Briefing
Office sector

February 2015

Image: Shanghai Skyline

SUMMARY

Shanghai's office market is expected to undergo a remarkable transformation over the next two years as the city experiences peak supply levels and the coming of age of the decentralised market, spearheaded by schemes such as the Hongqiao Transportation Hub.

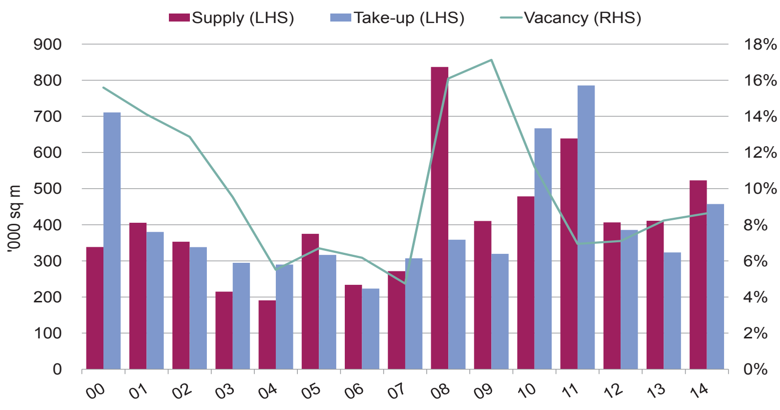
- Lujiazui Century Financial Plaza Tower 1 and Oriental Financial Centre were launched onto the market in Q4/2014, adding 187,500 sq m and bringing annual supply to 523,000 sq m.
- Net take-up totalled 126,000 sq m in Q4/2014, bringing total annual take-up to 457,300 sq m, up from 323,000 sq m in 2013.
- Core vacancy rates increased by 0.8 of a percentage point (ppt) quarter-on-quarter (QoQ) to 8.6%, up 0.4 of a ppt year-on-year (YoY).
- Average rents increased by 0.3% QoQ to RMB8.6 per sq m per day, up 1.8% YoY.
- Gross reversionary yields increased to 6.0% in Q4/2014, as a handful of investment funds came to the end of their fund life.
- 2015 is expected to see an influx of supply, with the completion of 15 projects adding 886,500 sq m of space to the core market.
- Sky SOHO and MTR City Plaza were launched into the decentralised market in Q4/2014, adding 242,000 sq m. Total supply witnessed in 2014 was 731,000 sq m, bringing total stock to 1.29 million sq m.
- The decentralised market is expected to receive 22 projects in 2015, adding 1.61million sq m to the market.

"Landlords will have to become more accommodative towards tenants moving forward, as new supply generates renewed competition."

James Macdonald, Savills Research

GRAPH 1

Grade A office supply, take-up and vacancy rate, 2000–2014



Source: Savills Research

Market commentary

Core market

The core office market received Lujiazui Century Financial Plaza Tower 1 and Oriental Financial Centre (OFC) in Q4/2014, adding 187,500 sq m. In 2014, eight projects were launched onto the core market, adding 523,000 sq m. These projects were evenly distributed between Puxi / Pudong and also prime / non-prime locations.

Net take-up reached 126,000 sq m in Q4/2014, 50% higher than the third quarter, and primarily focusing on recently launched projects in prime Puxi. Domestic financial and professional services companies continued to be the main demand drivers in 2014, taking up significant space in Lujiazui and prime Puxi. This trend is set to continue as measures put in place to develop these sectors persist.

While Pudong saw limited available space and continued rental growth in 2014, Puxi received ample supply of high quality projects at reasonable pricing. Multinational corporations (MNCs) took a more cautious approach to office expansion and capital expenditure in 2014, as they remained uncertain about economic and business prospects. Nevertheless, as the new economic norms are realised and understood, MNCs are beginning to look into more business opportunities and office space options, whether that be in core or decentralised locations.

Decentralised

Prior to 2010, only a handful of developers were looking at opportunities within decentralised areas, however, as land within core areas became more limited and expensive, developers started looking to emerging areas such as Minhang and Yangpu for development opportunities.

