

# Briefing Office sector

November 2016



Image: Raffles City Changning, Tower 2 and Tower 3

## SUMMARY

Some core leasing markets are beginning to feel the effect of supply-side pressures as decentralised landlords step up the competition for large tenants.

■ Supply in core areas totalled 150,000 sq m, pushing total stock to 6.9 million sq m. Office supply in the first three quarters of 2016 is up 46% year-on-year (YoY).

■ Net take-up in core markets fell to approximately 25,000 sq m in Q3/2016, bringing year-to-date (YTD) net take-up to 323,000 sq m, down 22% YoY.

■ Vacancy rates in core markets rose by 1.7 percentage points (ppts) quarter-on-quarter (QoQ) to 9.1%, up 2.0 ppts YoY. Average rents rose marginally to

RMB8.77 per sq m per day, up 0.5% QoQ and 1.8% YoY.

■ The decentralised market received two new projects with a total area of 68,000 sq m, raising decentralised office stock to 2.22 million sq m.

■ Decentralised market net take-up more than doubled QoQ to 205,000 sq m, causing vacancy rates to decrease by 7.2 ppts to 23.1%. Average rents in decentralised areas rose slightly by 0.3% to RMB5.50 per sq m per day.

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 “While the office sales market remains hot, some landlords who want to dispose of older projects in decentralised areas where demand is weaker, are looking for ways to convert floors of office buildings into residential units or serviced apartments, given the activity of the residential market in these precincts.” James Macdonald, Savills Research  
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## → Market commentary

### Core market

Net-take up in the core market was relatively weak in Q3/2016. This is attributed primarily to several projects in non-prime Puxi areas which have been unable to replace the flight of large P2P clients following increasing government regulation of the industry. At the same time, new projects in Puxi are finding it harder to fill vacancies following an exit of some clients to decentralised areas, which continue to receive large volumes of high-quality projects offering more affordable rents.

In contrast, take-up remained strong in Pudong, driven primarily by the financial services and technology sectors. New projects in both prime and non-prime locations boasted strong pre-commitment and occupancy levels, which gave landlords the confidence to raise rents.

### Decentralised market

The adoption of flexible sales and lease approaches by landlords of decentralised office projects has increased take-up in these areas. As a result, vacancy rates of decentralised areas improved noticeably over the past quarter, catalysing rental growth, albeit only slightly.

Non-finance multi-national companies (MNCs) seeking office expansions continue to relocate from central business districts to new, high-quality projects in decentralised areas. The greater affordability of these projects better suit the expansion needs of these companies, especially as many have become more cost sensitive in response to slowing economic growth. Among companies electing to move part of their operations further from the city centre was German manufacturing giant Thyssenkrupp, which leased 2,300 sq m in the Hongqiao Vanke Centre last quarter.

## Market News

### Government unveils plan for Seven new free trade zones

The government announced plans to launch seven new Free Trade Zones (FTZs) in Liaoning, Zhejiang,

Henan, Hubei, Sichuan, Shaanxi and Chongqing, bringing the total number to 11. The announcement came nearly three years after the launch of China's first FTZ in Shanghai, which has become the country's testing ground for financial reform, including the loosening of restrictions on international investment and outbound capital flows. The decision to launch new FTZs highlights the government's desire to push through with greater reform aimed at facilitating the development of the country's tertiary industries and the gradual opening up of the domestic economy.

The location of the new zones, primarily in Central and Western China, demonstrate the government's commitment to support the national development of the high-end service industry, namely the financial services, technology, fintech and e-commerce and trade sectors. As the commercial and financial centre of China, further economic liberalisation will only accelerate Shanghai's rise on the world stage, ultimately allowing the office market to compete with those of other international financial centres.

### China unveils measures to promote private investment

The nation's top economic planner unveiled policies this past quarter to encourage lagging private investment growth. The National Development and Reform Commission (NDRC) released a document outlining 26 measures aimed at promoting investment growth, improving financial services, reducing corporate costs and updating administrative services.

