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Another sunrise, new opportunities – 2023 market outlook

savills 第一太平戴维斯

Another sunrise, new opportunities – All eyes on the horizon

2022 was a challenging period for investors with many uncertainties making it hard to make decisions. This was especially so for international investors who were eyeing opportunities in other global markets as they emerged from covid restrictions.

However, the rapid reversal of the zero covid policy appears to have eased some concerns and uncertainty that had lingered for much of 2022 and has helped set a pro-growth tone for 2023. Analysts have raised their forecasts for China's economic growth in 2023, confident that the country's reopening and proactive fiscal and monetary policies will ensure solid economic growth. Meanwhile, more supportive policies for the property sector towards the year's end have also eased pressure created by the recent sector deleveraging.

Nevertheless, the path from here to there is often not as smooth as it would at first seem. There will undoubtedly be pain and challenges ahead as we make progress towards reconnecting with the global economy and getting back to where we were pre-pandemic. Businesses and investors should be ready for the rebound, while also being prepared for the short-term pain.

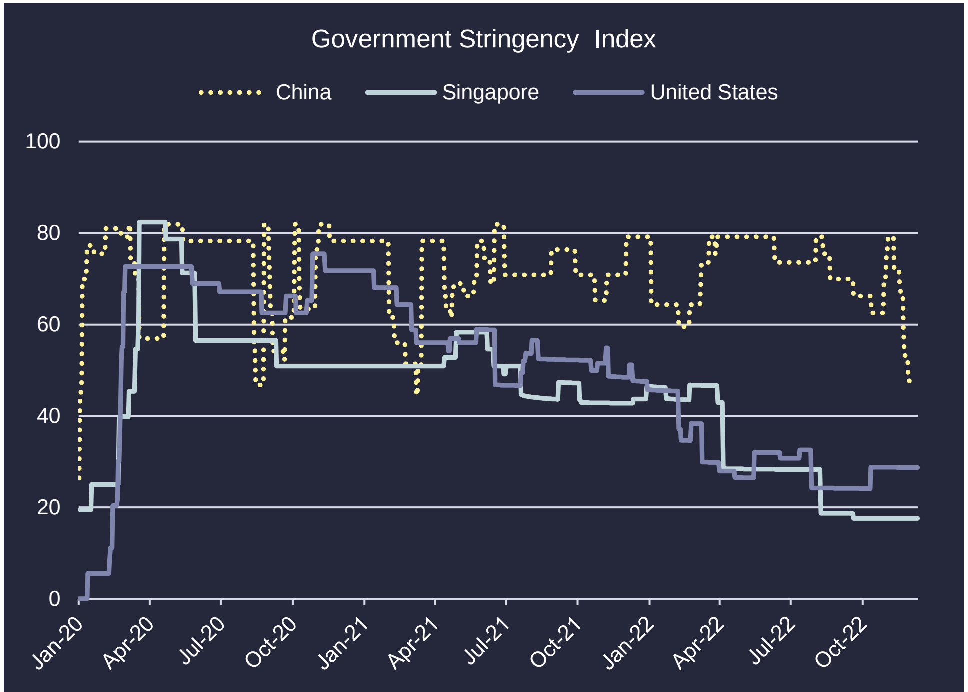
1	Sprint to the finish line
2	Healthy market cycle
3	Out with new, in with the old
4	Master of one
5	Reliable recurrent income
6	Resilience & security
7	Little Giants
8	Retail therapy
9	Going green
10	Bumpy road to recovery

1 Sprint to the finish line

Restrictions imposed on society and businesses to stop the spread of covid were equally stringent in many countries around the world from the second half of 2020 to the beginning of 2021. But while other countries started loosening restrictions, China held on and indeed doubled down on prevention measures. The ability and decision to continue with zero-covid restrictions were inevitably tied to national conditions and cultures.

20 measures for the optimisation of covid policies were released in November, a watershed moment in China, viewed as a response to the growing cost of continuing with previous approaches. The epidemic prevention apparatus has since been swiftly dismantled in many parts of China and the virus has subsequently spread swiftly being largely unchecked.

