Investment

Financing remains tight

Investment market slowed in 2018 with total en-bloc transactions at RMB97.2 billion, down by 6%.

- Two single deals over RMB10 billion each were completed in 2018: CapitaLand and GIC's purchase of Harbor 55 and Blackstone's purchase of Mapletree Business City.
- International investors had more opportunities to secure deals due to the lack of competition from domestic investors. International capital accounted for around 54% of the market's total consideration.
- A total consideration of RMB6.8 billion in retail properties was concluded in 2018, more than triple that of 2017. About 75% of space was intended for conversion.
- Project conversion remained a popular strategy for value-added investors especially given the fully-valued market. Both underperforming retail projects and hotels located in prime locations were targets.
- Logistics properties in China have been a target for both domestic and international investors in 2018, pushing China to become one of the world's largest logistics market.
- Niche markets such as elderly housing, for-leasing apartments, NPL and outlets are expected to garner more attention from investors as they opt to move up the risk curve in search of yields and to avoid competition.
- Gross yields for recently-traded Grade A office assets remained stable at 4.8% in Q4/2018, while net yields were around 3.4-3.6%. Expectations are that yields will rise in 2019.

"2018 saw investors' growing interest in large-scale, mixed-use projects and development sites."

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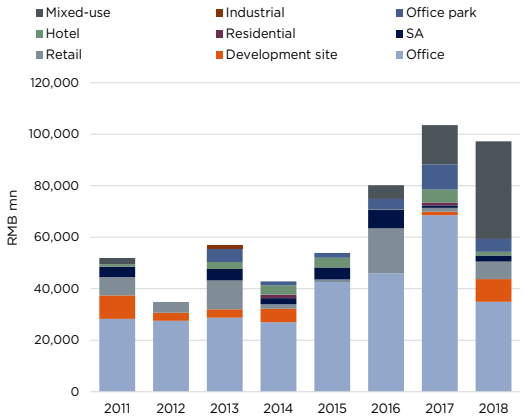
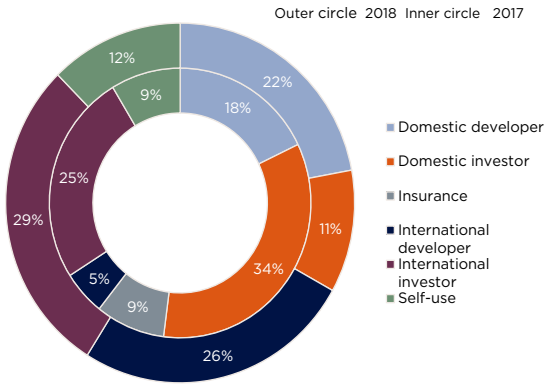
GRAPH 1: Shanghai Large-Scale Real Estate Acquisitions, 2011 to 2018



Source Savills Research

GRAPH 2: En-Bloc Transaction Breakdown By Buyer Type, 2017 to 2018



Source Savills Research

MARKET COMMENTARY

Shanghai's investment market was slow in 2018 with total en-bloc transactions at RMB97.2 billion.

Deals for nine development sites and mixed-use projects concluded in 2018 with a total consideration of RMB46.7 billion, more than double that of 2017. Most of the projects are located in emerging business areas such as Qiantan, North Bund and Hongqiao Transportation Hub, indicating investors' confidence in Shanghai's commercial real estate market—especially the potential of some of the emerging submarkets—despite softening market fundamentals and a slowing economy. Eight deals closed at over RMB1 billion, and international investors accounted for 73% of total transactions. As domestic investors and developers struggled with financing and debt repayment, international buyers took the opportunity to close deals—large-sized transactions in particular.

Project conversion remained a popular strategy for value-added investors especially given the fully-valued market. Both underperforming retail projects and hotels located in prime locations were targets. While 2017 was the year for hotel acquisition, 2018 was the year for retail projects. Investors concluded a total consideration of RMB6.8 billion in retail properties in 2018, more than triple that of 2017. About 75% of purchases were intended for conversion, and most of the buyers of those projects were international (or at least the source of capital was from overseas). Local governments are said to be very supportive of such conversion projects as they tend to bring "dead assets" back to life and, as a result, generate more tax revenue.

At the end of 2018, the State Council stated its decision to facilitate bond issuances for private companies, with liquidity support flowing from the central bank to professional institutions. However, it is expected that China will maintain its tough stance on regulating speculative behaviour in the real estate sector and will not expand financing channels for real estate companies' commercial projects. Instead, the latest guidelines encourage financing in a number of limited areas such as renovation of shanty towns, affordable housing projects, and rental housing.