Lowering the barriers to entry for private investors should help inject new liquidity into the economy. This will generate new business, which in turn will lead to quicker growth of the high-end services industry. As more companies are established and grow in this sector, the demand for office space will only increase, helping the city absorb the current oversupply of office stock and catalyse the growth of emerging business districts.

### Co-working company earns first major corporate subscriber

Less than five months after opening

its first Asian branch in Shanghai, New York-based co-working space operator WeWork announced that international banking giant HSBC had agreed to rent 300 hot desks at its new Hong Kong location. While WeWork has several large corporate tenants in its American and European locations – Mercer, General Electric, KPMG, etc. – the demand for co-working space among big office occupiers has been virtually unheard of in the Asia Pacific region. The deal may help to relieve some of the speculation regarding whether co-working offices have the broad range of appeal needed to win clients other than start-ups and freelancers.

Competition in China's co-working space continues to heat up as existing brands seek to consolidate market share with a quick succession of new location launches. SOHO China now has 17 3Q spaces in Shanghai and Beijing, while former Vanke's boss's URwork has 10 centres across the country. Local co-working space start-ups have also grown rapidly, such as Shanghai-based Naked Hub, which has opened six new offices in the city. International brands remain bullish on the local market, with WeWork promising to continue its region-wide expansion after raising funding from Chinese investors.

As co-working markets become increasingly saturated by larger players with deeper pockets of VC funding, emerging brands will face a tougher time fighting for market share, and it is likely that many will be forced to exit the market. The ability of co-working space to attract large anchor tenants such as HSBC will cause more traditional office landlords to enter this market by sub-dividing spaces into hot desking stations or leasing space directly to a co-working operator, as some landlords of Grade-A projects in Shanghai have already done.

## Core Market

Three new projects – Century Link Tower 2 in Zhuyuan, Raffles City, Changning Tower 2, and Gopher City in Huangpu – brought 150,000 sq m to the core market in Q3/2016, continuing the supply-side boom which began earlier this year.

→ Located in the Zhongshan Park business area, with convenient access to the city's metro system, the 32,000-sq m Raffles City Changning Tower 2 recorded strong pre-commitment levels. This bodes well for landlord Capitaland which expects to handover the project's final office tower, the 80,000-sq m Tower 1, sometime in late 2017.

South Huangpu received its first new Grade A office project since 2012, with the handover of the 60,000-sq m Gopher City. The project is expected to encounter rising competition from several projects scheduled to enter the surrounding South Huangpu business area over the next two years.

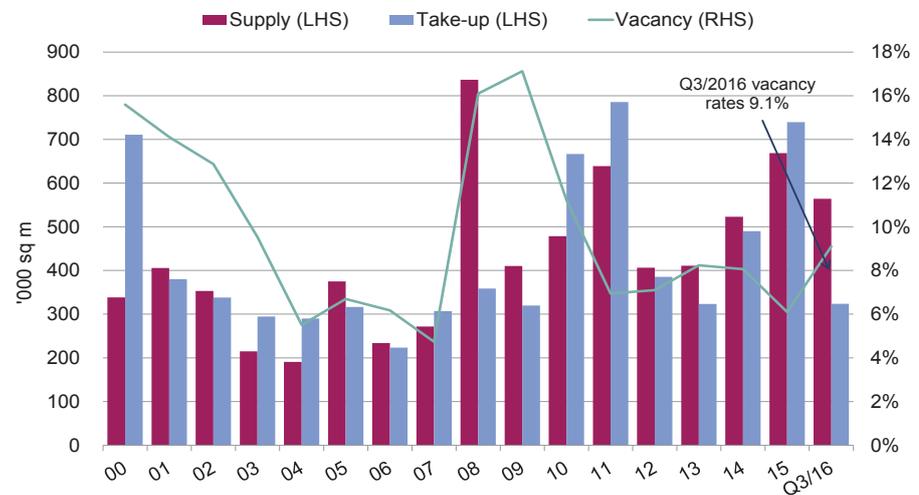
In the first three quarters of 2016, core market Grade A office supply was 46% higher compared to the same period last year. However, while the growth of demand for office space has continued, driven primarily by the city's developing service sector, core market net take-up has fallen by approximately 22% YTD. This is largely due to the exit of many P2P companies from the market entirely, increasing tenant outflows to more affordable decentralised areas, and delays in closing a number of large leasing and sales transactions this quarter.

