

# Briefing Office sector

November 2015



Image: Shanghai skyline

## SUMMARY

As Shanghai enters a period of peak supply, landlords shift their focus to new innovative ideas to retain existing tenants as well as attract tenants, especially in non-prime areas.

- Three new projects were launched onto the market in Q3/2015, adding nearly 125,000 sq m of space and pushing total Grade A office stock to over six million sq m.
- Net take-up totalled 122,000 sq m in Q3/2015, with 70% of all transactions seen in non-prime areas.
- City-wide vacancy rates in core areas fell to 7.1%, due to absorption of existing buildings handed over this year-to-date (YTD).
- Rents increased 0.3% to an average of RMB8.65 per sq m per day, as Puxi rents remained stable and Pudong rents increased 0.7%.
- As a direct consequence of the influx of supply, downward pressure will be placed on rents and occupancy rates as new projects compete to attract and retain tenants.
- Two new projects were launched onto the decentralised market in Q3/2015, increasing total stock to 1.53 million sq m.
- Rents remained flat at an average of RMB5.0 per sq m per day.
- The decentralised market witnessed vacancy rates of 18.8%, mainly due to low levels of pre-leasing at new projects.

“Although international investors remain cautious about investing in China, falling interest rates and increased liquidity are putting downward pressure on cap rates and pushing up values despite softening market fundamentals.” James Macdonald, Savills Research

➔ **Market commentary**

**Core market**

Nine projects, totalling over 380,000 sq m, were launched onto the market in the first three quarters of 2015. Pudong saw prime areas continue to tighten in the third quarter while non-prime areas continued to witness rental growth, despite increasing vacancy rates due to new supply. Puxi saw high absorption rates in recently handed over projects in Q3/2015. Supply levels are expected to triple in the final quarter compared to Q4/2014. New projects are scattered throughout the city, while Hongkou is expected to receive its first Grade A office building since 2012. Nevertheless, developers may decide to delay projects in the light of increased supply and intensifying competition.

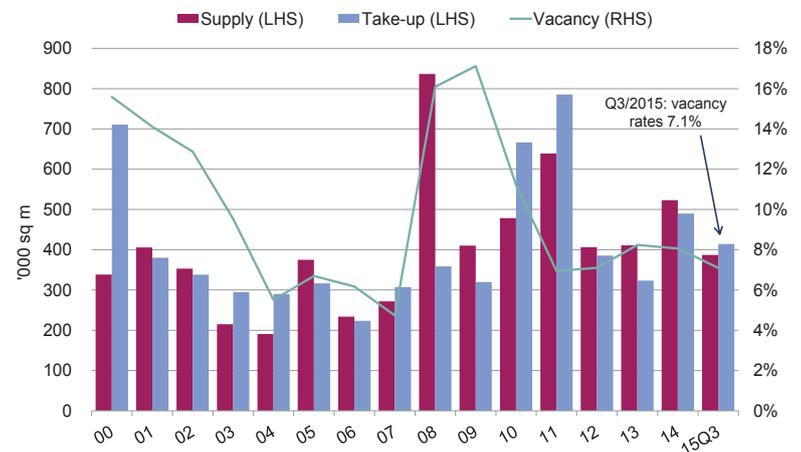
The key drivers of demand going forward will continue to be domestic companies as well as financial and professional services industries choosing to upgrade to larger spaces. Although many MNCs are positive about China in the long term and plan to continue investing in the country, high operating costs 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 by a review of business space requirements given the high-quality supply in non-prime areas, the emergence of not only non-prime areas but also decentralised ones and changes in the way office space is used.

**Decentralised**

Five new projects, adding nearly 300,000 sq m, were handed over to the market during the first three quarters of 2015, pushing stock to

GRAPH 1

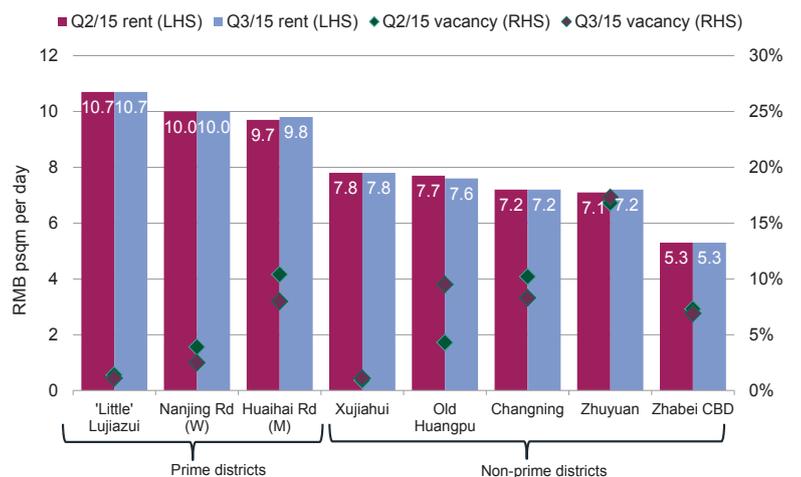
**Grade A office supply, take-up and vacancy rate, 2000–Q3/2015**