2014 witnessed the handover of a number of these projects that were started in 2010 and 2011, with around 730,000 sq m added to the decentralised markets, doubling the amount of stock within these areas. Decentralised supply in 2014 focused largely on Puxi with this expected to continue through into 2015. The Minhang district received the majority of new projects in 2014, with Hongqiao Transportation Hub seeing its first two projects launched. In 2015, Pudong is expected to see the launch of the first decentralised project in two years.

Many companies are taking advantage of the new supply coming onto the market in these decentralisation areas, using these emerging areas as secondary office space for back-end operations, such as marketing and finance departments; low-cost businesses may also consider these locations for their entire operations given the potential for lower overheads.

Market news

The emergence of the decentralised market

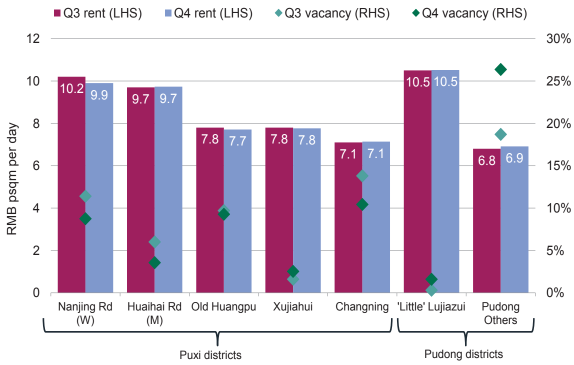
Shanghai is witnessing the evolution of its office market. In the past, more than 90% of the city's Grade A office stock was located within the inner ring road and Hongqiao areas. However, recent office completions are increasing the proportion of Grade A office stock located outside these areas.

The main decentralised areas which are witnessing this influx of new Grade A specification projects include Minhang – primarily the Hongqiao Transportation Hub, Putuo – with new supply such as MTR Plaza and Global Harbour, Yangpu –primarily The Springs development by Tishman Speyer and Xuhui – with the expected Greenland Centre.

One of the most significant master-planned areas in Shanghai to be developed over the next decade will be the Hongqiao Transportation Hub. The scheme is located close to the most significant intra and intercity infrastructure in Shanghai, tying in the city's domestic airport with the main high-speed railway terminal, a long distance coach terminal and two existing metro lines (line 2 and

GRAPH 2

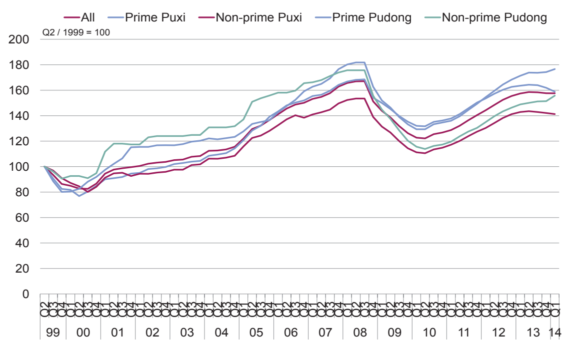
Business district comparison, rent vs vacancy rate, Q3/2014 and Q4/2014



Source: Savills Research

GRAPH 3

Core market Grade A office rental indices, Q2/1999–Q4/2014



Source: Savills Research

10), one under construction (line 17) and a further two under planning (line 5 extension and line 20). The area plans to attract overseas and domestic companies from industries most crucial to the development of Shanghai and the Yangtze River Delta area.

Nike is a prime example of a company relocating from a central office space to a more decentralised premises. Prior to relocation they were occupying roughly 15,000 sq m of office space on Nanjing Rd (W); their new premises is roughly 55,000 sq m on the new Springs Development in Wujiaochang. The relocation, while moving further away from the city centre, enables them to provide more space to employees, landscaped grounds and room for future expansion. The development consists of three office blocks and a five-story conference centre to host clients and promotional events, as well as an F&B area, a football pitch and a basketball court.

Moving to decentralised locations may not be for everyone as there are advantages and drawbacks to any decision. However, the key challenge faced by decentralised locations will be less about convincing occupiers to move and more about how to best differentiate themselves from all the other projects scheduled to come onto the market in the next few years.

