



# China Property Strategy

Remco Waller, CEO, China Property Company

Tesco in Asia 2010, 21st–23rd November

# Contents

---

- Introduction and strategy
- Tesco's mall experience and capability
- The Lifespace concept and blueprint
- Site selection and property development process
- Leasing and brand management
- A business model for value creation
- Update on trading malls
- Summary

# China PropCo Strategy: a challenge and an opportunity

## The Challenge

- Securing high quality hypermarket space to allow Tesco to become the Best Retailer in China
  - Leasehold sites for hypermarkets are often compromised in poor quality malls
  - In many Tier 2 & 3 cities suitable malls for leasehold hypermarkets don't yet exist

## The Opportunity

- How to capitalise on the multi-billion market for retail property in China
  - Strong demand for modern retail from rapidly growing urban middle class
  - Good supply of premium malls and dept. stores in Tier 1 cities but...
  - ...current mall offer in Tier 2 & 3 cities is limited and of poor quality

## Tesco's China Property Strategy

1. Freehold malls anchored by a Tesco hypermarket
  - Mass mid-market district malls
  - Focus on Tier 2 & 3 cities
  - Secures best hypermarket site in each city
  - Value also created from property development / appreciation
2. Leasehold hypermarkets in third party developments
  - For developments in which high quality space is available
  - And where freehold sites are not available
  - For catchments that cannot support a district mall but can support a hypermarket
  - Lower capital model
  - Complementary to freehold mall roll-out



# Meeting the needs of a huge market opportunity

## There is significant untapped demand for modern retail...

- Urban population of 320m in our strategy provinces in 2008, estimated to grow to 420m in 2020
- Assuming a demand profile of 200-300k population per mall and 50k per hypermarket we estimate a potential demand in 2020 for:
  - 1,400 - 2,100 malls in 2020
  - 8,000 hypermarkets
- By March 2011, Tesco plus the biggest four competitors, will have just 83 malls
- This leaves enormous potential to serve a rapidly urbanising and increasingly affluent consumer market

## We have identified target locations within our regions...

- c.90 cities currently on our radar with mall potential, with core urban population >120 million – twice that of UK
- All of the Tier 1 & 2 cities, some Tier 3 cities
- 600 'ideal' locations identified in these cities
  - c. 200 for Lifespace malls
  - c. 400 for leasehold hypermarkets
- 32 sites approved so far
  - 6 malls by end 2010/11
  - 4 new malls in 2011/12
- By 2014/15 we plan to have:
  - 50 malls trading (each with a hypermarket)
  - 30 malls in development
  - Over 150 leasehold hypermarkets

# Goals and strategy for China Property Company

## Our goals

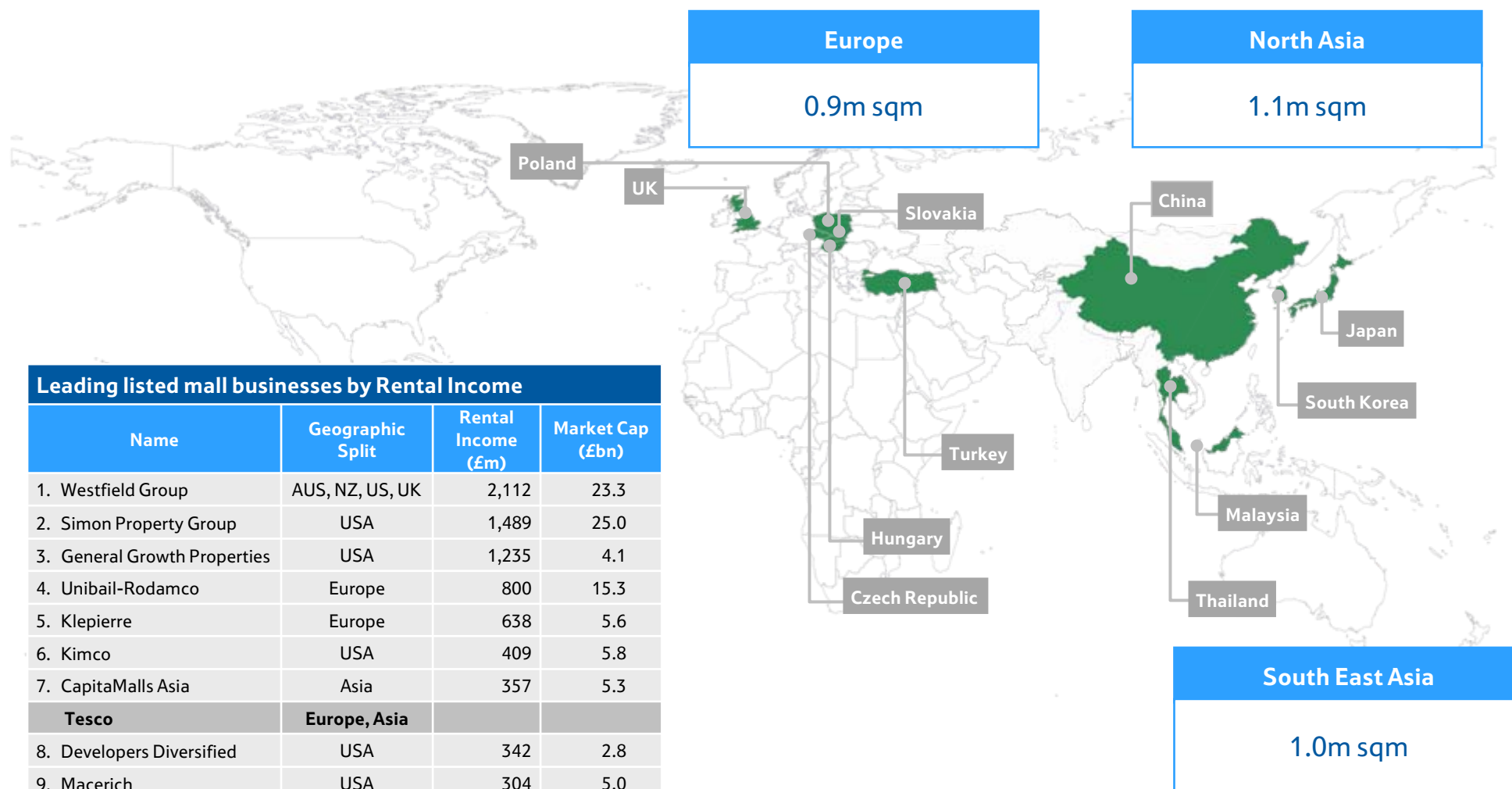
- Be the first choice mall for retail partners
- Be a growth business
- Become the business people value more than any other
- Have the most loyal and committed staff
- Deliver the committed financial returns for both Tesco and other shareholders
- Have deep domestic knowledge combined with international Tesco expertise

