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Savills World Research
Shanghai

Briefing
Office sector

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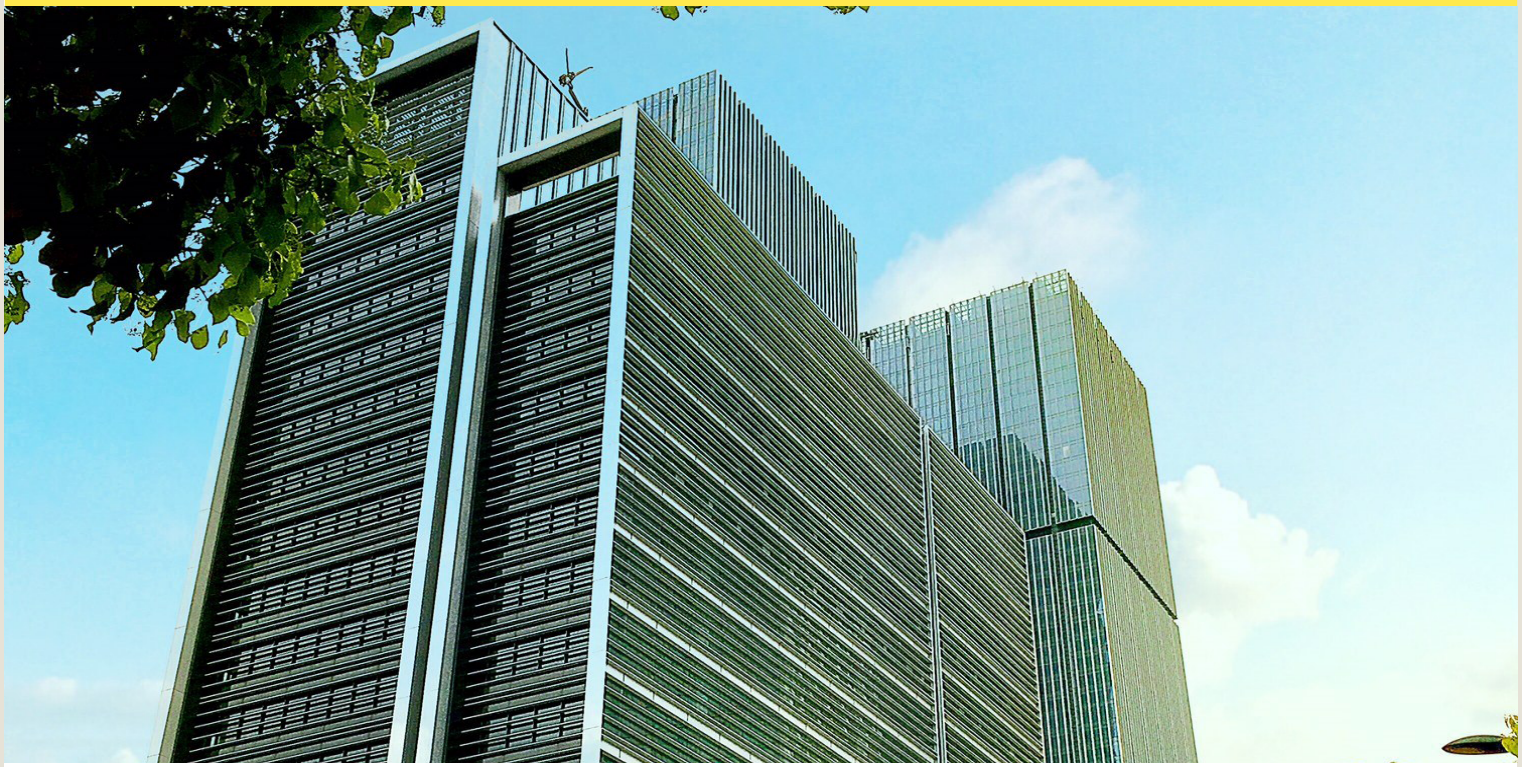


Image: United Overseas Bank Plaza

SUMMARY

Pudong rents reach all-time highs as demand from financial firms exacerbates the divide between Pudong and Puxi.

