Briefing
Investment

March 2015

Image: Shanghai International Shipping Centre, Hongkou

SUMMARY

The divergence in yields between domestic end users and institutional investors will persist as investors remain conservative while domestic end users buy properties for long-term hold and self use.

- RMB56 billion of investment deals were concluded in 2014, down 29% year-on-year (YoY). Six key deals were concluded in Q4/2014, for a total consideration of RMB8.1 billion.

- International institutions remained conservative, given the sluggish economy and continuous negative yield spread. The only downtown asset sold to an international institution was Shanghai International Capital Plaza, sold to Alpha Investment Partners for RMB1.55 billion.

- Gross yields for Grade A offices transacted by international funds increased to 6.0% on a gross reversionary basis, up 0.8 of a percentage point (ppt), while capital values decreased.

- Gross retail yields remained unchanged at 6.5%, due to subdued rental growth.

- The Dongjiadu plot blocks 13 & 15 were sold in November 2014 to the newly established China Minsheng Investment Corporation, for a record high total consideration of RMB24.85 billion.

"Softening market fundamentals are competing with the appetite for exposure to China, plentiful capital and falling borrowing costs to determine where property yields should rest."

James Macdonald, Savills Research

Market commentary

Despite a slowing economy, the Shanghai investment market remained active in 2014, in large part due to strong demand from domestic purchasers. Total transaction consideration of RMB56 billion was concluded in 2014. Transaction volume fell by 29% YoY, as international institutions turned cautious on the market given the weakening fundamentals and persistent negative yield spread. Six sizeable deals were concluded in Q4/2014, for a total consideration of RMB8.1 billion.

Office properties continued to dominate activity, accounting for nearly 60-70% of Shanghai's investment market in terms of total consideration in 2014. The office market offers greater transparency, stable demand, less management resources and strong liquidity. Retail projects remain highly sought after, but with limited tradable investment-grade stock, fewer exit options, and limited retail management expertise, this sector tends to produce fewer transfers.

In the past year we have seen a pickup in activity in more decentralised areas, both in the logistics, business parks and R&D facilities. The main driver behind this trend is the continuing rapid development of the ecommerce market, improved infrastructure, maturing business environment in these areas and relocation or bifurcation by companies looking to lower overheads.

The luxury hotel market, while seeing a pickup in activity of late, still remains one of the smallest markets, beset by strong competition, low yields (due to high running costs) and softening demand from corporate clients who are tightening belts. Much of the activity that has been witnessed has been between related parties or for conversion for other use.

While most investors remain optimistic on the mid- to long-term potential of the Shanghai market, many also have fixed term investment periods which mean that they will have to exit existing investments irrespective of market conditions within the next year or two, unless they can obtain an extension. Given the softening fundamentals and the fact that it is now taking longer to dispose of assets, some funds are taking steps to lower pricing in order to be able to exit investments in a timely manner. As a result, yields, based on recently transacted deals and ongoing negotiations by international funds, have started to rise reaching a gross reversionary level of approximately 6.0%, representing a net operating income (NOI) yield of approximately 4.5% -5.0%.

Fewer retail assets are held by funds, with the majority held by developers for the long term, and no stabilised retail assets have recently come to the market, resulting in relatively sticky yields, ending the year on a gross reversionary yield of approximately 6.5%.

