

Briefing Office sector

July 2015



Image: Corporate Avenue

SUMMARY

Project delays and stronger than expected demand has resulted in lower than predicted vacancy rates and continued rental growth despite looming supply.

- Three new projects were launched onto the market in Q2/2015, adding 130,500 sq m and pushing total Grade A office stock close to six million sq m.

- Net take-up totalled 172,350 sq m, 43% of this accounted for by pre-leasing of new supply.

- City-wide vacancy rates dropped to 7.2%, due to significant absorption of both existing buildings and new supply.

- Rents increased 0.5% to an average of RMB8.6 per sq m per day. Puxi rents increased 0.4% and Pudong rents increased 0.6%.

- Four sizeable office sales transactions were concluded in

Q2/2015 for a total consideration of RMB5.3 billion.

- Gross reversionary yields remained the same at 6.1% (NOI: 4.8%)

- Three new projects were launched onto the market in the first half of 2015, increasing total stock to 1.55 million sq m.

- Rents in the decentralised market remained flat at an average of RMB4.9 per sq m per day.

- The decentralised market witnessed vacancy rates of 22.6%, mainly due to low pre-leasing levels of new projects.

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 “High future supply levels and regulatory changes, including B2V reforms, will continue to unsettle the market in the mid-term.” James Macdonald, Savills Research

➔ **Market commentary**

Core market

Six projects, totalling over 260,000 sq m, were launched onto the market in 1H/2015. Pudong saw vacancy rates in prime areas fall and continued rental growth in non-prime areas, while Puxi received ample supply of high-quality projects with strong pre-leasing levels. The remainder of the year is expected to see supply levels pick up, with new projects scattered throughout the city and the first Grade A building launched in Hongkou since 2012.

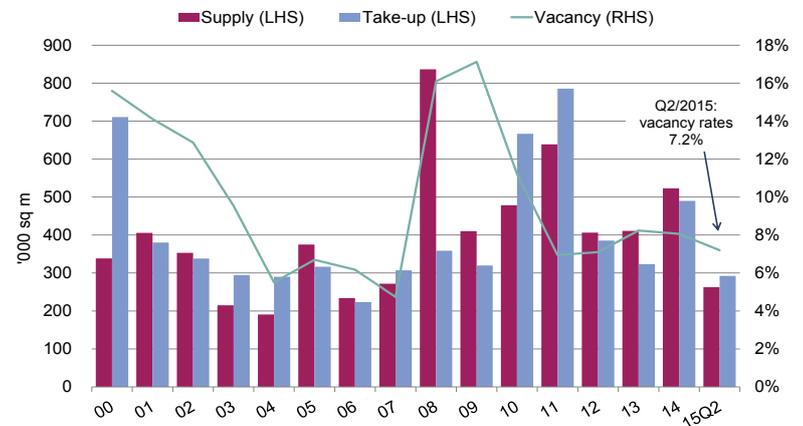
The key drivers of demand going forward will continue to be the financial and professional services industries as further deregulation opens up the sector to new companies and opportunities. Overseas and larger domestic companies are likely to be the main beneficiaries of this liberalisation, driving demand in prime business districts in Pudong and Puxi.

Further emphasis is also likely to be put on internet-related industries as a result of the "Internet plus" drive. China's "Internet plus" action plan will integrate mobile Internet, cloud computing, big data and the Internet of Things with modern manufacturing, to encourage the healthy development of e-commerce, industrial networks, and Internet banking, and to help Internet companies increase their international presence. This, alongside other policies put in place to encourage entrepreneurship and innovation, should lead to an increase in demand for flexible and non-traditional office space. Smaller domestic firms and start-ups are more likely to locate themselves in non-prime business districts in the interest of cost-saving and also in order to benefit from some of the subsidies and incentives offered by district governments.

Although many MNCs are positive about China in the long term and plan to continue investing in the country, high operating costs and the economic slowdown are forcing companies to pay closer attention to their operational costs and capital expenditure. Adjusting to the new norm, companies are looking for productivity improvements to drive growth and expansion. In the office market this is represented

GRAPH 1

Grade A office supply, take-up and vacancy rate, 2000–Q2/2015



Source: Savills Research

by a review of business space requirements given changing supply, area profiles and modes of space utilisation. One example is WPP, the world's largest advertising company by revenue, which has signed a lease in BM Tower Ph2 of 42,000 sq m –80% of the building.

