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Savills World Research
Shanghai

Briefing
Office sector

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Image: ICC

SUMMARY

Pudong saw limited available space in prime areas and continued rental growth in non-prime areas in Q1/2015, while Puxi received high quality projects at reasonable pricing.

- Three new projects were launched onto the market in Q1/2015, adding 131,900 sq m and pushing total Grade A office stock to 5.8 million sq m.
- Net take-up totalled 119,883 sq m in the first quarter of 2015, mainly in non-prime areas.
- City-wide vacancy rates dropped to 8.1%, due to the absorption of existing buildings and limited supply in certain areas.
- Average rents increased 0.1% to RMB8.63 per sq m, as Puxi rents fell 0.2% and Pudong rents increased 0.7%.
- Four major en-bloc office transactions were concluded in Q1/2015 for a total consideration of RMB3.14 million.
- Gross reversionary yields increased 10 basis points (bps) to 6.1% (NOI: 4.8%)
- No new supply was recorded in the decentralised market in the first quarter of 2015, leaving total stock at 1.29 million sq m.
- Average rents in the decentralised market were recorded at RMB4.7 per sq m per day.
- The decentralised market witnessed vacancy rates of 17.6%.

"Rising vacancy rates and falling rents will be the key trends of the market, as a direct consequence of the expected influx of supply irrespective of the relatively robust levels of demand expected from both domestic and overseas companies."
James Macdonald, Savills Research

Market commentary

Core market

The office market witnessed a strong start to the beginning of 2015. While Pudong saw limited available space in prime areas and continued rental growth in non-prime areas, Puxi received ample supply of high quality projects at reasonable pricing.

Both the financial industry and professional services industry are expected to continue growing, especially in Shanghai. As a result, larger domestic and overseas institutions are expected to remain the demand drivers in the prime areas of Pudong and Puxi respectively. This can be mainly attributed to the prestige nature of the areas and a clustering effect seen within these industries. However, smaller firms and start-ups are more likely to move to non-prime locations for cost-savings and also in order to benefit from the subsidies and incentives offered by district governments.

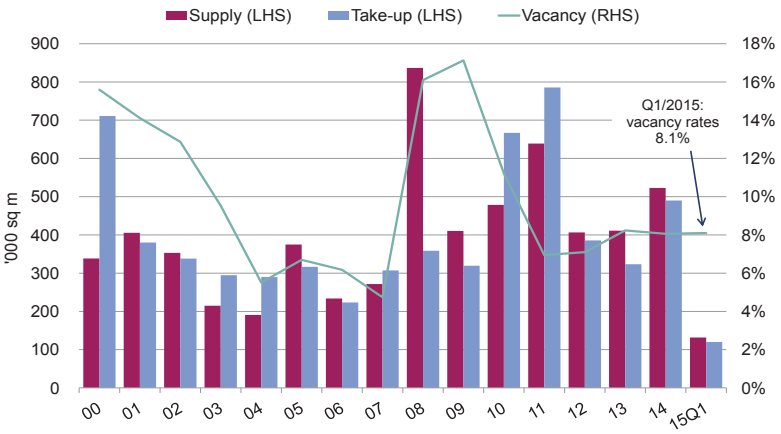
The slowing economic growth and the recent review of tax policies and framework, which has eliminated a number of tax incentives, have made multinational corporations (MNCs) more conscious about expansion plans and capital expenditure. However, as companies adjust to the new pace and environment they are beginning to utilise their office space in different ways, including larger spaces in decentralised locations or bifurcation of business lines across different areas.

Decentralised

2014 witnessed the handover of a number of projects, adding over 730,000 sq m to the decentralised markets which doubled the amount of stock within these areas. All decentralised supply in 2014 was located in Puxi, including the Hongqiao Transportation Hub in Minhang district seeing its first two projects launched. Despite no new projects handed over in Q1/2015, a supply peak of 1.42 million sq m is expected to be witnessed throughout the remainder of the year, including the launch of the first decentralised project in Pudong in two years.

