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Savills World Research
Shanghai

Briefing
Investment

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Image: The Bund

SUMMARY

Softening market fundamentals and the increasing cost of debt, forced investors to be more cautious, which resulted in protracted deal processes.

- Five key deals were concluded for a total consideration of RMB14.4 billion in Q3/2017, up 7% quarter-on-quarter (QoQ).
- All five deals predominately involved office developments.
- Domestic investors continue to focus on office properties with stable income for long-term lease hold and partial self-use.
- Gross yields for Grade A office assets stayed stable at 4.8% in Q3/2017, while net yields were at around 3.4%.
- The investment market is expected to continue cooling down as office yield spreads stays unappealing.

"The government has sent out a clear message supporting the for-lease apartment market, which has led to growing interest and capital chasing opportunities in this market."
James Macdonald, Savills Research

Market commentary

Q3/2017 concluded five sizeable deals for a total consideration of RMB14.4 billion. Though the total volume increased by 7% QoQ, the number of deals concluded dropped by 38% QoQ.

When the capital value for office properties remains at a high-level, property owners are taking the opportunity to reap value from their mature investment properties and realise returns. Developers are motivated to sell properties to improve their financial position when the source of capital is narrowed. This quarter, Shui On Land sold 49% stake in KIC properties after developing and managing the KIC project for over a decade. Current companies in KIC include IBM, Oracle, and Kaspersky. SOHO China has also sold its non-core assets which included SOHO Century Plaza and SOHO Hongkou.

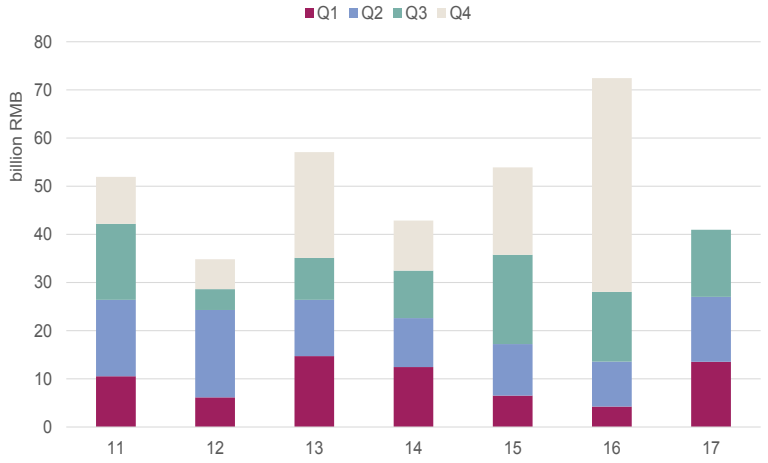
From the buyer side, domestic insurance companies with comparatively cheap capital are still the major buyers for core assets. For international and domestic real estate funds, the negative spread drove them to move up the yield curve to search for investment opportunities with higher returns. Note that in some cases, funds are acting on behalf of insurance companies. Besides digging for value-added deals in Shanghai, they are also looking at other asset types including hotels, service apartments, logistics and data centres and assets in second-tier cities such as Chengdu, Chongqing and Wuhan.

The Chinese government had indicated concern about inflation in the real estate sector, due to rapidly rising land values, increasingly unsustainable debt levels and irrational investment decisions. Therefore, from October 2016, they will rein in developer financing. Narrower financing channels, together with the PBOC's tightening of monetary policy, has resulted in a significant increase in financing costs for developers.

China's State Council issued new rules in August that put outbound real estate deals on restricted lists, reemphasising the recent campaign against "irrational" acquisitions of assets in overseas markets, which were often very visible and sometimes had only a tenuous link to core business operations. However, as it is presently challenging to identify property investments with reasonable returns in the current property market in first-tier cities, investors are expected to keep pursuing global investments. There are some expectations that the controls may be partially relaxed in 2018.