The full resumption of “normal” life and resumption of unhindered economic activity will still take time; however, the possibility of government-imposed lockdowns now looks much more remote.



Source: Blavatnik School of Government, University of Oxford

China’s vaccination drive has resulted in 3.44 billion doses of locally produced vaccines being administered by the end of November, equivalent to 2.4 doses per person, with more than 70% of the population fully vaccinated. That said, peak vaccination was in late 2021 and immunity will be waning, at the same time vaccination rates among the elderly are low. Still, more needs to be done in order to reduce future fatality rates.

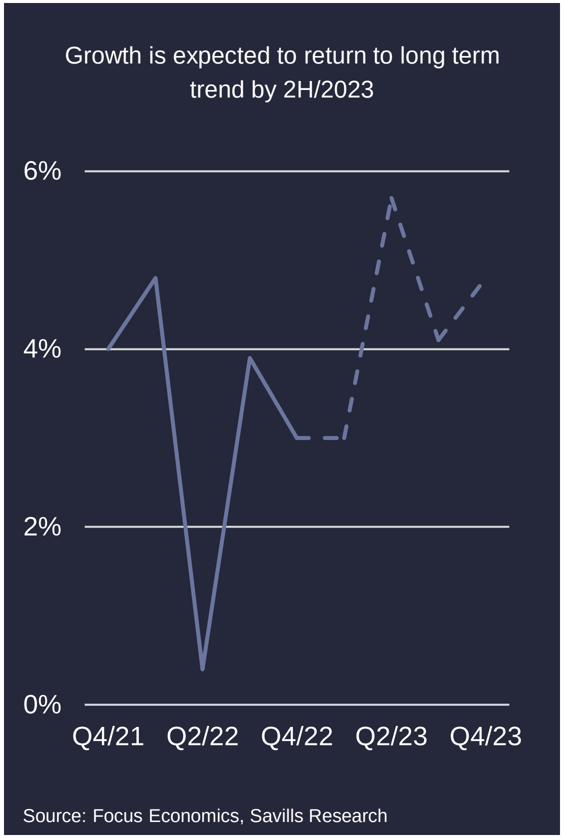
Set on this new path, all parties need to make plans for the eventual reopening. The transition, while welcomed by the majority, is likely to prove challenging both for society and businesses in the short term, whether that be effective and uniform implementation at the local level as well as necessary adjustments and temporary circuit breakers should case load overwhelm medical resources.

Employees’ and consumers' concerns about the rapidly spreading virus may mean that businesses and factories will unlikely be able to work at full capacity for some time, while online tools such as remote working and e-commerce are still likely to be relied upon in the short term.

In the United States and Singapore, it took roughly nine months to gradually lift epidemic prevention restrictions.

Nevertheless, the long-term benefits to society from liberalization are more meaningful than the short-term road bumps we are likely to experience, with businesses desperate for a road map out of the current situation and more certainty about future operations. In addition to covid policies, we are also witnessing more concerted and coordinated support for the property sector with the three arrows of credit, bonds, and equity at the end of 2022 expected to bring greater confidence to that sector as well.

2 Healthy market cycle



The relaxation of covid controls has encouraged market watchers to upgrade economic growth forecasts for 2023 amidst hopes of an eventual full reopening and less business disruption caused by lockdowns and travel restrictions. Nevertheless, the transition to living with covid is likely to be bumpy and the general consensus would seem to be weak growth in the first quarter, with economic activity picking up to “normal” levels in the second half of the year.

As the economy recovers so will optimism in the property market, it is also supported by more government action in recent months. The sector has been undergoing deleveraging of one form or another since the concept of "housing to live in, not speculation" was coined in 2016, with investment in real estate development not exceeding 10% growth. As the residential sector accounts for approx. 70% of the real estate market, the deleveraging of the market also represents government efforts to improve affordability and reduce systemic risks in the residential sector - a key store of household wealth.

Nevertheless, the challenges facing the industry are unprecedented. Investment in development contracted by 8.8% YoY in the first 10 months of the year, while land purchases fell 53%; sales contracted 26.1%, with the residential sectors falling 28.9%.