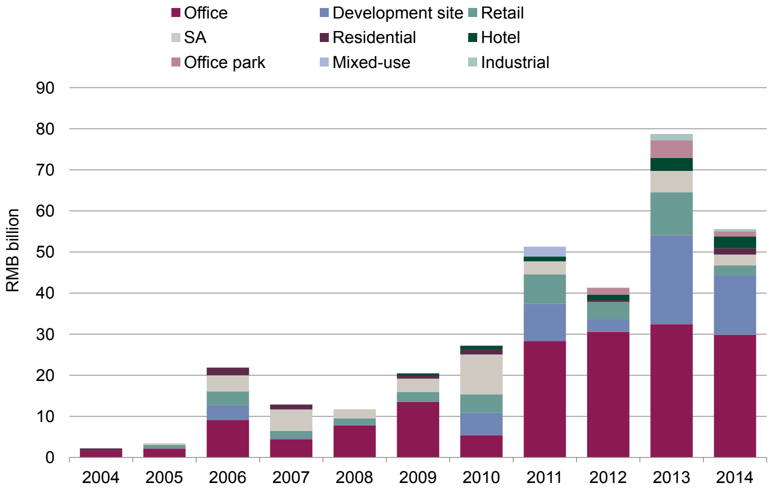
Office Sector

Shanghai's Grade A office stock stood at 5.7 million sq m by the end of 2014. 'Little' Lujiazui, the largest submarket in Shanghai, accounts for 1.9 million sq m of Grade A office space and has the lowest vacancy rate of any business district at just 1.6%, though the situation may change with the launch of the 200,000-sq m Shanghai Tower expected this year. Puxi's vacancy rate fell 4.7 ppts YoY to 7.3% by the end of 2014.

Grade A office rents increased by 1.8% in 2014, ending the year at an average of RMB8.6 per sq m per day, largely driven by strong demand in Pudong. Pudong recorded the highest rental growth of 6.5% YoY, to an average of RMB9.2 per sq m per day. The Puxi market witnessed a reduction in rents during 1H/2014 but saw them

GRAPH 1

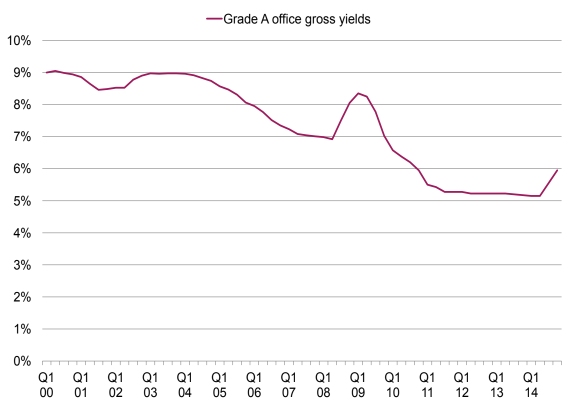
Shanghai large scale real estate acquisitions, 2004–2014



Source: RCA, Savills Research

GRAPH 2

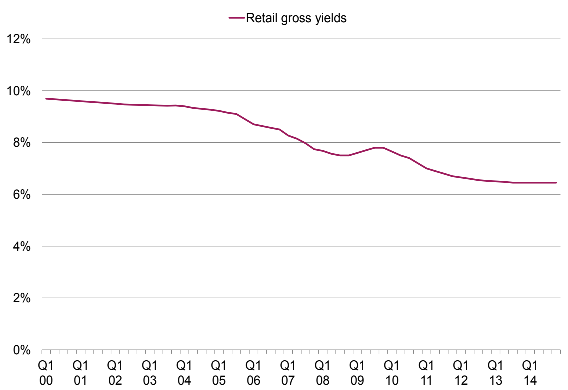
Office gross yields, Q1/2000–Q4/2014



Source: RCA, Savills Research

GRAPH 3

Retail yields, Q1/2000–Q4/2014



Source: RCA, Savills Research

stabilise in 2H/2014, ending the year at an average of RMB8.3 per sq m per day.

Gross reversionary yields on office assets traded by international funds are believed to have edged up, given recent transactions and deal negotiations ending the year at approximately 6.0%. Nevertheless, at the same time there are a number of assets that have been acquired by domestic funds and domestic end users at significantly lower yield valuations.

Retail sector

The city-wide shopping mall stock climbed to 7.0 million sq m by the end of the year, an increase of 12.5% YoY. Prime areas account for only 21.2% of total stock, though this figure is expected to fall to 16.5% by 2017, as new supply focuses on large-scale shopping malls in decentralised areas.

Retail rental growth has been very modest in 2014, with the market believed to be at an inflexion point. In the fourth quarter, prime retail area rents remained unchanged, while non-prime areas fell 0.2%. For the full year, this represents a 0.1% and -0.7% change respectively.

Gross yields for retail projects remain unchanged at 6.5%, due to subdued rental growth and a lack of traded assets.

