Office deals slow in Q3

Investors still interested in business parks but asset values in popular business parks are already high and have limited upside potential.

- Only seven deals were concluded in Q3/2019 for a total consideration of RMB6.3 billion, down 23% year-on-year (YoY).
- Gross yields for Grade A office assets continued to increase by 0.1 of a percentage point (ppt) quarter-on-quarter (QoQ) to 5.1% in Q3/2019, while net yields were around 3.6-4.0%.
- Potential investors are concerned about the state of the office leasing market given slowing economic growth, ample supply and falling rents.
- Self-use buyers remained active in the market, seizing upon the weaker investment sentiment to secure better opportunities.
- Several projects were purchased for conversion this quarter including Tiandeng Road Project, Xingfulai Hotel and Fudu Plaza.
- In Q3/2019, residential for-sale and residential for-lease AVs averaged RMB20,200 per sq m and RMB5,620 per sq m, respectively.
- Within the for-lease apartment sector, some landlords are still raising funds to expand operations while others are exiting the market, leading to further consolidation.
- Lendlease kicked off a US$400 million senior living project called Ardor Garden near Shanghai, which is scheduled to open in 2021.

“Concerned about the current health of the office leasing market, investors are now focusing on stable assets with strong tenant covenants and longer weighted average lease expirations.”

JAMES MACDONALD, SAVILLS RESEARCH
MARKET COMMENTARY
Q3/2019 recorded seven deals totalling RMB6.3 billion, down 23% YoY. The total for 1H/2019 was heavily influenced by deals negotiated in 2018 which then closed in 1H/2019. Thus Q3/2019’s figure would seem to be a better indicator of market sentiment.

Potential investors are concerned about the state of the office leasing market given slowing economic growth, ample supply and falling rents. Uncertainties in the market challenge investor’s ability to model and make decisions. Last year, for example, there were several cases of investors purchasing empty buildings and intending to extract value by leasing up the space with their project management experience. This arguably risky strategy was seen at Yifang Tower, Greenland Huangpu Center, Shengteng Tiandi and Star Harbor. However, this year investors are focusing on stabilised assets with strong tenant covenants and longer weighted average lease expirations (WALEs).

Even so, a significant amount of capital has been raised in the market, in part due to the government’s continued support of the for-lease market. For example, rental platform Cjia.com (城家公寓) raised nearly US$300 million from investors, including Jack Ma’s Yunfeng Capital, and China Vanke plans a US$51 million bond issue to fund its rental property projects. At the same time, other players are exiting the market, leading to further consolidation. Companies without other players are exiting the market, leading to a suitable business model or adequate cost controls are finding it hard to survive after this year’s longer weighted average lease expiration (WALEs).

Two new projects were launched in the core office market in Q3/2019, adding 227,000 sq m of new office space to the core Grade A office market while one project was handed over in the decentralised market, adding 14,000 sq m of new office space. Vacancy rates in the core market increased by 1.3 ppts in Q3/2019 to 13.2%, primarily as a result of new supply with low pre-commitment rates.

Meanwhile, vacancy rates in decentralised areas fell by 1.1 ppts QoQ to 28.8%. In terms of rent, core market rents continued to decrease by 0.2% in Q3/2019 to an average of RMB8.95 per sq m per day and rents in decentralised areas fell to an average of RMB5.76 per sq m per day. The office market is expected to receive about 1.1 million sq m of new supply in core and decentralised locations in Q4/2019, which should push vacancy rates up further.

Assets in good-quality, secondary business districts could continue to hold value for investors when compared to primary markets where yields are low and opportunities scarce as well as decentralised markets where supply is plentiful. The market saw yields softening, especially with distressed sellers or those with funds that need to exit in the next year or two. Investors are still interested in business parks due to the satisfactory leasing demand for this asset type, while some business park owners are keen lowering their price expectation, therefore, the market is expected to see more business park transactions.

RETAIL MARKET
Five new retail projects were launched in Q3/2019, adding a total retail GFA of 369,000 sq m. First-floor rents increased 0.3% QoQ in Q3/2019 to RMB27.3 per sq m per day. Vacancy rates fell by 1.0 ppt QoQ to 5.8% in prime retail areas and rose by 1.0 ppt QoQ to 8.8% in non-prime areas. Cosmetics, technology and sports brands are still expanding aggressively. Around 270,000 sq m of new supply is expected to open in the last quarter of 2019.

Investors are looking for opportunities to purchase small underperforming retail

### TABLE 1: Yields And Capital Values By Sector*, Q3/2019

<table>
<thead>
<tr>
<th></th>
<th>GRADE A OFFICE</th>
<th>PRIME SHOPPING MALL</th>
<th>PRIME RETAIL STREET STORE</th>
<th>HIGH-END SERVICED APARTMENTS</th>
<th>HIGH-END STRATA APARTMENTS</th>
<th>5-STAR HOTEL</th>
<th>LOGISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross reversionary</td>
<td>4.5-5.4%</td>
<td>5.5-6.5%</td>
<td>4.0-5.0%</td>
<td>4.0-5.0%</td>
<td>2.3-3.0%</td>
<td>5.5-7.5%</td>
<td>6.2-6.7%</td>
</tr>
<tr>
<td>NOI</td>
<td>3.6-4.0%</td>
<td>3.0-4.0%</td>
<td>2.0-3.5%</td>
<td>2.2-2.8%</td>
<td>2.0-2.5%</td>
<td>1.5-2.0%</td>
<td>4.5-5.5%</td>
</tr>
<tr>
<td>Approx. values (RMB per sq m)</td>
<td>50-90,000</td>
<td>60-100,000</td>
<td>150-250,000</td>
<td>55-70,000</td>
<td>100-200,000</td>
<td>40-50,000</td>
<td>6-8,000</td>
</tr>
</tbody>
</table>

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

Source: Savills Research
properties located in core locations with an intention for conversion. Most buyers with this strategy are international investors who have more experience with such a value-add strategy and more expertise in property management. For prime retail properties, the pricing is still too high to justify the risks for investors, limiting interested investors to mainly international funds.

