

Briefing Office sector

October 2014



Image: Lujiazui Century Financial Plaza, Pudong

SUMMARY

As new supply enters the Pudong market, rental change is expected to slow to similar levels seen in the Puxi market.

- Lujiazui Century Financial Plaza Tower 2 and Tower 3 were launched in Q3/2014, bringing quarterly supply to 140,000 sq m and total stock to 5.5 million sq m.
- Net take-up totalled 85,300 sq m in Q3/2014, bringing the year-to-date (YTD) take-up to 330,500 sq m, higher than the total for FY2013.
- Core vacancy rates increased by 0.8 of a percentage point (ppt) quarter-on-quarter (QoQ) to 7.8% to 7.0%.
- Average core rents increased 0.3% to RMB8.6 per sq m per day, with most districts seeing no significant changes.
- Six major large-scale office acquisitions were concluded in the third quarter, with three major deals seen in Hongqiao.
- Gross reversionary yields increased to 5.6% in Q3/2014, as a handful of investment funds come to the end of fund life.

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 “Pudong market remains extremely tight while Puxi rents are stable despite relatively high vacancy rates. Pressure from demand in Pudong is likely to ease when new supply starts to enter the market in the second half of the year.”

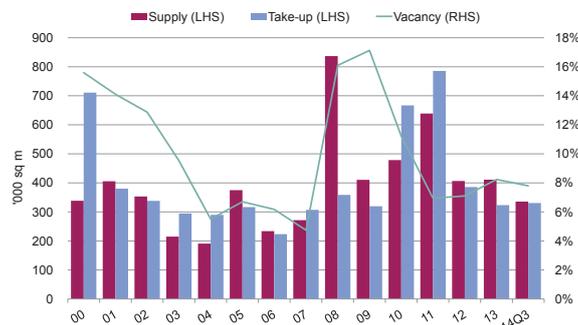
James Macdonald, Savills Research

➔ **Market commentary**

The core office market remained stable in the third quarter. The market received Lujiazui Century Financial Plaza Tower 2 and Tower 3, adding 140,000 sq m. In Q4/2014, two more projects are expected to be handed over including Lujiazui Century Financial Plaza Tower 1 and Oriental Financial Centre, adding 187,500 sq m.

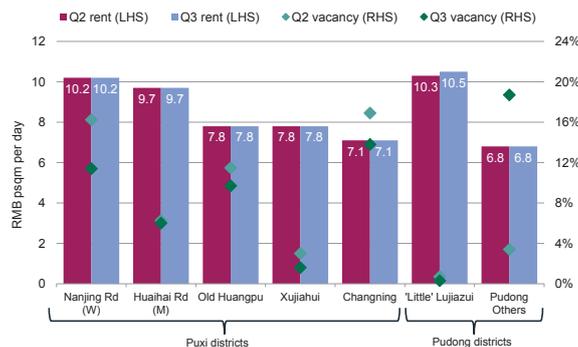
Net take-up reached 85,300 sq m in Q3/2014, similar to that seen in the second quarter, and was primarily focused on projects which had been launched in the last three quarters. Domestic financial and professional services companies continued to be main demand drivers, favouring

GRAPH 2 **Grade A office supply, take-up and vacancy rate, 2000–Q3/2014**



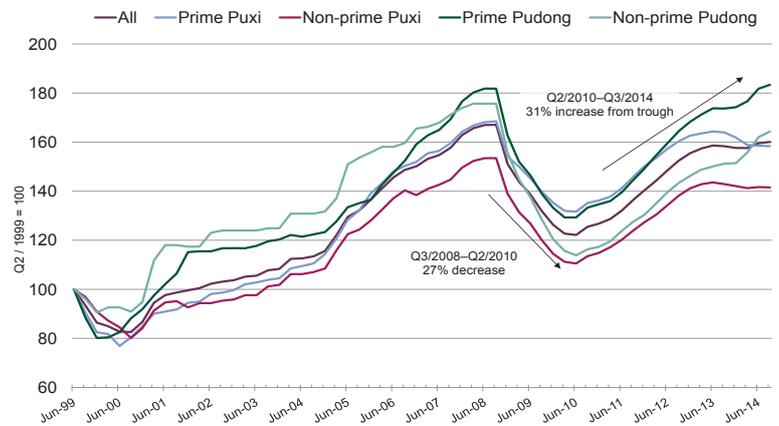
Source: Savills Research

GRAPH 3 **Business district comparison, rent vs vacancy rate, Q2/2014 and Q3/2014**



Source: Savills Research

GRAPH 1 **Grade A office rental indices, Q2/1999–Q3/2014**



Source: Savills Research

Lujiazui and prime areas in Puxi such as Nanjing Road (W). In Puxi, older projects saw tenants relocating to newer buildings, as more choice and price incentives were available in the market. Core vacancy rates increased by 0.8 of a ppt to 7.8%, with the highest vacancy rates recorded in non-prime Pudong areas at 18.7%.

