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Savills World Research
Shanghai

Briefing
Office sector

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Image: Sinar Mas Centre

SUMMARY

Oversupply concerns abound as the non-prime Puxi and decentralised office markets kick-start the year with large supply influx.

- Six new Grade A projects, with an aggregated office GFA of 380,000 sq m, entered the market in Q1/2017, increasing core office stock by 5.4% to 7.42 million sq m.
- Strong demand in the first quarter saw core market net take-up reach 305,000 sq m (including self-use).
- Vacancy rates in the Grade A core office market rose by 0.6 of a percentage point (ppt) quarter-on-quarter (QoQ), to 9.0%, up 3.4 ppts year-on-year (YoY).
- Supported by rental growth in Pudong, the average core market rent increased by 0.3% QoQ to RMB8.97 per sq m per day, up 2.5% YoY.
- Decentralised market supply reached 470,000 sq m in Q1/2017, following the handover of seven new projects, which pushed stock to approximately 2.70 million sq m.
- Decentralised market vacancy rates increased by 2.9 ppts in Q1/2017, to 25.7%, while average rents increased by 2.5% QoQ to RMB5.7 per sq m per day.

"As new projects are handed over and infrastructure improves, the development of large, master-planned business areas will play an increasingly vital role in the evolution of the city's economy and Grade A office market." James Macdonald, Savills Research

Market News

China to further open economy to foreign capital

China's Cabinet outlined new measures aimed at increasing foreign investment into the domestic economy. Under the new policy, the government eased investment limits into banks and other financial institutions. While it remains unclear when the new regulations will come into effect, the measures support the stance taken by China's President Xi Jinping last year against growing protectionism and nativism seen in many Western countries. The government also announced that multinational companies would soon be allowed to list themselves on both the Shanghai and Shenzhen exchanges and issue bonds in China, as well as a relaxation of current restrictions placed on foreign investment into a variety of sectors. The continued loosening of foreign investment regulations should ensure the steady growth of foreign direct investment into China, which rose 4.1% YoY in 2016, to RMB813 billion, on the back of strong investment into the domestic service industry.

The loosening of restrictions on foreign investment will encourage multinational companies to enter and expand in China. The emphasis the new measures place on relaxing guidelines for overseas financial institutions should especially benefit Shanghai as the capital of China's financial and professional services industries, generating new occupier demand for the city's Grade A office market. Districts and business areas that offer the greatest incentives to multinational enterprises, and the highest liveability and educational standards for their international workers and their families, as well as possess mature business environments with vibrant industry clusters, stand to benefit the most.

Shanghai consolidates place as China's MNC headquarter capital

The Shanghai government has rolled back regulations for overseas companies establishing headquarters in the city. Under the new Regional Headquarters Provisions announced on 27 January, all types of foreign-invested enterprises with a minimum registered capital of US$2 million are now eligible to apply for status as a regional headquarters (RHQs). Previously, only foreign-invested holding companies and foreign-invested management companies that met the capital requirement were allowed to apply. Additionally, for enterprises engaged in the service industry, total asset requirements of the parent company were reduced to US$300 million from US$400 million. Conditions for functional RHQs, such as office and staff size, have also been removed, while a rule stipulating the number of enterprises to be held by a parent company in order to be classified as a RHQ was reduced from three to two.

The new rules will help more companies set up RHQs in Shanghai, which will allow them to enjoy financial support, easier cross-border money management and faster customs clearances, while their employees receive easier entry-exit procedures, assistance in education for their children, and medical services. RHQs can also benefit from certain fiscal subsidies and incentives offered by the Shanghai Free Trade Zone as well as specific business districts. The new rules will solidify Shanghai's role as China's international financial centre, which in turn will continue to help generate new demand for the city's Grade A office market from international companies as well as the domestic services sector. Thanks to the city's growing influence, Shanghai is already home to the regional headquarters of more than 573 multinational corporations.