- Four projects, totalling 140,000 sq m, launched onto the core office market in Q1/2016, pushing total stock to 6.5 million sq m.
- Thanks to strong take-up rates of projects handed over in the past few quarters, vacancy rates in core areas fell by 0.4 percentage points (ppts) quarter on quarter (QoQ) to 5.7%, while rents stayed flat at RMB8.71 per sq m per day.
- Three new projects, totalling 180,000 sq m, launched onto the decentralised market in Q1/2016, increasing total stock to 2.04 million sq m.
- In response to new supply, vacancy rates in decentralised areas increased by 3.3 ppts QoQ to 30.4%, while rents stood at an average of RMB5.10 per sq m per day.
- Despite strong new demand, landlords of new projects are expected to increase various incentives to attract tenants, especially larger occupiers, in preparation for the continued supply influx.

"Vacancy rates in core areas fell as end-user acquisitions absorbed supply before it entered the leasing market. Meanwhile, vacancy rates in decentralised locations continued to rise." James Macdonald, Savills Research

Market commentary[1]

Core market

Rents and vacancy rates in the core market continued to rise and fall, respectively, though the pace of both trends slowed this quarter. Demand in Pudong prime areas continued to exceed new supply, pushing vacancy rates to new lows, while non-prime areas in Pudong witnessed strong take-up. Vacancy rates in Puxi increased due to new supply.

Companies searching to establish headquarters in Shanghai have been one of the major drivers of new demand recently, as many seek to capitalise on the city's deepening financial reform. Acquisitions by end-users, in particular, have helped absorb much of the new supply, keeping vacancy rates in core areas down.

Property owners of newer projects in Puxi have begun offering extended fit-out and rent-free periods to attract tenants in preparation for the expected supply influx. By comparison, landlords of established prime projects in core areas remain confident that rent and occupancy levels in these areas will remain flat, resulting in less incentives being offered. The stability of leases by Peer To Peer (P2P) companies has become an increasingly important consideration for property owners, as witnessed by landlords demanding that such firms pay deposits of six to nine months instead of the three months asked for in a typical leasing agreement.

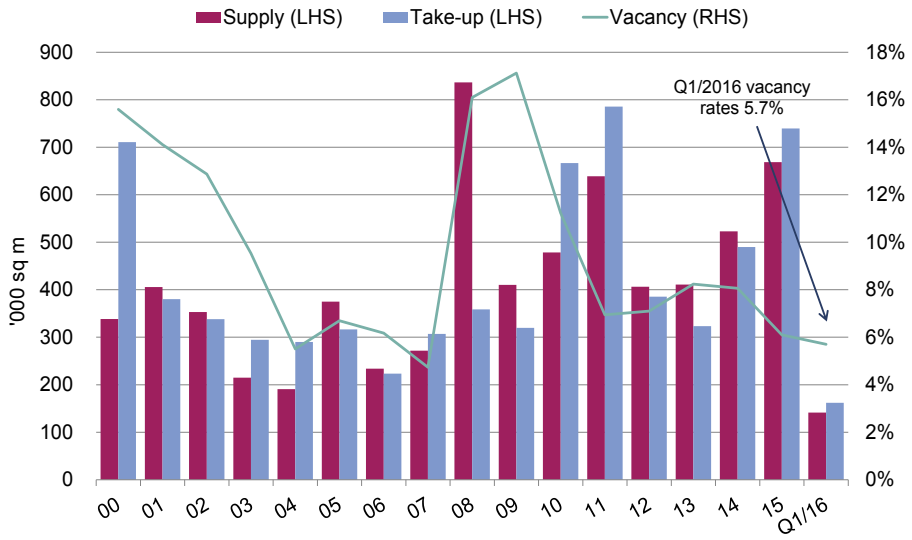
Decentralised market

Decentralised rents remained flat in Q1/2016, while vacancy rates increased due to the handover of several projects. Despite the strength of new demand, owners of new projects are aware that great volumes of supply are forecast to enter the market in the coming years. Under this intensifying competition, property owners will have to differentiate themselves, consider postponing their handovers, or consider strata-title or en-bloc sales. New projects in emerging areas with better traffic accessibility and commercial facilities will have an easier time weathering the supply influx of the next few years.

