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Savills World Research
Shanghai

Briefing
Office sector

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Image: Jin Mao Tower, Shanghai World Financial Centre, Shanghai Tower

SUMMARY

Vacancy rates across the city have risen as space was handed back to the market in Puxi and as Pudong received an influx of new supply.

- Two projects, Shanghai Tower and the first phase of Century Link, were launched onto the core office market in Pudong in Q2/2016, bringing 340,000 sq m of supply and pushing total stock to 6.84 million sq m.
- Net take-up in core areas totalled 190,000 sq m, up 17% quarter-on-quarter (QoQ), while vacancy rates in core areas increased by 1.9 percentage points (ppts) to 7.6%.
- The average core market rent remained unchanged in Q2/2016, at RMB8.65 per sq m per day.
- Two new projects entered the decentralised market in Q2/2016, bringing 118,000 sq m of supply and pushing total stock to 2.16 million sq m. Take-up stood at 85,000 sq m.
- Vacancy rates in decentralised areas decreased slightly, by 0.1 ppt QoQ to 30.3% in Q2/2016, while rents increased by 0.3% QoQ to RMB5.40 per sq m per day.
- Large volumes of new supply will push up vacancy rates in all areas of the city, with the largest rise expected in non-prime Puxi.

"The tight vacancy in 'Little' Lujiazui has been relieved with the launch of Shanghai Tower, which will limit rental growth in the short term. However, in the context of the wider market, rents in 'Little' Lujiazui remain the highest in the city." James Macdonald, Savills Research

Market commentary

Core market

Core market rents, which have recorded non-stop quarterly growth since 2014, stagnated in Q2/2016. Vacancy rates rose across the city as space was returned to the Puxi market and two new projects were handed over in Pudong. Though both new projects in Pudong achieved strong pre-commitment levels, the volume of supply increased vacancy rates in the sub-market.

A number of traditional financial companies have invested large amounts of capital into high-tech firms and start-ups. This combination of new technology and traditional finance, dubbed fintech, is quickly emerging as an industry with the potential to generate new office demand. Fintech companies with larger budgets will first look to the core market in Pudong, given their need to be closer to the financial companies headquartered there. Decentralised markets will also be attractive to more cost-conscious start-ups as well as larger firms looking to branch out.

Increasing industry competition and greater government regulation forced many peer-to-peer (P2P) companies to withdraw from lease agreements, which resulted in a large amount of supply returning to the market in Puxi. Due to the recent volatility of the industry and government warnings that owners of buildings where fraudulent lending occurs may be liable, landlords continue to treat P2P tenants with caution by asking for higher rental rates and larger deposits upfront.

Decentralised market

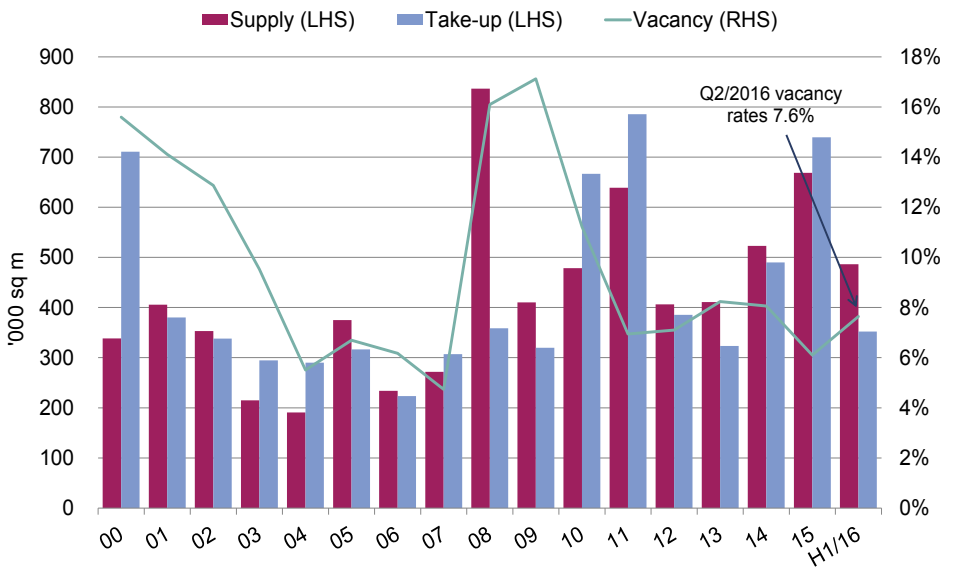
Strong demand for decentralised office projects saw vacancy rates decrease slightly in Q2/2016, with rents increasing slightly.