Source: Savills Research

GRAPH 2

**Business district comparison, rent vs vacancy rate, Q2/2015 and Q3/2015**



Source: Savills Research

1.53 million sq m. A supply peak of over one million sq m is expected during the last quarter of 2015. The majority of this supply will be located in Puxi, in Minhang district. Of the total, over 600,000 sq m is leasable space with the remaining accounted for by sales projects. Some areas will find oversupply especially acute, such as Minhang district, which is expected to account for around 60% of the total decentralised supply in 2015. However, government-backed and master-planned areas have proven to be at an advantage over other

areas, typically benefitting from high-quality transportation links and surrounding amenities.

**Market news**

**Jing'an and Zhabei districts to combine**

On 4 November 2015, the municipal government confirmed that the districts of Jing'an and Zhabei would merge. Currently Jing'an district covers 7.6 sq km; however, after the districts merge it will stretch north of Suzhou Creek to encompass the 29 sq km Zhabei district. The announcement comes after the

→ amalgamation of Huangpu and Luwan districts in 2011, and Pudong and Nanhui in 2009. The new Jing'an district will cover 37 sq km and be home to about 1.2 million permanent residents.

It is believed that the Jing'an district government will provide experience from its period of development and assist in Zhabei's development, especially in terms of its commercial and high-end residential markets. Zhabei district, in return, will provide an abundance of projects that can be repurposed, in particular old residences and industrial warehouses, and comparatively cheap new land plots for further development.

In terms of the current market, Zhabei district prices and rents have already begun to show growth in the last two years, especially in Daning area, showing the area's potential, especially with the helping hand of a district government like Jing'an. A number of companies have started moving out of the core areas of Jing'an to more cost effective and newer projects. However, with the unification of the two districts, Jing'an may be able to retain these companies – sharing benefits between the two areas and continuing to keep these taxpayers in the district.

**VAT reforms delayed**

It was recently announced that the VAT reforms for real estate will be delayed. The previous timeline for implementation was towards the end of 2015 – however, analysts now expect the implementation to be delayed for about a year, though it could be longer.

According to the State Administration of Taxation, the VAT reform will involve around ten million taxpayers in the real estate, financial and service sectors, which is double

the number of taxpayers in other industries that have already implemented the reforms. It will also involve around RMB1,600 billion worth of tax, which accounts for 67% of the entire country's tax income.

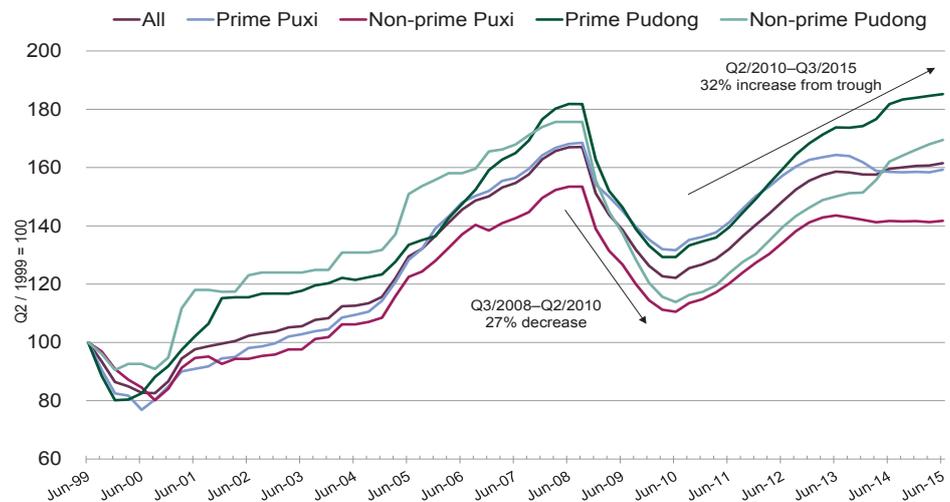
**Core market**

The core office market received three new projects in Q3/2015, adding nearly 125,000 sq m onto the market: Bund SOHO in Huangpu district and XinMei Union Square and Oriental One #3 in Zhuyuan. The last quarter of 2015 is expected to see seven additional projects enter the market, representing over 630,000 sq m of Grade A office space. All but one of these projects, Shanghai Tower, will be located in non-prime areas.