Developers are also adjusting to the new norm, adopting new approaches to retain and attract tenants. For example, SOHO China developed their SOHO 3Q platform, providing office space to tenants to rent on a flexible basis with all services –including booking and payment – done online. After spending less than five months developing the idea, both projects in Shanghai and Beijing were taken-up quite quickly. The company aims to concentrate on commercial properties within first-tier cities in prime locations to combat the downward trend of the economy.

Decentralised

Three new projects, adding nearly 200,000 sq m, were handed over to the market during the first half of 2015, pushing stock to 1.55 million sq m. A supply peak of over one million sq m is expected to be witnessed during the second half of 2015. Some areas will find oversupply especially acute, such as Minhang district which is expected to account for around 70% of decentralised supply in 2015. However, those with government backing and with master-planned schemes, such as Hongqiao Transportation Hub (HTH), will have an advantage over those with less

support and those in more remote locations without the critical mass to attract businesses.

Market news

Business Tax to Value Added Tax (B2V)

The announcement of the B2V policy for the real estate industry, originally scheduled for June, is believed to be delayed until early August, with implementation likely to start on 1 October or 31 December 2015.

Initial VAT reforms were launched in Shanghai at the beginning of 2012, replacing business tax with VAT. Most modern service sectors in China, including transportation and postal services, have already transitioned to the VAT programme.

The tax reforms hope to boost the service sector, planned as one of the key drivers of future economic growth. Originally it had been hoped the transition to VAT would reduce the tax burden on developers as it allows them to claim tax credits for a majority of the input costs that were previously double-taxed. However, developers are unlikely to gain tax credits for both land purchases and financing costs, the two highest costs, and so could see the tax burden rise. Business tax on sales was originally 5.5%, while the new VAT is expected to be closer to 11%. As the tax base will be markedly different given the application of tax credits, the effective tax rate will be lower than this.

The B2V transition is likely to cause anxiety and uncertainty in the real estate industry in the short term

→ while both landlords and tenants go through the transition period. In terms of the office market, PricewaterhouseCoopers stated one of the potential impacts is that, from a tax perspective, decentralised projects would become more attractive as a larger percentage of total investment would generate tax input credits. Another impact is that developers will increasingly look at entering down and upstream industries to lower tax burdens. One final implication is that VAT is a price-inclusive tax – excluded from revenue calculations – lowering revenues. Landlords are likely to pass these increasing leasing costs onto tenants.

Market Overview

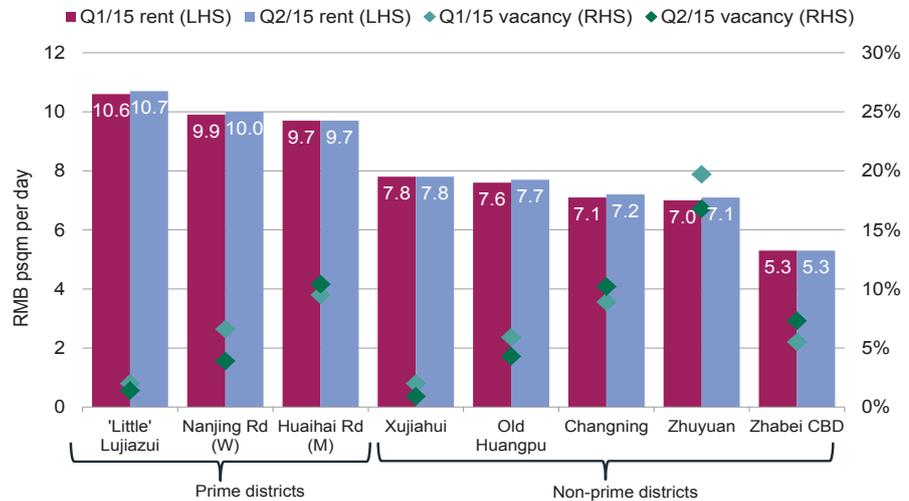
The core office market received three new projects in Q2/2015, adding 130,500 sq m onto the market: Corporate Avenue #3 in Huangpu district; Raffles City Changning T3 in Changning district; and BM Tower Ph2 in Zhabei district– the first Grade A supply in Zhabei since 2011. The remainder of 2015 is expected to see nine additional projects enter the market, an addition of over 800,000 sq m of Grade A office space. All but one of the projects, Shanghai Tower, will be located in non-prime areas.