OFFICE MARKET

One new project was launched onto the core office market in Q4/2018, adding 65,000 sq m of new office space and bringing the full-year supply to 778,500 sq m. Net take-up slowed to 637,800 sq m in 2018, down 9% from its 2017 high, but remained strong considering the history of the market. West Nanjing Road continued to record negative take-up and consequently higher vacancy rates. A continued oversupply situation resulted in an annual increase of 0.5 of a percentage point (ppt) in vacancy rates, to 12.4% in Q4/2018. Core market rents increased by 0.3% on an index basis in 2018, currently averaging RMB9.0 per sq m per day.

In the decentralised market in Q4/2018, two new projects were handed over, adding 69,000 sq m of new office space and bringing the total decentralised stock to 4.1 million sq m by year's end. Vacancy rates in decentralised areas fell by 1.8 ppts quarter-on-quarter (QoQ) and two ppts year-on-year (YoY) to 32% in Q4/2018. However, rents remained flat on an index basis in 2018 averaging RMB5.8 per sq m per day.

Supply will continue to be the biggest challenge for the Shanghai office market in 2019, especially after several projects were delayed from 2018. Both core and decentralised locations are scheduled to absorb more than one million sq m of Grade A office space in 2019. On the other hand, both a slow economy and a crackdown on P2P companies are expected to have a negative impact on the demand side.

INVESTOR SENTIMENT

Office properties, with their transparency and high liquidity, remain a highly sought-after asset type for investors. Office buildings in emerging submarkets keep drawing

TABLE 1: Yields And Capital Values By Sector, Q4/2018

	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%	5.5-6.5%	4.0-5.0%	4.0-5.0%	2.3-3.0%	5.5-7.5%	6.2-6.7%
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%	4.5-5.5%
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

investment interest because of their value-added potential, however, investors are also concerned about oversupply issues in certain decentralised submarkets. In the deleveraging market, owners of properties might have to offer a discount to close a deal when they attempt to pay off debt or recycle assets.

DEALS

Four key deals were concluded in the office market in Q4/2018, including:

-Gaw Capital and Quadreal Property acquired Ocean Tower from ARA for RMB2.9 billion. Ocean Tower has a total aboveground GFA of 50,200 sq m with some retail space on the first floor. ARA purchased the project from Ascendas in 2013 for RMB1.9 billion.

-China Reinsurance Group, 70% of which is owned by China Investment Corporation, purchased Shanghai Fuyuan Landmark Plaza for RMB3.1 billion for at least partial self-use. The project has a total GFA of 36,000 sq m and is located in Lujiazui, Pudong. The building was transacted on a turn-key basis, which is expected in 2020 and is part of the 113,690 sq m Shanghai Fuyuan Landmark project.

-CapitaLand and AEW Investment acquired part of Pufa Tower from Hainan Airlines for RMB2.97 billion. After the purchase, the JV will own levels eight to 19 and levels 21 to 32 with a total GFA of 41,773 sq m. Reports were that CapitaLand planned to enhance the property's value by upgrading specifications, tenant mix and improving operational efficiencies.

-Gaw Capital purchased four office buildings and a small portion of retail in MixC for RMB2.86 billion. The four office buildings have a total GFA of 56,950 sq m. MixC is located in Wuzhong Road, Minhang district.

RETAIL MARKET

Three new projects launched onto the market in Q4/2018, contributing a total retail GFA of 380,000 sq m. Vacancy rates increased by 0.2 of a ppt QoQ and 0.9 of a ppt YoY in Q4/2018 to 6.8% in prime retail areas, and they rose by 0.4 of a ppt QoQ and 0.1 YoY to 6.8% in non-prime retail areas. Overall average rent on first-floor space increased 0.3% QoQ to RMB27.7 per sq m per day and grew by 1.3% YoY.

Fourteen new projects, or a total of 1.1 million sq m of retail space, are expected to launch in 2019. New supply continues to bring great challenges to the retail market in Shanghai. The significant new supply and the macroeconomic environment will lead to a limited increase in overall rents.

INVESTOR SENTIMENT

Investors, especially international ones with expertise in flipping underperforming retail properties, are searching for more conversion opportunities. They typically look for retail assets located in core but not prime areas and, given the location and physical features, convert the malls into either co-working or for-leasing apartments. As a large number of new shopping malls have been launched in the market over the years, the market tends to have many outdated malls that could use some updating or conversion.