GRAPH 1

Shanghai Large-scale Real Estate Acquisitions, Q1/2011–Q3/2017



Source: Savills Research

Sectors and Deals

Five key deals were concluded for a total consideration of RMB14.4 billion in Q3/2017, up 7% QoQ. All four deals involved predominately office developments.

Office market

Market fundamentals

Two projects were launched onto the core office market in Q3/2017, adding 350,000 sq m of supply and pushing total core market stock to 8.1 million sq m.

New supply pushed up vacancy rates in core areas by 1.8 percentage points (ppts) QoQ, to 12.5%, up 3.4 ppts

TABLE 1

Yields and capital values by sector*, Q3/2017

	Grade A Office	Prime shopping mall	Prime retail street store	High-end serviced apartments	High-end strata apartments	5 star hotel	Logistics
Gross reversionary	4.0-5.3%	6.0-7.0%	4.0-5.0%	4.0-5.0%	2.3-3.0%	6.5-8.0%	6.7-7.2%
NOI	3.0-4.0%	3.0-4.0%	2.0-3.5%	2.2-2.8%	2.0-2.5%	1.5-2.0%	6.0-6.5%
Approx. values (RMB per sq m)	50-90,000	60-100,000	150–250,000	55-70,000	100-200,000	40-50,000	6-8,000

Source: Savills Research
Note: Yields refer to stabilised assets in downtown locations free of any impediments and a clean holding structure owning 100% of the building, and assuming 100% occupancy. Capital values refer to the average for the building on an Aboveground GFA basis – retail assets will have higher capital values for lower floors.

year-on-year (YoY). Core market rents remained flat on an index basis at RMB8.9 per sq m per day, up 1.8% YoY. However, average rents are down in absolute terms from RMB9.0 per sq m per day in Q2/2017, with projects launched in the last six months coming to market at below average rates.

Two new projects were launched onto the decentralized market in Q3/2017, bringing 139,300 sq m of supply and pushing total stock to 3.2 million sq m. New supply pushed vacancy rates in decentralized areas up a further 4.2 ppts in Q3/ 2017 to 37.6%, while rents remained flat on an index basis averaging RMB5.8 per sq m per day.

The Grade A office market is expected to receive 286,300 sq m and 640,000 sq m of new supply in the core and decentralized market, respectively, in the final quarter of 2017. Faced with oversupply, landlords will need to either adjust down rents in order to retain high-profile tenants or adopt more flexible leasing strategies to attract new tenants.

Investor Sentiment
Domestic buyers and insurance companies remain interested in core assets for long-term hold as they are more resilient towards rental depreciation. Meanwhile, due to shorter life cycle and return profile, international and domestic funds typically look for value-added opportunities in emerging submarkets when in a market where returns are at historically low levels.

Deals
Five key deals were concluded in the office market in the third quarter:
- Ting Hsin International Group purchased Eco City from SanPower Group for RMB6.4 billion. The project has 68,433 sq m office and 22,473 sq m retail. The office portion was handed over in Q3/2011 while the retail portion was completed in Q2/2013.

- Shui On Land disposed a 49% stake in KIC properties to a secret buyer (rumoured to be China Life) for RMB2.9 billion. KIC is a mixed-use project comprising of office, retail, car parking spaces, and a clubhouse, completed at the end of 2015. Shui On retains the rest of 51% stake to ensure the group controls the asset and to benefit from the future growth of the project.

- Tiancheng Group acquired International Metropolis Plaza Building 3 from KWG Property for RMB2.5 billion. The property, located in Yaoyuan Road, Pudong, has a total GFA of 33,800 sq m.

- Sinopharm Group purchased Greenland Huangpu Binjiang Building 1 from Greenland Group for RMB2.1 billion for partial self-use. The project is located on Mengzi Road, Huangpu district.

- Floors 6-21 of CITIC Pacific Festival Walk in Jiading District was transacted on strata-title basis for RMB430 million. Total transacted GFA was 31,194 sq m.