The government’s three arrows - bank credit, bond issuance and equity financing – announced towards the end of the year was extremely important to boost market confidence. As of November, the intended credit line of banks and high-quality real estate companies has exceeded RMB2 trillion; the scale of bond financing is expected to reach RMB250 billion; and the resumption of equity financing has allowed Vanke to issue new A-share for the first time in 15 years.

The recent market slowdown presents a rare opportunity to make meaningful changes to the composition and long-term dynamics of the real estate industry.

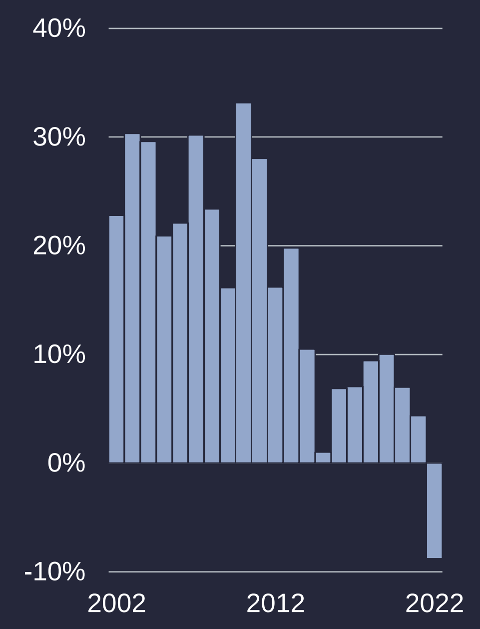
China is home to more than 100,000 real estate development companies, 95% of which are private companies, too many even for a market the size of China. The next few years are expected to see a consolidation of this space partly as a result of market dynamics but also resulting from tailored policies, particularly related to financing, that will favour high-quality private developers and state-owned enterprises. This should help improve standards and market stability in the long run.

Annual completions of commodity residential peaked at one billion sqm in 2014 which has largely coincided with a slowdown in urbanisation and a decline in the birth rate which are the two leading drivers of demand. This signals an end of the golden era of property development. Core cities remain attractive to many given the potential for job creation and rising living standards, but developers and investors still need to shift their mindset from new construction to urban redevelopment as well as encompass new economy sectors.

Residential development has accounted for an increasingly smaller share of overall development over the last 15 years, while commercial developments have been stable, and other property types have been on the rise. Long-term investors, such as China Ping An and China Life Insurance, have supported this trend by deploying more capital into new economy assets over the past two years.

Successful commercial and industrial developments not only need owners to have strong management capabilities to maintain day-to-day operations but also a far-sighted asset management mindset to be able to identify and capitalise on new trends as and when they emerge. Asset managers at the moment are focusing on how to best balance short-term changes in consumer and working habits resulting from covid disruptions while also adapting projects to meet long-term sustainability goals.

