Market transaction slows amid outbreak

Divergence in price expectations between vendors and buyers has protracted deal negotiations.

- Nine deals were concluded in Q1/2020 with a total consideration of RMB8.1 billion, down 65.3% compared to Q1/2019 (a high base of comparison).

- While some developers have been able to roll over existing debt facilities, others have found it more difficult, either in terms of availability or cost of debt.

- Developers that are in real need of additional working capital or are seeking to reduce their debt burden may consider offloading commercial assets, creating new opportunities for investors.

- Investment activities slowed in Q1/2020 amid the outbreak. Volumes are expected to recover in the second half of the year as pricing becomes more attractive and the outlook is clearer.

- Primary land sales totalled RMB65.25 billion in Q1/2020, up 75.8% year-on-year (YoY), as the government looks to offset tax revenue shortfalls.

- Residential for-sale and for-lease land AVs averaged RMB16,000 and RMB3,600 per sq m in Q1/2020, respectively.

- While most investors will try to stick to their original investment strategies, some may adopt more defensive strategies, while others may look for new opportunities that may have emerged from the current situation.

“The full impact of COVID-19 has yet to be realised in the economy and property markets and investors are having to take this into account when identifying new opportunities.”

JAMES MACDONALD, SAVILLS RESEARCH
MARKET COMMENTARY

Nine deals were eventually concluded in Q1/2020 for a total consideration of RMB18.1 billion, down 65.3% YoY (a high base of comparison). The largest deal in the first quarter was Haitong Securities’ acquisition of three HQ buildings in Greenland Bund Centre for RMB6.7 billion, this is compared to Q1/2019, which recorded four deals in excess of RMB8 billion. Difficulty concluding site inspections, international travel and differences in pricing expectation all contributed to lengthening negotiation periods.

Many investors remained cautious about making sizeable investments and focused on smaller deal sizes or expected vendors to offer more sizeable concessions. Nevertheless, strategic dispositions of larger development portfolios may become more common as companies look to reposition themselves amid changing market conditions. Long-term institutional investors are likely to witness a once-in-a-cycle opportunity to secure high-quality assets in first-tier cities.

While developers are faced with increased debt repayment pressure and weaker fundamentals, some companies were able to issue new bonds in Q1/2020 to pay down existing commitments. Developers were able to issue more than US$6 bn of offshore dollar bonds in January and then pivot back to the domestic market in March, as overseas markets became more expensive, with more than US$1 billion issued in the first 20 days of the month. Currently, guidelines state that overseas bond issuance should only be for rolling over existing maturing debt, and not expanding credit facilities and increasing gearing.

OFFICE MARKET

Several project launches were postponed in response to COVID-19. Consequently, no supply was recorded in Q1/2020, leaving the total Grade A stock at 13.3 million sq m. Net take-up, however, totalled 69,500 sq m in Q1/2020, on a par with the previous quarter. With new demand focused on existing stock, and citywide vacancy rates fell 0.5% of a percentage point (ppt) in Q1/2020 to 16.9%, though they are expected to rise in the coming years with significant new supply coming online. Grade A office rents fell 1.0% on an index basis in Q1/2020, to an average of RMB7.8 per sq m per day.

Shanghai’s office market has long been sought after by investors for its transparency, depth of market and liquidity. The current uncertainty in the market is starting to unlock assets that might have otherwise remained on owners’ books for much longer. In particular, there have been some high-quality portfolios that may prove attractive to longer-term investors. Gross yields have pushed to 5.1% as values, or at least speculative values, have fallen faster than market rents.

RETAIL MARKET

Retail sales fell 20.3% in the first two months of 2020 compared to a year earlier. No new projects were launched onto the market, and future supply will undoubtedly be delayed. First-floor rents were flat at an average of RMB27.5 per sq m per day, while many landlords offered half-month to two-month rental concessions to tenants adversely affected by COVID-19. Larger retailers continued adjustments to store networks with a preference for fewer but larger stores; some smaller restaurants under cash flow pressure closed stores, while demand from pop-up stores and temporary exhibitions also fell.

Prime retail area vacancy rates increased 1.4 pts QoQ to 7.4%, while non-prime area vacancy rates fell 0.2 of a ppt QoQ to 8.7%. Supermarket revenues generally increased in response to home quarantine measures and restaurant closures. General retail brands utilised live streaming or online community platforms to promote and sell products, while fitness centres, education intuitions and training companies also provided online classes.

More retail assets are coming to the market as developers look to streamline real estate holdings. Investors remain cautious, however, as long-term trends such as ecommerce weigh on the sector in...
addition to the recent disruption to business and consumer confidence from COVID-19. There will undoubtedly be outperformers, but investors will have to select assets wisely. For example, some community retail centres with local catchment areas, tenants focused on daily necessities and more affordable rents have been better able to weather the recent disruptions.