Retail Market
Market Fundamentals
One new project, the MixC launched in the third quarter of 2017, adding 240,000 sq m of new supply. Vacancy rates of prime and non-prime areas fell to 6.0% and 8.2% respectively, the lowest level in the past six quarters.

First-floor shopping mall rents increased 0.5% QoQ in prime and non-prime retail areas to an average of RMB50.5 and RMB16.6 per sq m per day respectively.

A total of 587,800 sq m of retail space is expected to launch in Q4/2017. As pre-commitment of larger malls scheduled to launch in the final quarter are proceeding along smoothly, citywide vacancy rates are not expected to be significantly impacted.

Investor Sentiment
A few international investors with experience managing shopping malls remain interested in acquiring retail properties in Shanghai. However, available projects remain limited. Platform and portfolio purchases, or equity injections into local operators, are the currently preferred investment vehicle. Market interest exists to purchase retail properties and REITs as a package.

Deals
No pure retail project was transacted in Shanghai in Q3/2017.

Hotel market
Market Fundamentals
The hotel markets in first- and second-tier cities remain one of the most challenging real estate sectors in China. Despite various challenges, Shanghai's hotel market recorded stable growth. Shanghai's five-star market ended August with Average Daily Rates (ADRs) of RMB902 and an average occupancy rate of 73%, while the four-star market stood at RMB516 and 73%. Revenue per available room (RevPar) for five-star and four-star hotels were RMB657 and RMB376, up by 1.4% YoY and 1.1% YoY respectively. Mid-scale hotels appealing to leisure and family travellers continue to attract more demand than luxury hotels targeting business travellers.

Investor Sentiment
The interest of purchasing hotels located in core areas for the purpose of converting them into other asset classes, usually apartments, still exists in the market. However, there are very few projects that meet such investment requirements.
It is said that Nova has basically confirmed with the purchase of Puxi New Century Hotel and the deal is expected to close in next quarter. Specialized investors are looking at opportunities to pick up hotel properties at a discount.

Deals
No hotel projects were transacted in Shanghai in this quarter.

UR Work is working with Home Inn to convert the vacant space at some of Home Inn hotels into co-working space. Such cooperation is expected to expand to about 380 cities in the country. The first trial ones would be Xuhui YITEL hotel in Shanghai and Home Inn Plus City Centre in Beijing.

Residential market
Market Fundamentals
First-hand commodity residential transaction volumes fell by 20.1% in Q3/2017 to 1.7 million sq m, down 60.8% YoY. Average transaction prices fell by 1.8% QoQ

to RMB46,700 per sq m, the first decrease in average transaction prices since Q3/2015.

Average serviced apartment rents increased by 1.6% on an index basis in Q3/2017 to RMB240.1 per sq m per month, while strata-title rental growth slowed to 1.4% QoQ with rents eventually reaching RMB188.8 per sq m per month. Meanwhile, villa rents recorded steady growth, up 1.1% QoQ to RMB158.6 per sq m per month.

To keep the residential sale market transparent and fair, Shanghai announced the public lottery system for first-hand commodity residential sales. The system requires the developers to provide a specific number of all the saleable housing units and a customer before the sales opening date.

Investor Sentiment
Although investors remain interested in serviced apartment properties, there remains a limited number of opportunities available for en-bloc sales. The government's recent restrictions on converting properties on commercial title into residential units for sale also deterred investors from buying older office buildings to convert into residential or serviced apartments.

As China's leadership pushes for the development of the for-lease market as a solution to the rising cost of homes in China's major cities, the market is drawing a lot of attention and capital from both developers and investors. Warburg Pincus redoubled its investment in a rental residence platform Nova Property Investment by investing US$183 million. GAW Capital led an investment of RMB400 million in Harbour Apartments, a Shanghai-based company that operates "co-living" apartments. Biggest obstacle for developing rental apartments is cost. However, lower value for for-lease land make it more attractive and economically viable.