Investment in real estate development has contracted for the first time in 2022



Source: CEIC, Savills Research

3 Out with new, in with the old

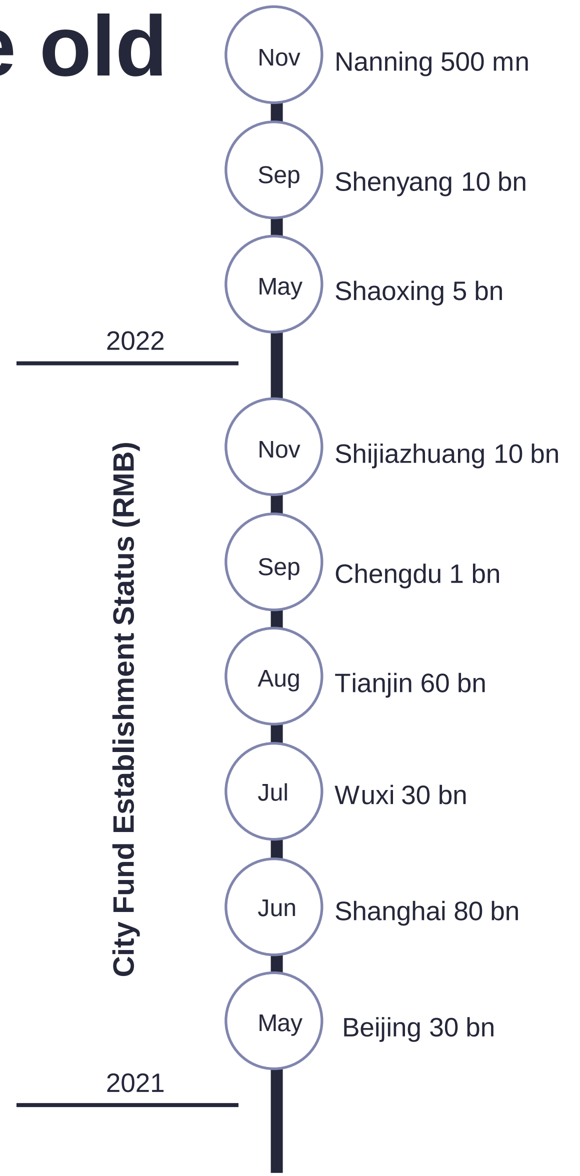
Land sales are an incredibly important source of income for local governments, but they also skew priorities. In addition to attracting investment in high-growth emerging industries, authorities also need to revitalise state-owned enterprises' assets.

Urban renewal has gained significant momentum in mature markets. In the United States, 52% of architects' business revenues are generated from urban renewal projects, up 7.6 ppts over the last five years. China completed 23,000 urban renewal projects from 2019 to 2021, with an investment of RMB5.3 trillion according to MOHURD.

The pace of urban renewal continues to accelerate, refraining from large-scale demolition and construction and emphasising preservation, conversion and adaptation. Demands upon operation and management capabilities for these types of projects are significant.

SOEs have distinct advantages when it comes to urban regeneration given their significant ownership of older developments in core locations, nevertheless many lack asset management capabilities and vision. In Shanghai, 14% of hotels and 45% of movie theatres were built before the 1980s, the majority of which are owned by SOEs.

The challenges might be even fiercer for older office or retail developments, which are facing more direct and intense competition from a new breed of high-spec developments better suited to the needs of modern corporates and consumers. The scope for, and usefulness of, project upgrades are likely to be limited and could be more expensive and take more time than simply starting from scratch. Owners need to work within project limitations, identify unique project characteristics and meet the untapped needs of corporates and consumers alike, in order to unlock asset values.



4 Master of one

The disruption and evolution of the market will not only benefit the best-positioned developers but also create opportunities for professional small and mid-sized funds and operators.

In first-tier cities, large-scale urban redevelopment has given way to smaller-scale adaptive reuse schemes which are often better suited to boutique funds and institutions with unique perspectives and skill sets that they can bring to revitalise the project.

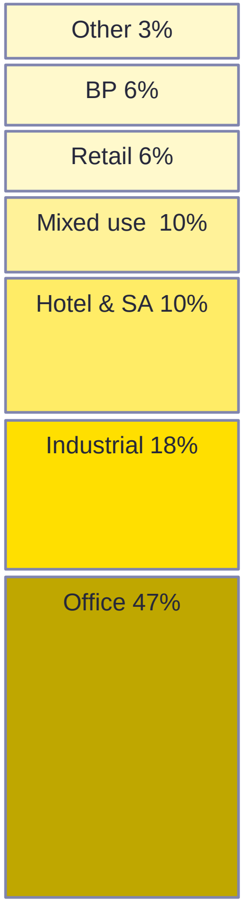
In niche asset classes, more specialised firms are emerging, utilising core competencies, reputation, access to stock and financing to gain the upper hand on larger all-purpose peers.

New economy sector assets are accounting for an ever-increasing share of investment deals, specialised investors are coming to the fore including Jingrui (rental apartments) and GDS (data centre), which have advantages in various sub-segments and were both active in 2022. Investment volumes in life science real estate reached RMB3.45 billion, up 44% YoY, while logistics assets reached RMB15.2 billion, up 7% from the same period last year, accounting for 9% of the overall volumes.