China's GDP growth increased 7.3% in Q3/2014, as growth continues its controlled slowdown. Multinational corporations (MNCs) remain cautious on expansion, while domestic financial companies remain a driving force in the take-up of premium space.

Grade A office rents increased 0.3% in Q3/2014, to an average of RMB8.6 per sq m per day, a second consecutive QoQ increase after a three-quarter decline. This can be attributed to both the sustained growth of Pudong rents and the stabilisation of Puxi rents.

Pudong continued to see the highest rental increases, up 1.1% QoQ to RMB9.1 per sq m per day, however this is 2.3 pts less than Q2/2014. Prime Pudong market rents increased 0.9% QoQ, while non-prime Pudong rents continued to show the strongest growth, up 1.4% QoQ, albeit at a much lower growth rate than has been seen in recent quarters.

The Puxi market recorded a 0.1% decrease in rents, as most landlords kept rents unchanged at post

promotional levels, only Nanjing Road (W) saw a slight decrease in rents. Prime and non-prime Puxi markets continued to see declines, both dropping 0.1% QoQ.

Pudong is expected to see slower rental growth, as the launch of Oriental Financial Centre and Lujiazui Century Finance Plaza aims to meet the pent-up demand within the market.

Recently, Puxi has seen falling rents and a number of newly-launched projects, which has created more attractive offerings to those who are becoming more cost conscious. While take-up rates are expected to increase in the short term, demand is expected to be inadequate to absorb the upcoming plethora of supply.

Market news
Shanghai to solidify the role of International Shipping Centre

The recent lifting of restrictions on overseas shipping management companies in Shanghai (China) Pilot Free Trade Zone (SPFTZ) was followed by the registration of the first three overseas shipping management companies, namely Shanghai Runyuan Ship Management Company, Haigong Ship Management Company and Maersk Ship Management and Consultancy Company. Six additional international shipping management companies are currently going through the registration process including the world's fourth largest, Fleet Management. In addition, the China

→ Insurance Regulatory Commission is pushing the development of marine insurance products, to increase support for the shipping industry,

To accommodate the expected spillover demand from FTZ, the Pudong government is developing a Shanghai Shipping Finance Base Project in Lujiazui. The base is expected to be operational by 2015, accommodating international institutions such as Braemar Shipping Services, Royal Institute of Chartered Shipbrokers and Maritime London.

Although the port of Shanghai stands out in terms of shipping volume, its shipping service industry is still in its infancy and current local players are suffering from low profitability. This series of reform measures will help to establish a comprehensive and competitive business environment, encouraging the setup of various types of companies related to the shipping services industry.

Courier industry market to open to overseas competition

As the world's second largest courier market, China has seen rapid development in domestic courier business in past years. However, overseas couriers only have a small presence due to a range of limitations. In order to open up the market, thus allowing players to compete equally, the State Council, China's Cabinet, has recently decided to fully open the country's domestic package delivery business to qualified overseas companies.

Additionally, the country will streamline license approval procedures and encourage mergers and acquisitions within the necessary review system. The government has also requested more support from civil aviation and intra-city transportation.

With China's e-commerce boom and more demand for high-end delivery services, the implementation of these measures is expected to attract more overseas companies to enter China, hence increasing demand for logistics and office properties.

Lujiazui Century Financial Plaza Tower 2 and Tower 3 were handed over in Q3/2014, adding 140,000 sq m to the market and bringing total stock to 5.5 million sq m.

Developed by Lujiazui Finance & Trade Zone Development Co, Ltd, Lujiazui Century Financial Plaza is located in Zhuyuan district. Lujiazui Century Financial Plaza consists of five office buildings: Towers 5 and 6 were handed over at the end of 2013; and Tower 1 is expected next quarter. The five towers have a combined office GFA of 312,000 sq m. This is the only project launched onto the non-prime Pudong market since Q3/2012 and will help to meet the spillover demand from companies wanting to be close to Lujiazui but not willing to pay the higher rents.