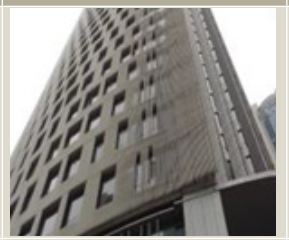
Deals
No service apartment projects were transacted this quarter.

Logistics market
Market Fundamentals
Strong demand from third-party logistics providers (3PLs), e-commerce and retail companies continues to drive demand in the logistics sector. Platform and portfolio purchases are the preferred investment vehicles.

Investor Sentiment
As yields for commercial asset classes continue to compress, logistics and industrial properties are attracting more interest. The market is dominated by a handful of players who are responsible for most investment cases. These players typically look for acquisitions of individual assets and development sites, or platform equity injections.

Deals
China Vanke announced plans to actively expand its logistics business.

TABLE 2
Key investment deals, Q3/2017

Project	International Metropolis Plaza Building 3 环球都会广场 3号楼	Greenland Huangpu Binjiang Building 1 绿地黄浦滨江1号楼	Eco City 1788国际中心	49% stake in KIC properties and YPU properties 创智天地物业及杨浦物业 49% 股权
				
Location	58 Yaoyuan Road, Pudong	778 Mengzi Road, Huangpu	1788 Nanjing West Road, Jing'an	Song Hu Road, Yangpu
Date	Aug, 2017	Aug, 2017	Sep, 2017	Sep, 2017
Property type	Office	Office	Office/Retail	Mixed-use
Transacted price (RMB mil)	2,489	2,111	6,400	2,949
Above-ground GFA (sq m)	33,800	29,324	90,905	400,000
Vendor	KWG Property	Greenland Group	SanPower Group	Shui On Land
Purchaser	Tiancheng Group	Sinopharm Group	Ting Hsin International Group	China Life
Deal Structure	Asset	Asset	Offshore equity	Onshore equity

Source: Savills Research

After it joined a Chinese private equity consortium to purchase warehouse operator Global Logistic Properties (GLP) for US$11.6 billion, China Vanke announced that its subsidiary company will join four other companies to set up a RMB6 billion fund specialized for logistics properties investment in October. Vanke accounted for 25% of the investment.

Invesco Real Estate made its first bet on China's warehouse sector by buying a portfolio of core logistics assets in the country from e-Shang Redwood (ESR) for over RMB2 billion through a joint venture. The assets in the portfolio are located in or around Shanghai.

Alibaba, the e-retailer giant, has acquired a controlling stake in logistics company Cainiao and has further announced an intention to invest RMB100 billion in its global logistical capabilities over the next five years.

Land Market[1]

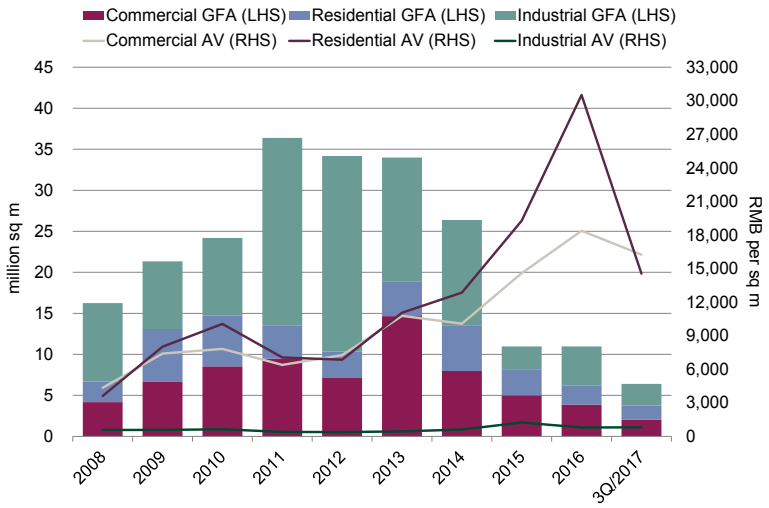
Total land sales consideration reached RMB41.9 billion in Q3/2017, down by 40% YoY. Commodity residential[2] and commercial sectors accounted for 45% and 51% of total sales, respectively. Commercial and residential AVs averaged RMB15,254 per sq m and RMB14,826 per sq m, respectively.

