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Briefing
Snapshot – China's hidden office vacancy

September 2012

Origins

As China's central bank continues cutting interest rates, launching liquidity-easing measures and engaging in further stimulus, we can't help but hark back to the massive stimulus package unveiled in 2009/2010, the largest ever attempted. In its wake, banks, financial institutions and insurance companies, along with other state-owned enterprises (SOEs) (believed to be the primary recipients of the stimulus), used their new influx of stimulus-package capital to rapidly grow their businesses and hence lease more office space, in some cases acquiring office towers. This manifested most prominently in Shanghai's Lujiazui area, although many other districts and cities throughout China have seen similar stories unfold.

Many state-owned banks including Agricultural Bank of China, China Construction Bank and Industrial and Commercial Bank of China (the world's biggest bank by market value), to name only a few, are now finding that rising funding costs are contributing to increased pressure on margins, according to a recent report by Mirae Asset Management. This issue is only compounded by the slowing growth in the general economy, which could cause considerable uncertainty over whether these institutions will want to maintain their properties as entirely self used.

While Beijing's vacancy rate is hovering around 3.4%, the lowest level ever recorded, and Shanghai's vacancy rate of 5.7% is nearing its historical low, the potential return of excess leased space or repurposing currently self-used space gives rise to 'hidden' vacancies, something which is difficult to account for in vacancy figures and forecasts.

Image: Yitong

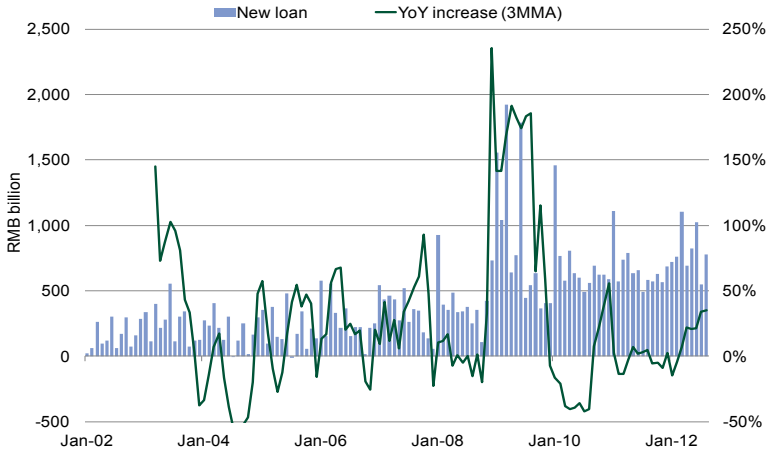
Inefficient space usage by SOEs

One consistent feature of SOEs, regardless of location, is their inefficient use of space. While non-SOEs are estimated to typically apportion one employee to every 7 sq m to 10 sq m (based on an average of six Chinese cities), the

> "I recently visited an SOE firm's office which occupied a whole floor (approximately 1,500 sq m) used by only four senior management employees."
>
> Shanghai commercial agent

GRAPH 1

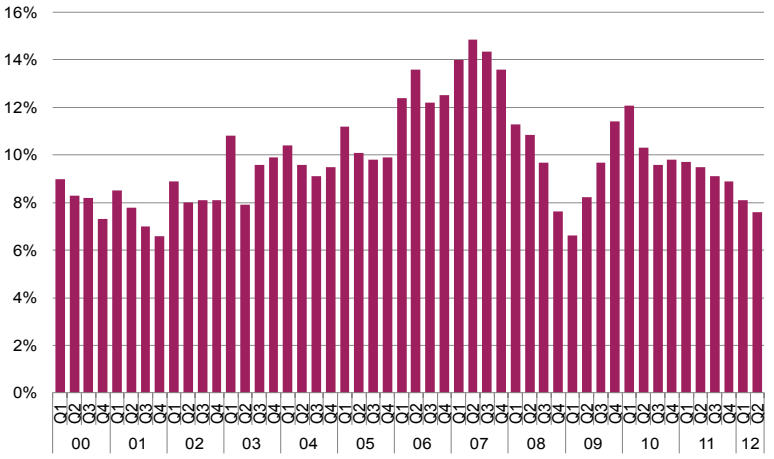
New loan issuance



Source: People's Bank of China, Savills China Research

GRAPH 2

China GDP growth rate



Source: People's Bank of China, Savills China Research

average Chinese SOE is estimated to use closer to 15 sq m to 25 sq m per employee workstation, although this will vary greatly depending upon industry and management level. This unnecessary use of space is particularly hard to justify in the face of a slowing economy. Should rents continue to increase, the overhead for these SOEs or the missed revenue from leasing self-owned space may be such that they will need to shrink their per capita space usage and return stock to the sales or leasing market.

Self-occupied space – owning more than you need

Both Beijing and Shanghai saw relatively large percentages of their stock accounted for by wholly and partially[1] self-occupied properties, at roughly 21%. These cities are the key economic powers in China and justify larger presences for major industry leaders. Beijing obviously attracts companies looking to be closer to the key decision makers in the central government, while also being home to many domestic institutions, both SOE and private. As one of China's most multicultural and cosmopolitan cities, Shanghai attracts a range of multinational corporations (MNCs), while simultaneously serving as a gateway to the rest of the world and a premier, central-government-sponsored international finance and shipping centre.