Net take-up reached 172,300 sq m in Q2/2015, with 43% of absorption accounted for by pre-committed space in projects handed over this quarter. The highest overall demand was in Puxi at 77%, as demand was driven by large space occupiers relocating to buildings handed over in Q2/2015. Corporate Avenue #3 saw strong pre-leasing rates of nearly 50%, while a large space occupier took up over 80% of BM Tower Ph2. Of the approximately 100,000 sq m of organic take up, Puxi saw nearly double the amount of space of Pudong, with Pudong primarily driven by absorption of the newest buildings handed over in non-prime areas. Prime Puxi followed the same trend, with the majority of absorption coming from newer buildings.

Shanghai Tower, located in the financial district of Lujiazui, will add significant supply to the prime Pudong market. The project comprises more than 280,000 sq m of office space, although only 220,000 sq m is open to the market. The project is now said to be delayed until Q4/2015 as it has yet to receive final permits, though some tenants

GRAPH 2

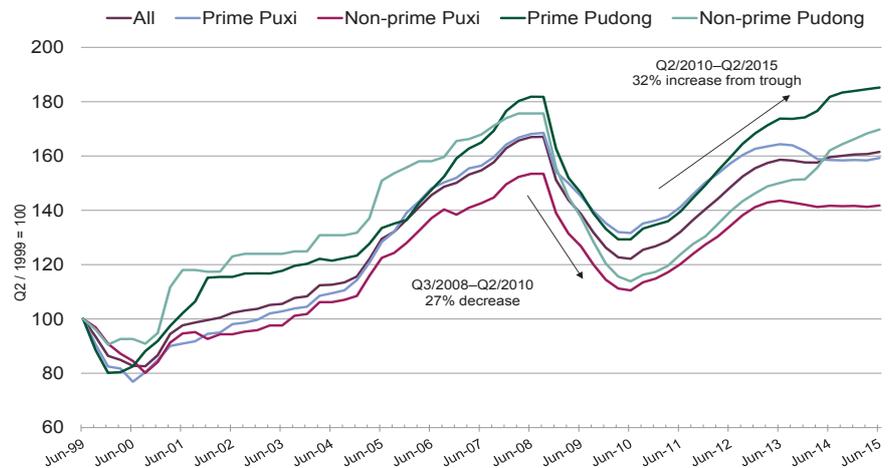
Business district comparison, rent vs vacancy rate, Q1/2015 and Q2/2015



Source: Savills Research

GRAPH 3

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



Source: Savills Research

TABLE 1

Selection of leasing transactions, Q2/2015

Tenant	Project	Location	Area leased (sq m)
WPP	BM Tower (NanFung) Ph2	Zhabei	42,000
China Minsheng Investment	100 Bund Square	Huangpu	20,000
Publicis Media	Henderson 688	Jing'an	14,000
E-CapitalTransfer	LJZ Century Financial Plaza	Zhuyuan	5,000
Shanghai Life Insurance	Oriental Financial Centre	Lujiazui	3,000
Samsung Logistics	MixC	Minhang	2,000

Source: Savills Research

have already begun fit-out. The project has witnessed stronger than expected pre-leasing levels and has already signed about 30-40% of its office space, including tenants such as Alibaba (around 18,000 sq m), All Bright Law firm (锦天城律所), around 10,000 sq m) and SNR Denton (around 8,000 sq m).

The entry of the project is expected to curb future rental growth, though when looked at in the context of the wider market of Lujiazui, it is still expected to be one of the most resilient markets. It will also push up vacancy rates in the short term, however, due to the current tightness of the market and lack of leasable supply in the coming years (the majority of space within new projects is expected to be for self-use), this space should be absorbed overtime.

Despite new supply, city-wide vacancy rates fell to 7.2% this quarter as a result of strong pre-leasing within new projects and further absorption of projects in Puxi handed over in 2014 and early 2015. Three areas saw an increase in vacancy rates, namely Huaihai Road (M) (0.9 of a percentage point (ppt)), Changning (1.3 ppts) and Zhabei CBD (1.8 ppts), all resulting from new supply entering the market.