En-bloc investment market

2014 overview

Total transaction consideration of RMB56 billion was concluded in 2014, down 29% compared with the previous year.

Core assets in prime locations remain popular among investors as they seek more defensive investment opportunities. Nevertheless, other more opportunistic investors are exploring opportunities in more decentralised locations that are beginning to see the benefits from improved accessibility and business environment and lower costs while still representing higher yields and greater scope for value appreciation in the midterm. The contribution of assets in core locations to the total consideration in 2014 fell to 48.4% from 65.8% in 2013.

Shanghai International Capital Plaza (ICP) was the only downtown asset sold to an international institutional investor in 2014, with others focusing on business parks for add-value opportunities and higher yields. Among the established business parks, Zhangjiang Hi-tech Park saw the most activity in 2014, benefiting from the prosperous IT industry and the expansion of Shanghai Free Trade Zone. Ascendas, Kailong REI, Starcrest Capital Partners and Morgan Stanley all purchased or established partnerships to develop commercial-use projects in this park.

Divergence between institutional investor and end-user yield valuations persisted in Q4/2014. While funds stood on the sidelines looking to pick up distressed or underperforming assets at higher entry yields, the end-user market remained very active. End-use purchasers continued to place a premium on these assets, buying above market to secure preferred premises and placing significant downward pressure on yields, especially in the office sector. While gross reversionary yields for international institutions ranged from 5.0% to 6.5%, end users were willing to pay the equivalent of 3.0-4.5%.

Q4/2014 overview

Six key deals were concluded in Q4/2014, for a total consideration of RMB8.1 billion. Assets along the Huangpu riverside remained highly sought after by both end users and investors.

Shanghai ICP was acquired by Alpha Investment for RMB1.55 billion. Located in Hongkou district, the project comprises both office and retail components, with a total GFA of 57,000 sq m.

Gopher Real Estate Fund, a subsidiary of Noah Holdings, acquired Suntown Plaza in Huangpu District for RMB3.126 billion. This is the largest deal in terms of total consideration in Q4/2014. Comprising office and retail podium space, this building is expected to be completed in 2016.

#18-1, Shanghai International Shipping Service Centre (SISSC) was bought for RMB1.3 billion by Suzhou Bank, representing a new record high unit price at roughly RMB100,000 per sq m.

Media Tek purchased 12,500 sq m of Poly West Bund Centre (13/F to 19/F)

TABLE 1

Yields and capital values by sector[1] , Q4/2014

	Grade A Office	Prime shopping mall	Prime retail street store	High-end serviced apartments	High-end strata apartments	5 star hotel
Gross reversionary	4.5-6.5%	6.0-7.0%	4.0-5.0%	4.0-5.0%	2.5-3.0%	6.5-8.0%
NOI	3.5-5.0%	4.0-4.5%	3.0-3.5%	2.2-2.8%	2.0-2.5%	1.5-2.0%
Approx. values (RMB per sq m)	50-90,000	60-100,000	150–250,000	55-70,000	100-200,000	40-50,000

Source: Savills Research

[1]Yields refer to stabilised assets in downtown locations free of any impediments and with a clean holding structure owning 100% of the building, assuming 100% occupancy. Capital values refer to the average for the building on a GFA basis – retail assets will have higher CV for lower floors.

in Xuhui district for RMB693 million. This project is located in Xuhui riverside area and was still under construction at the end of 2014.

City Development Limited, a Singapore-based developer, bought Xiang Shui Wan Villa in Qingpu district for RMB799 million. This high-end villa project was completed in 2013, with total GFA of nearly 48,456 sq m, of which 35,732 sq m comprising 85 units remains unsold.

Future Holdings acquired Block 6 in Guoson Centre in Putuo district from Guoco Land China for RMB623 million.

In January 2015, it was reported that AVIC Joy Holding had acquired #18-2 in SISSC, just next to the tower acquired by the local bank in December 2014. The valuation for this transaction was slightly lower, at RMB96,000 per sq m and a total lump sum of RMB1.6 billion.