## Our strategy

- Buy, build, and operate district shopping malls across China
- Provide a great trading environment for our retail partners
- Design and locate quality malls with a relevant offer for the changing lifestyles of our customers
- Put the community at the heart of everything we do

**Our aim is to become the foremost mall company in China**

# Tesco is one of the largest mall operators in the world



Source: Company Information as at YE 09;  
Share prices and currency data per FactSet as at 12/11/2010

# Tesco experience with expertise from outside

## A strong team, combining internal experience with external expertise...

- Vast experience in both leasing and mall management
- Extensive retailing backgrounds both in Asia and at Tesco
- Strong local knowledge and connections
- Senior team have extensive international retail property backgrounds, including experience with:



TISHMAN SPEYER

## ... in a regional structure to ensure we retain local focus

- Independent of – but close collaboration with – Tesco's retail business
- Three regions, each with CEO, supported by national head office which provides central services such as Finance, HR, Legal and IT
- Plan for 350 employees in national and regional offices and 75 in a typical mall
  - total headcount today c.700



# Customers are our priority

## A great place to shop

- I can get what I want
- Good value for customers
- Convenient and easy
- With a Tesco hypermarket
- Good community facilities
- The Lifestspace experience





# The Lifespace concept



## Typical Malls in China

Mass Mid-Market District Mall

**vs.**

Premium malls in Tier 1 cities, but few mid-market malls in Tier 2 and 3 cities

Mall design focused on customer experience

**vs.**

Malls designed to maximise tenant floor space, often with an incoherent tenant mix

Dedicated and proactive mall management operated by a professional mall company

**vs.**

Historical department store brands and inexperienced local retailers

Efficient, conforming hypermarket space

**vs.**

Poor hypermarket space

Future-proofed design for customers and retailers (e.g. car parking; customer flow)

**vs.**

Not future-proofed (e.g. small car parks and poor access and egress)

Focus on community space and activities

**vs.**

Limited space and community involvement

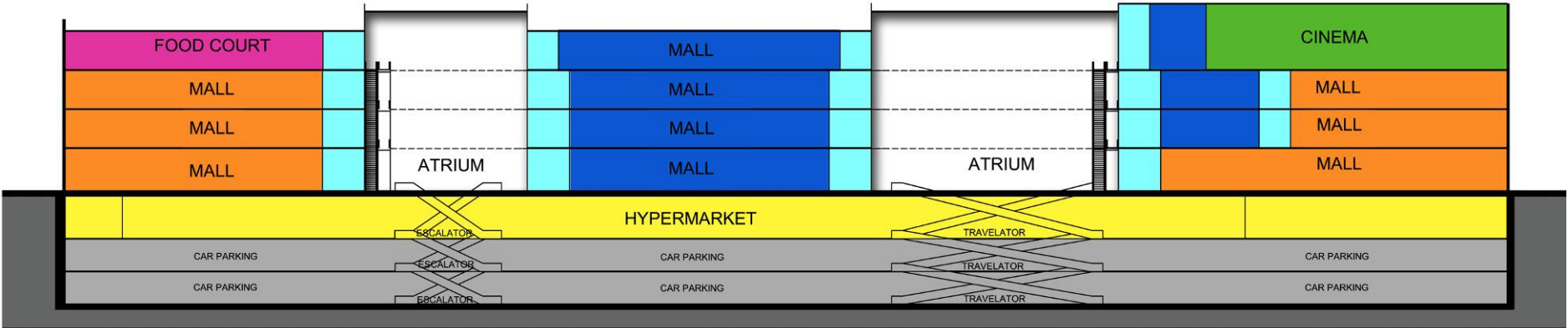
# Mass-market district mall anchored by Tesco hypermarket