Both Zhuyuan and Nanjing Road (W) saw a drop in vacancy rates of 2.9 ppts and 2.7 ppts respectively, which can be attributed to the continued absorption of newer projects. Rents in most districts rose marginally in Q2/2015, with both Puxi and Pudong increasing 0.4% and 0.6% respectively.

'Little' Lujiazui and Xujiahui continue to be the tightest markets due to limited available stock, with vacancy rates at just 1.4% and 0.9% respectively. Zhuyuan continued to have the highest vacancy rates, with ample supply in recent quarters. While a number of buildings in Zhuyuan are seeing continuously strong take-up levels, others are yet to see any transactions. Vacancy rates in Zhuyuan are set to jump again towards the end of the year when over 200,000 sq m of new supply is launched onto the market, should developers decide not to postpone amid tough competition. Xujiahui is expected to remain stable over the next 18 months, as no new supply is expected until then, unless current tenants decide to move to newer, higher quality buildings within other districts.

Grade A office rents increased 0.5% in Q2/2015 to an average of RMB8.62 per sq m per day. Puxi and Pudong saw sustained increases of 0.4% and 0.6% quarter-on-quarter (QoQ) respectively. Although growth has been seen in recent months due to landlords of newer buildings increasing rents as they achieve healthier vacancy rates, this upward trend has begun to slow this quarter as competition intensifies.

Both prime and non-prime rents increased 0.5% QoQ to RMB10.2 per sq m per day and RMB7.1 per sq m per day. Average rents in non-prime Puxi and non-prime Pudong now both stand at RMB7.1 per sq m per day after a 0.9% increase in non-prime Pudong in Q2/2015. Non-prime Pudong continues to record the strongest rental growth as spill over demand for Lujiazui and growth

in the financial sector stimulate demand.

All submarkets witnessed flat or increasing rents, with Zhuyuan and Nanjing Road (W) seeing the strongest growth at 0.9% and 0.8% QoQ. This can be attributed to higher demand levels in newer projects such as LJZ Century Financial Plaza and Henderson 688.

The strata-title market

The strata-title market witnessed an increase in transaction volumes in Q2/2015, reaching 421,900 sq m, compared with 299,200 sq m in Q1/2015. Self-use demand continues to drive the market with investors concerned about lower yields and more limited capital value appreciation potential. Supply decreased to 789,600 sq m in Q2/2015, compared with 958,400 sq m in Q1/2015. Total sales consideration for Q2/2015 was RMB13.6 billion and the average transaction price was RMB32,300 per sq m.

Investment market

After a very active final quarter in The Shanghai office investment market remained stable in Q2/2015, with four sizeable sales deals concluded, representing a total consideration of RMB5.3 billion.

The office sector is anticipated to continue to dominate Shanghai's investment market, despite a weakening economy and concerns about substantial supply in most areas. Domestic investors continue to remain the driving force behind demand in the office investment market, as international investors remain cautious due to increased

TABLE 2

First-hand strata-title building activity, Q2/2015

Project	District	Transacted GFA (sq m)	Average price (RMB per sq m)
21st Century Tower 二十一世纪中心大厦	Pudong	1199	104,468
Greenland Center Ph2 上海绿地国际广场	Xuhui	1842	65,200
Global Harbour 上海月星环球商业中心	Putuo	2303	56,000
Huijing International Plaza (Magnolia Plaza) 汇京国际广场	Xuhui	1843	54,384
Greenland Puchuang Centre 绿地浦创商务大厦	Hongkou	2931	53,603

Source: Savills Research

currency risk, low yields and weaker market fundamentals. Domestic investors continue to focus on new-builds in non-prime and decentralised locations, while international funds focus on add-value in core locations. Nevertheless, both pools of capital are actively exploring business parks in search of higher yielding assets.

In Q2/2015, yields for deals involving international investors are believed to have remained stable at 6.1% on a gross reversionary basis (NOI: 4.8%). While yields on assets sold to international funds remain high, recent deals to domestic funds and end-users continue to fall (around 1-2 ppts lower), given the different criteria for investment.

GC Tower in Pudong was purchased by Ping An Real Estate in June, for a total consideration of RMB2.2 billion, the highest deal in terms of price this quarter. The project, consisting of both office and retail podium space, has a total GFA of nearly 60,000 sq m for lease.

Greenland Central Plaza, located in Zhabei district, was purchased by Digiwin Software from Greenland Group for a total consideration of RMB259 million in May. The project comprises a total office GFA of nearly 10,000 sq m. The project is expected to be for self-use.