Land market

SShanghai's land market has witnessed an active end to the year, with land plots sold for new highs in terms of both accommodation values and total sales consideration in Q4/2014.

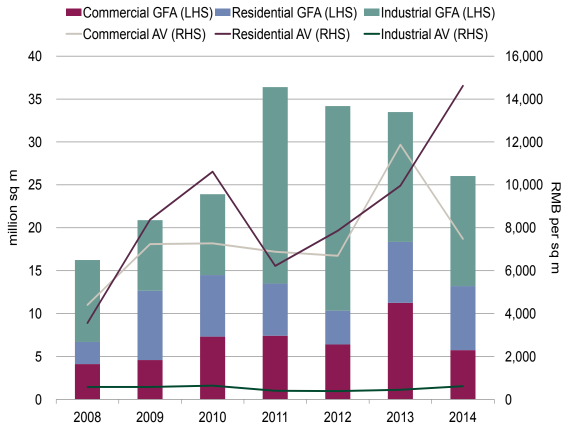
The land market in 2014 saw total sales fall by 22.9% to RMB171 billion, with commodity residential and commercial sectors accounting for 63.8% and 25.1%, respectively. Echoing a rebound in the residential market in the last quarter, commodity residential land sales recorded an average accommodation value (AV) of RMB15,786 per sq m in Q4/14, pushing up the annual average to RMB14,619 per sq m.

The Dongjiadu plot (blocks 13 & 15) was sold in November 2014 to the newly established China Minsheng Investment Corporation (中民投). The acquisition represents the most expensive plot sold to date in terms of total consideration at RMB24.85 billion, beating the previous record set by Sun Hung Kai Properties in September 2013 when it acquired the Xujiahui plot for RMB21.77 billion. This mixed-use development has a total GFA of 1.14 million sq m (above ground: 701,900sq m; below ground: 437,500sq m), comprising retail (not greater than 17%), office (not less than 65%) and residential (not greater than 18%) components.

The Jing'an land plot (南西社区111-09) was sold to Jing'an Real Estate (静安置业), a state-owned developer,

GRAPH 4

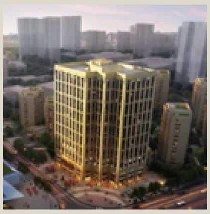
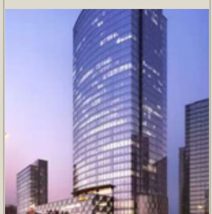
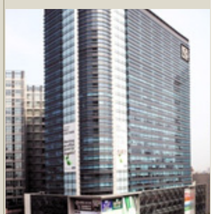
Land transaction spaces and AVs, 2008–2014



Source: Savills Research

TABLE 2

Key investment deals, Q4/2014

Project	Poly West Bund Centre	#6, Guoson Centre	18-1, SISSC	Suntown Plaza	Xiang Shui Wan Villa	Shanghai International Capital Plaza
						
Location	Xuhui	Putuo	Hongkou	Huangpu	Qingpu	Hongkou
Date	Dec, 2014	Dec, 2014	Dec, 2014	Dec, 2014	Dec, 2014	Oct, 2014
Property type	Office (under construction)	Office (under construction)	Office	Office and retail podium (under construction)	Villa	Office and retail podium
Transacted price (RMB mil)	693	623	1,309	3,126	799	1,550
Above-ground GFA (sq m)	12,490	24,928	13,012	73,300	35,732	56,859
Vendor	Poly Group	Guoco Land China	Franshion Group JV Shanghai Intl Port Group	Shanghai Sunac Greentown	TBC	ARA Asset Management
Purchaser	Media Tek	Future Holdings	Suzhou Bank	Gopher Real Estate Fund	City Development Limited	Alpha Investment Partners

Source: Savills Research

for a total consideration of RMB1 billion, giving an AV of RMB53,575 per sq m. With a total buildable GFA of 18,665 sq m, this commercial site is directly connected to the future Nanjing West Road station, Metro Line 12 and is designated as an open-plan retail space.