China (Shanghai) Pilot Free Trade Zone (FTZ)

The China (Shanghai) Pilot Free Trade Zone was approved by the State Council and officially launched in 2013 as a platform for the testing of new economic and social reforms. One feature of the FTZ is the negative list for foreign investment, which basically allows foreign investment in every sector unless explicitly prohibited in the list. In 2013, 18 service industries received more relaxed policies in the zone. The negative list was updated in July 2014, relaxing restrictions in the financial industry, manufacturing, and transportation services.

Also, at the end of 2014, the commerce ministry announced plans to expand the FTZ to include the Lujiazui Financial Area (34.26 sq km), Jinqiao Export Processing Zone (20.48 sq km) and Zhangjiang Hi-tech Park (37.2 sq km). This expansion will enlarge the FTZ from 28 sq km to 121 sq km.

The expansion of the FTZ should prove beneficial to the Zone the FTZ overcoming the stigma associated with the zone being located so far away from the city centre. It should also present an opportunity to the areas included in the enlargement, both from the actual tangible policy benefits and the association with the FTZ.

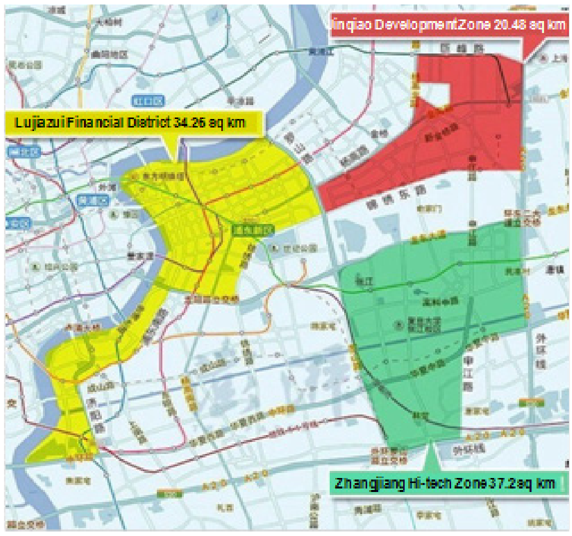
The FTZ is still in its early years and further reforms and opening up are expected to continue reaping benefits for companies, areas and landlords associated with the zone.

Lujiazui Century Financial Plaza Tower 1 and OFC were handed over in Q4/2014, adding 187,500 sq m to the core market. A total of eEight projects were handed over to the core market in 2014, totalling over 523,000 sq m, with the largest project, at 312,000 sq m, being Lujiazui Century Financial Plaza. The project is located in Zhuyuan district and consists of five office buildings. It is the only project launched onto the non-prime Pudong market since Q3/2012 and has helped to meet some of the spill overspill over demand from companies wanting to be close to Lujiazui but not willing to pay the higher rents.

Net take-up totalled 126,000 sq m in Q4/2014, bringing year-to-date (YTD) take-up to 457,300 sq m. Lujiazui

IMAGE 1

Proposed enlargement of Shanghai FTZ



Source: Savills Research

TABLE 1

Selection of leasing transactions, Q4/2014

Tenant	Project	Location	Area leased (sq m)
Uniqlo 优衣库	Henderson Metropolitan	Huangpu	4,500
Wuxi PRA 康德新药	SOHO Fuxing	Huangpu	3,000
CICC 中国国际金融有限公司	AZIA Centre	Pudong	3,000
Changxin Asset Management 长信基金	One Lujiazui	Pudong	2,200
Warburg Pincus 华平投资	Bund Centre	Huangpu	1,400

Source: Savills Research

TABLE 2

Selected large scale commercial site acquisitions, Q4/2014

Property	Location	Price (RMB million)	Buyer	Note
Suntown Plaza 融创广场	Huangpu	3,126	Gopher Real Estate Fund	Under construction Office and retail podium
Shanghai International Capital Plaza 上海盛邦国际大厦	Hongkou	1,550	Alpha Investment Partners	Office and retail podium
#18-1, Shanghai Int'l Shipping Service Centre #18-1,上海国际航运中心	Hongkou	1,309	Domestic bank	-
Poly West Bund Centre 保利西岸中心	Xuhui	693	Media Tek	Under construction (13-19F
#6, Guoson Centre 国盛中心6号楼	Putuo	623	Future Holdings	Under construction

Source: Savills Research

recorded 63,000 sq m of the take-up in Q4/2014 as a result of the handover of OFC and a sizeable portion of this was being for self-use. The second highest net take-up was recorded in Nanjing Road (W), totalling 21,000 sq m, which was more a result of organic take-up in relatively new projects such as Garden Square and Henderson 688.