Acquisitions of parking lots and self-storage facilities that were seldom witnessed in the past are becoming more frequent. The mainstream acceptance of new technologies such as new energy vehicles is giving investors the opportunity to upgrade and differentiate what was previously a rather mundane asset class, such as the adoption of double stacker car parks or the addition of charging piles.

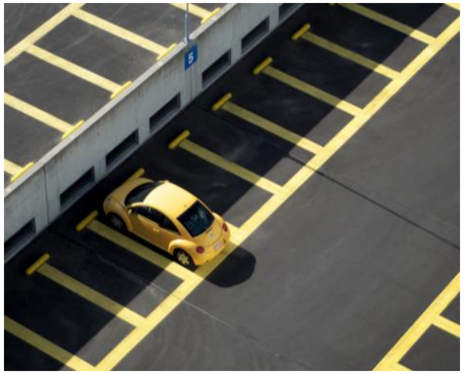
The more niche the asset type, the fewer investment-grade assets are available requiring investors to upgrade assets, convert or build to core which increases risks, hold periods and reduces short-term revenues. The investment market is also likely to be relatively illiquid with few potential buyers. Most investments at the moment will be through platform equity injections with the view of growing firms into market leaders and potential IPOs or REITs.

2022 transaction by asset type



Source: Savills Research

StorHub opened its first self-storage facility in Shanghai in 2012 and has since expanded its operations to Beijing and Shenzhen. StorHub opened its own site in Shenzhen in December 2022, with approximately 10,000 sqm of space, offering more than 6,000 individual storage rooms and over 100 storage types ranging from 1 to 100 cubic metres.



Limetree Capital focuses on acquiring, developing and operating parking assets in China under the "Huipo (汇泊)" and "WE PARK" brands. Higher returns are achieved through the introduction of advanced parking technology, proactive measures to improve occupancy, increase parking rates and create technology-leading parking brands.

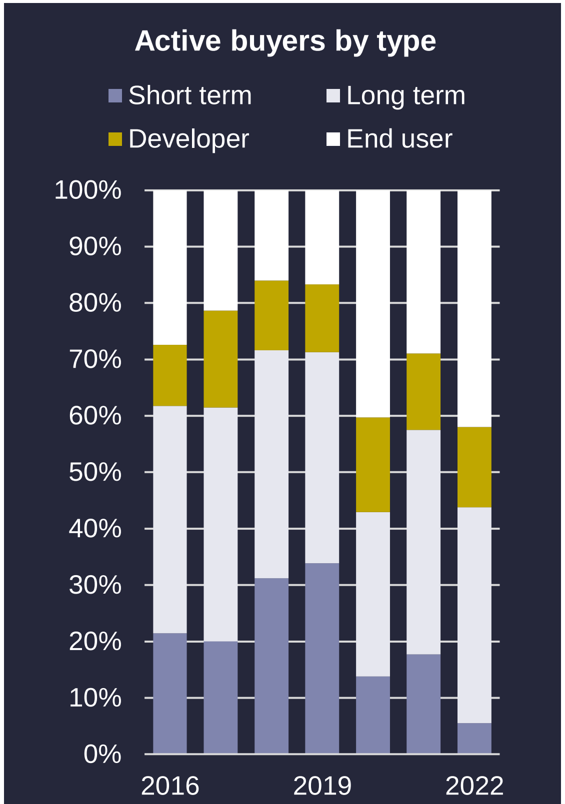
Perennial announced in July 2022 that it would build China's first integrated medical and healthcare project featuring Alzheimer's care in the Zhouzhi Louguan Ecological and Cultural Tourism Resort in Xi'an. The project will occupy a site of approximately 43,000 sqm, will have a GFA of 38,000 sqm, and will host over 400-bed dementia care centre, a nursing home, a rehabilitation hospital and an international geriatric health management institute.

