Briefing
Investment

May 2015

Image: Lujiazui

SUMMARY

The combination of ongoing economic reforms and the relaxation of interest rates and mortgage policies will help to boost investments and reshape the property market in the future.

- Five key deals were concluded in Q1/2015, for a total consideration of RMB3.5 billion, with all deals concluded by domestic buyers

- The landmark deal in the first quarter was the Shanghai Shipping Service Centre which was purchased by AVIC Joy Holding for RMB1.6 billion, giving a unit price of roughly RMB100,000 per sq m.

- Gross reversionary yields for Grade A offices transacted by international funds increased 10 basis points (bps) to 6.1%.

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

- CR Land and Huafa Group jointly acquired a mixed-use land plot in the Zhabei district for RMB7.0 billion, the highest total consideration for any land plot in Shanghai this year, giving an accommodation value of RMB34,871 per sq m.

"Overseas investors remain cautious given legal and taxation reforms and sluggish market conditions." James Macdonald, Savills Research

Market commentary

Shanghai's investment market had a quiet start to 2015; five key deals, all by domestic purchasers, were concluded, for a total consideration of RMB3.5 billion, down 72% year-on-year (YoY). Office transactions continued to dominate the majority of en-bloc transactions, accounting for 90% of the first quarter's consideration. A number of sizable core assets are still under negotiation and are expected to be concluded by the end of this year.

Domestic end-users have contributed 54% of the total investment in Q1/2015, focusing on non-prime assets for long-term hold. Investors are looking for investment opportunities in the challenging market. Foreign sovereign funds are looking for core assets with clear structure, high occupancy rates and stabilised income. Opportunistic funds continue to focus on downtown assets with distressed price and value-add opportunities. Domestic developers are more likely to buy office or serviced apartment developments in the downtown district and sell the projects strata to gather revenue quickly. Additionally, fewer asset management resources will remain an important concern for domestic investors, particularly for commercial assets.

The central government continued to introduce reforms in legal and taxation systems and cut the over-five-year lending rate by 65 bps for the past four months to boost investments and avoid economic risks. In addition, China tried to introduce Public-Private Participation (PPP) models to involve more private capital in infrastructure construction and provide a more transparent and effective environment. How the government will impose these new regulations is still unclear; investors remain cautious and additional easing of monetary policies is expected to roll out in the coming months.

Office Sector

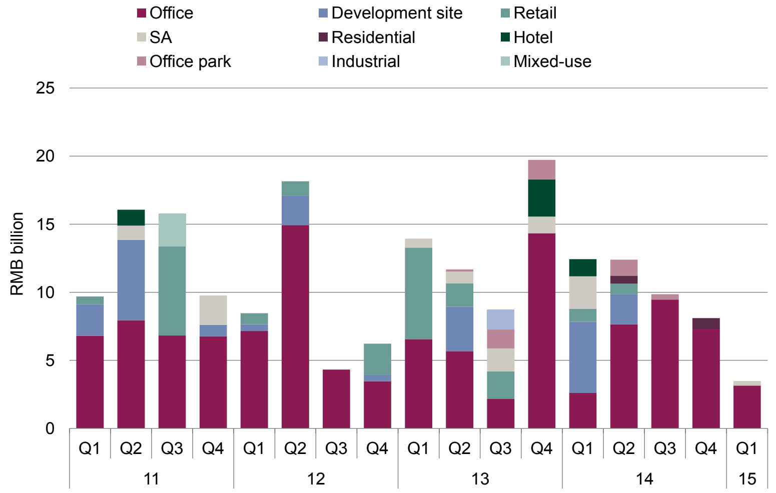
Net take-up in core areas totalled 173,950 sq m, the highest recorded levels since 2012, and was primarily focused in non-prime areas. The highest demand was recorded in non-prime Pudong, with many financial companies relocating business lines to the area to benefit from the close proximity to Lujiazui without the high rents. Demand in Puxi was driven by companies relocating to buildings handed over in 2014.

Overall Grade A office rents remained at RMB8.63 per sq m per day, however the divergence between Puxi and Pudong rents expanded as Puxi rents fell 0.2% and Pudong rents increased 0.7%. City-wide vacancy rates dropped to 7.7%, due to the absorption of existing buildings and limited overall supply.