## Key Mall Design Features

- Four floors of retail space with Tesco hypermarket across a single basement level
- Sufficient car parking to cater for growth in car ownership
- Customer-friendly circulation throughout mall
- Strategic positioning of Delicious Life and entertainment (e.g. cinema) on upper floor to draw customers up through the mall
- Open atriums and strong signage allow easy navigation
- Events in the community space (e.g. karaoke, celebrity events) to drive footfall and build Lifespace brand
- Shuttle bus service to widen potential catchment

## Typical Mall Characteristics

Gross Floor Area	75,000 sqm (ex. car parking)
Tesco Net Floor Area	9,000 sqm
Tenant Net Floor Area	Average 35,500 sqm
Car Parking	600 – 900 spaces
Bike Parking	Minimum of 300 spaces
Shuttle Buses	4 – 8 buses serving local catchments



# Strong brand identity will be market leading for China

**LIFESPACE**  
**乐都汇**

- 'Lifespace' brand emphasises destination nature of mall and association with family, lifestyle and entertainment
- Chinese name is Le Du Hui: 'Happy Fun Shopping Place'



- Delicious Life incorporates a food court, family dining, event hall and entertainment facilities



- Chinese 'ren' symbol meaning 'people'

# Site Selection – Researching winning locations

## Site Research is a competitive advantage

- 30-strong team in China, split across the three regions
- Responsible for identifying ideal locations for Lifespace malls and leasehold hypermarkets – two teams under one leadership
- Investment in this team brings benefits of:
  - Extensive knowledge gained in Tesco China and other international markets
  - Bright local talent with knowledge of China, both in terms of hypermarkets and shopping malls
  - Market leading data-sets, with sophisticated analysis using our Geographical Information Systems (GIS)
  - Independence within the decision making process, with the research separate from the property acquisition executives

## Extensive processes, data and experience helps to ensure we target the best locations

### Step 1: Ranking of target cities

- City Quality Matrix (CQM) ranking developed, based on economic and modern retail indicators, all extensively mapped and then scored
- Key competition measures (e.g. population per mall)



### Step 2: Identifying the right districts within cities

- Government meetings to understand future development plans
- Team driving every road, visiting every competitor



### Step 3: Identifying best locations within district

- Analysis of catchment spending power (hypermarket + mall)
- Analysis of competition
- Understanding micro-location factors (roads, access, public transport)

# Property Development Process Timeline



**Typical development timeline takes 30 - 45 months**

\* Note: All land in China is leasehold in the conventional sense operating on 40 - 70 year leases or land use rights. Where the land use rights have been acquired in China, it is referred to as 'freehold'.

# Working with local partners while retaining control

---

- Through our experience elsewhere in Asia we understand the importance of building up strong relationships with local developer partners
- All our partners have excellent knowledge of local markets and relationships with local governments
- Clearly defined project and construction management roles mean we have appropriate control on the quality and cost of the scheme
- Standardisation of design and specifications combined with technical competency and truly understanding authority constraints will allow us to construct high-quality malls at a rapid rate
- For our leasehold acquisition we are building strategic partnerships with commercial developers





# Mixed use developments offer an excellent opportunity

## Mixed use sites offer economic upside...

- Re-selling of residential units improves project cash flows and IRR
- Value of residential units is enhanced by proximity to quality mall developments – by developing this residential space we capture more of the value we create
- Mall developers, such as Wanda and CapitaLand, have successfully made use of mixed-use components to enhance returns

## ... and help to unlock sites

- Ability to develop mixed-use sites enables us to access a wider range of opportunities
  - Local governments often bundle residential lots with retail lot auctions to ensure coordinated neighbourhood re-development
- Example: Anshan Railway development.
  - We acquired the best site in the city through our ability to develop over 3,000 apartments to complement the mall



Anshan Railway, Liaoning Province

# Leasing strategy

## Retail mix

- Aspirational and affordable international brands
- Leading national brands
- Favourite regional / local brands



## Customer focused tenant mix

Customer insight to understand the shopping and brand preferences of our customer base

## Category Zoning

- Identify gaps in the market for tenant categories and brands
- Group retail categories to create precincts
- Position key brands to create destination retailing