Three commodity residential land plots in Qiantan were sold to two domestic developers, Gree (格利) and Sanxiang (三湘) for RMB4.9 billion, representing the highest AV of residential plots on record for Pudong. The “land king” was Sanxiang, which acquired one of the plots for RMB1.86 billion, with an AV of RMB66,629 sq m. Located along the Huangpu river and planned as a new high-end international commercial and residential compound, Qiantan is highly valued among international and domestic developers.

Market news

Free Trade Zones

China’s free trade zone scheme has dramatically expanded in recent months.

In late December it was announced that China would replicate some practices from China (Shanghai) Pilot Free Trade Zone (SFTZ) in other parts of the country including Tianjin (Tianjin Port, Tianjin Airport and the Binhai New Area industrial park), Guangzhou (Nansha New Area in Guangzhou, Shenzhen Qianhai and Zhuhai Hengqin New Area) and Fujian (industrial areas in the provincial capital of Fuzhou, the whole of Xiamen, and Pingtan).

The SFTZ will also expand its geographical coverage to include Lujiazui Finance and Trade Zone, Zhangjiang Hi-tech Park and Jinqiao Export Processing Zone. This expansion will increase the area to 120 sq km from the current 29 sq km.

Tax reforms

VAT reforms for the construction and real estate sectors will be accelerated in 2015. The transition from business taxes to VAT was first announced in late 2011, with a trial started in Shanghai in January 2012, and then later in the year expanded to Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei and Guangdong, and the cities of Xiamen and Shenzhen. This was later extended to the whole country in August 2013.

The tax reforms hope to boost the services sector, planned as one of the key drivers of future economic growth. China has long imposed VAT on tangible goods but services are instead subject to a business tax, often resulting in double taxation. The transition allows companies to claim an “input credit”, deducting the VAT they have paid on their supplies and therefore eliminating the double taxation. The pilot programme first focused on transportation but has expanded to cover other services sectors such as telecoms in 2014 and now the real estate sector in 2015. The transition is expected to reduce the tax burden on developers as it allows them to claim tax credits for much of the input costs that were previously double-taxed, therefore while business tax on sales was originally 5.5% and the new VAT is expected to be closer to 11%, as the tax base will be markedly different given the application of tax credits, the effective tax rate is expected to be lower than it was previously.

Retail Estate Investment Trusts (REITs)

China REITs were once again in the spotlight as China’s Ministry of Housing and Urban-Rural Development (MOHURD) announced plans to speed up the implementation of REITs in China. The pilot plan, announced in January, is expected to begin with four tier-1 cities and focus on financing state-subsidised affordable homes for rent to low-income families.

TABLE 3

Key land deals, Q4/2014

Plot	District	Use	GFA (sq m)	Consideration (RMB million)	AV (RMB per sq m)	Buyer
#36-01, Qiantan	Pudong	Residential	27,931	1,861	66,629	Sanxiang
#32-01, Qiantan	Pudong	Residential	24,517	1,614	65,832	Gree
#38-01, Qiantan	Pudong	Residential	26,899	1,450	53,905	Gree
#111-09, Jing’an	Jing’an	Commercial	18,665	1,000	53,757	Jing’an Real Estate
Pingliang	Yangpu	Residential	51,318	2,108	41,078	Yango
Dongjiadu	Huangpu	Mixed-use	702,140	2,485	35,392	China Minsheng

Source: Savills Research

OUTLOOK

- The office sector will still continue to account for the majority of deals in Shanghai, despite weakening fundamentals and concerns about substantial supply in most areas. Given the low yields, institutional investors are expected to focus on add-value opportunities in core locations and business parks, over stabilised assets, unless they have long-term core money mandates. Portfolio and platform deals are expected to be more common, particularly in the retail sector as well as in finance.

- Some developers and owners may be faced with increasing financing difficulties over the next twelve months, and we may see the disposal of previously acquired land plots to better capitalised developers and rising yields. Muddled market conditions open up new investment opportunities for brave investors.

- The divergence in yields between domestic end users and institutional investors is expected to remain significant in 2015 as institutional investors, particularly international ones, remain conservative and seek out distressed asset opportunities, while domestic end users buy core new build properties for long-term hold and self use.

Please contact us for further information

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