China - June 2020

MARKET IN MINUTES

Savills Research

Coping with COVID-19 – China Office

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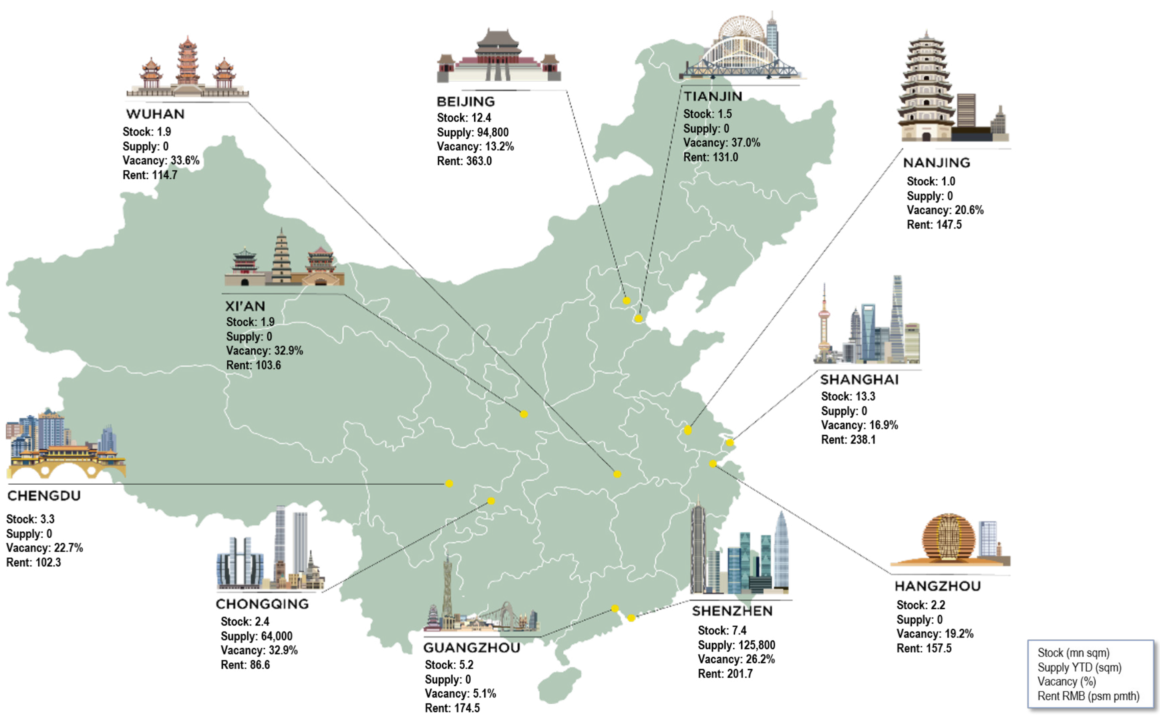
The calm before the storm – Q4/2019

China's economy had already been slowing since 2010, with growth reaching 6.1% in 2019. Economic growth rates in China were boosted in 2009, thanks to the RMB4 trillion stimulus package and laxer lending restrictions in response to the Global Financial Crisis (GFC). At that time, it was forecast that growth would slow to 5.9% in 2020. Slower growth was a result of the ongoing trade war with the US, which saw tariffs applied to US$550 bn worth of Chinese imports, and the government's attempts to control China's debt situation and reduce financial risk. Nevertheless, there were signs that things were turning a corner at the beginning of 2020 with a Phase 1 trade deal in place, an opening up of financial markets and reforms and investment in China's 2025 industrial policy.

While there was hope that there would be a pickup in demand, especially from the finance and tech sectors, China's commercial markets were already faced with looming supply peaks that threatened to push up vacancy rates. The impact of this caused rent in many markets to fall or stay flat. This was certainly not universal, with markets such as Hangzhou, Chengdu and Guangzhou recording less supply and strong demand from key sectors, which helped lower vacancy rates and raise rents.

> "Despite a rapid slowdown in economic activity in the first quarter, the Chinese economy is still expected to record full-year growth albeit at a much slower rate than previously forecast."
>
> JAMES MACDONALD, SAVILLS RESEARCH

GRAPH 1: State Of The Office Market, Q1/2020



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During COVID-19

Lockdown

The outbreak of COVID-19 in Wuhan in December/January eventually led to the lockdown of the city on January 23 and then all of Hubei province just before Chinese New Year (January 25). As the virus spread to other parts of the country, the government announced an extension of the Spring Festival to February 2 (ten days), while many central and coastal provinces extended this through to February 10 (17 days).