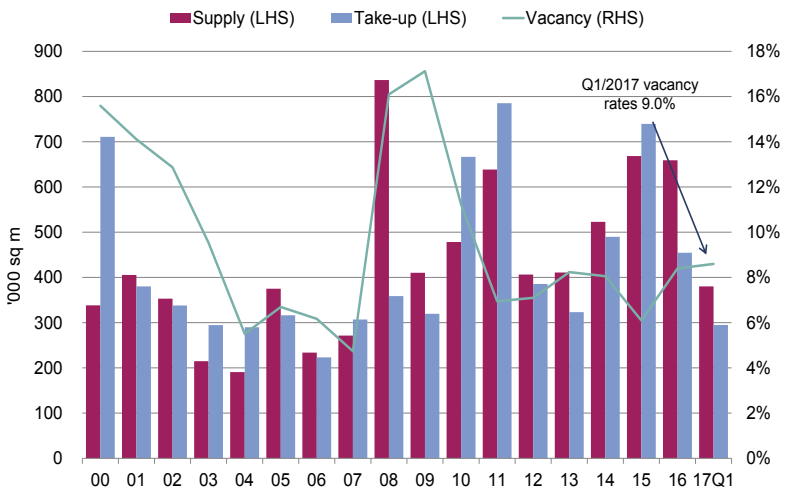
Government regulators crack down on commercial-titled apartments

In its latest attempt to cool the overheating national housing market, the government has cracked down on a growing number of investors who have purchased commercial and office properties, converted them into residential units, and then sold them on. Converted apartments, which typically sell below market value of a similarly sized apartment in the same area, have become increasingly popular due to the increasing unaffordability of housing due to red hot demand and the shrinking supply of new residential land. While local governments have been tolerant of conversions due to the tax revenues they generate, pressure from Beijing to reign in unfettered housing prices has resulted in a recent clampdown on commercial apartment sales, which have previously avoided the same home purchasing restrictions as general residential properties, meaning individuals, including non-residents, could purchase as many units as they liked.

In Shanghai, the government froze online purchases of commercially-titled properties in January, to allow

GRAPH 1

Grade A Core Market Supply, Take-up & Vacancy 2000-Q1/2017



Source: Savills Research

the government to investigate existing projects, while some districts such as Minhang and Jiading delivered an ultimatum to developers in February to tear down apartment partitions and restore the original office contours. Beijing took an even harsher stance, banning the sale of commercial properties to individuals outright and even terminating the licences of Nasdaq-listed Fang Holdings for violating rules that restrict brokerages from marketing flats converted from office space. The crackdown on commercial apartments is not expected to abate soon and will likely result in a decrease of office sales, especially strata-title projects in non-core office locations, where conversions typically occur.

Core Market

Supply, take-up & vacancy

Kicking off what is forecast to be a year of peak supply, the city's core office market received six Grade A projects totalling 380,000 sq m in the first three months of the year. While the volume of new supply increased the core market vacancy rate by 0.6 of a ppt QoQ to 9.0%, the vacancy rate among existing buildings decreased by 2.3 ppts QoQ to 6.1% on the back of strong performances by a number of prime projects. Core market absorption levels remained robust due to strong take-up in Prime Pudong and the handover of one self-use project, with net-take up exceeding 305,000 sq m during the period.

As the recipient of all new supply in Q1/2017, Puxi's secondary Grade A office stock increased by 17% QoQ, to 2.22 million sq m. The Hongkou district's North Bund area received the largest amount of new supply, 245,000 sq m. The majority of take-up (approximately 185,000 sq m) also occurred in Puxi's non-prime market, where the availability of new, high-quality projects and its maturing business environment attracted many tenants. Nonetheless, due to the large number of projects handed over, the market still witnessed a sharp rise of vacancy rates to 17.6%, an increase of 7.7 ppts QoQ and 8.2 ppts YoY.

In contrast, Prime Puxi saw vacancy levels decline in Q1/2017, by 1.2 ppts QoQ to 5.1%. While negative take-up and the handover of HKRI Taikoo Hui Tower One in the latter half of 2016 pushed vacancy rates up from a low of 2.7% recorded in Q1/2016, the absence of new projects last quarter, combined with strong demand for prime projects along Nanjing West Road, provided the market with a respite to absorb existing vacant space, even as it braces for the arrival of the Taikoo Hui project's second tower next quarter which will add a further 65,000 sq m of office space.