The decentralised market attracted another high-profile relocation this quarter, as American consulting firm AECOM moved from Nanjing Rd (W) to a 6,000 sq m office in Yangpu. The Fortune 500 company's decision to relocate signals the growing competitiveness of the decentralised market as more high quality projects become available.

In preparation for the large amount of supply entering market in the coming years, many landlords of newer projects are becoming more flexible in their use of sales and leasing options in order to achieve healthy occupancy rates.

GRAPH 1

Grade A office supply, take-up and vacancy rate, 2000–Q2/2016



Source: Savills Research

Market news

Fintech on the rise:

A number of technology firms and traditional financial companies announced strategic partnerships in the past quarter. Baidu and China Pacific Insurance Co (CPIC) agreed to establish a new online insurance company, giving the insurance giant access to the search engine's powerful data collection platform in order to set more competitive pricing. Smartphone maker Xiaomi has also indicated an interest in using its technology to provide banking services to clients, and became an investor in China's newest private bank, New Hope Bank, which successfully registered with the government earlier this month. This preceded an investment of approximately US$600 million by China Life Insurance into ride-hailing app Didi Chuxing, which will lead to further innovations in financial technology and services between the two partners.

While investment in fintech has been ongoing for some time, the latest wave marks an increasing trend of cooperation between domestic tech and financial firms, which hope to merge technology and financial services to generate new products for their consumers. Growing cooperation between traditional finance and technology companies will help generate new demand for the office market in Shanghai, especially in Pudong.

Wework opens first space in Shanghai as competition for co-working space intensifies:

New York-based co-working space provider Wework opened its first Asia centre in Shanghai in the last quarter. Wework has announced plans to open two spaces in Shanghai as well as other mainland cities in the remainder of the year, in the hope of establishing a foothold in China's shared working space market. While the launch of Wework has been highly anticipated, the company is a latecomer to a market already dominated by a number of local players, such as SOHO 3Q, Urwork, Uban, and Jack Ma-backed Krspace. It will be interesting to see how Wework fares in this competitive market, especially as

its desk rates (RMB2,800-4,000) are currently 50% higher than the rates charged by some of its local competitors.

The flexibility and affordability of co-working space is most attractive to freelance workers and smaller start-ups who have smaller budgets and whose spatial requirements are constantly in flux as the size of their teams vary greatly from project to project. The increase in funding for start-ups and small businesses in China, particularly in technology, will undoubtedly increase the demand for co-working space. Landlords will have to consider how they will choose to enter this market, either leasing space to co-working space operators directly or subdividing floor plates and providing independent shared workstations in order to foster co-working space tenants, which could eventually grow into full sized tenants.

Government crackdown on P2P lenders continues

During the inaugural Lendit China Executive Tour in Shanghai, the vice secretary of the Association of Shanghai Internet Financial Industry (ASIFI) claimed that more than 43% of China's 4,100 P2P financing companies are believed to be in violation of Chinese internet lending law, with many having had their business licenses suspended. Increasing government regulation combined with greater competition in the industry could reduce the number of P2P platforms by as much as 90% over the next few years.