Net take-up reached 122,000 sq m in Q3/2015. Take-up levels in Puxi and Pudong were very similar this quarter, each reaching approximately 60,000 sq m. The highest overall demand was in non-prime areas at 72%, as tenants relocating to buildings handed over this year drove demand. Xujiahui witnessed space given back to the market this quarter, as a number of tenants relocated from aging buildings to newer projects in emerging areas. In addition, the area has seen no new supply since 2007, leaving limited supply for companies to expand.

Despite new supply, city-wide vacancy rates stabilised at 7.1% this quarter, as a result of further

GRAPH 3 Core market Grade A office rental indices, Q2/1999–Q3/2015



Source: Savills Research

TABLE 1 Selection of leasing transactions, Q3/2015

Tenant	Project	Location	Area leased (sq m)
Decathlon	International Business Park	Changning	13,000
Everbright Pramerica	Bund IFC	Huangpu	6,000
Richemont	ICC Two	Xuhui	5,500
Guohua Life	Shanghai Tower	Pudong	4,000
China Eastern Airline	Sky SOHO	Changning	1,500

Source: Savills Research

→ absorption of projects in non-prime areas handed over in 2014 and early 2015. Three business districts saw an increase in vacancy rates, namely Xujiahui (0.2 of a percentage point (ppt)), Old Huangpu (5.2 ppts) and Zhuyuan (0.5 ppt), resulting from new supply entering the market and tenants deciding to relocate to other business districts.

'Little' Lujiazui and Xujiahui continue to be the tightest markets due to limited available stock, with vacancy rates at just 1.1% and 1.4%. Zhuyuan continued to have the highest vacancy rates, as a result of ample supply in recent quarters. The area is currently seeing mixed reviews with some buildings seeing continuously strong take-up levels, while others are yet to see any transactions. During the final quarter

of this year the area is expected to receive the second highest amount of supply – should developers decide not to postpone amid heightened levels of competition – which will likely result in vacancy rates increasing significantly.

Similarly 'Little' Lujiazui is also expected to feel the pressure, with the launch of 220,000 sq m of leasable area in Shanghai Tower. Although the project has already reached pre-leasing levels of roughly 50%, the launch of the project and the softening of the market is expected to curb future rental growth. In the context of the wider market, Shanghai Tower is still expected to be one of the most resilient performances. However, it will push up vacancy rates in the short term, 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), although this space should be absorbed over time.

Grade A office rents increased 0.3% in Q3/2015 to an average of RMB8.65 per sq m per day. Puxi rents remained stable this quarter, while Pudong saw continued increases in prime and non-prime areas of 0.2% and 1.2% respectively. Although rental growth has been witnessed in recent months as landlords of newer buildings increase rents as they achieve healthier occupancy rates, this upward trend has begun to abate this quarter in anticipation of the upcoming influx of supply that will continue over the next two years.

TABLE 2  
Sizeable sales transactions, Q3/2015

Property	Location	Price (RMB million)	Buyer	Deal Structure	Usage
Corporate Avenue #1 #2 企业天地1、2号楼	Huangpu	6,600	Link REIT	Offshore equity	Lease
Platinum Tower 新茂大厦	Huangpu	2,853	ARA	Offshore equity	Lease
Hongjia Tower 宏嘉大厦	Pudong	2,627	Yuexiu REIT	Offshore equity	Lease
Tower 5, Guoco Changfeng City 国浩长风城5号楼	Putuo	832	Future Holdings	Onshore asset	-
Crystal Galleria 富邦晶品	Jing'an	820	Cura	Offshore equity	Lease / sale
Chuang Yi Tower 创屹商务大厦	Pudong	801	Van Shung Chong	Onshore Equity	Lease