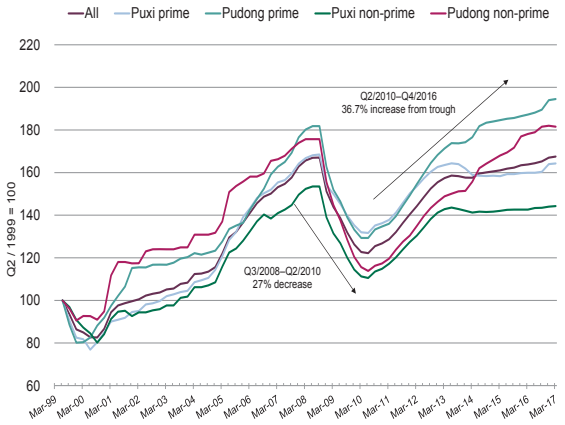
On the opposite bank of the Huangpu, strong demand from domestic financial services and technology sectors continues to lift Pudong's core office market, with net take-up reaching 140,000 sq m this quarter. After experiencing lukewarm demand in 2H/2016, as a result of a few highly anticipated projects failing to meet leasing expectations, strong demand for projects in prime Pudong helped lower the area's average vacancy rate by 3.0 ppts to 2.9%, the lowest in the city. Due to limited space in the Lujiazui CBD, spill over demand continues to benefit Pudong's secondary office market, which saw vacancy rates drop by 5.3 ppts to 7.3%.

Rent

The city's average core office rent rose again in Q1/2017, by 0.3% QoQ and 2.5% YoY, to RMB8.97 per sq m per day. However, the period of peak supply the city entered in the second half of 2016 has begun to have an effect on even the most resilient prime markets, causing quarterly rental growth to decline by 0.8 of a ppt compared to the previous quarter.

GRAPH 2

Core market Grade A office rental indices, Q1/1999-Q1/2017



Source: Savills Research

Higher rents in Pudong's Lujiazui CBD continued to help underpin city-wide rent growth in Q1/2017, increasing by 0.5% QoQ, albeit a far cry from the 1.6% growth rate achieved in the previous quarter. This decrease can be attributed to several projects failing to meet leasing expectations, forcing landlords to curtail rental hikes to attract tenants who now have a growing list of new, high-quality and more affordable buildings to choose from in non-prime Pudong and other emerging business areas.

Non-prime Puxi also contributed to city-wide rental growth in Q1/2017, with the average rent increasing for the first time in twelve months, by 0.5% to RMB7.26 per sq m per day. After the first three quarters of 2016 saw vacancy rates in this submarket skyrocket due to the sudden flight of

TABLE 1

Notable leasing transactions, Q1/2017

Tenant	Project	District	Area leased (sq m)
Shimadzu	China Fortune Project, Phase 2	Xuhui	10,600
Pepsi Co	Gopher Center	Huangpu	7,000
MetLife	Landmark Center	Hongkou	3,500
Jebsen	East Ocean Centre II	Huangpu	3,185
Suntory	Kerry Parkside	Pudong	1,300

Source: Savills Research

many P2P tenants due to increasing government regulation of the industry, as well as the handover of several new projects, demand for non-prime Puxi rebounded in the past three months, namely in the North Bund, Hongqiao and North Station (former Zhabei) areas.

Rents in prime Puxi stagnated, despite consistent demand for office space in the area, due to high volumes of new supply in the latter half of 2016, resulting in an uptick of vacancy rates which saw landlords offer more favourable terms. Meanwhile, non-prime Pudong registered no quarterly rental growth, though rents still remain up 4.0% YoY, signalling that three straight quarters of rental hikes last year may have finally caught up with landlords who are beginning to feel squeezed by new competitors in emerging locations.

Submarkets

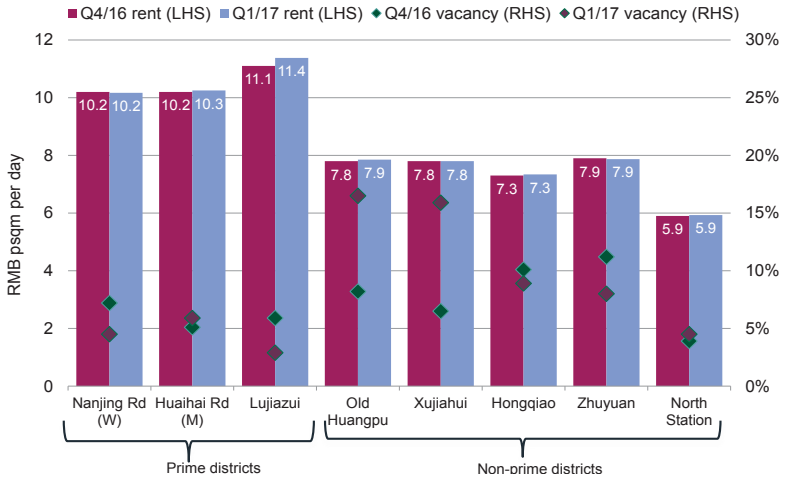
Of last quarter's supply, over half entered the market in the Hongkou District's North Bund business area, which received three new projects – Financial Street Hailun Centre, Yifang Tower and Shanghai Landmark Centre – with an aggregate GFA of 245,000 sq m.