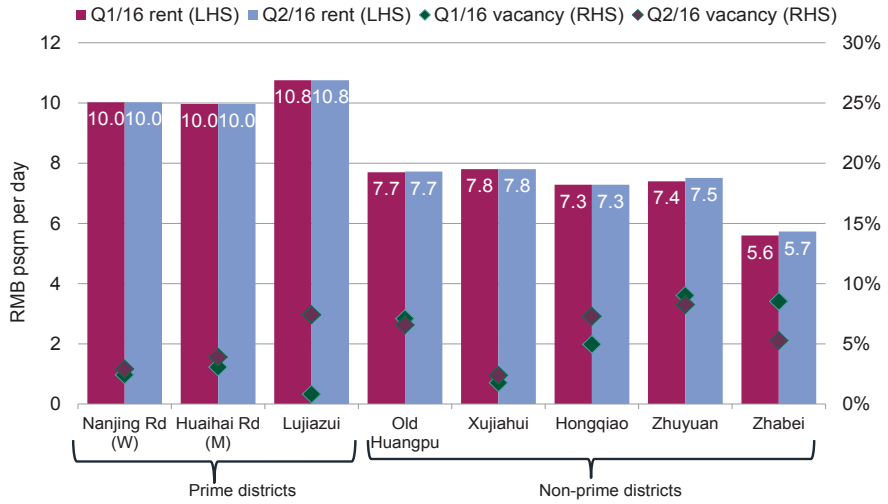
The exit of P2P companies will put more pressure on the city's office leasing market, as witnessed in Q2/2016 when a number of P2P companies backed out of lease agreements in some business areas, resulting in skyrocketing vacancy rates in the area and contributing to the stagnation of future citywide rental growth.

Core market

Shanghai Tower in Lujiazui and the first phase of Century Link in Zhuyuan came onto the market in Q2/2016, bringing approximately 340,000 sq m of supply. Shanghai

GRAPH 2

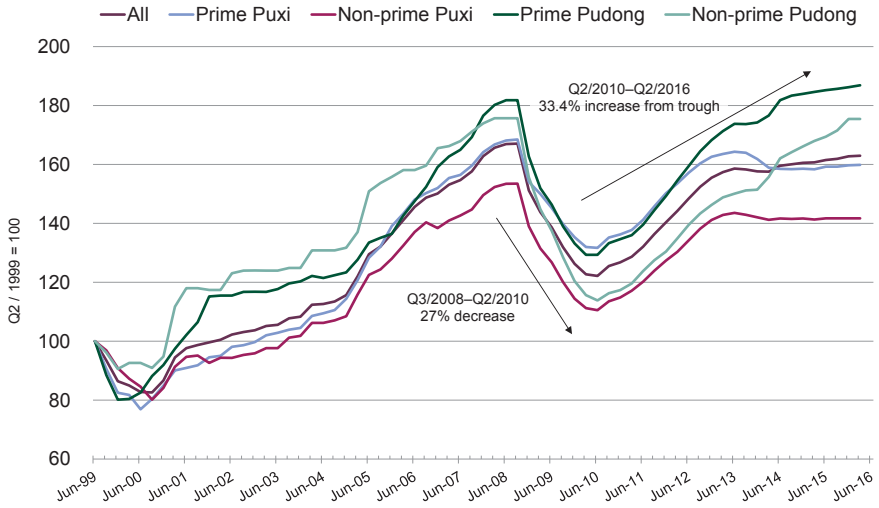
Business district comparison, rent vs vacancy rate, Q1/2016 and Q2/2016



Source: Savills Research

GRAPH 3

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



Source: Savills Research

TABLE 1

Selection of leasing transactions, Q2/2016

Tenant	Project	District	Area leased (sq m)
Panasonic	SOHO Hongkou	Hongkou	10,000
Huacheng Law Firm	The Centre	Xuhui	4,500
AEGON-Industrial Fund	Kerry Parkside	Pudong	4,000
MOL	Kerry Everbright City Ph3	Zhabei	4,000
Tianan Property Insurance	Xin Mei Union Square	Pudong	1,100

Source: Savills Research

Tower is the tallest building in Shanghai and, despite recording a pre-commitment level over 50%, is responsible for 81% of the vacant space added to the market last quarter. Hutchison Whampoa's Century Link project has also attracted a high level of interest, benefiting from the development of the adjacent Century Avenue metro station (lines 2, 4, 6 and 9).