As a number of investment funds are coming to the end of their fund life, many fund managers are

GRAPH 1

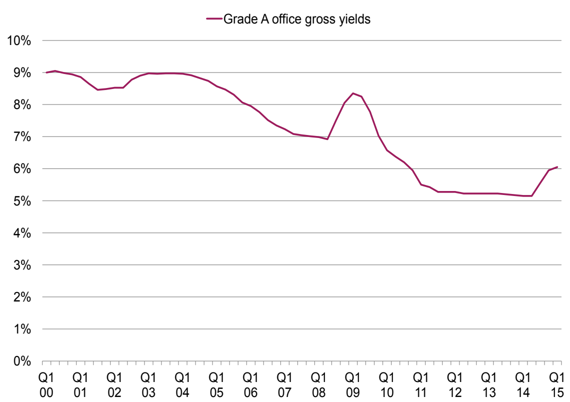
Shanghai large scale real estate acquisitions, Q1/2011–Q1/2015



Source: Savills Research

GRAPH 2

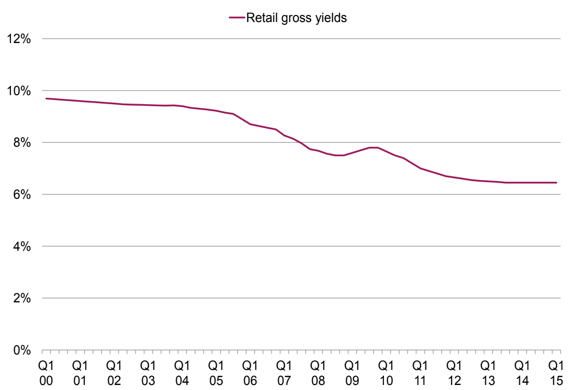
Office gross yields, Q1/2000–Q1/2015



Source: Savills Research

GRAPH 3

Retail yields, Q1/2000–Q1/2015



Source: Savills Research

considering reducing prices in order to accelerate sales. As a result, yields for international institutions continued to increase, by 10 bps to 6.1% on a gross reversionary basis, while capital values have decreased.

Retail sector

Shanghai's retail market received only one new project in Q1/2015, Shanghai New World Daimaru, which added 60,000 sq m of retail space onto the market. Rental growth remained subdued in the first quarter as vacancy rates increased for the fourth consecutive quarter.

Rental growth continued to be subdued, and tenant adjustment was quiet in Q1/2015. Benchmark project rents in both prime and non-prime areas increased 0.1% QoQ, while other projects in non-prime areas continued to record a decrease of 0.1% QoQ.

Prime vacancy rates rose 0.3 of a percentage point (ppt) to 4.4%, a fourth consecutive quarter increase. Non-prime areas showed a more divergent performance, with Hongqiao vacancy rates decreasing 4.9 ppts and Sichuan Road (N) vacancy rates increasing for the fifth consecutive quarter to 11.5%.

Gross yields for retail projects remain unchanged at 6.5% due to subdued rental growth.

En-bloc investment market

Five key deals were concluded in Q1/2015 for a total consideration of RMB3.5 billion, down 72% YoY. With the exception of China Garden, a serviced apartment complex, all the deals were office transactions. Some sizable core assets are still under negotiation and are expected to be concluded by the end of this year. All deals were concluded by domestic buyers as overseas investors remain cautious given legal and taxation reforms and sluggish market conditions.

AVIC Joy Holding acquired #18-2 in SISSC in January, located next to the tower acquired by the Suzhou Bank in December 2014. The valuation for this transaction was slightly lower, at RMB96,000 per sq m, and was acquired for a total lump sum of RMB1.6 billion.

Zhongrong River Capital acquired #1B, Sincere Space from Chongqing-based Sincere Group for RMB908 million. This 40,000-sq m office building comprises retail space (1/F to 3/F) and Grade A office spaces (4/F to 23/F), and it is expected to be completed by the end of 2015.

China Garden, a serviced apartment complex in Gubei, Changning district, was acquired by Shanghai Zhongchengjian Asset Management Limited for RMB340 million in February. China Garden was completed in 1994 and renovated in 2014 to comprise 84 serviced apartment units.

