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Savills World Research
China

Asian Cities Report
Shanghai Office

1H 2014

TABLE 1

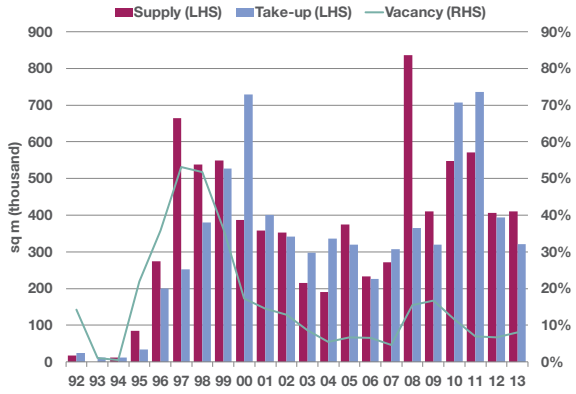
Global financial centres index – major Asia Pacific cities, 2013

	City	Rating	Ranking YoY change	Rating YoY change
3	Hong Kong	761	-	⮝28
4	Singapore	759	-	⮝34
6	Tokyo	718	⮝1	⮝34
9	Seoul	710	⮟-3	⮝25
19	Sydney	686	⮟-4	⮝16
21	Kuala Lumpur	681	⮝5	⮝37
22	Osaka	676	⮟-1	⮝26
24	Shanghai	674	⮟-5	⮝18

Source: Z/Yen, Savills Research & Consultancy

GRAPH 1

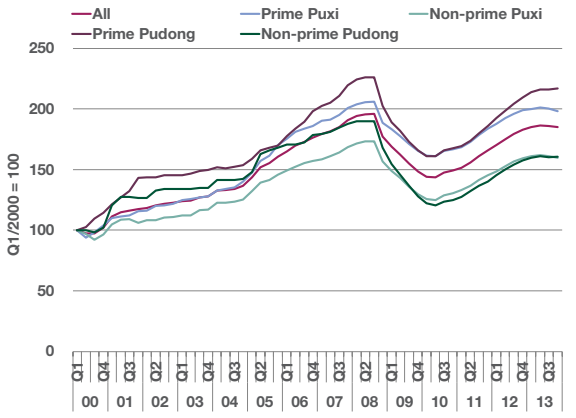
Grade A office supply, take-up and vacancy rates, 1992–Q4/2013



Source: Savills Research & Consultancy

GRAPH 2

Grade A office rental indices, Q1/2000–Q4/2013



Source: Savills Research & Consultancy

Economy

Following the historical economic reform led by Deng Xiaoping in the 1970s, Shanghai has become one of the strongest performers of all mainland cities, registering a remarkable nominal GDP compound annual growth rate (CAGR) of 13.5% between 2000 and 2010. In an effort to accelerate the city's development, the State Council hastened plans to turn the city into an international financial hub and shipping centre in 2009.

In the late 2000s, due to weak external demand, a strong renminbi, and rising labour and raw material costs, China's economic growth slowed to single digits. The manufacturing sector has remained sluggish for the last two years as the Purchasing Managers Index has been close to 50. Foreign direct investment saw negative growth in 2012, suggesting global concerns over China's sustainability. Given such challenges, the present central government are demonstrating strong ambition in revitalising the economy through a range of measures, the highlight of which is the launch of the Shanghai Pilot Free Trade Zone (SPFTZ). Although still at its initial stage, details of the reform have started to roll out, especially in the finance sector.

Supply and demand

Shanghai's Grade A office market had a total stock of 5.4 million sq m by the end of 2013, representing an increase of 115% from 2000. Much of this growth has occurred in Pudong's Lujiazui district, a government-designated financial industry zone. In the late 2000s, Shanghai's decentralised market started to emerge and quickly grew into an important component of the whole market.

Before the global financial crisis, strong demand had been seen during the last decade, especially when financial companies from around the world streamed into the city, helping to further entrench finance as one of the city's pillar industries. With the maturation of the Chinese market, national and regional headquarters are also relocating to Shanghai, given its improved infrastructure, governmental support and proximity to customers. While Shanghai continues to serve as China's 'window to the west', the present dominant demand drivers have been domestic corporations and state-owned enterprises, which accounted for around 30% by 2013.

However, the recent slowdown in the Chinese economy has delayed tenant expansion plans, and supply is pouring into the market, both in core and decentralised areas. The combination of these two factors has resulted in fierce competition among landlords to secure occupancy.

Vacancy rates and rents

Strong demand amid a limited supply environment helped push vacancy rates down by 12.3 percentage points (ppts) during the first part of last decade, declining by an average of 1.7 ppts per year between 2000 and 2007. Meanwhile, rents followed an inverse relationship, increasing by roughly 90%.

The 2008 handover of the Shanghai World Financial Centre, China's tallest building, marked a high point for developers' confidence in the market. This handover coincided with the global financial crisis, however, leading to a surplus of supply and a rise in vacancy rates. Rents contracted by 26% between 2008 and 2010.

