End-users pick up buildings

Well-financed end-users are taking advantage of the recent market weakness to secure HQ spaces at favourable pricing.

- Eleven deals were concluded in Q2/2020 for a total consideration of RMB14.8 billion, bringing YTD consideration to RMB39.6 billion, down 48% year-on-year (YoY).

- Seven deals involved office properties, accounting for around 55% of the total value. Of these deals, five were purchased for at least partial self-use.

- The logistics sector remains one of the most highly sought-after sectors in the real estate market with long-term structural demand coming from the growing consumer market and the growth of e-commerce.

- Many investors are interested in purchasing business parks with stable leasing cashflow and comparatively lower leasing risks, with popular areas including Zhangjiang and Caohongjing.

- The local government has sped up land sales to generate more revenue and attract more investment. Commercial land transaction volume for the first half of 2020 is already 18% more than the total transacted volume of the whole year 2019.

- Transaction volumes are expected to pick up in the remainder of 2020 as long as motivated sellers adjust pricing to meet the needs of the investors who are currently sitting on the sidelines.

“Traditional short-term value-add investment strategies are becoming increasingly difficult to underwrite as the fundamentals remain challenging in the office and retail markets given excess supply, weakened demand and falling rents.”

JAMES MACDONALD, SAVILLS RESEARCH
MARKET COMMENTARY
Eleven deals were concluded in Q2/2020 for a total consideration of RMB14.8 billion, bringing YTD consideration to RMB39.6 billion, down 48% YoY (albeit from a high base of comparison). Post-COVID-19, the investment market is recovering slowly as sellers and buyers are holding quite different price expectations at the moment given the uncertainties in the market. Deal negotiation time has grown longer than before. Some sellers with cashflow stress will have to offer a discount to offload assets.

Self-use demand drove the market in 1H/2020, accounting for 40% of the total transaction number. Well-financed end-users are taking advantage of the recent market weakness to secure HQ spaces at favourable pricing, with most end-users being from the financial industry. Occasionally, it can be difficult for deal transactions to obtain the necessary tax requirement permissions from the local government, but this seems to be less restrictive recently. In Q2/2020, the Bank of Shanghai purchased Greenland Bund Central Plaza T2 for self-use. Sketch and Lian Tai Properties purchased two buildings of the Hongqiao R&F Centre which are intended for at least partial self-use.

OFFICE MARKET
Two new projects, Expo Riverfront Centre (North Tower) and Lujiazui Riverside Centre (Hi) were handed over in Q2/2020, adding a total office GFA of 104,800 sq m. Leasing activity picked up in the second quarter, though net take-up totalled just 14,200 sq m. Due to new projects and limited absorption, the citywide vacancy rate increased 0.5 of a percentage point (ppt) to 17.4% in Q2/2020 and is expected to rise further in the second half of 2020 given ample new projects in the pipeline. Citywide Grade A office effective rents fell 4.0% on an index basis in Q2/2020 to an average of RMB7.5 per sq m per day as landlords continued to increase rental concessions.

Office properties remained the focus for investors because of their high liquidity, availability and relative ease of management. Given the soft market fundamentals and forecast, office buildings with stable long-term tenants and some upside potential are popular with investors, driving demand for business parks. Popular business park areas include Zhangjiang and Caohaijing where there are strong tenant bases. Faced with stress in cashflow, some property owners must offload some properties to survive and are willing to offer significant discounts to close the deal.

RETAIL MARKET
Retail sales fell 13.8% YoY in the first five months of 2020. No new projects were launched onto the market in 1H/2020. Future supply is likely to be significantly delayed due to the continued impact of COVID-19. Overall shopping mall vacancy rates grew by 3.1 ppts in Q2/2020 to 11.6%. F&B outlets, particularly domestic casual dining, were hardest hit by COVID-19 and accounted for more than 40% of the newly vacant space in Q2/2020. First-floor rents fell 1.6% in Q2/2020 at an average of RMB26.5 per sq m per day as landlords adapted to the new business realities of a post-COVID-19 market.

Investors are being very cautious about purchasing retail properties because of the disruption to business and consumer confidence from COVID-19. That said, community retail centres have recovered the fastest from the pandemic crisis with their tenants focusing on daily necessities. Therefore, some investors with retail management experience are exploring opportunities to buy community retail centres.

### TABLE 1: Yields And Capital Values By Sector, Q2/2020

<table>
<thead>
<tr>
<th>APPROX. GROSS TO NET RATIO</th>
<th>GRADE A OFFICE</th>
<th>PRIME SHOPPING MALL</th>
<th>PRIME RETAIL STREET STORE</th>
<th>HIGH-END SERVICED APARTMENTS</th>
<th>HIGH-END STRATA APARTMENTS</th>
<th>5-STAR HOTEL</th>
<th>LOGISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI</td>
<td>4.0-4.5%</td>
<td>3.5-4.5%</td>
<td>3.5-4.0%</td>
<td>2.5-3.0%</td>
<td>2.0-2.5%</td>
<td>1.5-2.0%</td>
<td>5.5-6.0%</td>
</tr>
<tr>
<td>APPROX. VALUE</td>
<td>50,000-90,000</td>
<td>60,000-100,000</td>
<td>100,000-200,000</td>
<td>55,000-70,000</td>
<td>100,000-200,000</td>
<td>40,000-50,000</td>
<td>8,000-10,000</td>
</tr>
</tbody>
</table>

1 Yields refer to stabilised assets in downtown locations free of any impediments with a clean holding structure owning 100% of the building, and assuming 100% occupancy. Capital values refers to the average for the building on an aboveground GFA basis – retail assets will have higher capital values for lower floors.
2 Takes into consideration the costs, including taxes, fees, and other miscellaneous.