[1] NB: The database of core area and decentralised area has been reviewed in Q1/2016 according to Savills Grade A office standard, resulting in corresponding changes on stock, rent and vacancy.

GRAPH 1

Grade A office supply, take-up and vacancy rate, 2000–2016Q1



Source: Savills Research

Market news

China expands Value Added Tax(VAT) pilot programme to all industries

At the fourth session of the 12th National People's Congress on 5 March, the government announced that work to include the final four sectors under the new VAT system would begin on 1 May 2016. These sectors are the construction sector, financial services, consumer services (includes hotels, restaurants, education, healthcare and others), and the real estate sector. For the real estate sector, the current business tax is 5% on the sale of immovable property and 3% on construction services. Under the new VAT regime, the tax rate will be set at 11%, though there will be the introduction of input tax credits that will allow companies to offset some of their costs.

The new VAT system could prove to be beneficial to the taxpayer; however, this will be decided on a case-by-case basis. It will be important for tenants to understand if their landlords are under the new system and can provide tax invoices that can help reduce corporate tax.

WeWork's first Asian centre expected to launch in Shanghai soon

American co-working space company WeWork is expected to launch its first location in Shanghai this June. Located near the intersection of Yangping road and Wuding road in north Jingan, the location occupies two 1,600-sq m floors and is said to be already over 60% leased.

As one of the most successful American co-working space providers, WeWork's China launch has been highly anticipated; however, WeWork, like Uber, will be faced with competition from a number of established local players already running similar businesses such as SOHO 3Q, Urwork, Jack Ma-backed

KRSpace, as well as Shanghai's Youwork and Nakehub centres. As the latest entrant, WeWork will have to play a game of catch-up in order to establish itself as a significant co-working provider before further market saturation occurs.

Shanghai's high hopes for Big Data hub

The Shanghai Data Exchange, a site of over 150 data and cloud-computing firms located in the Shibei Industrial Park, opened on 1 April. The Exchange will allow companies and organisations to buy data via authorised channels at reasonable prices on a case by case basis. The Bank of Shanghai announced a credit of RMB2 billion (US$309 million) to the Shanghai Data Exchange Corp, the operator of the exchange.

Data in China is currently stored internally at companies, preventing its sharing and exchange with third-party platforms. Connecting data at an exchange location will improve the economic utility of data, furthering the development of Shanghai's tech sector.