In response to the influx of new supply, vacancy rates in both the Hongqiao and Zhuyuan areas rose. Vacancy rates in the Huaihai Road (M) and Xujiahui areas also increased, caused by a loss of tenants. Landlords of older projects continue to offer rental incentives or longer fit-out and rent-free periods in order to attract large anchor tenants, which is expected to stymie the pace at which existing tenants are relocating to emerging business areas.

Core market rents remained flat in Puxi during Q3/2016, while they rose in both prime and non-prime Pudong, by 0.7 and 1.8 ppts, respectively.

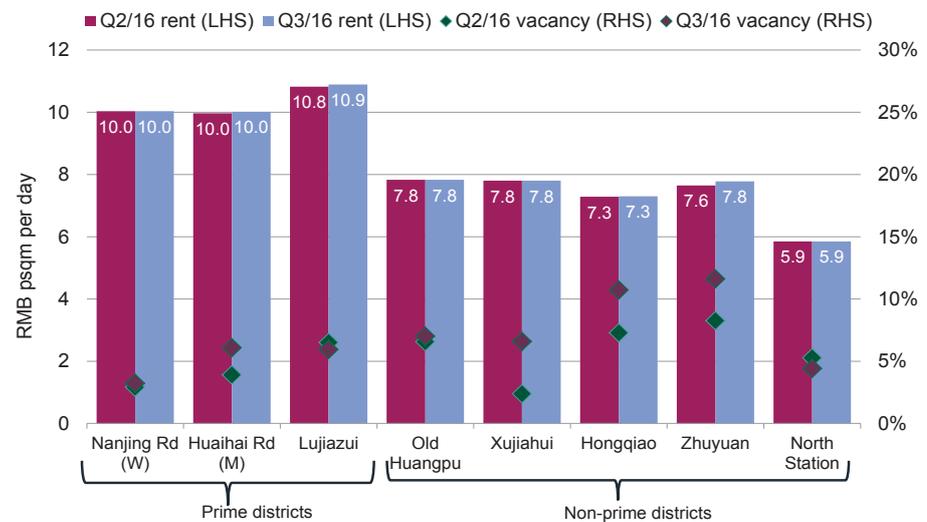
City-wide, core office rents recorded a small increase in Q3/2016, to RMB8.77 per sq m per day, pulled up by rising rents in Pudong's Lujiazui and Zhuyuan areas, reflecting a growing discrepancy between projects on opposite sides of the

GRAPH 1 Grade A Core Market Supply, Take-up & Vacancy 2000-Q3/2016



Source: Savills Research

GRAPH 2 Business district comparison, rent vs. vacancy rate, Q2/2016 and Q3/2016



Source: Savills Research

TABLE 1 Selection of leasing transactions, Q3/2016

Tenant	Project	District	Area leased (sq m)
Jun He Law Firm	HKRI Taikoo Hui	Jing'an	6,000
Willis Insurance	Century Link	Pudong	6,000
Founder Meiji Yasuda Life Insurance	Oriental Financial Plaza	Pudong	2,360
Kobelco Trading	Gopher Centre	Huangpu	1,200
Bocorn Wincent	Raffles City Changning	Changning	740

Source: Savills Research

→ river. The preferred location for the city's quickly expanding financial services and technology sectors, new projects in Pudong have continued to achieve high levels of pre-commitment and occupancy, giving landlords the confidence to ask for higher rents.

In contrast, rents in Puxi have come under pressure from landlords of projects in non-prime areas, who are looking to attract large anchor tenants with lower face rents and longer rent-free periods in anticipation of the large volume of supply expected to enter the market over the next two years.

The recent transition to Value Added Tax has also increased face rents for some tenants as landlords look to lessen their own tax burden. However, the majority of tenants should be able to offset these increases as a business cost under the new tax regime, keeping the effective rent the same.