Source: Savills Research

TABLE 3  
First-hand strata-title building activity, Q3/2015

Project	District	Transacted GFA (sq m)	Average price (RMB per sq m)
Sincere Space 中环协信中心	Zhabei	706	25,891
Huijing International Plaza (Magnolia Plaza) 汇京国际广场	Xuhui	1,366	58,004
Global Harbour 上海月星环球商业中心	Putuo	2,315	56,000
Xuhui Vanke Centre 徐汇万科中心	Xuhui	1,273	40,165
Hongqiao Zhenro Centre 虹桥正荣中心	Minhang	2,592	39,980

Source: Savills Research

Both prime and non-prime rents increased 0.1% and 0.4% QoQ to RMB10.2 per sq m per day and RMB7.2 per sq m per day respectively. Average rents in non-prime Pudong have now overtaken non-prime Puxi at RMB7.2 per sq m per day, after a 1.2% increase in non-prime Pudong in Q3/2015. Non-prime Pudong continues to record the strongest YTD rental growth at 1.2% as growth in the financial sector stimulates demand and spills over from Lujiazui.

All submarkets witnessed flat rents, apart from Zhuyuan and Lujiazui, which grew by 0.2% and 1.2% QoQ respectively.

## Investment market

The Shanghai office investment market was quite active in Q3/2015, with six sizeable sales deals concluded, representing a total consideration of RMB14.5 billion.

The office sector continues to dominate Shanghai's investment market, accounting for 68% of transaction volumes this quarter. Despite only concluding two deals in the third quarter, domestic investors are expected to continue being the driving force behind the office investment market. Although international investors remain cautious about investing in China, given the slow economy and rising

debt burden, falling interest rates and increased liquidity are increasing the likelihood of falling cap rates and rising values despite softening market fundamentals.

Domestic investors continue to focus on new-builds in non-prime and decentralised locations, while international funds, even as they continue to focus on add-value in core locations, are also seeking core assets with stable income for long-term hold. Nevertheless, both pools of capital are also actively exploring opportunities in business parks in search of higher yielding assets.

Yields for deals involving international investors are believed to have fallen to 5.8% on a gross reversionary basis in Q3/2015 (NOI: 4.5%). While yields on assets sold to international funds remain high, recent deals involving domestic funds and end-users continue to fall (around 1-2 ppts lower), given the different criteria for investment.

Shui On Land sold Corporate Avenue #1&2 in Huangpu District to Link REIT for a total consideration of RMB6.6 billion, the largest deal this year, with a unit price of RMB79,380 per sq m. This is the second deal concluded by Link REIT in China, following its acquisition of EC Mall in Beijing last year. Corporate Avenue #1&2 have a total leasable commercial GFA

of 83,155 sq m, comprising two premium office towers (75,780 sq m), a retail podium (7,375 sq m) and basement car parking.

ARA purchased Platinum Tower for a total consideration of RMB2.8 billion. This is the fourth time the building has been sold – mainly due to its advantageous location, a clean deal structure allowing for offshore equity (both domestic and international funds are in the game) and the ease of asset management within the project.

Yuexiu REIT purchased Hongjia Tower in Zhuyuan in August, for a total consideration of RMB2.6 billion. The project has a total office GFA of 54,000 sq m and is expected to remain for lease.

## Strata-title market

The strata-title market witnessed a supply increase, reaching 879,000 sq m in Q3/2015, up 11% QoQ while transaction volumes fell 0.9% to 418,000 sq m. The total sales consideration fell from RMB13.66 billion to RMB11.28 billion in Q3/2015, as more reasonably priced projects were transacted this quarter, bringing the average price of projects transacted to RMB26,985 per sq m. Self-use demand continues to drive the market, with investors concerned about lower yields and further limited capital value appreciation potential.

TABLE 4

## Key supply, Q3/2015

Project	District	Supply (sq m)	Developer
Bund IFC 外滩国际金融服务中心	Huangpu	155,681	Zendai Bund IFC
Mapletree Minhang 莘庄丰树中心	Minhang	99,921	Lin Feng
Xiaofu Financial Tower 晓富金融大厦	Pudong	62,550	Xiaofu
SCG Huihao Plaza 建工汇豪商务广场	Xuhui	51,764	Dahao
Zhongjun Plaza 中骏广场	Minhang	50,910	Zhongjun Chuangfu

Source: Savills Research

→ Prices based on a basket of 40 premium quality office projects<sup>1</sup> and analysed on a un-weighted index basis, recorded a more moderate fall of 0.5% QoQ to RMB45,677 per sq m in Q3/2015.