1 Majority or sole ownership in a building and not occupying a proportion themselves.

Maintaining a larger business presence increases overheads significantly and also limits the number of leasing options available to the tenant – no leasable project wants to allocate more than roughly 30% of their project to one tenant as that would leave them exposed should the tenant ever decide to leave. In order to eliminate the risk of rising rents and to secure premises, many will turn to either buying or developing premises themselves, either occupying all the space or leasing part of it back to the market – hence self use (whole) and self use (partial). While cities other than Shanghai and Beijing do have larger corporations occasionally buying space for self use, they are seldom large enough to occupy all the space themselves.

The remaining partially self-used projects are occupied by the developer or investor landlords after having developed or acquired the building.

Self occupation in itself is seen to be a good thing for local markets as it shows faith in the long-term business operations of a company, reaffirms the desirability of the asset class and signifies the belief that prices and rents will continue to rise (and therefore rising overheads need to be mitigated), giving investors another exit strategy for divestments. However, the rapid acquisition of office space for "self use" that has occurred over the last two to three years is not necessarily justified in terms of the business requirements of the companies which have done the purchasing. Companies have acquired more space than is currently needed or could be needed in the next three to five years without staggering rates of growth, which given the economic situation would seem to be untenable.

Some firms have chosen to leave whole sections vacant, eschewing leasing the space on the open market, or have awarded employees with excessive desk space. The consequence of this splurge in office acquisitions is that vacant space is being hidden from the market, as it is not available for lease, while also remaining vacant.

The remainder of space can be further subdivided into strata-title and lease-only space, with the latter including developments either solely owned or

majority owned, leasing units on the open markets. The former includes developments sold on an individual unit basis, irrespective of whether the purchaser uses the space themselves or consequently places it on the leasing market.

Shanghai has the largest percentage of space designated as lease-only, as many of the landlords are from Hong Kong and Singapore and tend to disapprove of project stratification, while many of the tenants are MNCs and prefer to lease than buy. On the other hand, the southern cities of Guangzhou and Shenzhen, as well as second-tier cities, tend to have a larger percentage allotted to the sales market, as developers tend to be domestic and prefer the quick return from asset sales, rather than lease, and tenants tend to be domestic and prefer to own their own premises.

Beijing, the largest office market in China, tends to fall somewhere in between the two camps with tenants and landlords coming from a more diversified range of backgrounds.

While it is probably the easiest to track vacancy in actively marketed lease-only developments, it is very hard to gauge whether strata-title space is being properly utilised, with smaller landlords either speculating on price rises (using office space as a store of wealth) or unsuccessfully marketing space and attracting clientele. This will therefore also contribute to the inefficient use of space and the "hidden vacancies" in these cities.

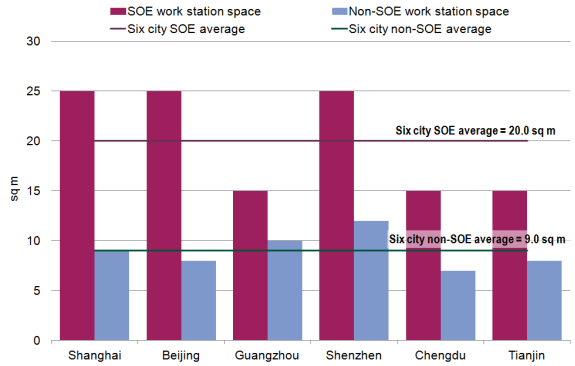
Implications

Increased financial pressure from a slowing economy, and in many industries, slowing revenue growth/contraction, could result in some companies trimming overheads or making better use of assets. Add to this the rising rents in the key markets, most notably Shanghai and Beijing, and some of this "hidden vacancy" could begin surfacing.

The economy, however, is unlikely to go into a tailspin, as the central government is already taking steps to prop it up. As such, the "hidden vacancy" is unlikely to have a dramatic impact on the market in the short term, while in the longer term we might expect it to have a dampening impact on future rental and price growth, with space being released back into the market every time the cost of holding underutilised stock becomes too great to ignore.

GRAPH 3

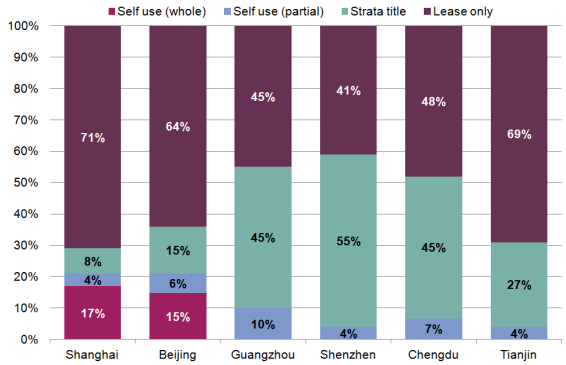
Workstation sizes for SOEs versus non-SOEs, 2012



Source: Savills China Research

GRAPH 4

Grade A office stock by usage, 2012



Source: Savills China Research

Savills Research team

Please contact us for further information

Simon Smith
Senior Director
+852 2842 4573
ssmith@savills.com.hk

James Macdonald
Head of Research
+8621 6391 6688
james.macdonald@savills.com.cn

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