Making it work

Work resumption was staggered, with most companies initially working from home (WFH). HR departments had to apply to local authorities for work resumption before they could reopen physical offices. Online work tool adoption, such as Alibaba's DingTalk, ByteDance's Lark and Tencent's WeChat Work, skyrocketed as companies scrambled to transition to WFH. Employees returning from outside their cities were required to self-quarantine before returning to work. While every company is different, many enterprises resumed work tentatively, initially with skeleton crews or essential teams, then gradually moving to shift work and eventually back up to full operation. The pace of resumption was specific to the city and province, with the central government pushing for work resumption as fast as safely possible while local authorities treaded softly, hoping to prevent secondary outbreaks.

New norms

While businesses have resumed work, things have not necessarily reverted to the norm. Some employees still need to remain at home to look after dependents, as schools in many locations remain closed, and domestic helpers find it difficult to travel. Temperature checks, travel history and other details are still frequently checked before buildings allowed access to premises. Many companies are also staggering working hours to avoid rush hours and encouraging private car usage versus public transportation. Air conditioning systems, in some cases, were switched off, with landlords preferring natural ventilation where possible. Mask wearing and social distancing are widespread, and regular disinfection is also carried out in many locations. Companies have also further curtailed business trips and meetings were carried out online.

Winners and losers

Some industries were more impacted than others:

- Hospitality & travel, esp. airlines
- Manufacturing, esp. automotive
- Retail, esp. F&B, leisure, entertainment
- Oil and logistics

Others have benefitted or are less impacted by the viral outbreak and shifts in behaviour:

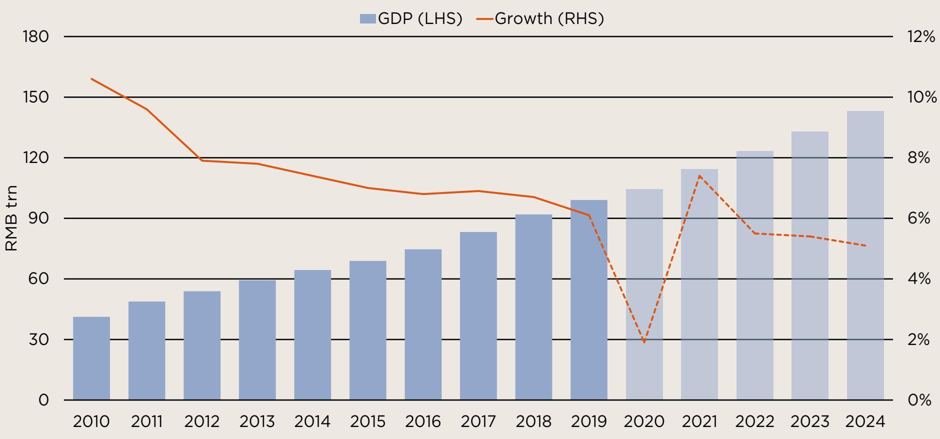
- Internet services
- Ecommerce platforms
- Telecoms and Media
- FMCG

Economic performance

Economic indicators for Q1/2020 have been sober reading. Some of the impact may have been conflated with the Spring Festival and cyclical economic changes, but, even taking these factors into account, the short-term situation looks bleak. Caixin PMI figures in February fell to 40.3 (manufacturing) and 36.5 (services), they subsequently recovered to 50.1 and 43.0 respectively in March. Retail sales contracted by 13.2% and 3.6% month-on-month (MoM) in January and February, eventually recording a growth of 0.2% in March, while surveyed urban unemployment rates jumped to 6.2% in February from 5.3% a month earlier but have subsequently fallen to 5.9% in March.

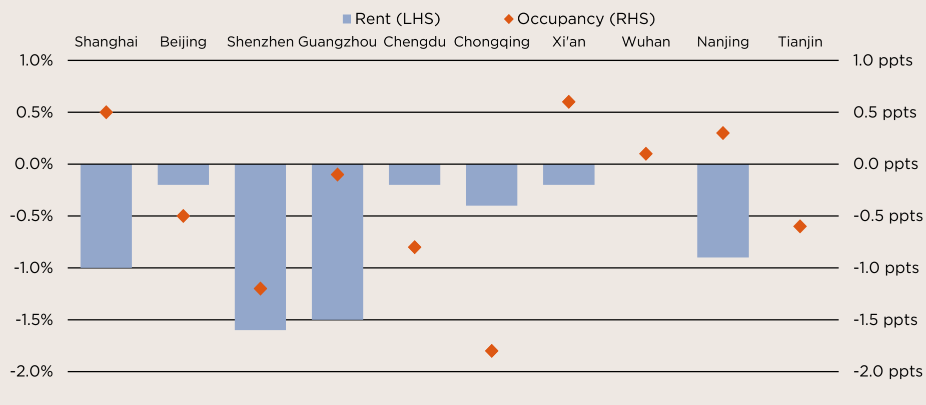
Analysis shows that while the majority of businesses (outside of Hubei) were operational by the end of Q1/2020, many were still not operating at full capacity—either as a result of workforce constraints, logistics, procedural obstacles or, more worryingly, a fall in demand from home and abroad. While China seems to have seen a recovery in supply output, generating demand is now a key focus of the government.