### Sales Market

#### Overview:

In Q3/2016, 34 office projects with a total GFA of 676,000 sq m received pre-sale certificates. Though 30% fewer QoQ, the number of certificates granted is equal to the quarterly average of the past two years. While obtaining a permit does not exclude a landlord from leasing space in a project, the large amount of pre-sales permits reflects how landlords are increasingly considering flexible sales and lease strategies to increase occupancy levels in their projects as city-wide vacancy rates begin to

creep upwards. Of the projects that received pre-sales certificates last quarter, 12 projects, accounting for 317,000 sq m, were located within the middle ring road.

A similar amount of office space was transacted in Q3/2016 as in the previous quarter, approximately 686,000 sq m. The total consideration for first-hand office transactions stood at RMB21.6 billion, with an average transaction price of RMB31,600 per sq m. The above figures include strata-title deals and en-bloc asset deals where property certificates exchanged hands.

#### Large Transactions

Activity in the office investment market remains hot. Five major

deals, with a total consideration of RMB9.137 billion, were transacted. Rising property prices continue to compress gross yields, which fell by 0.1 of a ppt QoQ to 5.2%, while net yields stood at 3.9%.

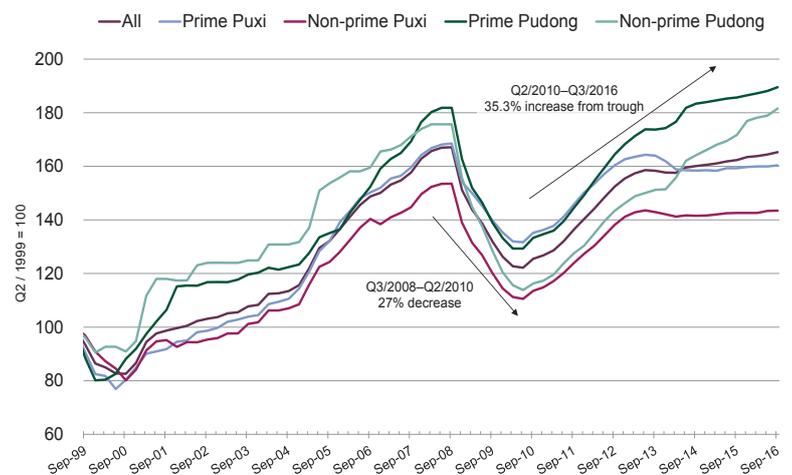
Investors remain interested in core assets with stable rents that they can hold for long-term lease hold and partial self-use. At the same time, rising capital value growth has motivated some domestic developer landlords and international private equity funds to cash in existing assets for higher returns.

#### Strata-Sale

Hongqiao R&F Centre was the largest project to receive pre-sales certification in Q3/2016. The project, which is located in the intersection

GRAPH 3

### Core market Grade A office rental indices, Q2/1999 –Q3/2016



Source: Savills Research

TABLE 2

### Notable sales transactions, Q3/2016

Property	Location	Total (RMB mil)	Price (RMB/sq m)	Buyer	Usage
SOHO Century Plaza	Pudong	3,221	75,700	Guohua Life Insurance	Lease
Wise Logic International Centre	Jing'an	829	26,407	Sino-Ocean Land	Lease
Hongqiao Zhengrou Centre T2	Minhang	430	34,838	Glodon	Self-Use
The Tower at Jinqiao Life Hub (80%)	Pudong	3,412	37,174	Chongbang Group	Lease
Standard Chartered Tower (49%)	Pudong	1,245	65,963	Shanghai Life	Self-Use

Source: Savills Research

area of the Shenhong and Huaihong roads in the Hongqiao Transportation Hub, is expected to earn an average price of RMB43,000 per sq m.

The other project that drew attention was Upper West, developed by Hutchison Whampoa. The project is located in the Zhenru area of the Putuo District, and consists of residential apartments, executive mansions, office blocks, a retail podium and hotels.