Quarterly net take-up totalled 85,300 sq m, bringing YTD take-up to 330,500 sq m. Core vacancy rates increased this quarter, mainly in the Pudong market, as a large amount of leasable supply has been released onto the market. The Puxi market saw nearly 75,000 sq m of take-up this quarter, significantly higher than this time last year, continuing the higher levels seen in the last three quarters.

Half of this was seen on Nanjing Road (W), as a number of high-specification buildings with favourable rental levels attracted both domestic and international companies.

Core vacancy rates increased 0.8 of a ppt QoQ to 7.8%, though only one business district saw an increase in vacancy rates, Pudong Others increased to 18.7%, due to a substantial new project launched this quarter.

Prime Pudong market remains extremely tight with vacancy rates in 'Little' Lujiazui at their lowest levels since 2007. Due to the very limited vacant space on the market, net take-up in 'Little' Lujiazui was only 7,300 sq m in Q3/2014, similar to last quarter. Pudong Others, the only area to see new supply this quarter, continued to benefit from spillover demand from 'Little' Lujiazui, showing the strongest rental growth among all submarkets, up 1.6% QoQ.

TABLE 1 Selection of leasing transactions, Q3/2014

Tenant	Project	Location	Area leased (sq m)
VF 威富	Henderson 688	Jing'an	6,000
McCann Erickson 麦肯世界集团	Huaihai Plaza	Huangpu	5,600
CPIC Asset Management 太平洋保险资产管理	SWFC	Pudong	4,800
RR Donnelley 当纳利	Lansheng Plaza	Huangpu	4,000
Tod's 托德斯	Wheelock Square	Jing'an	2,100

Source: Savills Research

TABLE 2 Selected commercial development site acquisitions, Q3/2014

Property	Location	Price (RMB million)	Buyer	Note
Shanghai Mart 上海世贸商城	Changning	3,563	Shanghai Industrial Urban Development (51%), Nan Fung (49%)	Include 42,000 sq m office space, 238,000 sq m exhibition/retail space
Sky SOHO SOHO凌空	Changning	3,050	Ctrip	Include 91,400-sq m office space and 8,600-sq m retail space
Hongqiao Sincere Centre 虹桥协信中心	Minhang	1,330	Ping An Trust	Blocks 2/3/5/6/8
Datang International Plaza 建工大唐国际广场	Pudong	1,035	Shanghai Pudong Properties Group	Under construction
G2-01 development site in Waigaoqiao Free Trade Zone 外高桥保税区G2-01	Pudong	484	Sino-Ocean Land	Under construction
Zhangjiang Riverfront Harbor 张江集电港	Pudong	399	Kailong REI	

Source: Savills Research

All submarkets in the Puxi area showed stable rents. Nanjing Road (W) and Changning saw the largest drop in vacancy rates, down 4.8 and 3.1 ppts respectively. This can be attributed to the absorption of recently launched projects. Nanjing Road (W), which has many high-specification projects as well as lower rents than Lujiazui, benefited the most from demand. Xujiahui remains the steadiest market among all the business districts, given its limited new supply and stable demand.

Investment market

Shanghai investment market remained active this quarter, with six large-scale acquisitions concluded, representing a total consideration of RMB9.9 billion. Most of the deals happened in decentralised areas, with Hongqiao becoming a hotspot for investors, accounting for around 80% of the total transacted value. Domestic purchasers are still the main demand drivers, while only one acquisition was for end-use purpose.

As a number of investment funds are coming to the end of fund life, many fund managers are reducing prices in order to make the transaction process shorter. As a result, yields have increased to 5.6% on a gross reversionary basis, while capital values decreased.

The largest deal in terms of total consideration in the third quarter was concluded in September by a joint venture of Shanghai Industrial Urban Development (51%) and Nan Fung Group (49%), which purchased Shanghai Mart for RMB3.6 billion. The project comprises exhibition and office components. The total GFA is 280,000 sq m and the office tower accounts for 42,000 sq m.

Ctrip (a Chinese travel agency) acquired 100,200 sq m of Sky SOHO (about half the size of the whole project) in Changning district for RMB3.05 billion. The premises will be for self-use. This is SOHO's third large-scale disposal of assets after the sale of SOHO Hailun Plaza and SOHO Jing'an Plaza in Shanghai earlier this year.