OTHER MARKET

Niche sectors
During the pandemic, trends that were already apparent in China (e.g., online shopping, online entertainment) were accelerated as consumers adopted new habits and companies invested more in the digitisation of business and their online presence. This has driven investor appetite for niche asset classes that have exposure to these sectors, such as logistics facilities, particularly cold chain storage, and data centres as well as other sectors such as healthcare facilities. GLP has recently closed on an RMB15 bn fund while Ivanhoe and Bouwinvest have teamed with Logos for a US$820 mn fund. GDS was actively investing in data centres during 2019, while Alibaba announced US$28 bn investment into cloud infrastructure and next-generation data centres.

NPLs
Most of China's commercial bank loans are secured against real estate (roughly 70%-90%), while default rates did not increase in the first quarter due to bank forbearance, default rates are expected to rise in 2H/2020 as sluggish global economic growth weighs on many firms' profitability. At the same time, the China Banking and Insurance Regulatory Commission (CBIRC) officially approved the establishment of the country's fifth national state-owned asset management company (AMC), China Galaxy, in March—the same sign that we are far from the peak default rates and that there will be many opportunities for investors to work with national/provincial/municipal AMCs to unlock real estate values.

State assets
March also saw the State-owned Assets Supervision and Administration (SASAC) approve China Rongtong AMC. The entity will be the manager of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value of centrally-owned assets in a wide range of areas, including real estate, agriculture, tourism and hotels, as well as services for industries from recycling, technology and healthcare to security and finance, and a key priority will be to improve returns on state-owned capital. The state has significant real asset holdings and has been working hard to increase value

Land market
Primary land sales consideration totalled RMB5.2 billion in Q1/2020 with commodity residential and commercial sectors accounting for 13.1% and 75.5%, respectively. Residential for-sale and for-lease land plot AVs averaged RMB1,600 per sq m and RMB1,600 per sq m, respectively. Commercial land plot AVs averaged RMB12,300 per sq m.

Since work resumption on February 10th, the local government has speeded up land sales to generate revenues. Commercial land transaction volume in Q1/2020 was roughly 85% of the total transacted volume of the whole year 2019, including a number of high profile plots such as Hongkong Land’s acquisition in Xuhui Riverside for RMB31 billion. The eventual development is expected to contain Hongkong Land Plaza retail mall, a Mandarin Oriental Hotel, 660,000 sq m of office space, more than 1,187 serviced apartment units, commodity residential units as well as sports and recreation facilities.

Outlook
Banks are expected to show forbearance to debtors in the first half of the year given the exceptional circumstances and guidance from the government. However, they will have to start dealing with the loan defaults in 2H/2020 and NPLs are expected to rise as a consequence.

Investment strategies, for the time being, have remained largely consistent with the later part of 2019, though investors are turning more risk-averse and looking for some adjustment in pricing. Shifts in strategy may become more apparent in 2H/2020 as the economic and market situations become clearer.

Transaction volume is expected to remain low in 1H/2020, but a pick-up in activity in the second half of the year is expected.

Land sales exclude public and economic housing

### Table 2: Key Land Deals, Q1/2020

<table>
<thead>
<tr>
<th>PLOT</th>
<th>DISTRICT</th>
<th>USE</th>
<th>GFA (SQ M)</th>
<th>CONSIDERATION (RMB)</th>
<th>AV (RMB PER SQ M)</th>
<th>BUYER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Xuhui 2002-023</td>
<td>Xuhui</td>
<td>Commercial</td>
<td>2,659,953</td>
<td>31,050</td>
<td>11,673</td>
<td>Hongkong Land</td>
</tr>
<tr>
<td>Putuo 2019-210</td>
<td>Putuo</td>
<td>Commercial</td>
<td>293,036</td>
<td>6,271</td>
<td>21,400</td>
<td>Haisheng Huansheng Real Estate</td>
</tr>
<tr>
<td>Xuhui 2019-205</td>
<td>Xuhui</td>
<td>Residential For-lease</td>
<td>350,057</td>
<td>4,628</td>
<td>13,221</td>
<td>Tianyu Shihong</td>
</tr>
<tr>
<td>Jing’an 2020-019</td>
<td>Jing’an</td>
<td>Commercial</td>
<td>87,704</td>
<td>2,108</td>
<td>24,033</td>
<td>Shibei High-tech Group</td>
</tr>
<tr>
<td>Jiading 2020-017</td>
<td>Jiading</td>
<td>Residential</td>
<td>70,501</td>
<td>1,974</td>
<td>28,000</td>
<td>Poly Group</td>
</tr>
<tr>
<td>Baoshan 2019-217</td>
<td>Baoshan</td>
<td>Residential</td>
<td>94,182</td>
<td>1,905</td>
<td>20,232</td>
<td>Chengweiing Real Estate</td>
</tr>
<tr>
<td>Jinshan 2020-011</td>
<td>Jinshan</td>
<td>Residential</td>
<td>153,009</td>
<td>1,677</td>
<td>10,960</td>
<td>Chengzhan Real Estate</td>
</tr>
</tbody>
</table>

Source: Savills Research