Prices based on a basket of roughly 40 premium-quality office projects that were analysed on an un-weighted index basis remained flat at RMB44,830 per sq m.

It is not unheard of for owners of older projects to try and change their project's title when there are fewer buyers of a particular asset class. For example, in the past few years, a number of hotel owners have converted floors of older projects into office space in order to capitalise on the hot strata-sales market. At present, it is rumoured that some landlords of office projects in non-core locations where the office strata-sales market is weaker are considering converting some

floors into apartments or serviced residences, which they believe will give them a better return on investment due to the recent activity seen in the city's residential property market.

### Market outlook

In the remainder of the year, the core market is expected to receive a further 450,000 sq m of Grade A office space, the majority of which will be located in Puxi. Another 1 million sq m will come onto the decentralised market. Approximately half of this will be located in the Hongqiao Transportation Hub area, while the Expo area is expected to receive 25%.

With the city-wide supply boom expected to extend through 2017, landlords of new and existing projects will be squeezed to fill vacancies. Already some landlords in non-prime Puxi have begun to adopt more flexible leasing strategies, similar to those already utilised by landlords in decentralised areas. As new projects continue to offer below-market rents to large anchor tenants in order to boost pre-lease commitment numbers, existing projects will have to adjust rates or

offer other incentives to attract and keep tenants. Landlords of older projects in the CBDs have already begun to increase fit-out and rent-free periods for preferred tenants to five or even six months from the standard market practice of two to three months. At the same time, rental growth of these projects has stagnated and will likely remain flat, if not decline, in the coming months, slowing city-wide rental growth.

From a tenant's perspective, market conditions are expected to improve over the next 12 to 18 months. Companies will have an ample supply of new projects to choose from, especially in Puxi, in both established and emerging business districts with good surrounding infrastructure and supporting amenities. Landlords in core markets are expected to keep rents flat or offer other advantages to large anchor tenants in order to keep them from moving to neighbouring projects or those in decentralised areas. In time, this will slow or even reverse the trend of companies moving their offices to emerging districts. ■

TABLE 3 **First-hand, strata-title transactions Q3/2016**

Project	District	Transacted GFA(sq m)	Average price (RMB per sq m)
Chuangfu Centre 创富中心	Zhabei	6,700	33,600
Hongqiao Zhengrou Centre 虹桥正荣中心	Minhang	1,800	37,000
Rongxin Greenland Business Plaza 融信绿地商务广场	Minhang	1,600	24,500
RCITIC Plaza 中信广场	Hongkou	2,300	44,700

Source: Savills Research

TABLE 4 **Key pre-sale supply, Q3/2016**

Project	District	Supply (sq m)	Start asking price (RMB per sq m)
Hongqiao R&F Centre 虹桥富力中心	Minhang	58,000	43,000
Upper West (A6) 高逸尚城 (A6地块)	Putuo	43,000	51,000

Source: Savills Research

## Future project

### Capitaland Square

Capitaland Square, developed by Singaporean-based Capitaland Group, is located in the New Jingan District (the former Zhabei district). The development will be directly linked to Hanzhong Road metro station (lines 1, 12, and 13), and a five-minute walk to the Everbright City commercial area as well as a 15-minute walk to the Nanjing Road (W) commercial area. The project has approximately 55,000 sq m of office space, which is expected to enter the market in Q2/2017. Capitaland Square will be followed by a 15,000-sq m retail podium, expected to open in late 2018. Based on a comparison of similar projects in the area, the starting asking rent is forecast to be between RMB7.5 to RMB9.0 per sq m per day.

TABLE 5  
**Capitaland Square**

Location	New Jingan District, Hangzhong Rd.	
Developer	Capitaland	
Handover date	Q2/2017	
Office GFA	Approximately 55,000 sq m	
No. of storeys	Floors 8-30	
Typical floor plate	2,344-2,375 sq m	
Typical Clear ceiling height	2.80 m	
Raised floor	150mm	
Passenger lifts	10	
Asking rent	RMB7.5-9.0 per sq m per day	

Source: Savills China Research

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