Core areas continued to witness strong levels of demand, with net take-up exceeding 190,000 sq m in Q2. Pudong recorded the strongest levels of take-up since Q3/2011, of which 65% occurred in Lujiazui due to the high pre-commitment levels achieved by newer projects such as Shanghai Tower. However, the sheer volume of new supply in Pudong combined with the handing back of space in Puxi by P2P tenants pushed up citywide vacancy rates.

The tightness of supply in prime areas has left tenants wishing to remain in the area with little choice but to renew. Companies with expanding spatial requirements continue to consider relocating to non-prime and decentralised areas, or adopting split operation strategies.

The limited supply in 'Little' Lujiazui, which has kept the sub-market's vacancy below 3% since 2013, was alleviated to some degree with the launch of Shanghai Tower. Vacancy rates increased 6.6 ppts to 7.4% in Q2/2016. The softening of the market should help curb future rental growth in Lujiazui over the short term, though rents in the area will remain more resilient to market pressures than in other locations of the city.

Apart from Lujiazui, several business areas witnessed slight increases in vacancy rates in Q2/2016, including Nanjing Rd (W), Huaihai Rd (M), Xujiahui and Hongqiao. The Hongqiao area recorded the largest rise in vacancy, by 2.3 ppts to 7.3%, as P2P companies returned space to landlords.

Vacancy rates in Old Huangpu, Zhabei and Zhuyuan decreased to varying extents because of the take-up of projects handed over in the past few quarters. The Old Huangpu area is experiencing discrepancies in vacancy rates, with some new buildings recording strong take-up levels, while many older buildings are experiencing a loss of tenants.

The new surge of supply has begun to put pressure on the city's office market. Grade A office rent in core areas averaged RMB8.65 per sq m per day in Q2/2016, recording no change over the previous quarter.

Property owners in prime areas remain confident, as these areas will receive relatively limited supply over the next three years. In non-prime areas, some landlords of older projects are beginning to offer increasingly favourable terms to attract clients, amid fears that newer projects and more affordable rents in other non-prime and decentralised areas may encourage tenant relocations.

Sales Market

Overview:

Nearly 945,000 sq m of office space received pre-sales certification in Q2/2016, triple that of Q1/2016 and similar to the quarterly average of the previous year. While the application of a pre-sales certificate, allows the developers the right to sell their property it does not preclude the right to lease space. This is evident as some landlords have applied for certificates while continuing to lease, keeping their options as rent and occupancy rates may prove to be too low in less desirable locations and vice versa. The 945,000 sq m of new supply came from 36 projects, of which 11 (245,000 sq m) were located within the middle ring road.

The total consideration of asset sales, increased from RMB8.7 billion in Q1/2016 to RMB19.6 billion in Q2/2016 with the total transacted area increasing from 335,000 sq m to 580,000 sq m over the same period giving and average transaction price to RMB33,850 per sq m. The above figures include strata title deals and en-bloc asset deals where property certificates exchanged hands.

A great discrepancy in demand can be seen between strata-title and en-bloc sales. Activity in the strata-title market continues to decrease, as more investors grow aware of the difficulties and inherent risks of strata-title investment, such as difficulty finding prospective buyers and the relatively lower yields. By contrast, en-bloc sales activity remains strong, as large-scale end-users and institutional investors continue to generate new demand. While strata prices five years ago were typically higher than en-bloc prices, this is no longer the case under the current market conditions. In some areas, such as along Huangpu River, en-bloc prices can be much higher than strata prices for the same project.

TABLE 2

Sizeable sales transactions, Q2/2016

Property	Location	Total (RMB mil)	Price (RMB/sq m)	Buyer	Usage
East Ocean Centre	Huangpu	2,390	48,000	Sino Ocean	Lease
#6 Riverside Int'l Plaza	Yangpu	805	53,114	Shanying Paper	Self-use
Evergo Tower	Xuhui	1,220	49,481	Real Power Capital	Lease

Source: Savills Research

En-bloc:
The city's office en-bloc sales market concluded three sizeable sales deals, representing a total consideration of RMB4.42 billion. Yields fell to roughly 5.2% on a gross reversionary basis in Q2/2016 (NOI: 3.9%).