The North Bund Area, which ended a four-year office supply drought with the handover of Star Bund in Q3/2016, continues to possess a relatively underdeveloped office market compared to other non-prime business areas, despite its convenient location near the city's Lujiazui CBD and historical Bund area. However, with historical levels of supply outstripping current demand, vacancy rates will continue to rise.

After Hongkou, the Huangpu district witnessed the greatest influx of new supply in Q1/2017, with the handover of two projects totalling 108,000 sq m. The first, Oriental Securities, is a two-tower project located in South Huangpu, with an office GFA of 112,000 sq m. Tower One (76,000 sq m) is fully-owned and occupied by Oriental Securities Co., while Tower Two entered the leasing market last quarter, adding 36,000 sq m of office space. SOHO's Bund IFC brought an additional 81,000 sq m of office space to the market, following the handover of the first of two towers scheduled to enter the market this year. The added supply put further pressure on the Huangpu submarket, causing vacancy rates to rise by 3.2 ppts QoQ to 14.0%, while rents remained flat.

GRAPH 3

Business district comparison, rent vs. vacancy rate, Q4/2016 and Q1/2017



Source: Savills Research

The performances of Puxi's two prime office markets – Nanjing West Road and Huaihai Middle Road – showed further divergence in Q1/2017.With the handover of Swire's Taikoo Hui Building in Q4/2016, the Nanjing West Road CBD saw vacancy rates rise by 4 ppts to 7.2% after hovering around the one to three percent mark for much of the past few years. However, given the popularity of the business area, especially among multinational companies, market absorption has remained strong, with approximately 25,000 sq m of net-take-up seen last quarter, resulting in a 2.7 ppt quarterly decrease in the average vacancy rate.

In contrast, due to the lack of available new supply, the Huaihai Middle Road CBD recorded negative take-up as an increasing number of tenants chose to relocate to newer and more affordable projects in non-prime business areas. As a result of the exit of several tenants from older projects, vacancy rates along Huaihai Middle Road increased by 0.7 of a ppt QoQ to 5.9%. With no projects expected to enter the submarket until the handover of Capital Tower in 2019, Hauihai Middle Road vacancy levels should increase as the leases of tenants in aged buildings gradually expire, giving them the option to look elsewhere.

After experiencing an influx of new projects in the latter half of 2016, the Lujiazui CBD regained its position as the business area with the lowest vacancy rates in the city, at 2.9% in Q1/2017, down 3.0 ppts from the previous quarter. Strong demand from financial services and technology companies continued, giving landlords the confidence to raise rents, which increased by 0.4% to RMB11.38 per sq m per day, the highest in the city. Strong demand from Lujiazui spilled over the border into neighbouring Zhuyuan, where vacancy rates decreased 3.2 ppts to 8.0%.

Decentralised market

After construction delays resulted in no new decentralised supply in Q4/2016, the market braced for a flood of new space in the subsequent quarter. The first three months of 2017 lived up to this expectation, with approximately 470,000 sq m entering the city's decentralised submarkets, pushing decentralised office stock up to 2.70 million sq m.

In response to the handovers, the average decentralised market vacancy rate rose by 2.9 ppts to 25.7%, but remained down 4.6 ppts YoY. However, the absence of supply

in the previous quarter gave some landlords of existing, high-quality projects the confidence to raise rents, resulting in an increase of the average decentralised market office rent by 2.8% QoQ to RMB5.9 per sq m per day.

The development of the city's decentralised office market continues to shift towards several master-planned business areas, namely Hongqiao Transportation Hub (HTH) and the New Bund Area, which comprises both Qiantan and the Expo business areas.

Both Qiantan and Expo welcomed their first Grade A office projects in Q1/2017. Two projects were handed over in the Expo area with an aggregated office GFA of 140,000 sq m. Combined, the two projects achieved a pre-leasing rate of approximately 50% at the end of the quarter. Qiantan's new project added 78,000 sq m of office space, of which 80% has been occupied or committed by the end of March. The newly-launched projects achieved achievable rents above the decentralised market's average between RMB6.0-6.5 per sq m per day.

