Impacts of Oversupply**

By Michael Hart

A decade ago, the joke was that the crane was the official bird of China, they were everywhere. Of course, that crane wasn't a bird, but rather a construction tool that was hovering over building sites across the country as buildings of every type were rising in the air. Today there are far fewer cranes on the skyline and many of those we can see have stopped moving. Just as their abundance before illustrated the construction boom, their stillness today exemplifies a downturn in the fortunes of property developers. Where once developers seemed to be making money on every project, now they have portfolios that are full of many projects that hurt rather than help their bottom line.

**Residential Foundations**

The construction boom has been running for well over two decades in China as developers worked hard to meet the residential demand of China's consumers looking for housing and then lucrative investments. Large apartment complexes were built in central locations and then as land prices rose and transportation systems improved housing estates were built further and further from the city center. Developers made money; consumers got rich.

**Commercial Boom**

For developers, residential projects were good business, but if developers don't build, they can't continue to prosper. As residential land became harder to acquire, some started to enter the commercial real estate market. The idea was that a large income producing commercial building such as an office building, hotel or shopping mall held in their own portfolio would help balance their cash flows. This idea coincided with many city governments looking to develop their commercial markets to meet the demands of consumers and service sector firms and to also broaden their tax base. So, governments approved more land for commercial developments and more developers ventured into this unfamiliar part of the real estate development sector. Early commercial projects were not always great, many just looked like standard apartment buildings and weren't developed with end users in mind. Over time projects improved and before long developers with only short experience in commercial development were building some extremely tall office towers. In addition to office buildings, hotels, shopping malls and serviced apartments were also built. In some cases when more seasoned private developers felt the market was being overbuilt, they stopped bidding for land while, government linked developers stepped in to help construct these buildings.

Nearly every one of the operators involved in commercial real estate including hotel management firms, mall operators and commercial leasing agents saw rents starting to decline as increasing amounts of commercial space continued to enter the market. They saw troubles emerging as competing projects started to outpace demand. And yet, once a commercial project is started, it isn't easy to stop, so construction continued.

**Consumers win**

The positive side of this story is that as hotel rates decline and office rents fall, consumers can access properties at record low rates. Now is a great time to travel to new cities or have a weekend at a local five-star hotel and for business looking to upgrade their space, many choices exist of office properties that are much better than the previous generation. Offices with good transportation links, lots of natural light and good floor plans exist all across the city for similar rents to those in buildings a decade or two older. In theory, these discounted rates will help to spur the service sector which as it grows will eventually help take up some of this excess space.

**Consolidation**

Currently office vacancy rates in Tianjin are high, with nearly half of all space sitting idle. The high vacancy rates however aren't universal. Some projects are nearly full thanks to superior space, better management, better locations or transportation, while others sit nearly empty. Additionally, wholly owned properties, ie those that haven't sold off the property floor by floor and thus are better able to manage the overall environment in their building are outperforming their peers. Similar challenges can be seen in hotels and shopping malls, with either low occupancy rates or high numbers of empty store fronts respectively creating challenges for property owners.

Most of the projects are financed with debt, and that is where the real challenges appear. For developers unable to repay their loans, pressure will mount to lower their rents to find tenants, thus hurting all landlords. Over the past year, some developers have started to sell their properties at discounted prices to reduce their debt loads, other developers have started to sell other assets in their portfolios to lower their overall debt. In times like these, a few bankruptcies would also not be surprising. This trend has happened in the North America and Europe in down markets and the same is likely to occur here as well. We are also likely to see some projects sit idle waiting for the market to recover. Planned construction projects will be delayed and the market will take some time to regain balance before new building booms begin.

**Conclusion**

It is clear that currently the commercial real estate sector (office, hotel, retail and serviced apartment) is overbuilt. A real demand for service sector infrastructure led to the boom of construction which ran a little too long. The combination of slowing development, reduced rents, alternative uses, developer bankruptcies and the growing service sector will eventually help the real estate sector become healthier. In the meantime, the cranes will migrate to other markets and wait for the right time to return to our city.

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