Domestic investors were especially active in the first half of 2016, increasing asset values, which in turn incentivized more owners to place their properties on the market. However, on-going yield compression will continue to slow down international investors' purchasing activities.

Strata Title:
U-Centre was the largest project that received pre-sales certification in Q2/2016. U Centre is located near the Lianhua Road metro station (line 1), and consists of three office blocks (totalling 180,000 sq m), a large-scaled retail podium (150,000 sq m) and a hotel.

Prices based on a basket of roughly 40 premium quality office projects that were analysed on an un-weighted index basis recorded a moderate fall of 0.48% QoQ to RMB45,980 per sq m in Q2/2016.

Hongqiao Transportation Hub(HTH) in Minhang, New Jiangwan Town in Yangpu, Riverside and Zhangjiang Business Park in Pudong, and North Station in Zhabei[1] are the most active areas in terms of sales supply and transaction volumes since 2015.

Market outlook

Approximately 600,000 sq m of new supply is scheduled to enter the core market in the remainder of 2016, of which 90% will be located in Puxi. The decentralised market also expects to receive 1.2 million sq m of Grade A office supply in the second half of 2016, 40% of which will be located in HTH.

The establishment of headquarters by large financial institutions, the development of private banks and the growth of the fintech sector will continue to drive demand in Pudong, especially in Lujiazui. The spillover of demand from Lujiazui will boost take-up in Zhuyuan and push some larger multinational occupiers to consider bifurcation or relocation to Puxi or emerging areas such as Qiantan.

As supply in prime Puxi is forecasted to remain relatively limited over the next three years, landlords in these areas expect good pre-commitment levels which will give them confidence in rent negotiations. Puxi non-prime areas will see the highest rise in vacancy rates, as they will receive great volumes of new supply. Projects with better accessibility and facilities will be better prepared to cope with the increasingly competitive market.

The influx of new projects in decentralised areas will force landlords to remain open to all strategies – en-bloc sales, strata-title sales, and leasing – in order to improve take-up rates, especially in the most highly competitive markets, such as HTH.

1 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 3

First-hand, strata-title transactions, Q2/2016

Project	District	Transacted GFA(sq m)	Average price (RMB per sq m)
Shanghai Urban Development Business Centre	Minhang	2,190	49,840
Riverside International Plaza	Yangpu	2,050	41,335
Sincere Space	Zhabei	1,445	22,500
Oriental Blue Ocean Plaza	Yangpu	1,170	21,625

Source: Savills Research

TABLE 4

Key pre-sale supply, Q2/2016

Project	District	Supply (sq m)	Start asking price (RMB per sq m)
Sunland Meilun Tower	Pudong	72,270	30,000
U Centre	Minhang	181,720	45,000

Source: Savills Research

Future project

Shanghai Huadian Centre

Shanghai Huadian Centre, developed by Huadian Corporation, is to be handed over in Q3/2016. Located in the Expo area, the development will be a three-minute walk to Expo Avenue metro station (line 13), and a ten-minute walk to China Art Museum metro station (lines 8) as well as the River Mall. The project consists of approximately 41,000 sq m of office space.

The office component of Shanghai Huadian Centre spans 17 floors. Typical floor plates will be 1,838 sq m, with whole floor efficiency of approximately 70 to 75%. The typical clear ceiling height is 2.8 m and raised floors are 140 mm. The office buildings will be serviced by ten passenger lifts.

Asking rents of Shanghai Huadian Centre range from RMB7.0 to 8.5 per sq m per day.

TABLE 5
Shanghai Huadian Centre

Location	Guozhan Road, Pudong
Developer	Huadian Corporation
Handover date	Q3/2016
Office GFA	Around 41,000 sq m
No. of storeys	17 floors
Typical floor plate	1,838 sq m
Whole-floor efficiency	70 – 75% Approx.
Typical Clear ceiling height	2.8 m
Raised floor	140 mm
Passenger lifts	10
Asking rent	RMB7.0 – 8.5 per sq m per day

Source: Savills China Research

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