**Level 4 & 5 – Delicious Life**  
Food court, event hall, entertainment



**Level 3 – Active**  
Sportswear and fashion



**Level 2 – Zest**  
Casual fashion



**Level 1 – Style**  
Fashion, cosmetics and accessories

## Partnership with core retailers

- Core retailers such as KFC, Bestseller, Watson, Holiland Bakery, Jinyi Cinemas who will create traffic across the mall



## Partnerships with local/regional retailers

- Smaller retailers offered turnover based leases to help them grow; we support them building their retailing skills so they grow their business with us



# Building the Lifespace brand

## Communicating the brands

- In- and outside the mall
- Advertising / direct mailing
- Joint promotional activities with tenants

## Marketing teams

- Central capability to manage brand, concepts & plans, executed by local marketing teams
- Utilising expertise of Tesco retail company



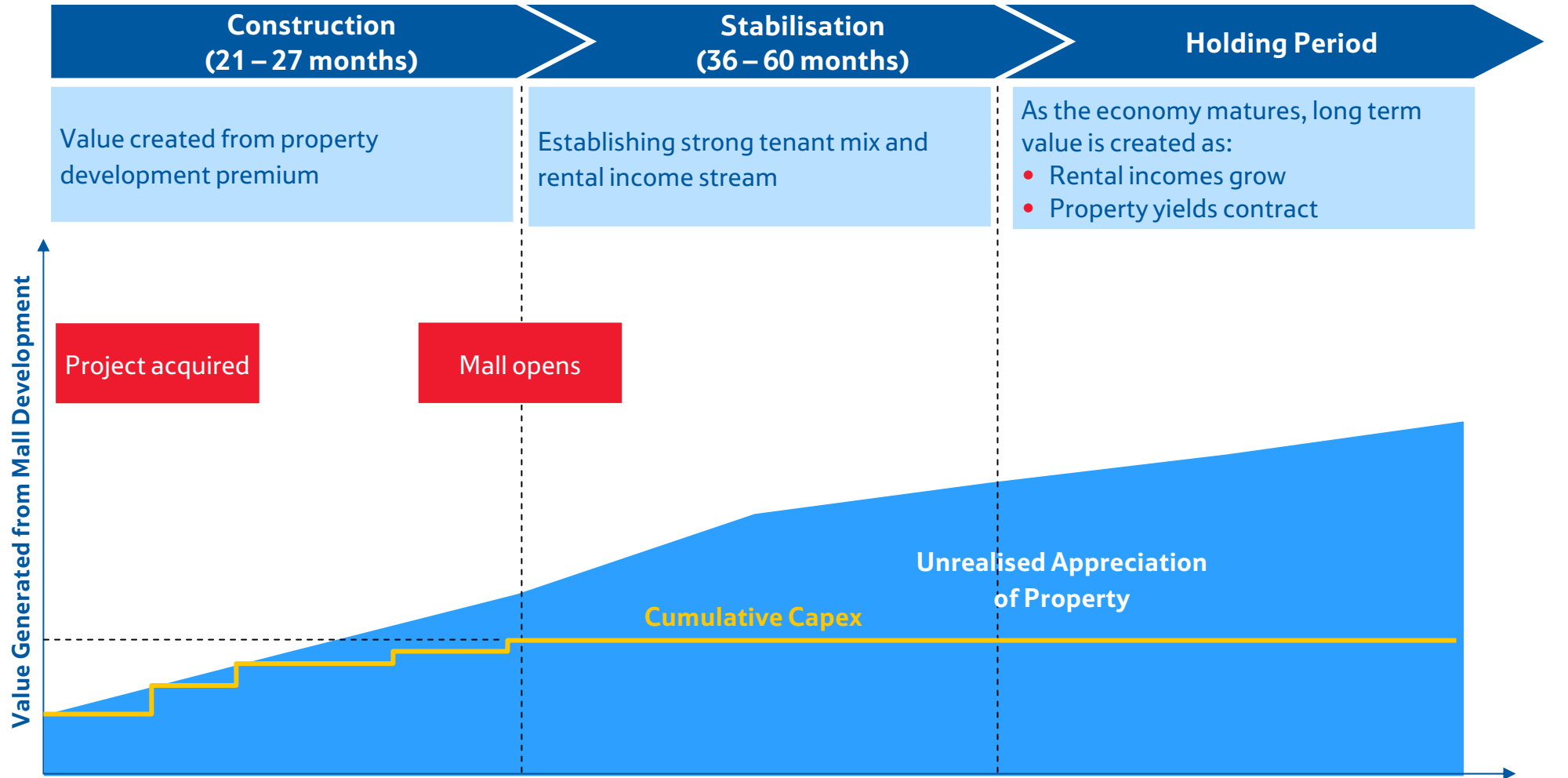
## Events

- Regular community and customer entertainment activities in the Event Hall
- Programme of events attracts customers and creates loyalty through participation