GRAPH 1

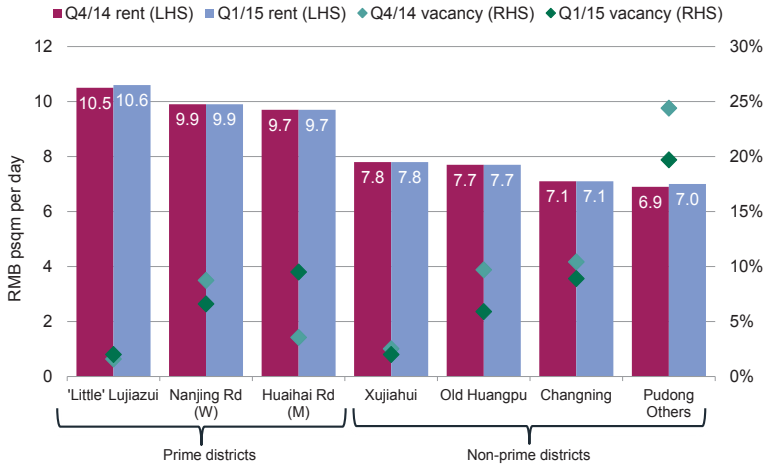
Grade A office supply, take-up and vacancy rate, 2000–Q1/2015



Source: Savills Research

GRAPH 2

Business district comparison, rent vs vacancy rate, Q4/2014 and Q1/2015



Source: Savills Research

Market news

Amcham Business report – cause for conservative optimism

The American Chamber of Commerce in Shanghai released their annual China Business Report in April, including a survey of American companies' business sentiment for China.

One of the main highlights was the fact that most US companies are remaining optimistic and are increasing focus on the Chinese market, with 29% reporting China as their number one global investment priority. In addition, 95% of those surveyed are planning to maintain or increase the amount of investment in the market.

While revenues from the services sector continued to exceed manufacturing, more companies are looking into ways to improve productivity to drive growth rather than other factors.

High operation costs, risks associated with the slowing economy and the perception of regulatory bias are making the long term opportunities and growth outlook unclear. In addition, companies believe the regulatory environment is becoming increasingly opaque and deteriorating, which may have an impact on business. This increasing concern about the direction of economic reform and its potential impact on foreign businesses would

mean having to address the long-standing market access and regulatory obstacles.

The "In China, for China" strategy (produce or source services and goods in China for the China market) is continuing to strengthen, indicating a confidence in the local market and future prospects as well as many opportunities available to companies.

Companies continue to report positive but more moderate growth prospects, however, healthcare, consumer goods and energy sectors are expecting especially high levels of growth.

Going forward, most companies are likely to pay more attention to reducing costs to increase operating margins and profitability. At the same time, they will be more mindful of market positioning and emphasising innovative concepts to stay ahead.

The overall direction is good in the long term as clarity and consistency are required to make business decisions easier and faster. However, the short-term implications could mean a shortfall in investment as companies adjust.

Tax breaks no longer approved by central government.
Foreign companies in China are now fighting to save tax breaks and benefits promised by Chinese cities and provinces as Beijing campaigns against big spending by local governments.

The crackdown could lessen the attractiveness of foreign investment in China and has also taken many companies by surprise. Many governments are now shying away from the previous tax breaks and benefits while several are also seeking guidance from Beijing about other topics such as promises to sell land at a discount or waiving social insurance payments.

Local governments are now required to submit detailed overviews of preferential policies by the end of the March. All tax incentives without state approval will be considered unauthorised and must stop, resulting in companies being subjected to 25% corporate tax rates.

As well as figuring out how to deal with large local debts, Beijing is currently facing a slowdown in tax revenue as overall growth slows. China is also trying to stay in line with trade agreements as last month the US challenged China's subsidies programme in front of the World Trade Organization.

The core office market received three new projects in Q1/2015, adding 131,900 sq m onto the market: Two ICC in Xuhui district; The Place Ph3 in Hongqiao; and HNA Project in Pudong. The remainder of 2015 is expected to see 13 additional projects enter the market, an addition of 863,600 sq m of Grade A office space. The majority of this space will be located in non-prime areas.