GRAPH 2: GDP Forecast



Source Focus Economics, Savills Research

GRAPH 3: Rental And Occupancy Rate QoQ Changes, Q1/2020



Source Savills Research

Government response
The government has so far been relatively targeted in its approach in supporting firms over these challenging times. Central government policy support has been focused on work resumption, stabilising trade, deferred bank payments, tax reductions/exemptions/deferments and the postponement of social security contributions, to name just a few. There is also policy support for specific cities/provinces, which will potentially look at minimum salaries and reducing/exempting rents for SMEs, amongst others.

Leasing
During the lockdown and subsequent weeks of gradual opening up, companies have been unable to go on site inspections, and there were delays in fitting out new offices as well as the postponement of many new project handover dates. While many tenants will typically begin looking for suitable premises for relocating offices six to nine months before lease expiries, delays and the associated costs with fitting out a new space mean that many will look to renew their current premises temporarily or for another full term. Apart from some SMEs in SOE projects, there have been few rent concessions/deferments available to tenants.

Where to go from here?

Gloomy economic forecast
Economic forecasts for the recovery vary greatly and are constantly changing as new information comes to light. Most forecasters currently agree that the world will record its worst decline since the Great Depression and that no country will be spared. China, the first to experience the devastation of COVID-19, may have the domestic situation under control and, while there is a risk of secondary outbreaks, measures are in place to reduce that risk and mitigate it quickly should it occur. Nevertheless, the country's economic prosperity is closely intertwined with that of the global economy. Forecasters are predicting a rapid slowdown in economic growth, though the domestic economy is still expected to record growth as opposed to a contraction.

Government steps up broader support
In response to economic growth rate concerns, the government has started indicating that they will be giving more financial support and gradually increase macro leverage. March credit data showed the growth in total aggregate financing increased to 11.48% YoY, the highest rate since August 2018.

Commercial market's likely response
New demand for office space tends to be correlated with economic growth levels, so we can assume that take-up levels may be significantly impacted. This means that recently completed projects will take longer to stabilise occupancy rates, and tenants will continue to hold the upper hand in negotiations. Additionally, tenants will require concessions such as face rent reductions, extended fit-out/rent-free periods or subsidies for capital expenditure. Future pipelines have generally been postponing handover dates in response to construction and approval delays, financing problems and developer priorities/market conditions. This should help offset demand shortfalls and mean vacancy rates may not necessarily increase as fast as they would otherwise do.

Nuances in demand
All companies have been impacted and will respond to the economic fallout in different ways, depending on their size, background and industry.

– **SOEs** and national leaders were given priority on work resumption in order to kickstart the economy. These companies might also have had better access to credit lines and working capital while also being from essential industries or able to pivot operations to online platforms or different services.

– **SMEs**, on the other hand, have been struggling for years under the financial de-risking and will tend to have limited cash reserves and may be overlooked in the rush to get the economy back to its feet. Some 460,000 Chinese firms are believed to have shut in Q1/2020, while registration of new firms fell 29% YoY.

– **MNCs** are likely to be impacted by COVID-19 in their home markets and may either face acute stress, bankruptcy or retreat to core markets. Alternatively, they could look to double down on the China market as the economy starts to recover and the government looks to open up to foreign investment and continue to implement reforms.

In terms of different industries, we would expect to see companies involved in trade and manufacturing, travel, leisure and hospitality particularly affected over the short-to mid-term. These companies will be looking at reducing operational costs, including salaries and rentals. Other sectors will be less affected, and some may see growth potential either as a result of the COVID-19 outbreak or from reforms and fundamentals already previously established. These will be primarily the finance, tech, healthcare and pharmaceutical sectors.

- International **financial** firms have been salivating over the prospect of majority ownership and greater access to the mainland China market for a long time. Last year, there were concrete steps towards this with the announcement that overseas firms would be able to achieve majority ownership of securities, futures, mutual funds and insurance firms. The change is not just for international firms—domestic enterprises and national tech giants look to bolster their positions as securities and bonds are added to global tracker funds as well as the continued expansion and development of the insurance and pension sectors.

- **IT & Tech** firms have seen explosive growth over the last decade. Over the last five years, in particular, leaders in their fields (Tencent, Alibaba) continue to expand into additional sectors and regions and a second wave of companies emerge (Bytedance, etc.). The temporary lockdown and shift to online platforms for work, social and consumption have deepened inroads in these areas and allowed them to forge new ground into others. At the same time, the need for fiscal stimulus and economic modernisation is creating opportunities for hardware and infrastructure companies to build 5G networks, EV charging stations and data centres.