5 Reliable recurrent income

The real estate market is increasingly focused on long-term sustainable returns as the era of easy capital growth returns fades away, this, along with policy initiatives, has given rise to new exit channels into the public markets via REITs and other products. Annual consolidated returns in the public REIT market reached 4.9% as of 21 October, significantly outperforming the stock, bond and gold markets. A total of 21 public REITs had been listed by the end of November, with a total market value of over RMB70 billion. As investors and sponsors become more familiar with the product, the sector is expected to continue to grow and prosper. REITs will also encourage managers to think more deeply about operational efficiency and reinvestment of funds in order to maximise shareholders' dividends. While C-REITs are currently limited to infrastructure assets such as warehouses, industrial parks and IDCs, there have been some discussions about potentially expanding the scope to introduce commercial and residential real estate projects.

Short-term investors have proved much less active in the market in recent years. As the scope for capital appreciation has diminished, the proportion of deals concluded by short-term investors has fallen from 34% in 2019 to just 6% in the first three quarters of 2022. In contrast, longer-term investors, such as insurance, REITs and pension funds, continued to account for 35% to 40% of deal-buying activity, with themselves and end-use buyers accounting for 80% of deal activity in 2022. Longer-term investments are likely to remain dominant in the near term as market dynamics lend themselves to more stable, yield-focused returns and new sources of capital such as REITs continue to emerge.

Despite investors' misgivings about traditional commercial properties, the office market remains one of the most actively invested asset classes, accounting for about half of the overall transaction value. While many investors continue to have misgivings about the sector, further price reductions and recovering economic activity in the second half of 2023 could bring investors back to the sector which still remains one of the largest, most liquid, transparent and easily managed asset classes.



Source: RCA, Savills Research

Trends and returns

1	Retail	Gradual recovery in the consumer market	4.0-5.5%
2	Office	Leasing activity to pick up after the Chinese New Year	4.0-5.0%
3	BP	Parks with established high growth industry clusters prioritised by investors. Specialised services and facilities required for the upper hand	4.5-5.5%
4	Logistics	Supply chain efficiency continues to be the driving force of demand with the digitalisation of the sector a must	5.0-6.0%
5	Residential development	Supply and demand side support to be enhanced, restoring market confidence. Leading private and state-owned enterprises are expected to expand and consolidate their market share	—
6	Multi family	The market is favoured by relative stability / resilience in recent years, strong policy support (insurance capital/REITs, more flexible guidelines on renovation and land transformation) and clear long term demand drivers (migration, affordability, etc.)	3.5-4.5%

6 Resilience & security

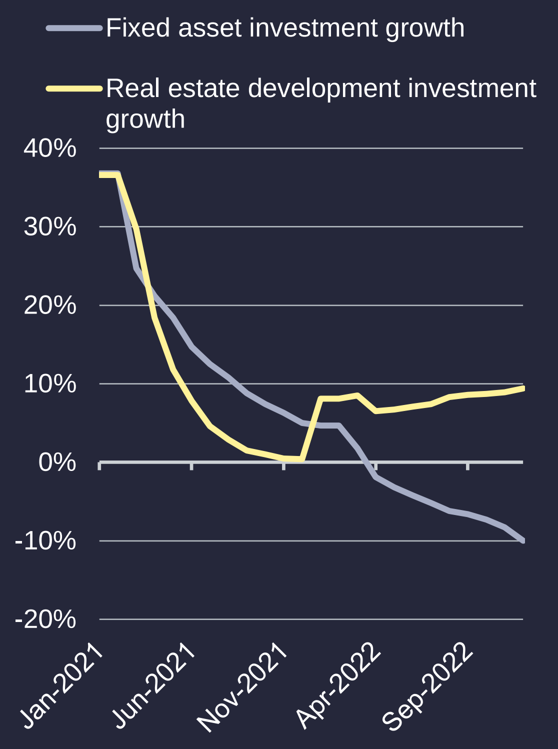
Analysis of the 12th National Congress Report and the 14th Five-Year Plan (FYP), indicates that safety and security are of increasing importance to China. This is especially true given the unprecedented global challenges facing China whether it be geopolitical, or a global recession resulting from inflation and interest rate hikes, or the technological decoupling with the west. China plans to become more self-reliant in order to shield itself from some of these issues.