## Customer insight process

- Customer insight is driving our improvement plans
- Using the Tesco Brand Review & Customer Plan process

# A business model for value creation



# Mall economics

**At maturity (4 years +) the mall will generate good profitability and returns...**

## Typical mall economics at maturity

	£m
Total Capital Cost (includes capitalised interest)	68.5
Total Income	11.6
Total Expenses and Local Taxes*	(5.3)
Net Operating Income (EBITDA)	6.4
Depreciation	(2.8)
EBIT	3.6
Corporation tax @ 25%	(0.9)
Profit after tax	2.7
Return on Invested Capital = EBITDA/Invested Capital	9.3%
Return on Equity Invested (assumes 40% debt financing) = (EBITDA less Interest Costs)**/Invested capital	11.5%

**...and will have increased significantly in value from higher rents and lower yields**

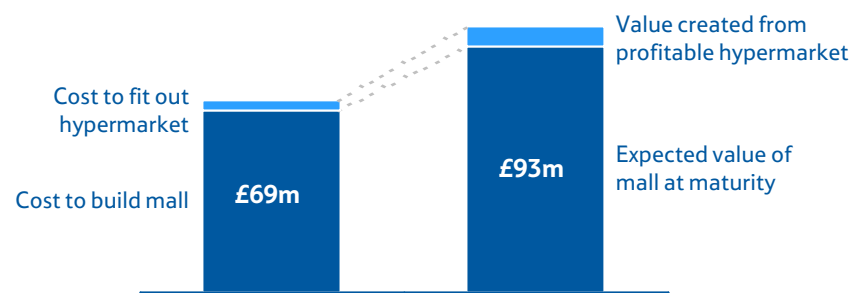
## Value of typical mall at maturity

**vs. £69m cost to build**

		Net Operating Income		
		£6m	£6.5m	£7m
Yield*	7.5%	£80m	£87m	£93m
	7.0%	£86m	£93m	£100m
	6.5%	£92m	£100m	£108m