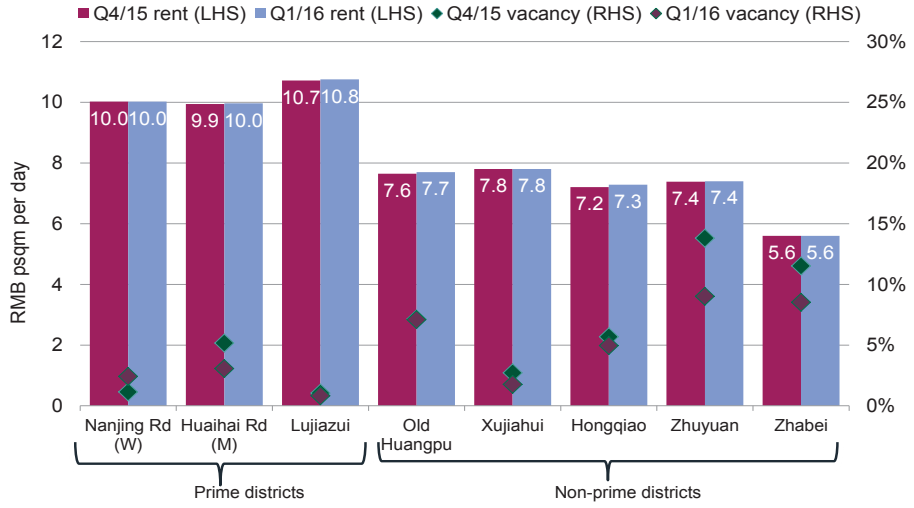
Core market

The core office market received four new projects in Q1/2016, adding nearly 140,000 sq m of supply. This included two projects in Puxi, Crystal Galleria in the Jing'an district, and Star Bund T1, which is the first Grade A project to be launched in the Hongkou district since 2012, and two projects in Pudong, United Overseas Bank Plaza and Poly International Plaza, which were both pre-committed for self-use.

Net take-up in core areas totalled 162,000 sq m, with the majority of demand (73%) in non-prime areas, as more cost-conscious tenants search for more affordable options in these areas. Pudong non-prime areas accounted for a particularly high percentage of core market take-up (64%), due to high demand from the financial sector.

GRAPH 2

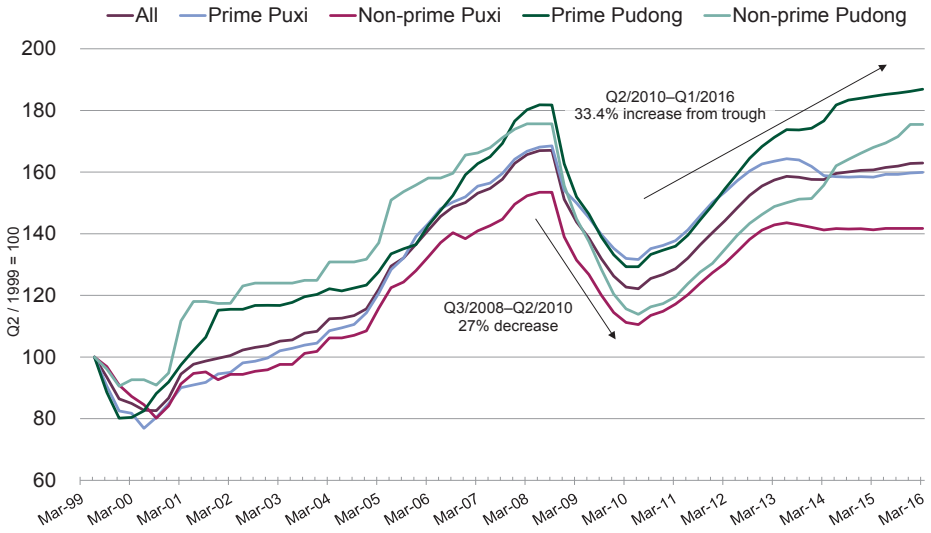
Business district comparison, rent vs vacancy rate, Q4/2015 and Q1/2016



Source: Savills Research

GRAPH 3

Core market Grade A office rental indices, Q2/1999–Q1/2016



Source: Savills Research

TABLE 1

Selection of leasing transactions, Q1/2016

Tenant	Project	District	Area leased (sq m)
China Oceanwide Holding	Bund SOHO 204	Huangpu	6,000
Huacheng Law Firm	The Centre	Xuhui	4,500
China Zheshang Bank	Century Grand Metropolis	Pudong	4,500
Hitachi Chemical	Park Place	Jing'an	1,800

Source: Savills Research

Of the core areas, only Nanjing Road (W) saw an increase in vacancy rates, of 1.3 ppts, resulting from new supply entering the market; however, this is expected to be absorbed in the coming quarters.

'Little' Lujiazui continued to be the tightest market, with limited available stock and vacancy rates at just 0.8%, though the expected handover of Shanghai Tower is expected to provide some short-term relief. Zhuyuan continued to have the highest vacancy rates because of ample supply in recent quarters, though it also boasted the strongest take-up levels among all of the core area submarkets, with vacancy rates in the area decreasing by 4.8 ppts.