Source: Savills Research
OTHER MARKET

Niche sectors
The logistics sector remains one of the most highly sought-after sectors of the real estate market with long-term structural demand coming from the growing consumer market and the growth of ecommerce. Yields have fallen from 9-10% a decade ago to their current levels of 5.5-6.0%. It is hard to source investment-grade opportunities in the market at the moment with ownership of most of the properties dominated by a handful of developers. Investors look to specialise and go up the value chain to tap new growth segments of pharmaceuticals and fresh food. In Q2/2020, Manulife partnered ESR and PGGM to launch a new core JV to hold logistics assets in China. The venture acquired four logistics properties from Redwood China Logistics Fund for around RMB1.7 billion. The portfolio consists of more than two million square feet of net rentable area in four cities including Guangzhou, Kunshan, Wuxi and Dongguan.

REIT
The China Securities Regulatory Commission (CSRC) and National Development and Reform Commission (NDRC) published two documents regarding the trial policy for China infrastructure REITs on 30 April 2020. The scope of the pilot REIT is narrowly defined, and there are still many unknowns, with more that needs to be done to develop a REIT regime comparable to Hong Kong, Singapore, Japan, or the US. The development of REITs should hopefully facilitate the real estate market shift from debt to equity and improve transparency and management standards, though this will take time.

KEY DEALS
- Bank of Shanghai purchased Greenland Bund Centre T2 for RMB4.85 billion intended for self-use. Located in Dongjiadu area, Huangpu District, Greenland Bund Centre T2 expected to be completed at the end of 2021 and has a total lettable GFA of 52,900 sq m and is one of 11 buildings in the entire complex. Together with Bank of Shanghai’s purchase, six of the planned 11 commercial buildings in the complex have been sold, including two buildings to PICC and three buildings to Haitong Securities.
- Ping An acquired the Gopher Centre for RMB4.28 billion. Gopher Centre is located in Huangpu District and has a total lettable GFA of 74,100 sq m. Besides office space, the project also includes 14,400 sq m of retail space.
- Dahua Group purchased Shanghai Guoman Hotel for RMB1.45 billion. The hotel is located in Putuo district and has 442 rooms and 256 parking spaces. The hotel was opened in July 2010 and is part of the 492,300 sq m Guoson Centre mixed-use development which also includes the Guoson Mall, offices and serviced apartments.

LAND MARKET
Primary land sales consideration totalled RMB130 billion in H1/2020 with commodity residential and commercial sectors accounting for 40% and 53%, respectively. Residential for-sale and for-lease land plot AVs averaged RMB20,874 per sq m and RMB4,786 per sq m, respectively. Commercial land plot AVs averaged RMB9,428 per sq m.

Post-COVID-19, the local government has sped up land sales to generate more revenues and attract increased investment into the city. Commercial land transaction volume for the first half of the year is already 18% higher than the total transacted volume for FY2019, including a number of high profile plots such as Lanhai purchasing a land site north of Jing’an Temple in Jing’an District for RMB6 billion and Hong Kong Land purchased a mixed-use land site in Xuhui for RMB31 billion in February.

OUTLOOK
The remainder of the year is expected to see end-users and longer-term capital with lower underwriting remain active. Nimble investors may adapt their strategies by shifting to debt, alternative asset classes or structured deals. Other investors will continue to wait on the sidelines until pricing falls more in line with their expectations.

Some REITs’ products abiding by the newly released policies are expected to be launched in the near future. Given the rules in the guidance, state-owned companies are more likely to be the sponsors for the first trial REITs.

1 Land sales exclude public and economic housing

<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>Gaoqiao C02C-01</td>
<td>Pudong</td>
<td>Residential</td>
<td>73,168.00</td>
<td>210[1]</td>
<td>28,715</td>
<td>Baohua (宝华)</td>
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<tr>
<td>Sijin 03-01</td>
<td>Songjiang</td>
<td>Residential</td>
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<td>27,609</td>
<td>Tongji Properties (同济房地产)</td>
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<tr>
<td>West Hongqiao 09-15</td>
<td>Qingpu</td>
<td>Residential</td>
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<td>290[2]</td>
<td>36,123</td>
<td>Gemdale</td>
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<tr>
<td>Jiangning 023-7</td>
<td>Jing’an</td>
<td>Commercial</td>
<td>118,003.30</td>
<td>6,00</td>
<td>50,846</td>
<td>Lanhai Holdings (览海控股)</td>
</tr>
</tbody>
</table>

Source Savills Research