Over the last 12 months Hongqiao transportation hub (HTH), New Jiangwan Town and Pudong Binjiang have recorded the most amount of new supply, while demand has focused on HTH, Shanghai South Station and Longhua areas. Aside from these business areas, the North Bund and Changfeng have also seen some activity in recent quarters.

### Market outlook

The last quarter of 2015 is expected to witness a further 630,000 sq m of office space entering the core market. All but one project will be located in non-prime locations, with the majority of them situated in Puxi. Current forecasts predict that new supply in core areas will average 1.2 million sq m per annum, reaching an all-time high in 2015, a further peak in 2016 and a slight drop in 2017 – nevertheless, these estimates may change should developers postpone handover dates. Decentralised areas are also anticipated to see an influx of supply, with around a million sq m expected to enter the market in the final quarter of 2015 and an average annual supply of over 1.5 million for the next two years.

Demand is expected to remain firm over the next few years, although it is expected to be inadequate to absorb the majority of the influx of supply entering the market. Key drivers of demand will continue to be from the financial and IT related sectors in Pudong, while Puxi is expected to see demand come from professional services and retail related companies. Domestic companies will increasingly look at upgrading their office space or purchasing for self-use, leading to demand for quality office space

<sup>1</sup> 30 projects in Puxi and 13 projects in Pudong

and strata-title projects, while MNCs 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 consider the bifurcation of 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, 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 of 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. Additionally, projects entering these areas are of a higher quality and therefore will be able to demand higher than average rents, despite the levels of supply seen across the city.

However, landlords of existing buildings within prime areas that historically recorded high occupancy rates are expected to feel the pressure. While a number of companies will continue to be in prime areas to maintain a certain image and also due to the clustering effect, many may make the decision to move non-client facing departments to more cost effective projects in non-prime areas. Also, as non-prime and emerging areas build better infrastructure and surrounding amenities improve, companies may not feel the need to be in prime areas, instead opting for larger office spaces in these areas. As replacement costs begin to increase, landlords will have to shift their focus to new innovative ideas to retain

existing tenants as well as attract tenants.

Expo, Pujiang Yaohua, Xuhui Binjiang and Qiantan areas are all anticipated to play an important role in the future decentralisation of Shanghai's office market. Based on master plans provided by the government, these districts will be developed into business centres through the improvement of infrastructure and surrounding amenities such as international schools and hospitals. These areas are also to be connected with Puxi and Lujiazui through extensive metro access to improve accessibility of the area.

The Pudong master-planned areas plan to attract companies from the financial, consultancy, legal and professional services industries to set up their headquarters, providing a complementary and supportive function for the "Little Lujiazui" area. Xuhui Binjiang is expected to focus on attracting media companies as well as leisure and entertainment operators.

A large percentage of the future supply in the Expo area is being developed by state-owned enterprises for self-use. Qiantan has attracted a number of well-known international developers including Tishman Speyer, Swire and Hong Kong Land, known for their international experience, management quality and reputation. ■

## Future project

### Lilacs International Commercial Centre

Lilacs International Commercial Centre, developed by Shanchuan Properties, consists of two Grade A office towers. Located on Dingxiang Road, the project benefits from close proximity to Lujiazui. The project, which is expected to be launched onto the market in Q4/2015, consists of 57,800 sq m of office space and 45,000 sq m of retail space. The project has already pre-leased over 65% of its office space.

The office component spans 16 floors (nominal 5-20F). Typical floor plates will be around 1,600–1,950 sq m, with whole floor efficiency of 70%. The clear ceiling height is 3.0 m and raised floors are 150 mm. The office building will be serviced by ten passenger lifts and will have around 540 car parking spaces to support the whole project. The development is a five-minute walk from Yanggao Road (M) metro station (line 9), however there are also plans to link it directly to a future metro station on line 18 in 2020.

Asking rents start at RMB8.5 per sq m per day. The project is managed by Savills and property management fees are expected to be RMB36.0 per sq m per month.

TABLE 5  
Lilacs International Commercial Centre

Location	Dingxiang Road, Pudong	
Developer	Shanchuan Properties	
Handover date	Q4/2015	
Office GFA	57,800 sq m	
No. of storeys	16 floors (nominal 5-20F)	
Typical floor plate	1,600–1,950 sq m	
Whole-floor efficiency	70%	
Clear ceiling height	3.0 m	
Raised floor	150 mm	
Passenger lifts	10	
Car parking spaces	~540 spaces (whole project)	
Starting asking rent	RMB8.5 per sq m per day	
Property management fee	RMB36.0 per sq m per month	

Source: Savills China Research

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