The most anticipated new project to enter the market this year is Shanghai Tower in the financial district of Lujiazui. With a GFA of 574,000 sq m and standing at 632 m high it will be the tallest building in Shanghai. The project comprises more than 200,000 sq m of office space, an upscale hotel and retail components boasting an observation deckofferings.

Net take-up reached 119,883 sq m in Q1/2015, with 77% of absorption focused on non-prime areas. The highest overall demand was seen in non-prime Puxi as demand was driven by large space occupiers relocating to buildings handed over in 2014.

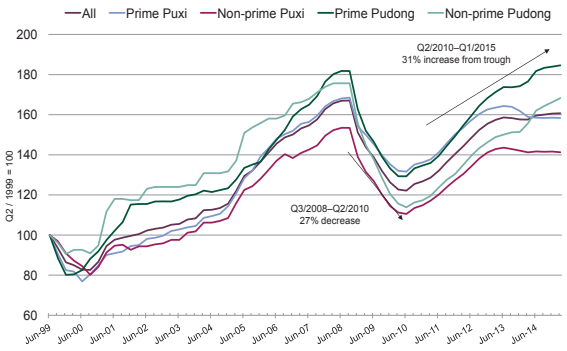
Non-prime Pudong witnessed many financial companies relocating business lines to the area to benefit from the close proximity to Lujiazui – without the high rents. As a result, prime Pudong witnessed space around 7,000 sq m of space being handed back to the market, causing vacancy rates to continue tomoderately increase and easing ease the tightness of the market.

Domestic financial and professional services companies continued to be the main demand drivers at the beginning of 2015, taking up significant space in non-prime Pudong areas. This trend is set to continue as companies continue to search for contiguous space in the Pudong market and look to lower costs.

City-wide vacancy rates fell to 8.1% this quarter, mainly due to the absorption of space within existing projects in non-prime areas. Only two districts saw an increase in vacancy rates, namely Huaihai Road (M) at 5.9 ppts and 'Little' Lujiazui at 0.5 of a ppt, resulting from new supply

GRAPH 3

Core market Grade A office rental indices, Q2/1999–Q1/2015



Source: Savills Research

TABLE 1

Selection of leasing transactions, Q1/2015

Tenant	Project	Location	Area leased (sq m)
Alibaba	Shanghai Tower	Lujiazui	18,000
Goodbaby	Sky SOHO	Linkong	6,000
MediaV	Global Habor	Putuo	4,000
Baby Tree	KIC Ph4	Wujiaochang	2,300
Mitsubishi Motors	China Fortune Tower	Zhuyuan	2,000
Ikon Medical	The Hub Ph1	Minhang	1,300

Source: Savills Research

and relocations from these areas respectively.

Both Zhuyuan and Old Huangpu saw a significant drop in vacancy rates of 4.7 ppts and 3.8 ppts respectively, which can be attributed to the digestion of existing projects. Rents in most Puxi districts remained stable in Q1/2015, with the Puxi market falling an average of 0.2% due to increased competition between landlords, while rents in Pudong districts increased 0.7% mainly due to absorption of existing buildings.

'Little' Lujiazui and Xujiahui continue to be the most competitive markets due to limited available stock, with vacancy rates at just 2.0%. On the other hand, Zhuyuan remained the most volatile market, with continued supply levels and fluctuations in vacancy rates. While Lujiazui recorded 7,000 sq m of space returned to the market in Q1/2015, non-prime Pudong demand equated to over 40,000 sq m, pushing vacancy rates down 4.7 ppts, mainly due to the further decentralisation trend of the market and the increase in demand from finance-related domestic companies.

Grade A office rents remained stable in Q1/2015, with an average of RMB8.63 per sq m per day, a fourth consecutive QoQ increase.