Jiuxing Holdings purchased one block in Hongqiao Sincere Centre for RMB325 million via asset transfer. Ping An Trust also acquired five blocks for investment purposes last September.

Easthill, a domestic investor, bought an old office building in the Xuhui district for RMB344 million from COFCO Property via equity transfer.

In April 2015, it was reported that Shun Tak Group acquired a hotel project in the MixC mixed-use development for RMB700 million from a 50/50 joint venture between CR Land and Shentong. With a GFA of 29,000 sq m, this 478-room hotel

TABLE 1

Yields and capital values by sector[1] , Q1/2015

	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.

will be operated by Shun Tak's hotel management subsidiary, Artyzen.

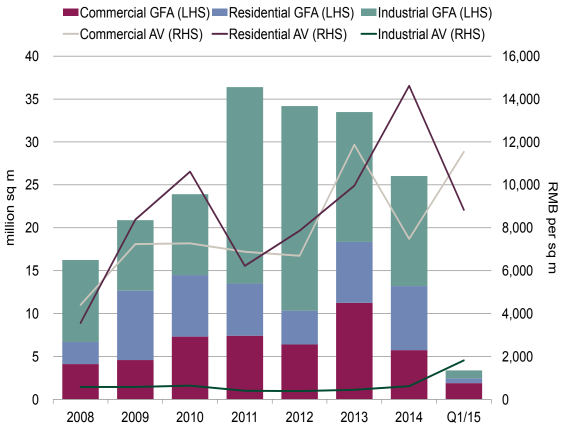
Land market

The land market saw total sales fall by 38% YoY to RMB32.7 billion in the first quarter of 2015, with commodity residential and commercial sectors accounting for 67% and 16%, respectively. As two high-end logistics land plots in Hongqiao Transportation Hub were sold in the first quarter, the accommodation value of industrial land plots climbed to RMB1,819 per sq m.
China Resources Land and Huafa Group jointly acquired a mixed-use land plot in the Zhabei district (#10-03, Unit N070501 in Shibei Hi-tech Park) for RMB7 billion, the highest total consideration for any land plot in Shanghai this year. This represents an AV of RMB34,871 per sq m. As the developers are required to build and transfer public facilities, the adjusted AV will exceed RMB34,871 per sq m.

Three commercial land plots in Zone A, Expo site were sold for a total consideration of RMB8.1 billion, with an AV of over RMB27,000 per sq m. Expo "Green Valley" is the largest land deal in the Expo site in terms of total GFA and consideration. This mega site was acquired by SPD Bank and Shanghai Expo Group for RMB5.9 billion, with an above-ground GFA of 210,300 sq m and a below ground GFA of 167,400 sq m. Chongbang Group acquired a commercial land plot in the Hongkou district (hk354b-01, Jiaxing Road) for RMB1.01 billion, representing an AV of RMB23,087 per sq m. The Chongbang Group has previously successfully developed Daning Life Hub and Jinqiao Life Hub.

GRAPH 4

Land transaction spaces and AVs, 2008–2014



Source: Savills Research

Market news

Interest rate cuts

The People's Bank of China (PBoC) cut interest rates by the end of March, with over-five-year lending rates decreasing 65 bps to 5.9% since November 2014. This is the

TABLE 2

Key investment deals, Q1/2015

Project	18-2, SISSC	#1B, Sincere Space	China Garden	Hongqiao Sincere Centre	COFCO Tower
					
Location	Hongkou	Zhabei	Changning	HTH, Minhang	Xuhui
Date	Jan, 2015	Jan, 2015	Feb, 2015	Mar, 2015	Mar, 2015
Property type	Office	Office	Office	Office and retail podium (under construction)	Villa
Transacted price (RMB mil)	1,566	908	340	325	344
Above-ground GFA (sq m)	16,352 (total GFA)	40,723	9,560	11,047	18,467
Vendor	Franshion Group JV Shanghai International Port Group	Sincere Group	Tysan Holdings Limited	Sincere Group	COFCO Property
Purchaser	AVIC Joy Holding	Zhongrong River Capital	Shanghai Zhongchengjian Asset Management Limited	Jiuxing Holdings	Easthill

Source: Savills Research

second time the PBoC has cut interest rates in the past four months, resulting in lower financing costs and a more liquid market.