Sales Market

Overview

The office investment market witnessed 256,000 sq m of deals concluded in Q1/2017, approximately a third of the volume recorded in the previous quarter. The total consideration for transacted deals reached RMB11.93 billion, down 62% QoQ.

With the occurrence of the traditional slow period of the year, caused by the Chinese New Year holiday, as well as the unusual frenzy of activity seen in the final quarter of 2016, it is no surprise that the first quarter saw a notable decrease in office deals. However, given the existing regulatory environment, which has seen the government encourage more foreign direct investment while simultaneously tightening regulations governing overseas capital outflows, more capital is expected to find its way into the city's office investment market this year, leading to an uptick in transaction and consideration volumes.

The above figures include all first-hand, strata-title and en-bloc asset deals where property certificates exchanged hands.

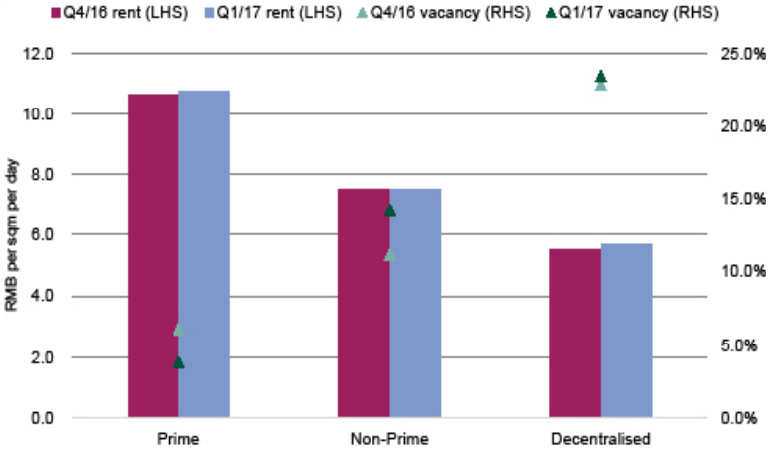
En-bloc

In response to softening market fundamentals, domestic investors and buyers continue to look for long-term investment opportunities, or for end-user headquarter acquisitions. Notable deals include: Zhong Rong Trust acquired Silver Tower for RMB3.5 billion; the Xuhui district government purchased Xuhui Vanke Centre Phase 2; and Jiangsu Yancheng Investment acquired Poly Greenland Square B1 and the C1-C2 buildings for at least partial self-use.

International funds remained interested in value-added opportunities that play to their strengths, such as BlackRock's purchase of Central Park Tower for RMB1.37 billion, and Ascendas-Singbridge Group's purchase of the Baolong building for RMB1.32 billion.

GRAPH 4

Prime, non-prime & decentralised market comparison, rent vs. vacancy rate, Q4/2016 and Q1/2017



Source: Savills Research

TABLE 2

Notable sales transactions, Q1/2017

Property	Location	Total (RMB mil)	Price (RMB/sq m)	Buyer	Usage
Central Park Tower	Putuo	1,372	43,286	Blackrock Group	Lease
Xuhui Vanke	Xuhui	2,716	47,000	Xuhui Government	Self-use
Silver Court	Huangpu	3,500	60,057	Zhong Rong Trust	Lease
Baolong Building	Huangpu	1,319	53,000	Ascendas-Singbridge Group	Lease

Source: Savills Research

Limited alternative investment options continued to place downward pressure on yields, which fell by 0.1 of a ppt QoQ to 4.8%, while net yields stood at 3.9%.

Office assets continue to attract the majority of demand in the city's investment market, accounting for 88% of all transaction considerations in Q1/2017, of which 32% were acquired for at least partial self-use.

Strata-sale

Prices of strata-title offices sold within the inner-ring road last quarter averaged RMB41,114 per sq m. All recorded sales occurred outside the city centre, with the majority located in the Zhabei district, followed by Putuo, Yangpu and Changning, respectively.

No notable projects received pre-sales certification in Q1/2017, a significant decrease in strata-title supply over the previous quarter. The decline is believed to be attributed to the uncertainty of the strata-title market, which until recently has benefitted from a surge of investors intending to purchase and convert office space into residential units given the surge of demand for residential property. However, with the legality of such commercial-to-residential property conversions called into question by the municipal government this quarter, with a government freeze of commercial-title apartments coming into effect in January, and certain districts going as far as to order developers to restore original office formats, strata-title investment will likely decrease in the short- to mid-term.