DEALS

KaiLong purchased the JAJE Plaza (嘉杰国际广场) retail podium for RMB700 million. The project is located in Sichuan Road, with a total retail GFA of 22,000 sq m. Reports say that KaiLong intends to convert part of the retail space into co-working space.

HOTEL MARKET

Though the hotel market in first-and second-tier cities remains one of the most challenging real estate sectors in China, market fundamentals are strengthening thanks to the growing tourism industry. Shanghai's five-star market ended October with Average Daily Rates (ADRs) of RMB1,053 and an average occupancy rate of 73.8%, while four-star hotels achieved ADRs of RMB585 and an average occupancy rate of 69.8%. The revenue per available room (RevPar) for five- and four-star hotels in October increased by 3% and 6% YoY.

Alibaba opened its first hotel in Hangzhou. Called FlyZoo Hotel, the hotel is embedded with many hi-tech functions including check-in via facial recognition, voice-activated lights, televisions and curtain controls as well as robot servers. Besides Alibaba, other Chinese tech companies such as JD.com, Baidu and Tencent are planning forays into the hospitality sector.

INVESTOR SENTIMENT

Converting hotels located in core areas into other asset classes—mostly for-leasing apartments—remains the main purpose for purchasing hotels in China. Meanwhile, some domestic developers are seeking opportunities to rebrand and revitalise hotel portfolios. Investors are starting to look at this submarket with more interest, thanks to the strengthening domestic tourism sector and rising travel demands.

TABLE 2: Key Investment Deals, Q4/2018

	SANLIN HOLIDAY INN EXPRESS	SHANGHAI OCEAN TOWER	MIXC (FOUR OFFICE / RETAIL)	JAJE PLAZA (RETAIL PORTION)	HARBOR 55	MAPLETREE BUSINESS CITY	PUFA TOWER	SHANGHAI FUYUAN LANDMARK PLAZA
Location	215 Taihuan Road, Pudong	550 Yan'an Road, Huangpu	1799 Wuzhong Road, Minhang	1689 North Sichuan Road, Hongkou	55 Haimen Road, Hongkou	Qixin Road and Gudai Road, Minhang	588 South Pudong Road, Pudong	1799 Wuzhong Road, Minhang
Property type	Hotel	Office	Office	Retail	Mixed-use	Mixed-use	Office	Office (under construction)
Transacted price (RMB mil)	470	2,938	2,858	700	20,500	11,000	2,750	3,090
Sellable GFA (sq m)	16,200	50,200	60,800	22,100	312,700	289,000	41,800	36,000
Seller	Vanke and Xincheng Properties	ARA	Harvest Capital	China Calxon Group	SIPG	Mapletree	Hainan Airlines	JV of Sunac & China Enterprise
Purchaser	China Resources	Gaw Capital & Quadreal Property	Gaw Capital	KaiLong	CapitaLand & GIC	Blackstone	CapitaLand & AEW Investment	China Reinsurance Group
Deal structure	Onshore equity	Offshore equity	Onshore equity	Asset	Offshore equity	Offshore equity	Onshore equity	Asset

Source Savills Research

DEALS

China Resources acquired Sanlin Holiday Inn Express for RMB470 million. The hotel, with a total GFA of 16,200 sq m, has 299 keys and is located in Sanlin City Commercial Plaza (三林城市商业广场中心).

RESIDENTIAL MARKET

Overall new commodity residential supply decreased by 5.9% in Q4/2018 to 2.9 million sq m. First-hand commodity residential transaction volumes decreased by 33.2%, totalling 1.5 million sq m, up 30.5% YoY. Average transaction prices increased by 12.2% QoQ to a new high of RMB61,300 per sq m.

Two new serviced apartments launched onto the market in Q4/2018: Somerset Gubei in Minhang and Yanggo's Leville Residences in the Biyun area of Pudong for a total of 465 units. Serviced apartment rents experienced a QoQ increase of 1.3% to RMB248.4 per sq m per month. Serviced apartment vacancy rates were up 0.4 of a ppt to 15.3%.

INVESTOR SENTIMENT

Although investors remain interested in serviced apartments, there are a limited number of opportunities available for en-bloc sales. On the back of the government's sustained goal to develop the for-leasing sector, investors remain interested in the long-term rental apartment market. Currently, there are three main strategies for tackling the market: buying and developing for-leasing only land; project conversions; and sublets. Each has its unique strengths and weaknesses. The market also continues to see ABS and REITs products issued to fund for-leasing projects as capital requirements and long term timelines can be the main challenges for businesses.

DEALS

There were no residential transactions in this quarter.