- **Healthcare and pharmaceutical** sectors could also see significant growth, not only in response to COVID-19 but also as part of a longer-term campaign to develop and modernise the sector which is coming under increasing strain as demand rises from an increasingly elderly society. At the same time, a more prosperous society is looking for improvements in healthcare commensurate to those it has seen in other aspects of life as well as looking for more elective procedures. The pharmaceutical sector is also being disrupted by new advances in drug developments and treatment plans.

These trends have obvious implications for the level and nature of occupier demand. International Grade A offices are likely to benefit from leading financial, IT/tech and healthcare/pharmaceutical firms as they are usually based in high spec buildings in more decentralised locations, campuses or business parks. Grade B offices, which might have a higher percentage of SME tenants, might struggle in the short term.

How has the market changed?

The longer-term implications may be profound but are more likely to be an acceleration of trends that were already discernible prior to the outbreak of COVID-19.

Remote work

While remote working technologies have been around for a long time, many businesses have written them off as being inefficient, unsecure, too slow, prone to glitches, lacking adoption by employees or incompatible with management styles. However, technologies (Zoom, Microsoft Teams, DingTalk, WeChat Work) and bandwidths (5G) have continued to improve while younger, more digitally savvy employees continue to rise through the ranks. Companies that are being forced to adopt and begin transitioning/investing into these platforms are unlikely to give them up as work starts to return to normal.

What are the implications of these online tools? We could see more permanent WFH situations, but productivity, while initially high, tends to drop off sharply after the novelty of working in your pyjamas wears off. Hybrid models for employees could be a solution—staff might work in the office three days a week and have two days working from home, coming in only on days when there are team meetings or collaborative work sessions. This could result in the rise of hot desking and, consequently, a reduction in office demand over the long term.

There are flexible work hours that have been adopted by some companies to allow staff to avoid rush hour periods on public transportation, though this could also be applied longer-term to improve efficiency and experience on public transportation and reduce road congestion. Small regional offices may become more common with the ability for teams to better collaborate across longer distances with online meeting tools.

Nevertheless, the change in management styles and the more decentralised approach may not be suitable for all employers or employees. Some teams may need the social/emotional/creative environment provided by a centralised office environment; some employees may live in cramped homes or multigenerational households and appreciate the opportunity to escape and come to the office. Some employers may prefer to keep a close eye on staff and micromanage employees or feel that leadership can only be achieved through regular face-to-face interactions.

Property management and build quality

Many tenants will be looking for a prioritisation of office spaces and better communication with landlords, as well as more collaboration and compromise where reasonable. There will also be a prioritisation of building quality and property management teams that are often overlooked—frontline workers have played a major role in keeping office tenants safe during the outbreak. Additionally, tenants will place an increased emphasis on the principles of wellness (especially air ventilation), resilience, flexibility and contingency planning.

Disruption and innovation

The economic slowdown will undoubtedly lead to an increase in bankruptcies and unemployment in the short term. However, those that survive should be leaner, meaner and potentially more innovative, having adapted rapidly to changing business conditions to survive. At the same time, changing business and consumer behaviour may give rise to new opportunities for businesses, giving birth to a new wave of start-ups, similar to what was seen in response to the GFC of 2007-2008.

Flexible space

Finally, one of the biggest casualties of COVID-19 and the subsequent economic slowdown might be flexible workspace operators. Ironically, however, the sector may also be one of the biggest long-term beneficiaries.

The flexible workspace has continued to evolve since the emergence of co-working spaces in the wake of the GFC; there are now many different operators, tenant profiles and business models, and some will likely fall by the wayside while others will see renewed life.

<u>Lease terms</u> – Sublet business models—those with long-term master leases, low fixed rates and short-term tenant income—are likely to find cash flow challenging as tenants end leases as a result of bankruptcies, cost-cutting or WFH. Operators will likely have to renegotiate terms with landlords for either lowering base rent, converting to profit-sharing arrangements or early terminations. Operators that are already in profit-sharing arrangements will be better covered on downside risks.

<u>Operators</u> – Larger national or international operators with stronger financial backing, staying power, brand credibility and backing to survive a short downturn in market conditions. This is especially true for those that are backed/owned by landlords.

<u>Tenant profile</u> – Operators that have increased the percentage of their space that they lease to larger tenants for longer periods as a part of their enterprise solutions are likely to fair better as revenues may be more stable.

In the long term, as companies adopt new technologies and see the benefits of short lease terms that give them greater flexibility and space efficiency in uncertain times, flexible working spaces will continue to garner significant attention. Flexible spaces may become a greater part of landlords' offerings (as opposed to standalone operators) thereby enabling tenants to enter into long-term leases for most of their workforce at lower rates and then have short-term space on demand with the operator either being the landlords or a third-party management company. Whatever form they take, the disrupters are likely to be disrupted, but they will nonetheless prove an important part of the commercial real estate universe.