Vacancy rates in Huaihai Rd (M) and Zhabei also decreased by 2.1 ppts and 3.0 ppts respectively, due to strong take-up of projects handed over in the past few quarters. The Old Huangpu district is experiencing discrepancies in take-up, with some new buildings seeing strong take-up levels, while many old buildings are experiencing a loss of tenants.

Grade A office rents in core areas remained flat in Q1/2016, at an average of RMB8.71 per sq m per day; however, the discrepancy between rents in Pudong and Puxi increased, as rents in Pudong reached a record high of RMB9.18 per day. Non-prime rents remained flat at an average of RMB7.31 per sq m per day this quarter, while prime rents increased 0.2% to an average of RMB10.32 per sq m per day.

Prime market rents continued to rise, suggesting that the economic situation has not adversely affected landlords' strength in rent negotiations. Property owners in prime areas may be especially confident, as leasable supply forecasts for the next three years remain relatively limited in these areas. However, landlords of new prime projects are still willing to provide discounts to attract larger occupiers, especially industry-leading companies. In non-prime areas, some landlords are beginning to offer increasingly favourable terms to attract clients, amid fears that new supply and more affordable rents in other non-prime and decentralised areas may encourage relocation.

Investment market

The Shanghai office investment market concluded two sizeable sales deals, representing a total consideration of RMB2.38 billion. Yields fell to roughly 5.4% on a gross reversionary basis in Q1/2016 (NOI: 4.0%).

Shanghai's property market remains attractive for international investors, with higher yields relative to other global markets and the expectation of further interest rate cuts. Investors also remain eager to acquire prime buildings in business parks, as witnessed by the conclusion of another deal in the first quarter.

The long awaited transition from Business Tax to Value Added Tax for the real estate sector is set to begin on 1 May. Developers and investors are currently exploring the potential implications of how the change could slow deal activity in the short term, though it is believed that the new policy will cut the overall tax burden significantly in the long term.

Strata-title market

The strata-title market witnessed a supply decrease of 265,000 sq m in Q1/2016, one-third of last quarter's supply. The total sales consideration fell from RMB38.3 billion to RMB7.7 billion in Q1/2016, as more reasonably-priced projects were transacted this quarter, bringing the average price of projects transacted to RMB25,658 per sq m.

Prices based on a basket of roughly 40 premium quality office projects that were analysed on an un-weighted index basis recorded a more moderate fall of 0.3% QoQ to RMB46,139 per sq m in Q1/2016.

Minhang, Yangpu, and Pudong have seen the greatest supply influx since 2015, especially in HTH, New Jiangwan Town, Pudong Binjiang and Zhangjiang Business Park. In terms of demand, Pudong, Minhang, and Zhabei[2] have seen the greatest transaction volumes since 2015.

A great discrepancy in demand can be seen between strata-title and en-bloc sales in the Shanghai market. Activity in the strata-title market has decreased as more investors grow

[2] In November 2015, the Jing'an District and the Zhabei District officially merged into the New Jing'an district; however, Savills continues to consider Jing'an and Zhabei as separate submarkets in order to maintain consistency.

TABLE 2

Sizeable sales transactions, Q1/2016

Property	Location	Total (RMB mil)	Price (RMB/sq m)	Buyer	Deal Structure	Usage
Towers E & G, Waterfront Place	Putuo	800	28,772	Pramerica Asia Fund	Offshore equity	Lease
H88	Xuhui	1,580	28,000	Everbright Ashmore	Offshore equity	Lease

Source: Savills Research

wary of the inherent risks of strata-title investment, such as difficulty finding prospective buyers and the properties' relatively lower yields. By contrast, en-bloc sales remain strong in Shanghai, as the demand from large-scale end-users and institutional investors continues to grow.