OTHER MARKETS
With the government’s policy support and the potential demand, several investors are looking for opportunities in the senior housing market, which has seen more enquiries from foreign investors looking for local partners to invest in the sector. Most of these investors are targeting the high-end senior housing segment where they can leverage expertise and establish their brand. CITIC Capital is planning a US$200 million fund to focus on senior housing investment in first- and second-tier cities and the target IRR for the fund is said to be 13-15%. In addition, Lendlease kicked off a US$400 million senior living project called Ardor Garden near Shanghai, which is scheduled to open in 2021. The community plans to host approximately 1,300 seniors in more than 850 apartments.

As China continues its growth in fintech, digital transformations and big data sectors, there has been a concurrent rise in data centres, with the introduction of 5G communication pushing demand to a new level. A growing number of investors are looking at this market since it offers diversification benefits and generates higher yields than traditional asset classes. Some second-tier cities would be a perfect fit to build data centre facilities due to the availability of land and power, lower operating costs, improving networks and support infrastructure. GDS Holdings entered into an agreement with GIC to build and operate data centres in China. Under the terms of the agreement, GDS will enter contractual commitments with internet and cloud providers to develop build-to-suit data centres under separate project companies. Upon completion, GDS will sell 90% of the equity in the project companies to GIC at pricing based on development costs plus financing. GDS also received a US$150 million equity investment from Ping An Overseas.

KEY DEALS
- Zhong Cai Group acquired Dong Ying Tower for RMB2.35 billion from SPD Bank. The building is in Huangpu, adjacent to People’s Square, with a total GFA of 65,000 sq m of which SPD Bank accounts for 95%. Dong Ying Tower is currently used as the headquarters for SPD Bank, and it is planned to be leased back to SPD Bank for another two years until the bank finishes the construction of its new HQ building in the Expo area. Given the agreed upon rent for the next two years, the cap rate for the deal is estimated to be around 3.2%.
- Hantong Capital and KKR created an investment platform and then sold Fudu Plaza into the platform for around RMB750 million. The retail property is located in Huangpu with a total sellable GFA of 14,846. After purchase, KKR intends to convert the property into a mixed-use project and rename it into “The Bund NEO”. A JV comprised of Sunac, Nova and Metro acquired Fudu Plaza for RMB700 million in 2018 and immediately sold it to Hantong Capital.
- Bank of Ningbo purchased floors 15-20 in Jasper Tower from SRCB for RMB1.25 billion. Jasper Tower is in the Lujiazui suburb, Pudong. The total purchased area covers around 13,200 sq m.

LAND MARKET
Total primary land sale consideration reached RMB108.3 billion in the first three quarters of the year. Commodity residential and commercial sectors accounted for 60% and 33%, respectively, of total sales. Residential for-sale and residential for-lease AVs averaged RMB20,200 per sq m and RMB5,620 per sq m, respectively. Commercial AVs averaged RMB5,700 per sq m. Over 90% of the land plots transacted were in suburbs and outlying districts.

OUTLOOK
Investors are hoping for one of three things: more certainty in the market, fiscal and monetary stimulus from the government, or more significant discounts offered by sellers. If any of these happen, we could see a pick-up in activity next year.

Many investors are turning to the debt market as returns are higher and opportunities are more plentiful. Nevertheless, the debt portion of their portfolios is more junior and risks are significant if financing remains tight and developers’ cash flow position remains stretched.

TABLE 2: Key Land Deals, Q3/2019

<table>
<thead>
<tr>
<th>PLOT</th>
<th>DISTRICT</th>
<th>USE</th>
<th>GFA (SQ M)</th>
<th>CONSIDERATION (RMB)</th>
<th>AV (RMB PER SQ M)</th>
<th>BUYER</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Jiangwan Town n091104</td>
<td>Yangpu</td>
<td>Residential</td>
<td>72,610</td>
<td>3,813</td>
<td>52,514</td>
<td>China Enterprise</td>
</tr>
<tr>
<td>Pujiang Center 34-1/34-6</td>
<td>Minhang</td>
<td>Commercial</td>
<td>50,075</td>
<td>2,502</td>
<td>49,975</td>
<td>Poly</td>
</tr>
<tr>
<td>Sheshan Town g7sj0002</td>
<td>Songjiang</td>
<td>Residential</td>
<td>102,066</td>
<td>2,351</td>
<td>23,040</td>
<td>ITG Holdings</td>
</tr>
<tr>
<td>Huacao Town mhp0-1402 unit 07-06</td>
<td>Minhang</td>
<td>Residential</td>
<td>62,338</td>
<td>1,938</td>
<td>31,100</td>
<td>Shouchuang Zhenheng Properties (上海首创正恒置业有限公司)</td>
</tr>
<tr>
<td>Yongfeng Town h39-06</td>
<td>Songjiang</td>
<td>Residential</td>
<td>58,483</td>
<td>1,228</td>
<td>20,999</td>
<td>ITG Holdings</td>
</tr>
<tr>
<td>Huaxin Town 27-01</td>
<td>Qingpu</td>
<td>Residential</td>
<td>65,000</td>
<td>1,073</td>
<td>20,176</td>
<td>Jinke Properties</td>
</tr>
</tbody>
</table>

1 Land sales exclude public and economic housing

Source | Savills Research