+ Current yield for China retail property is c.7.5%

**In addition to the mall development, Tesco will realise value from operating a profitable hypermarket**

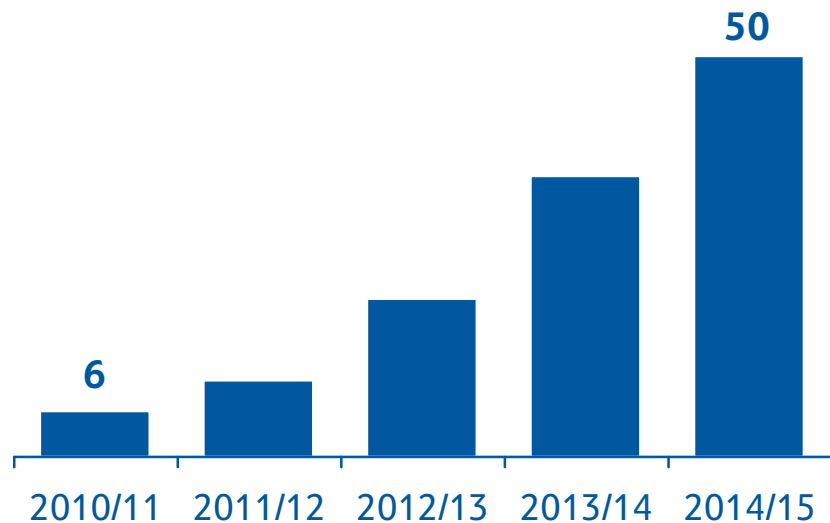


\* Excludes central costs of China Property Company

\*\* Assumes JV with 40% debt funding at 6% interest charge on debt

# China PropCo plans to invest c.£2 billion over five years

## Malls planned to be trading in each year



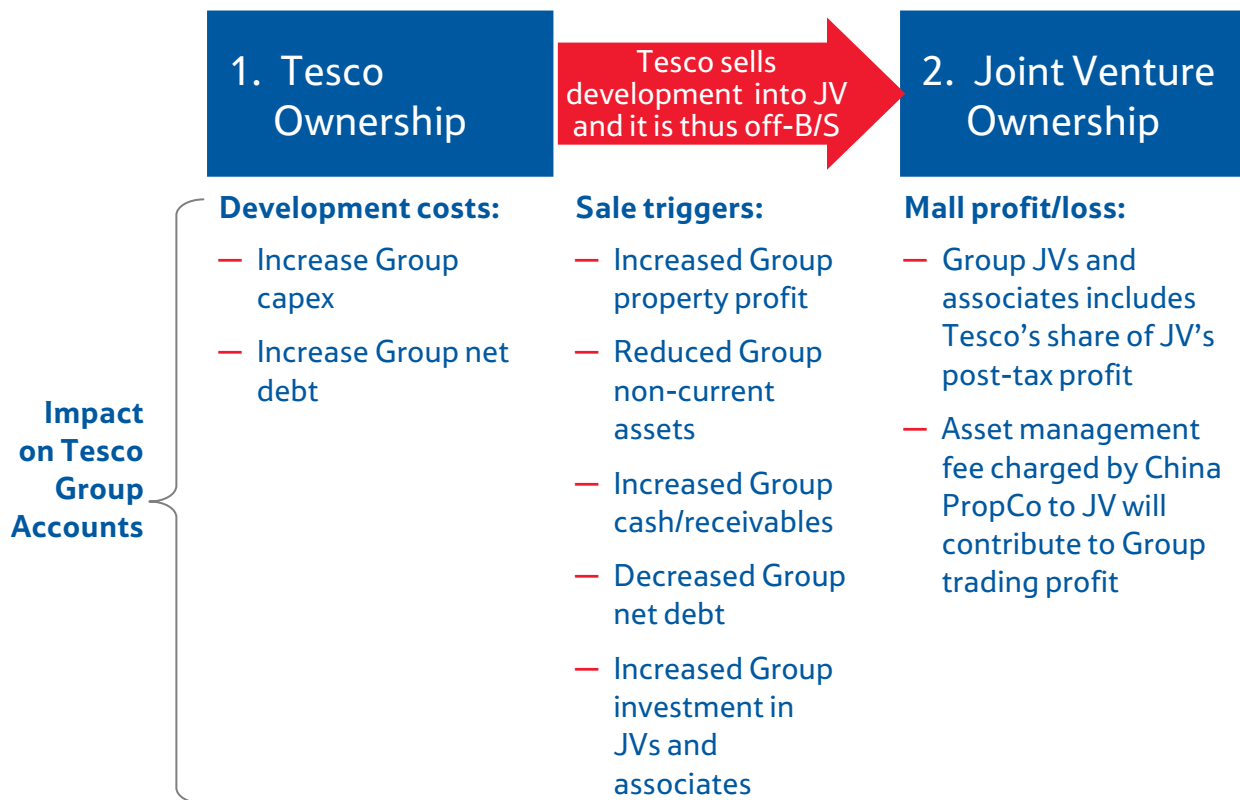
## By 2014/15

- No. of malls trading: 50
- No. of malls under construction: 30
- Cumulative gross investment: £5-6bn
- Cumulative net investment from Tesco balance sheet: c.£2bn

# China property funding

Rationale for working with JV partners		Progress to date	
External capital helps accelerate growth	<ul style="list-style-type: none"> <li>• More malls = more high quality hypermarkets</li> <li>• By moving fast we'll get the prime location in more cities</li> <li>• Reaching scale quickly will help us develop Lifespace as a brand</li> </ul>	Deals	<ul style="list-style-type: none"> <li>• Closed initial JV for three malls with consortium of leading investors, with debt provided by ICBC</li> <li>• Interest from large number of offshore and onshore investors</li> </ul>
Partners bring skills and experience	<ul style="list-style-type: none"> <li>• Investors bring third party endorsement of business plan</li> <li>• Advice / contacts of experienced local investors can be helpful</li> </ul>	Structures	<ul style="list-style-type: none"> <li>• First transaction structured as a corporate JV</li> <li>• Also investigating longer-term fund-style facilities</li> </ul>
		Capability	<ul style="list-style-type: none"> <li>• Corporate Finance team of ten in Asia</li> </ul>
		Market	<ul style="list-style-type: none"> <li>• Re-invigorated Chinese property market</li> <li>• Western funds turning to China because of perceived poor prospects in home markets</li> </ul>

# Accounting treatment of JV structure



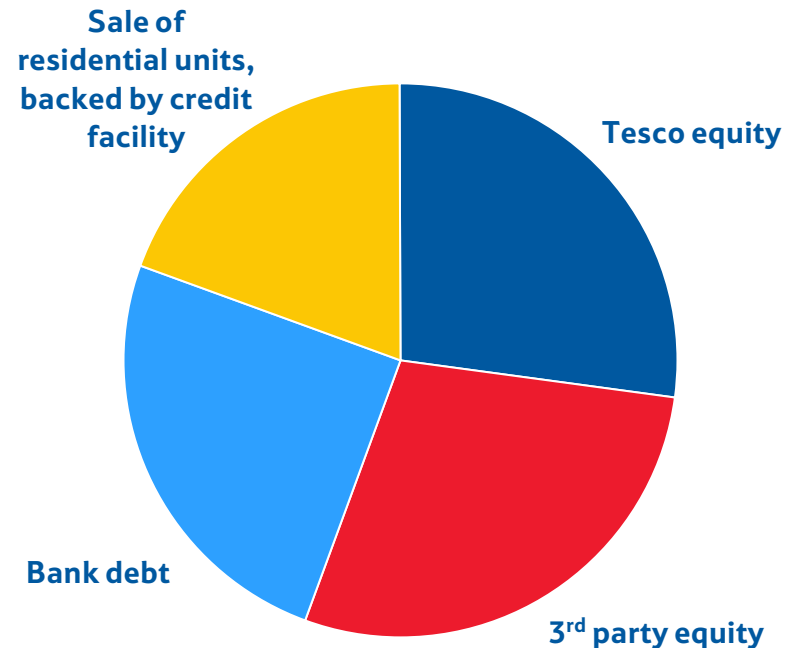
- A JV structure funded by debt finance reduces Tesco's net investment by up to 75%
- If the project has been in development for some time Tesco is likely to realise a modest property profit at the point the project is put into the JV
- Sites may be acquired by a JV before any development costs are incurred, in which case the project starts at stage 2. In such cases Tesco's investment in the project will be in the form of equity investment into the JV rather than capex