The divergence between rents in Pudong and Puxi further expanded as Puxi rents fell to RMB8.3 per sq m per day, while Pudong saw rents increase to RMB9.2 per sq m per day. Pudong rents saw continued growth at the beginning of 2015 with prime Pudong up 0.4% QoQ and non-prime Pudong up 1.2% QoQ. Due to the expected influx ofNew supply in 2015, both the pent-up demand within the prime Pudong market and the increased demand for projects in non-prime Pudong is expected to be met, is expected to resulting in weaken ing landlord bargaining power for landlords and leading to slower rental growth in the future as pent-up demand is met.

Puxi continued to witness a reduction in rents during Q1/2015, which can be attributed to the expected influx of supply into non-prime and decentralised areas causing increasing competition between landlords and resulting in a downward pressure placed on rents. This trend has led to both prime and non-prime Puxi recording a negative rental growth of 0.2% and 0.7% respectively in Q1/2015. Only Huaihai Road (M) and Old Huangpu witnessed a significant decline in rents, to RMB9.7 per sq m per day and RMB7.7 per sq m per day respectively. Puxi continues to discount rents in a number of recently-launched projects, resulting in more attractive offerings to those who are becoming more cost conscious.

Investment market

After a very active final quarter in 2014, the Shanghai office investment market quietened in Q1/2015, with only four significant en-bloc deals concluded, representing a total

TABLE 2

Selected large scale commercial site acquisitions, Q1/2015

Property	Location	Price (RMB million)	Buyer	Deal Structure	Nationality	Usage
#18-2, Shanghai Int'l Shipping Service Centre 上海国际航运服务中心 18-2	Hongkou	1,566	AVIC Joy Holdings	Onshore equity	Domestic	Lease
Sincere Space 中环协信中心#1B楼	Zhabei	908	Zhongrong River Capital	Onshore equity	Domestic	Lease /sale
Hongqiao Sincere Centre 虹桥协信中心	Minhang	325	Jiuxing Holdings	Onshore equity	Domestic	Self-use
COFCO Tower 中粮大厦	Xuhui	344	Easthill	Equity	Domestic	Lease

Source: Savills Research

TABLE 3

First-hand strata-title building activity, Q1/2015

Project	District	Transacted GFA (sq m)	Average price (RMB per sq m)
Greenland Puchuang Centre 绿地浦创商务大厦	Hongkou	3,590	52,505
Greenland Huichuang Plaza 绿地汇创商务广场	Xuhui	1,422	44,049
MTR City Plaza 近铁城市广场	Putuo	4,427	36,726
Yinyi Chengpin Centre 银亿诚品大厦	Pudong	1,296	35,184
Hongqiao Vanke Centre 虹桥万科润园	Minhang	2,724	34,770

Source: Savills Research

consideration of RMB3.14 billion. Although domestic purchasers continue to dominate the market, only one of the three deals was for self-use.

Domestic investors continue to remain the driving force behind demand in the office investment market, whereas international investors remain cautious due to increased currency risk, low yields and weaker market fundamentals. Both international and domestic investors are shifting their focus towards business and logistics park markets in search of higher yields.

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 continued to increase to 6.1% 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 the different criteria for investment.

AVIC Joy Holding purchased #18-2, Shanghai Int'l Shipping Service Centre in Hongkou for a total consideration of RMB1.57 billion in January. The project has a total office GFA of 16,350 sq m and is expected to be for lease.

The largest deal in terms of GFA was the purchase of Sincere Space in Zhabei district by Zhongrong River Capital, for a total consideration of RMB908 million. The project is currently under construction, with the handover expected in 2016, and is expected to have a total office GFA of 40,700 sq m for sales and leasing.

Hongqiao Sincere, located in the Hongqiao Transportation Hub in Minhang district, was purchased by Jiuxing Holdings from Sincere Group for a total consideration of RMB325 million in March. The project comprises a total office GFA of 11,000 sq m. The project is expected to be for self-use.

COFCO Tower in Xuhui district was purchased by Easthill for a total consideration of RMB344 million. The project is expected to be for lease with a total GFA of around 20,000 sq m.