The market saw continued growth in the for-leasing sector. Gaw Capital and developer China SCE Group agreed to establish a long-term rental apartment investment platform – Funlive – backed by initial funding of US$800 million. The JV aims to acquire, develop and operate multi-family residential projects in China's core cities.

INDUSTRIAL MARKET

Backed by the rapid growth of e-commerce and the domestic consumer market's huge potential, the market has been seeing constant demand for high-quality, modern logistics facilities and services. Rising demand, together with tight supply in first-and second-tier cities, has resulted in steady rental growth for logistics properties. Faced with competition, logistics owners are keen to take advantage of high-technology to increase efficiency and thus achieve higher profit margins. However, as the sector matures, it is expected that yields will have limited room to be compressed further.

Shanghai has been striving to develop into an advanced manufacturing centre in response to the government's Made in China 2025 initiative. Demand is on the rise for manufacturing centres that combine multiple functions under one roof, such as manufacturing, R&D and logistics.

Data centres have also experienced a surge in demand as China continues to be a world leader for big data and cybersecurity. The strong underlying fundamentals of data centres—higher yields and typically longer lease terms—are motivating asset owners to redevelop existing properties into data centres. However, the heavy capital expenditure needed to set up the facilities, which requires longer investment timelines, and ongoing regulatory hurdles might be an issue for some short-term funds.

INVESTOR SENTIMENT

The market is dominated by a handful of players, such as GLP and ESR, who are responsible for most of the investment deals. They typically look for acquisitions of individual assets and developments while PE funds look for big platform investments. Investors are also looking for opportunities to acquire more advanced assets, such as cold chain, which can create barriers to entry for other investors. Properties located in the satellite cities of Shanghai are very popular among investors.

DEALS

Allianz acquired a 50% stake in a Gaw Capital-owned logistics portfolio. The portfolio comprises five projects located in Shanghai, Jiaxing, Foshan, Wuhan and Shenyang and has a total leasable area of around 375,000 sq m. Constructed between 2016 and 2017, the properties are occupied by tenants such as Vipshop, Carrefour, Miniso and Alog.

LAND MARKET

Total land sale consideration reached RMB17.2 billion in 2018, up 47% YoY. Commodity residential and commercial sectors accounted for 42% and 53%, respectively, of total sales. Residential for-sale and residential for-lease AVs averaged RMB27,414 per sq m and RMB6,498 per sq m, respectively. Commercial AVs averaged RMB14,397 per sq m. The market saw an increase in supply when compared with the previous three years. Most of the land plots were transacted at reserved pricing.

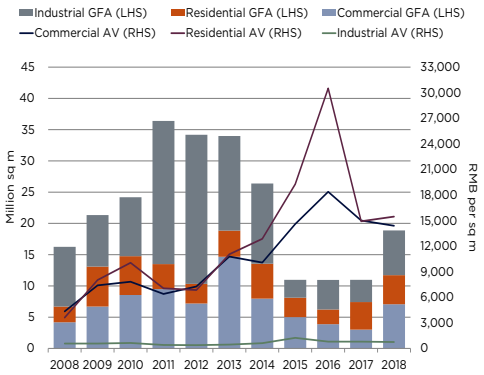
OUTLOOK

The market will likely see a price adjustment in 2019 when sellers become more pressured to sell properties in the slow market. We also expect to see a pickup in transaction volume as a change in market dynamics creates more opportunities.

Niche markets such as elderly housing, for-leasing apartments, NPL and outlets are expected to garner more attention from investors as they opt to move up the risk curve in search of yields and to avoid competition.

With India about to list its first REIT product, REITs in China loom on the horizon. This could be very positive for the market since REITs as an investment product are stable, asset-light, large-scale, and can also be an important way for investors to exit the market.

GRAPH 3: Land Transaction Area And Avs, 2008 To 2018



Source Savills Research

TABLE 4: Key Land Deals, Q4/2018

PLOT	DISTRICT	USE	GFA (SQ M)	CONSIDERATION (RMB)	AV (RMB PER SQ M)	BUYER
Pingliang w060401	Yangpu	Commerical	108,217	4,188 million	38,700	Jiaotong Construction Group, Green Town
Shiquan a06-04	Putuo	Residential	81,871	3,741 million	45,690	COLI Group
Shibei Hi-tech Industrial Park n070501	Jing'an	Residential	65,474	3,052 million	46,610	Sunac
Shiquan a07a-04	Putuo	Residential	57,805	2,930 million	50,690	COLI Group
Kangjian Street n05-10	Xuhui	Residential	49,060	2,260 million	46,066	Gemdale Group

Source Savills Research