Ping'an Trust bought five office blocks in Hongqiao Sincere Centre with a unit price of RMB28,000 per sq m. The

TABLE 3

First-hand strata-title building activity, Q3/2014

Project	District	Transacted GFA (sq m)	Average price (RMB per sq m)
Vanke Time No. one 虹桥万科润园	Minhang	9,658	33,557
Greenland Xuhui Centre 绿地汇创商务广场	Xuhui	7,577	50,071
Huijing International Plaza 汇京国际广场	Xuhui	4,515	55,093
Greenland North Bund Business Center 绿地浦创商务大厦	Hongkou	4,138	53,054

Source: Savills Research

properties are to be managed by a five-year trust fund.

As for Pudong market, one of two towers in Datang International Plaza, a Grade-A office project expected to be launched in 2015, was sold to Shanghai Pudong Properties Group for a total consideration of RMB1.04 billion. Additionally, one block in Zhangjiang Business Park and one in Waigaoqiao Free Trade Zone were sold to Sino-Ocean Land and Kailong REI respectively, with both unit prices at about RMB11,000 per sqm.

The strata-title market was less active compared with last quarter, with transaction volumes falling to 261,218 sq m, compared with 347,672 sq m in Q2/2014. Self-use demand continues to drive the market forward. Quarterly new supply reached a YTD high of 685,291 sq m. Total sales consideration for Q3/2014 was RMB6.66 billion and the average price was RMB 25,491 per sq m

Market outlook

Two new projects, both located in Pudong, are expected to be delivered to the core market by the end of 2014, representing total new supply of around 187,500 sq m. As a result, the Pudong market is expected to see higher vacancy rates and slower rental growth in the short term. In addition to the new supply in core areas, 437,000 sq m is expected to enter decentralised areas, all within Puxi market and mostly in Minhang district.

One of the most notable projects expected to be completed this year is the last phase of Lujiazui Century Financial Plaza. Developed by Lujiazui Finance & Trade Zone Development Co Ltd, the project is located in Zhuyuan.

The first two towers of the project were completed at the end of last year, with two additional towers handed over in Q3/2014. The final tower is scheduled to enter the market in the Q4/2014.

The scale of the project should satisfy demand from financial companies looking for office space near 'Little' Lujiazui and companies registered in the FTZ looking to setup new offices.

2015 is expected to see a further influx of supply, with around 1.1 million sq m entering the core market. In addition, decentralised areas are expected to gain popularity, with landlords aggressively promoting projects and a large amount of projects being launched onto the market. Hongqiao Transportation Hub is expected to account for around 40% of expected decentralised annual supply in 2015.

Relatively high vacancy rates in recently-launched projects, and a large amount of new supply in the coming years, is expected to result in a rise in vacancy rates despite the robust levels of demand expected. These higher vacancy rates will, in turn, result in falling rents both in Pudong and Puxi next year, despite the better than expected performance in Pudong in 2014 to date.

The office market is expected to continue to dominate the investment market in Shanghai in 2015, both in terms of end user and institutional investor activity. However, valuations on deals are expected to be discounted based on previous expectations as many funds near the end of their fund life and pricing is lowered in order to accelerate sales and shorten the transaction process. ■

Future project

Lilacs International Commercial Centre

Located at 778 Dingxiang Road in Pudong, Lilacs International Commercial Centre, developed by Shanchuan Property, is scheduled be handed over in Q2/2015. The project is a five-minute walk to Yanggao Road (M) metro station (line 9) and a 10-minute walk to the Shanghai Science & Technology Museum metro station (line 2). The project is close to Lujiazui Financial district and a 35-minute drive to Pudong International Airport.

Lilacs International Commercial Centre consists of two office towers and a shopping mall, with a total GFA of 58,000 sq m and 42,000 sq m respectively. Both towers have 20 floors with office space between the fifth and eighteenth floors. The typical floor plate is 1,600 sq m GFA, with a 70% efficiency rate and a 3.0m net ceiling height. There will be a 150mm raised floor when it is handed over.

Asking rents are estimated to start from RMB6.5 per sq m per day. The project will be managed by Savills, with the management fees to be confirmed.

TABLE 4 Lilacs International Commercial Centre

Location	778 Dingxiang Road, Pudong district	
Developer	Shanchuan Property	
Handover date	Q2/2015 (tentatively)	
Office GFA	58,000 sq m (twin towers)	
No. of storeys	5F – 18F	
Typical floorplate	1,600 sq m	
Whole-floor efficiency	70%	
Net ceiling height	3.0m	
Raised floor	150mm	
Passenger lifts	10 Schneider per building	
Car parking	540	
Starting asking rent	RMB6.5 per sqm per day (estimation)	
Management fee	TBC	

Source: Savills Research

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