China's command economy tends to default back to infrastructure investment in order to address its economic challenges and this time seems no different. Investment in new infrastructure areas such as solar energy, charging piles and data centres are all expected to grow by more than 10% per annum during the 14th FYP. This will not only support growth in the short term but will put essential building blocks to future manufacturing upgrades and technological advances. In the real estate industry, a focus will be resilience, facilitating industrial development as well as urban renewal.

For example:

- Cities will need to be more resilient and adaptable in order to cope with the effects of climate change, meet the changing needs of businesses and the population at large, and improve living standards. Cities require: smart city platforms, green building standards, resource-efficient designs such as transit-orientated developments (TODs) and people-orientated developments (PODs), as well as a range of affordable housing options such as rental apartments, elderly homes and student housing;
- World-class facilities, communities, environments and amenities needed for breakthroughs in core industries such as science and technology and biomedicine.
- Energy security and the transition to renewable energies require significant investment over decades. China is developing both centralised and distributed renewable energy production at a rapid rate. Many developers and funds are exploring the potential of photovoltaic roofing and other distributed energy generation in order to achieve sustainability goals while also reducing running costs.

The gap between infrastructure and real estate investment growth widens in 2022



Source: CEIC, Savills Research

100倍

Four affordable rental housing REITs were successfully listed in 2022, namely Hotland Innovation Shenzhen Talent Affordable Rental Housing REIT (180501.SZ), CICC Xiamen Affordable Rental Housing Infrastructure REIT (508058.SS), China Beijing Affordable Housing Centre Rental Housing REIT (508068.SS) and China Resources Youchao REIT (508077.SS). The four REITs raised a total of RMB5 billion with the four over 100 times oversubscribed.

There is talk that the scope of REITs may be enlarged to include market-oriented long-term rental housing, but there are still many issues to be clarified including land tenure and property rights.

60%

Institutional investors and self use buyers have very different objectives when acquiring real estate assets. The former are focused on risk adjusted rate of return while the latter pay more attention to location, preferential tax policies and supporting amenities. While institutional investors have turned cautious on the office market given rising vacancy rates and soft rents, self-use buyers are seizing the opportunity to secure favourable terms to secure new headquarters.

Office and business park acquisitions accounted for 53% of large-scale transactions in 2022, up 9 ppts YoY. Self-use buyers accounted for 60% of the deal flow, with firms from TMT, new energy, and finance sectors dominating.

1GW

GLP and Brookfield established a joint venture company (Pufeng New Energy) to focus on the acquisition and development of renewable energy facilities. Pufeng New Energy acquired a 73.32MW distributed photovoltaic project in Hubei in 2022, which includes a grid-connected PV platform and self-consumption capacity. According to estimates, the annual power generation is 73.32 million kilowatt-hours (Kwh), which is equivalent to saving about 23,071 tons of standard coal and reducing carbon dioxide emissions by about 59,984 tons. The cumulative development scale of Pufeng New Energy has now exceeded 1GW in China.

7 Little giants

The emphasis on innovation and entrepreneurship to drive economic growth has gained increasing momentum in recent years.

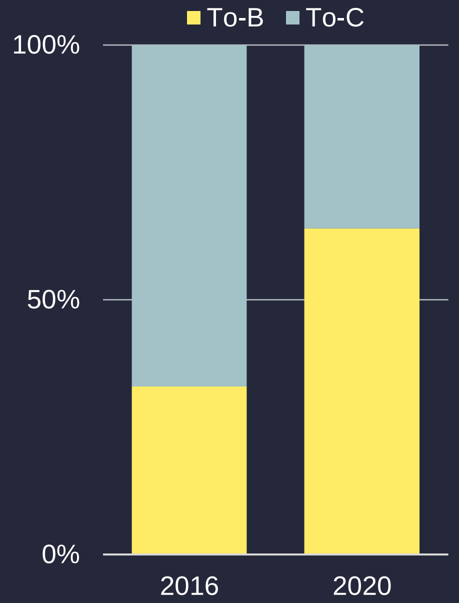
In the field of science and technology, the number of incubators grew on average 8.7% per annum over the past three years, with more than 6,000 incubators in 2021. The real estate required to accommodate more innovative companies, e.g. maker space, incubator, accelerator, and science parks are becoming increasingly mature with a growing VC & PE community helping to form a number of unicorn companies.