# Joint venture structure – an example

## A consortium led by HSBC Nanfung acquired 50% in a bundle of three mall developments through a JV structure

- JV formed by a consortium of investors, including HSBC Nanfung and Metro Holdings, acquiring 50% of the equity
- HSBC Nanfung is a private equity business based in Hong Kong with US\$700m under management and a fund life to 2015
- Metro is a Singapore based investor which has frequently invested alongside HSBC Nanfung in Chinese real estate
- Debt finance and credit facilities for the JV were provided by ICBC

## Sources of finance for the joint venture



# Trading malls

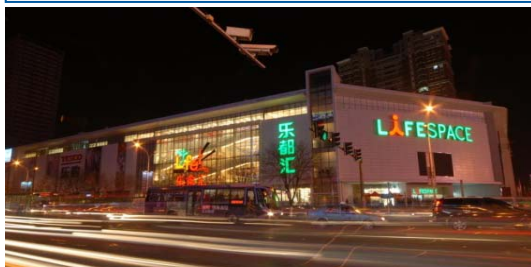
## Anshan

Opening Date:	25 Oct 2010
Scheme Type:	Mixed use (3,115 homes)
Tenant Net Area (sqm):	33,509
Tesco Net Area (sqm):	9,044



## Qinhuangdao

Opening Date:	15 Jan 2010
Scheme Type:	Stand alone
Tenant Net Area (sqm):	16,051
Tesco Net Area (sqm):	8,966



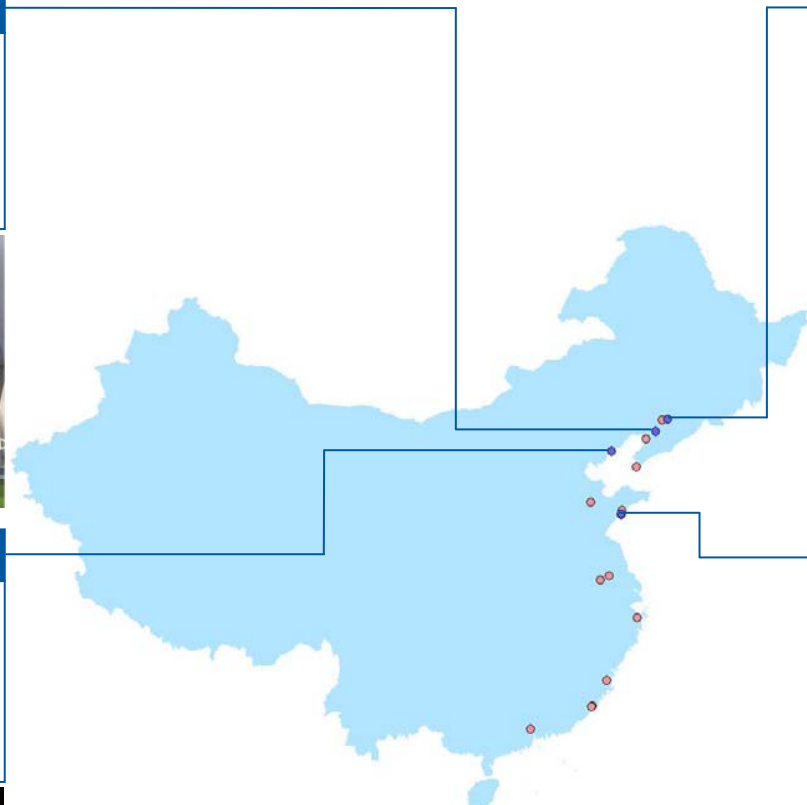
## Fushun

Opening Date:	29 Jan 2010
Scheme Type:	Mixed use (693 homes)
Tenant Net Area (sqm):	20,714
Tesco Net Area (sqm):	8,610



## Qingdao

Opening Date:	9 Jan 2010
Scheme Type:	Stand alone
Tenant Net Area (sqm):	11,849
Tesco Net Area (sqm):	9,013