The recent 70 cities' residential price indices indicate that prices in all cities have decreased YoY and over 50 cities have seen six consecutive month-on-month price decreases. Combined with more relaxed mortgage policies, interest rate cuts are expected to boost property market sentiment and improve residential transaction volumes in the short-term. The easing of monetary policies is likely to continue to the end of this year with further policy easing expected to limit downside economic risk on the property market in particular.

Foreign Investment Industrial Guidance Catalogue

The Ministry of Commerce has released 2015 Foreign Investment Industrial Guidance Catalogue covering three main types of foreign-investment enterprises: wholly-foreign owned enterprises; equity joint ventures; and cooperative joint ventures. All restrictive lists regarding real estate investment have been completely removed from the new guidance catalogue, the largest change in terms of relaxations since 2007, echoing the lacklustre economy and property market.

Foreign investments in the property market slowed down in 2013-14 due to high financing costs, stricter currency exchange limits and sluggish market conditions. This approach is a significant step towards a more transparent environment for foreign investment, indicating the government's strong willingness to continue its economy reform. However, this may not change foreign investor appetite in the short term; significant hurdles that the market needs to overcome are still very present, including negative yield spread, slowing appreciation of the RMB and an incomplete tax system. Foreign institutional investors will remain careful and cautious about China's property market. However, sovereign funds from the United States, Europe, the Middle East and South Korea will continue focusing on the four tier-one cities, particularly core assets with clear structure and stabilised revenue.

Indirect transfer tax regulations

The State Administration of Taxation released new tax regulations on indirect equity transfers by non-resident enterprises (Bulletin 7), providing a broader scope of indirect transfer, stricter provisions on scrutinising indirect transfers of China's taxable assets and new reporting obligations.

Foreign owners were previously required to report offshore equity transfers and pay a 10% withholding tax, however, a lot of the time these rules were not enforced. As a result, investors were able to avoid paying capital gains taxes on offshore holding structures leading to higher returns. This new regulation is expected to result in a noteworthy tax obligation increase for foreign sellers, together with an important impact on the investment market.

TABLE 3

Key land deals, Q1/2015

Plot	District	Use	GFA (sq m)	Consideration (RMB million)	AV (RMB per sq m)	Buyer
Shibei	Zhabei	Residential & office	202,234	7,052	34,871	CR Land & Huafa
Expo "Green Valley"	Pudong	Commercial	210,269	5,914	28,126	SPD Bank & Shanghai Expo Group
Expo a03d-01	Pudong	Commercial	44,345	1,201	27,075	Tian'an Property Insurance
Expo a03c-02	Pudong	Commercial	18,665	955	27,075	AVIC International Leasing
Jiaxing	Hongkou	Commercial	51,318	1,010	23,087	Chongbang

Source: Savills Research

OUTLOOK

■ As a number of sizable trophy assets come to the market (with most under negotiation with good prospects for completion), the remainder of this year is expected to witness some significant transactions. In addition, international institutions, such as PAG, have completed new capital raising with China allocation and are expected to invest this sizable capital in the following 12 months. As a result, investment volumes are expected to increase with an influx of new capital and further relaxing of monetary policies.

■ If the macro market is unable to meet the government's expectations, additional easing of monetary policies – including lower bank reserve ratio, lower interest rates and relaxed mortgage policies – are expected to be released in the following months. All of the simulative policies will bring more capital to the domestic physical market, particularly the real estate sector.

■ The government is expected to release detailed implementation guidelines about VAT reforms, including tax rates, scope of deductable income and other issues. For new development sites, tax burdens are expected to be reduced; for existing properties, the owners may transfer potential increasing tax obligations to occupiers, resulting in higher effective overhead costs.

■ Although there still remain hurdles and challenges for investors, the on-going economy will help boost the market sentiment and open up new investment opportunities by providing a more transparent and effective investment environment. Considering the mature market, comparatively strong demand and potential to develop into an international financial centre in the long term, Shanghai remains the top choice for developers, institutional investors and high net worth individuals.

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