Baolong Building in Huangpu district was purchased by AEW from Blackstone for a total consideration of RMB900 million. The project has a total GFA of around 25,000 sq m.

Sandhill Plaza in Pudong was sold by Morgan Stanley (MSREF VII) to Mapletree Greater China Commercial Trust (MGCCT) for a total

consideration of RMB1.84 billion. The project GFA is 63,000 sq m.

Market outlook

The second half of 2015 is expected to witness a further 700,000 sq m of office space entering the core market. The majority of this supply will be located in non-prime locations, especially in Puxi. Current forecasts predict that new supply in core areas will average one million sq m per annum, reaching new records in 2015, with a peak seen in 2016 and continuing throughout 2017. However, these estimates may change depending upon developer decisions in terms of development pace and handover period.

Decentralised areas are also anticipated to see an influx of supply, with over a million sq m expected to enter the market in 2H/2015 and an average annual supply of over one million for the next two years.

Demand is expected to remain firm over the next few years; although it is expected to be inadequate due to the influx of supply entering the market. Key drivers of demand will continue to be from the financial and IT sectors. 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, while MNC's are beginning to adjust to the new pace and environment of the market. Lower margin operators are expected to relocate to more affordable office premises, while larger occupiers give consideration to bifurcate front and back office operations. As office occupiers review these different opportunities, take-up patterns are expected to continue to transform.

As a direct consequence of the influx of supply, regardless of the strength of demand, a downward pressure will be placed on rents and occupancy rates as new projects compete to attract and retain tenants.

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. Landlords of existing buildings within prime areas that historically recorded high occupancy rates may also begin to feel increasing pressure to retain tenants as replacement costs begin to rise.

Non-prime areas are expected to see more supply and indirect competition from the increasing percentage of stock in decentralised areas, potentially resulting in significant increases in vacancy rates, especially in smaller and immature submarkets. More cost conscious occupiers will try to benefit from the market driven opportunities for significant overhead costs savings by relocating from prime to these non-prime areas.

As the Puxi market is expected to see a larger proportion of leasable uncommitted supply over the next three years, vacancy rates are likely to increase while rents fall. 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. ■

TABLE 3 **Sizeable sales transactions, Q2/2015**

Property	Location	Price (RMB million)	Buyer	Nationality	Deal Structure	Usage
GC Tower 葛洲坝大厦	Pudong	2,200	Ping An Real Estate	Domestic	Onshore equity	Lease
Sandhill Plaza 展想广场	Pudong- Business Park	1,840	Mapletree Greater China Commercial Trust (MGCCT)	Int'l	Offshore equity	Lease
Baolong Building 宝龙大厦	Huangpu	930	AEW	Int'l	Offshore equity	Lease
Greenland Central Plaza 绿地中央广场	Zhabei	259	Digiwin Software	Domestic	Onshore asset	Self-use

Source: Savills Research

Future project

Gopher Center

Gopher Center, located in Huangpu district, was developed by Sunac Group. Gopher Asset Management, a subsidiary of Noah Holdings, acquired Gopher Center (formerly known as Suntown Plaza) for RMB3.126 billion in December 2014. The project is expected to be launched in Q2/2016 and will consist of approximately 59,700 sq m of office space and 15,000 sq m of retail space.

The office space will span floors five to 32 (nominal). Typical floor plates will be around 2,070 sq m with whole floor efficiency of 72%. Ceiling height is 2.8 m and raised floor space is 120 mm. The office building will be serviced by 12 passenger lifts and the whole development will have around 450 car parking spaces. The development will benefit from direct access to Expo Museum metro station (line 13).

Asking rents start at RMB7.5 per sq m per day. Management fee has not yet been confirmed.

TABLE 3
Gopher Center

Location	Huangpu district	
Developer	Sunac	
Owner	Gopher Asset Management	
Hand over date	Q2/2016	
Office GFA	59,700sqm	
No. of storeys	5-32 floors (nominal)	
Typical floorplate	2,070 sqm	
Whole-floor efficiency	72%	
Clear ceiling height	2.8m	
Raised floor	120mm	
Passenger lifts	12 passenger lifts	
Car parking spaces	450 spaces	
Starting asking rent	RMB 7.5 per sqm per day	

Source: Savills China Research

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