[1] Land sales exclude public and economic housing
[2] Residential excludes public housing

Central and local government are in the position to support the for-lease apartment market including selling out land for lease usage. Six land plots for lease were sold in Q3/2017, totalling 420,000 sq m of buildable area with a AV of RMB7,561 per sq m. All sold at their reserve price (zero premium).

FIGURE 2

Land Transaction Area and AVs, 2008–Q3/2017



Source: Savills Research

Market News

More Capital Injected into Co-working Market

Betting on the future growth, investors are still pouring capital in the co-working market. Softbank and Vision Fund invested US4.4 billion into the world's biggest co-working operator, WeWork, for its expansion in the Asian market. In addition, IDG Capital Partners made a new RMB100 million investment in Beijing-based co-working start-up, Kr Space, who has raised RMB500 million since its launch in Jan 2016.

Government's Full Support in For-Leasing Market

In July, 9 government departments led by Ministry of Housing and Urban-Rural Development (MOHURD) issued announcement to emphasize on the progressive development plan on the for-leasing market. Further plans to regulate the

TABLE 3

Key land deals, Q3/2017

Plot	District	Use	GFA (sq m)	Consideration (RMB million)	AV (RMB per sq m)	Buyer
Beicai area z000501/03-02,03-03 plot	Pudong	For-lease	132,770	896	6,748	Shanghai Land
Gubei area w040502/ e1-10 plot	Changning	For-lease	27,949	357	12,762	Shanghai Land
Nanmatou area Binjiang 06-05 plot	Pudong	For-lease	43,806	345	7,872	Shanghai Land
Caohejing area 196a-08 plot	Xuhui	For-lease	13,941	90	6,466	Shanghai Land
Zhangjiang a3-06 plot	Pudong	For-lease	130,015	724	5,568	Shanghai Zhangjiang
Jiading new town e17-1 plot	Jiading	For-lease	71,284	424	5,950	Jiading New City

Source: Savills Research

market are expected to be disclosed soon.

Besides selling six for-lease land plots this quarter, eleven commercial and mixed-use land plots were also recently converted into for-lease usage, with around 10,000 housing units expected. The majority of the plots were located in relatively central locations, six in Pudong, two in Jing'an as well as plots in Huangpu, Changning, and Minhang (Hongqiao CBD).

In addition, China Securities Regulatory Commission is also working on regulations and policies hoping to release REITs products using for-lease projects as vehicles. In October, China Young Professional Apartments (CYPA), a Beijing-based condominium operator catering to urban professionals in first-tier cities, won approval to issue RMB270 million worth of securities backed by its rental flats. In addition, Poly Real Estate has been offered a RMB5 billion quota for the sale of securities backed by its rented flats portfolio (quasi-REIT) by the Shanghai Stock Exchange.

Outlook

Despite deteriorating conditions, a number of deals are still in negotiation. With the last quarter of the year forecast to see a flurry of activity as investors push deals across the line before 2018, we could still see more deals announced in Q4/2017.

As debt financing becomes more costly and increasingly difficult to access, investment activity by leveraged investors is likely to slow down. While longer term investors focus on yields, equity investments are likely to make up a larger percentage of investment considerations.

Chinese developers have raised a lot of debt in the bond markets over the last 3 years, which are now maturing. In 2018, the total amount of corporate bonds to repay by Chinese developers will double at around RMB15 billion and then peak in 2020 at around RMB45 billion.

Faced with the pressure to repay debt in the next three years, developers may be reassessing their business by disposing of non-core assets, restructuring portfolios. As a result, we could see an increase in portfolio deals and M&A activity and an accelerated consolidation of the developer market space.

Please contact us for further information

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