The strata-title market witnessed a decrease in transaction volumes in Q1/2015, reaching 299,274 sq m, compared with 431,441 sq m in Q4/2014. Self-use demand continues to drive the market with investors concerned about lower yields and more limited capital values appreciation potential. Supply reached a high point of 958,455 sq m in Q1/2015, compared with 695,068 sq m in Q4/2014. Total sales consideration for Q1/2015 was RMB8.92 billion and the average transaction price was RMB29,136 per 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 995,500 sq m of Grade A office space in core areas and an additional 1.42 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 with decentralised supply accounting for an increasing percentage of total stock. Given projects in these areas offer lower rents and there is an abundance of supply, it is anticipated these locations will attract many corporations relocating out of core areas, thus placing 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 keep changing. 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, while larger occupiers give consideration to bifurcate front and back office operations.

Rising vacancy rates and falling rents will be the notable trends of the market, as a direct consequence of the expected influx of supply irrespective of the relatively robust levels of demand expected from both domestic and overseas companies.

All areas of the city are expected to feel the pressure from competing projects, albeit to different degrees. Prime business areas with more limited supply and demand that is less susceptible to cost increases are likely to see more stable rents as vacancy rates remain lower, 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 increases in vacancy rates, especially in smaller and immature submarkets.

The Puxi market is expected to see a larger proportion of leasable uncommitted supply over the next three years, likely resulting in vacancy rates increasing and rents falling. Despite strong demand and lower levels of supply, Pudong is expected to witness a similar trend, albeit not to the same levels, as the majority of new leasable uncommitted supply is to be located in Zhuyuan, Pudong's non-prime business district.

Decentralised areas that have limited existing stock and/or tenant bases and few distinctive selling points will find it very difficult in the mid-term. However, those with master-planned areas are expected to outperform in terms of take-up, such as the Hongqiao Transportation Hub due to its scale and infrastructure links, and Qiantan due to its backing from the Pudong government and leading developers.

Current forecasts predict that new supply in the city as a whole will peak in 2015, continuing throughout 2016 and 2017 with an average annual supply of 920,000 sq m. However, these estimates may change depending upon developer decisions in terms of development pace and handover period. ■

Future project

Century Link Ph1

Century Link, located in Zhuyuan area, was developed by Hutchinson Whampoa. The whole project consists of two office towers and a 130,000 sq m shopping mall. Phase one of the development is expected to launch in Q4/2015, adding 64,850 sq m to the market, with the second phase expected in Q1/2016 at approximately the same size.

The development benefits from access to multiple metro stations including lines 2, 4, 6 and 9.

The first phase office space will cover floors 6 to 38 (nominal). Typical floor plates will be 2,400 sq m with whole floor efficiency of 75%. Ceiling height is 3 m and raised floor space is 150 mm. Each tower will be serviced by seven passenger lifts and the whole development will have 823 car parking spaces.

Property management will be provided by the landlord, with management fees at RMB40 per sq m per month. Asking rents start at RMB10 per sq m per day.

TABLE 3

Century Link Ph1

Location	Zhuyuan, Pudong
Developer	Hutchinson Whampoa
Handover date	Q4/2015
Office GFA	64,850 sq m
No. of storeys	6- 38F (nominal)
Typical floorplate	2,400 sq m
Whole-floor efficiency	75%
Clear ceiling height	3m
Raised floor	150mm
Passenger lifts	7 (double-deck lifts)
Car parking spaces	823 (both towers)
Starting asking rent	RMB10 per sq m per day
Management fee	RMB40 per sq m per month

Source: Savills China Research

Please contact us for further information

Savills Research

James Macdonald
Director, China
+8621 6391 6688
james.macdonald@savills.com.cn

Savills Agency

Craig Carr
Senior Director
+8621 6391 6688
craig.carr@savills.com.cn

Yann Deschamps
Director
+8621 6391 6688
yann.deschamps@savills.com.cn

Cary Zheng
Senior Director
+8621 6391 6688
cary.zheng@savills.com.cn

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