- Trading malls
- Freehold sites

Note: Mall GFA excludes car parking space

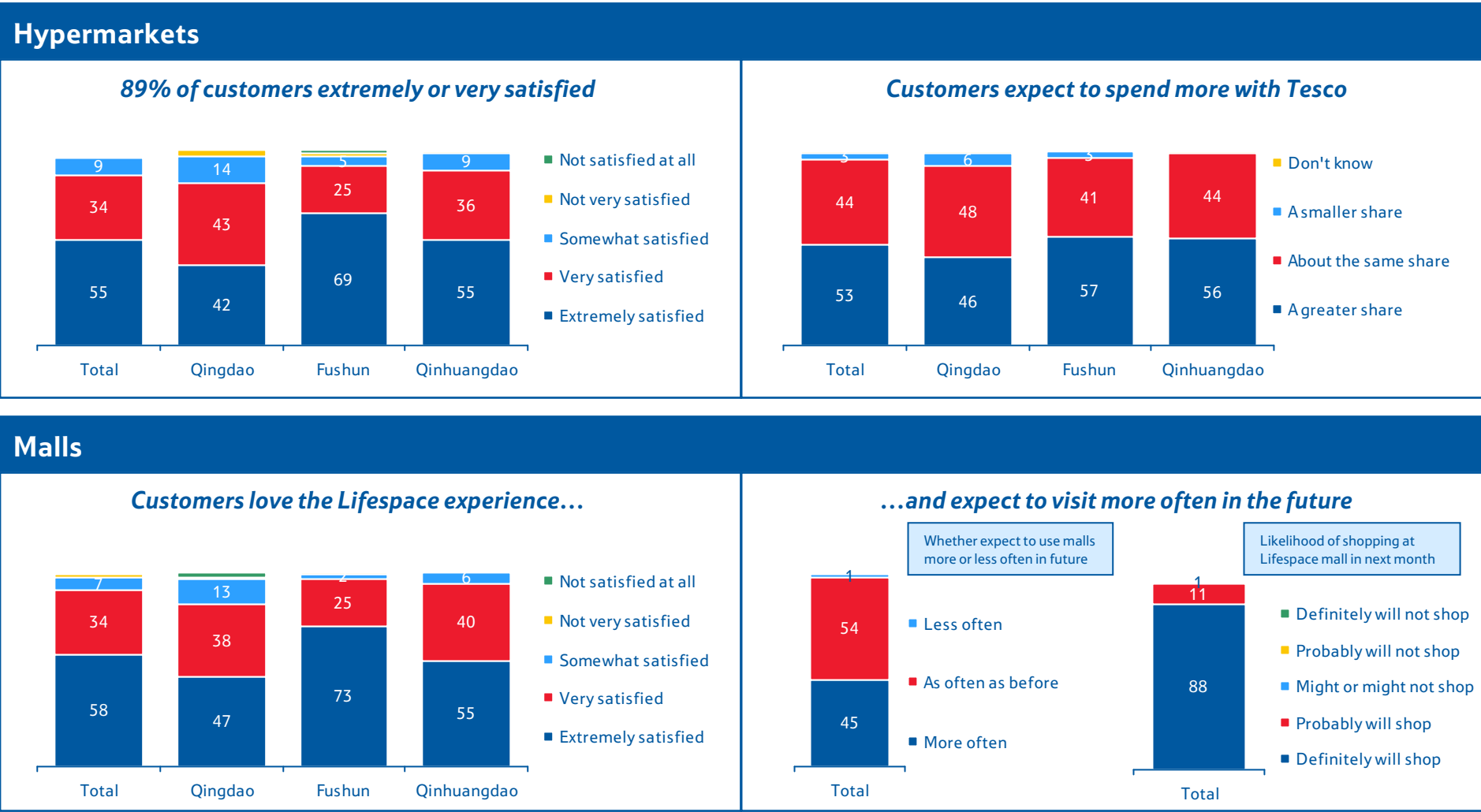


# Updates on malls currently trading

---

- Our Lifespace mall hypermarkets in Tier 2 and 3 cities are performing as well as hypermarkets in Tier 1 cities
- Four malls trading with two more to open this financial year, first opened in January 2010
- Circa 600,000 customers flow through our malls each week in total
- Over 800 tenants in the four trading malls
- Average occupancy rate: 89%

# Independent survey results are extremely positive



Malls

Customers love the Lifespace experience...

7

34

58

Total

13

38

47

Qingdao

2

25

73

Fushun

6

40

55

Qinhuangdao

Not satisfied at all

Not very satisfied

Somewhat satisfied

Very satisfied

Extremely satisfied

...and expect to visit more often in the future

Whether expect to use malls more or less often in future

1

54

45

Total

Less often

As often as before

More often

Likelihood of shopping at Lifespace mall in next month

1

11

88

Total

Definitely will not shop

Probably will not shop

Might or might not shop

Probably will shop

Definitely will shop

Source: TNS research commissioned by AKO Capital. Surveys completed October 2010 at Fushun, Qingdao and Qinhuangdao

Page 26

TESCO

property

LIFESPACE

乐都汇

# Summary of the Lifespace mall strategy