2014 saw the highest levels of net take-up since 2011, supported in large part by strong demand from domestic companies. Puxi recorded a larger portion of take-up in 2014, largely attributableed to ample supply, reasonable pricing and higher vacancy rates than Pudong. Lujiazui witnessed the highest take-up of any business district in 2014; , at 106,500 sq m, this was also the highest take-up recorded in Lujiazui since 2011, highlighting the importance of Lujiazui to financial institutions.

Vacancy rates in core areas increased by 0.8 of a ppt in Q4/2014 to 8.6%, with the highest vacancy rates recorded in non-prime Pudong areas at 26.4%, as a result of newly -handed -over projects.

Prime Pudong remains extremely tight with vacancy rates in 'Little' Lujiazui at 1.6% at the end of the year, up 1.3 ppts QoQ, as a result of the launch of OFC. Pudong Others continued to benefit from spill overspill over demand from 'Little' Lujiazui, recording net take-up of 7,800 sq m., hHowever, vacancy rates increased 8.0 ppts as a result of new supply.

Puxi vacancy rates fell to 7.3%, down 2.0 ppts QoQ. Hongqiao and Nanjing Road (W) saw the largest drop in vacancy rates, down 3.3 and 2.7 ppts respectively. Nanjing Road (W), which has many high-specification projects as well as lower rents than Lujiazui, benefited from stronger demand. Xujiahui remains the least -changed market among all the business districts, given its limited new supply and stable demand, though it was the only district in Puxi to see vacancy rates increase in Q4/2014, up 0.9 ppt from its low base of 1.6%.

Grade A office rents increased 0.3% in Q4/2014, to an average of RMB8.6 per sq m per day, a third consecutive QoQ increase.

Pudong rents saw continued growth in 2014, however, albeit at a slower rate towards the end of the year than at the beginning. Pudong rents increased 0.6% in Q4/2014 to RMB9.2 per sq m per day;, with prime Pudong up 0.3% QoQ and non-prime Pudong up 1.2% QoQ. With the recent launch of OFC and Lujiazui Century Finance Plaza, and more to come in 2015, pent-up demand within the Pudong market is expected to be met, resulting in slower rental growth in the future.

TABLE 3

First-hand strata-title building activity, Q4/2014

Project	District	Transacted GFA (sq m)	Average price (RMB per sq m)
Huadu Building 华都大厦	Pudong	10,484	35,735
Greenland Huizhong Centre 绿地汇创商务广场	Xuhui	7,734	46,438
HTH Site Core 5 Longfor Paradise Walk 虹桥龙湖天街商业中心一期	Minhang	5,409	37,695
Greenland North Bund Centre 绿地浦创商务大厦	Hongkou	3,462	49,764

Source: Savills Research

Puxi witnessed a reduction in rents during the 1H/2014, but managed to stabilise rents during the second half, mainly thanks to tenants upgrading their space. Both prime and non-prime Puxi recorded rental growth of 0.1% in Q4/2014, as the majority of landlords kept rents unchanged. Only Nanjing Road (W) witnesseding a significant decline in rents, to RMB9.9 per sq m per day. Puxi has seen flat or falling rents and a number of newly-launched projects in 2014, resulting in 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 in 2015, leading to further decreases in rents as landlords offer additional incentives to attract tenants.

Investment market

Shanghai's investment market remained active in Q4/2014, with a number of large-scale acquisitions concluded, totalling RMB7.85 billion. Domestic purchasers continue to dominate the market while at least two of the recorded acquisitions are believed to be for self-use.

As a number of investment funds are coming to the end of their fund life, many fund managers are considering reducing prices in order to expedite sales. As a result, yields for deals involving international investors are believed to have increased to 6.0% on a gross reversionary basis, while capital values have decreased. While yields on assets sold to international funds are increasing, recent deals to domestic funds and end -users continue to fall, given their quite different investment criteria.