From 2010, the market started to recover and witnessed strong demand. Vacancy rates had fallen to roughly 7% by the end of 2012, near pre-crisis levels, while rents increased by 27%.

The market began to stagnate in 2013, signalling a new turning point in the near future. Given that uncertain economic conditions

continue to restrain demand from tenants and that competition from new supply will intensify in the years to come, landlords responded to these challenges by lowering asking rents and extending rent-free periods.

Investment

Capital values began a steep ascent in 2004, as the en-bloc investment market kicked off and international players initiated a short-lived investment boom. A combination of eager investors, limited investment options and seemingly unstoppable growth in rents led to capital values rising by 74% between 2005 and 2007.

The combination of the global financial crisis and a peak in supply caused the market to plummet, and capital values to fall in turn. Although a lack of transactions made it hard to gauge the exact degree of the correction, overseas investors responded by withdrawing from the market, largely as a result of the difficulty in raising funds and overseas investors seeking opportunities in their own markets.

Despite weakening fundamentals, significant future supply and low yields, investors still view the office market as one of the most transparent, liquid and deep markets in China. Being more resilient than overseas investors, domestic end users are playing a more active role in acquiring assets in both the en-bloc and strata-title markets. Other investors who made purchases despite the low yields are expecting returns through value appreciation or to add value.

Market outlook

The Shanghai market found itself at a turning point towards the end of the year, with demand slowing and a large volume of supply starting to emerge, pushing vacancy rates up and convincing landlords to lower rental expectations. This trend is likely to gain momentum in 2014 and through to 2015. Economic growth forecasts, while not as dire as they were at the end of 2008, have deteriorated in recent months. While the GDP growth rate is no longer the key indicator for many companies, the headline figure does relate a story; one of slower growth in many sectors but especially manufacturing. Slower business growth is likely to follow and consequently weak demand for office space, especially when compared with take-up levels recorded in 2010 and 2011.

On the bright side, the central government is demonstrating firm determination in allowing the market to take a more decisive role in the economy through a range of actions, with the SPFTZ expected to generate the biggest impact. With the expectation that more market freedom is to be given, there is still a huge potential to attract companies who intend to secure a foothold in Shanghai.

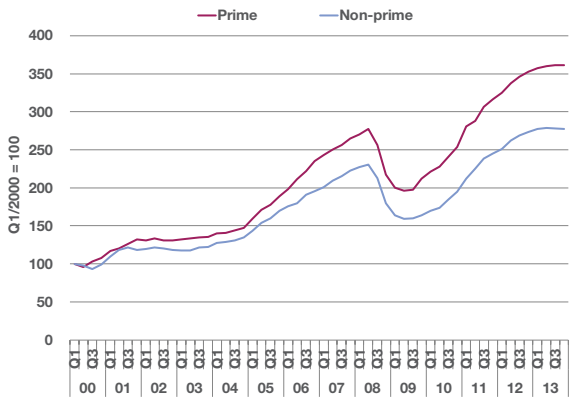
Investment outlook

Shanghai's investment market is expected to remain active in the coming years. Domestic companies, which are mostly end users, are expected to increasingly dominate the investment market, given their numbers, appetite, home turf advantage, longer holding periods and willingness to invest on a value per sq m basis rather than yields. Considering the subdued rental growth and a large amount of capital chasing limited properties, yields are expected to compress further.

International investment is expected to become increasingly marginalised as overseas investors seek higher yielding investment alternatives. In addition, policies designed to prevent overseas "hot money" inflows have complicated the investment process. Nevertheless, they are likely to vie for returns by taking on development risk, value-added strategies, minority equity stakes in development portfolios or exploring opportunities in niche markets.

GRAPH 3

Capital value indices, Q1/2000–Q4/2013



Source: Savills Research & Consultancy

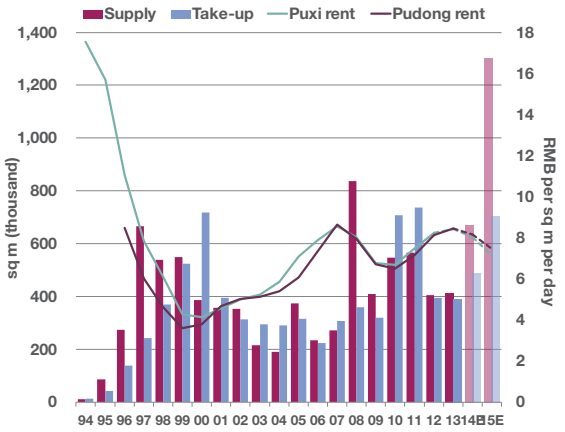
GRAPH 4

Grade A office yields, Q1/1994–Q4/2013

Source: Savills Research & Consultancy

GRAPH 5

Market forecast, 1994–2015E



Source: Savills Research & Consultancy

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