Market outlook

Close to 1 million sq m of new supply, including the 280,000-sq m Shanghai Tower, is expected to enter the core market in the remainder of 2016, split 36% and 64% between prime and non-prime locations, respectively.

Strong demand from large occupiers in prime areas is expected to remain over the next few years. However, in response to slowing economic growth, many tenants are growing increasingly cost-conscious, prompting even the largest, multi-national firms to consider bifurcation strategies, moving back-office departments to more affordable locations in non-prime or even decentralised areas should the need for expansion come.

Tenant quality is becoming a growing concern for property owners in Shanghai, especially in response to the growth of the P2P and private banking industry. In order to protect themselves, landlords are demanding larger deposits from tenants working in such industries.

Decentralised areas will see a greater proportion of Grade A office supply in 2016. HTH alone is slated to receive 1.3 million sq m, more than the entire core market. Such a large amount of supply will put great pressure on the occupancy rates. However, HTH still faces the challenges of an emerging district and its landlords will have to differentiate themselves, consider postponing their handovers, or consider strata-title or en-bloc sales in order to compete in a fiercely competitive market.

Co-working space is gaining traction in Shanghai. Higher rents are driven by new demand for co-working space by the architecture, design, and other creative industries, the standard occupiers of such projects. The co-working space market is expected to see further growth over the next few years with leading co-working space developers already announcing projects in the pipeline.

TABLE 3

First-hand strata-title building activity, Q1/2016

Project	District	Transacted GFA(sq m)	Average price (RMB per sq m)
Sincere Space 中环协信中心	Zhabei	1,446	22,487
Rongxin Greenland Business Plaza 融信绿地商务广场	Minhang	1,898	25,973
CITIC Plaza 中信广场	Hongkou	1,122	53,282

Source: Savills Research

TABLE 4

Key pre-sale supply, Q1/2016

Project	District	Supply (sq m)	Start asking price (RMB per sq m)
Suning Tianyu Int'l Plaza 苏宁天御国际广场	Putuo	44,372	32,000
Hongqiao Zhenro Centre 虹桥正荣中心	Minhang	22,550	33,000

Source: Savills Research

Future project

HKRI Taikoo Hui

HKRI Taikoo Hui, developed by Swire Properties and HKRI, consists of two Grade A office towers. Tower 1 is to be handed over in Q3/2016, while Tower 2 is estimated to be launched in 2017. Located in the Nanjing Rd (W) area, the development will be directly linked to Nanjing Rd (W) metro station (line 13) and is a five-minute walk to lines 2 and 12 as well. The project consists of 160,000 sq m of office space (95,000 for Tower 1 and 65,000 for Tower 2) and 100,000 sq m of retail space.

The office component of Tower 1 spans from 6th to 51st floor. Typical floor plates will be around 2,100 – 2,300 sq m, with whole floor efficiency of 70 – 75% approximately. The typical clear ceiling height is 2.9 m and raised floors are 115 mm (for specific floors, 250 mm raised floor clearance). The office buildings will be serviced by eight high-speed passenger lifts per zone, serving no more then 15 office floors.

Asking rents start at RMB12.0 per sq m per day to RMB 14.0 per sq m per day. Property management fees are expected to be RMB46.0 per sq m per month during 2016 to 2017.

TABLE 5

HKRI Taikoo Hui Centre 1

Location	Nanjing Rd (W) & Shimen Rd (No.1), Jingan
Developer	Swire Properties / HKRI
Handover date	Q3/2016
Office GFA	95,000 sq m
No. of storeys	6F - 51F
Typical floor plate	2,100 – 2,300 sq m
Whole-floor efficiency	70 – 75% Approx.
Typical Clear ceiling height	2.9 m
Raised floor	115 mm (* For specific floors 250 mm raised floor clearance)
Passenger lifts	8 high speed passenger lifts per zone serving no more 15 office floors
Starting asking rent	RMB12.0 – 14.0 per sq m per day
Property management fee	RMB46.0 per sq m per month (2016 - 2017)

Source: Savills China Research

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