Market Outlook

The core office market will receive five additional projects in Q2/2017, adding a further 380,000 sq m of office space. All projects in the pipeline for the second quarter are located in Puxi, which will continue to put pressure on vacancy rates and rental growth on the west bank of the Huangpu. Puxi's non-prime business areas account for a majority of the supply, with only one project –Taikoo Hui Tower Two – expected to enter the prime Puxi market next quarter. While the arrival of Swire's new tower along Nanjing West Road should temporarily increase vacancy rates in the CBD, strong demand and the absence of future supply until 2018 will ensure that the rise of vacancy rates will only be temporary in the submarket.

The decentralised market expects to receive a further 1.2 million sq m of Grade A office space in the remainder of 2017, of which Hongqiao Transportation Hub (HTH) will account for approximately 940,000 sq m. Although construction delays may push some handover dates into early 2018, HTH is expected to enter a later stage of development at the end of 2018, with supply levels dropping off between 2019 and 2020.

New master-planned business areas such as Qiantan and the Expo area began to receive their first Grade A office projects in 2017. With the development of HTH winding down, decentralised market supply and take-up is expected to slowly shift towards these two new areas, given strong government support including the development of surrounding infrastructure and supporting facilities. A fourth master-planned business area, Xuhui Binjiang, will receive a large volume of new supply over the next three years (2017-2019). Also over this three-year period, Qiantan and the Expo areas expect to receive approximately 915,000 sq m of new office space, of which 70% will be located in Qiantan. The handovers will cause vacancy rates to increase over the short-term, stagnating rental growth, especially as the city-wide market enters a period of high supply. However, the long-term development of the New Bund area is positive, given growing demand from the city's tertiary sector and improving connectivity between the area and Pudong's more developed office markets.

The market outlook continues to tilt in favour of tenants as historical high levels of new supply in both core and decentralised markets increase city-wide vacancy rates. With an ample selection of new, high-quality projects and emerging business areas, as well as a greater variety of flexible office formats for tenants to choose from, landlords, in particular those of aged or poorly-managed projects, will have no choice but to offer rental incentives, more generous lease terms, or increase agency commissions in order to attract and retain anchor-tenants.

While demand for co-working space from the city's quickly growing start-ups and IT companies continues to increase, it remains unclear if current supply has already outpaced demand, given the pace of new shared office centre openings by large domestic and overseas players. However, as many of the larger operators are backed by serious capital, it is likely that the pace of expansions will continue as they opt to bleed capital in the short-term to grab long-term market share in one of the world's largest markets for co-working space. However, as a result of increasing competition, expect further industry consolidation as smaller players are run out of business or gobbled up by an increasing number of developers, landlords and serviced-office companies looking to enter the market with their own brands.

TABLE 3

First-hand, strata-title transactions, Q1/2017

Project	District	Transacted GFA(sq m)	Transacted Price (RMB per sq m)
Zhejiang Greentown Changfeng Centre	Putuo	840	41,317
Greenstar Plaza	Zhabei	1,600	25,070

Source: Savills Research

Future project

HKRI Centre Two

The second tower of HKRI and Swire Property's flagship project, HKRI Centre Two, is scheduled for handover in Q2/2017. The 170-m HKRI Centre Two comprises 65,000 sq m of office space across 36 floors. Located along Nanjing West Road in the heart of Jing'an, one of the city's core business districts, HKRI Centre Two offers its clients a centralised location with access to superb transportation infrastructure to the entire city. Two of the city's main expressways, the Yan An expressway and North-South expressway, are located in the vicinity, as is one of the city's main Metro hubs – Nanjing West Road Metro Station (Lines 2, 12 and 13). The surrounding area includes many high-end shopping malls, restaurants and luxury apartments.

Starting asking rents begin at RMB11 per sq m per day, while management fees are RMB45 per sq m per month.

TABLE 5

HKRI Centre Two

Location	Jingan District Nanjing West Road/Wujiang Road
Developer	Swire, HKRI Properties
Handover date	Q2/2017
Office GFA	65,000 sq m
No. of storeys	6F - 35F
Typical floor plate	Approximately 2,100 sq m
Typical Clear ceiling height	2.8 to 3.3 m
Starting asking rent	RMB11-13 per sq m per day
Management Fees	RMB45 per sq m per day

Source: Savills China Research

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