The only deal by an overseas fund in a core location in 2014 was the purchase of Shanghai International Capital Plaza (ICP) in Hongkou by Alpha Investment Partners for RMB1.55 billion, in October 2014. The project comprises of both office and retail components, with a total GFA of 57,000 sq m. This deal, in part, is a visible indicator of the re-rating of yields for international institutional investors in Shanghai.

The largest deal in terms of consideration was the purchase of Suntown Plaza in Huangpu by Gopher Real Estate Fund, for RMB3.1 billion. The project consists of both office and retail components, with a total GFA of 73,300 sq m and is expected to be for sales and leasing.

Other sizeable deals include: the purchase of #18-1, Shanghai Int'l Shipping Service Centre in Hongkou for RMB1.3 billion, by a local bank, expected to be for self -use; the acquisition of Guoson Centre Block 6 by Future Holdings Group for RMB623 million; and the purchase of 12,500 sq m in Poly West Bund Centre (F13-19) in the Xuhui district for RMB693 million by Media Tek (the project is currently under construction and is expected to be for self-use).

The strata-title market witnessed a pick-up in transaction volumes in Q4/2014, reaching 431,441 sq m, compared with 258,923 sq m in Q3/2014. Self-use demand continues to drive the market.

Supply reached a year -to -date high of 695,068 sq m in Q4/2014. Total sales consideration for Q4/2014 was RMB6.66 billion while and the average transaction price was RMB 30,433 per sq m.

The strata-title market in 2014 saw new supply fall to 2.13 million sq m, while and transaction volumes fell to 1.21 million sq m.

Market outlook

Supply, not demand, will most likely be the key determinant of the near future of the office market. In 2015 alone, the market is expected to see the addition of 886,500 sq m of Grade A office space in core areas and an additional 1.6 million sq m in the decentralised market.

The new supply, especially in the first half of the year, is not expected to be even, with the vast majority of new buildings located in non-prime and decentralised locations, accounting for 87.5% of total supply. This trend is likely to persist over the next few years, but not as pronounced, with decentralised supply accounting for an increasing percentage of total stock. These projects with their lower rents and an abundance of supply will start attracting some corporations to relocate out of core areas, putting pressure on projects located closer to the city centre. Some schemes will find the issue of oversupply especially acute with areas such as the Hongqiao Transportation Hub expected to account for around 50% of decentralised supply in 2015. As office occupiers review opportunities for expansion and different ways to utilise their office space, take-up patterns are expected to shift. Domestic companies will increasingly look at upgrading their office space or purchasing for self-use, leading to demand for quality office space and strata-title projects. Lower margin operators are expected to relocate to cheaper office premises, and larger occupiers are likely to bifurcate back- and front-office operations.

The key trend over the next few years will undoubtedly be that of rising vacancy rates and falling rents as a direct consequence of the volume of new supply coming onto the market irrespective of the relatively robust levels of demand expected from both domestic and overseas companies.

Pressure from competing projects will be felt in all areas of the city but to differing degrees. Prime business areas with more limited supply and demand that is less susceptible to cost increases are likely to see vacancy rates remain relatively low and rents comparatively firm, even in Lujiazui with the addition of the 200,000 sq m Shanghai Tower. Non-prime areas are expected to see more supply and indirect competition from decentralised areas, potentially resulting in quite sharp increases in vacancy rates, especially in relatively small and young submarkets.

The Puxi market is expected to see a larger proportion of the new leasable and uncommitted stock over the next three years, likely resulting in vacancy rates hikes and decreases in rents due to most supply being located in non-prime areas. Despite robust demand and more manageable levels of supply, Pudong is expected to witness a similar trend during the same period, albeit not to the same extent with the majority of new leasable uncommitted stock to be located in Zhuyuan, the main non-prime business district.

Decentralised areas that have limited existing stock and/or tenant base and only a small number of unique advantages will find it very difficult in the coming quarters and years. Certain master-planned areas, however, will outperform, such as the Hongqiao Transportation Hub due to its scale and infrastructure links, or Qiantan with its backing from the Pudong government and leading overseas and domestic developers.

Current forecasts predict that new supply in the city as a whole will peak in 2016, continuing into 2017. However, these estimates may change depending upon developer decisions in terms of development pace.

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