As the pace of e-commerce growth slows, greater attention is being paid to fields such as hard technology, new energy and life sciences, generating a shift from B2C to B2B start-ups. Data from Cyzone show that 64% of start-ups in 2020 were B2B firms. The self-driving company Autowise and integrated circuit chip design company Broadchip Technology took new office space in 2022, an indication of good growth prospects despite market challenges and uncertainties.

2023 will see the opening of the economy, an acceleration of the industrial supply chain localisation and the development of native technologies gaining pace in sectors such as semiconductors and advanced manufacturing. This will fuel the growth of local start-ups that focus on hard technologies and empower enterprises with technological solutions.

In the consumer market, the rise of domestic start-ups has been staggering in the last few years. As consumption concepts and consumer behaviour undergo dramatic changes, local brands emerge or adapt to meet changing needs, such as the trend for experiential consumption after lockdowns and with the dismantling of zero-covid and the resumption of travel.

The percentage of start-ups focusing on B2B business increased to 64% in 2020, helping to drive demand for Grade A office space.



Source: Cyzone, Savills Research

奈雪的茶

Since the opening of the first Chinese store in Shenzhen in November 2015, Nayuki tea has caught the attention of the Chinese consumer. The brand was listed on the Hong Kong Stock Exchange in 2021, and the number of directly-operated stores now exceeds 1,000.

2014
Brand established

2015
First store in Shenzhen Excellence Century Centre

2016
First round financing RMB100mn Tiantu Capital

2017
National expansion (first store outside Guangdong) – Xidan Joy City Beijing

2018
International expansion – Vivocity Singapore

2019
New store formats – Sake house and Dream factory

2020
Opened “Pro” store and expanded its product range

Adopted paper straws

2021
Listed on the Hong Kong stock exchange

2022
Acquired 3,700 sqm office in MixC Park Qibao Shanghai for second Headquarters

8 Retail therapy

The zero-covid policies of the past three years have been swiftly lifted, but it will take longer for the consumer market to fully recover. Owners and brands need to create a comfortable and safe environment to bring consumers back. Leaving aside covid, the encroachment of work into personal lives, societal anxiety and 24-hour information overload means that consumers can be frazzled. Landlords and retailers should do their utmost to alleviate these pressures, rather than add to them, by being more creative in producing the right atmosphere for shoppers.

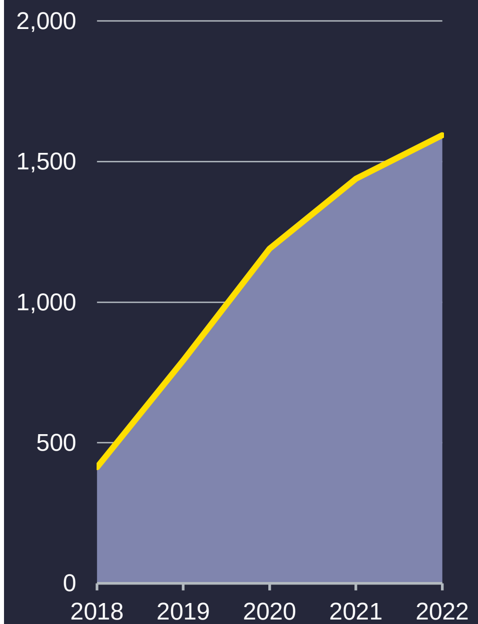
Arts and culture and outdoor experiences were a key focus in 2022, bringing more levity to consumers while also giving greater prominence to projects such as Qinhuangdao's Aranya and Chengdu's Luxe Lakes. Diverse retail formats that tap into the desire for day trips or weekend getaways, providing a sense of leisure while also focusing on all-embracing experiences will continue to be popular with consumers in 2023. More projects are likely to strengthen their cultural and artistic elements by tapping into local heritage and/or collaborating with art institutions to give a more diverse character and feel.

Judging by overseas experiences, the removal of zero covid policies will likely result in a travel boom, particularly to popular tourist cities such as Sanya. Traditional tourist shopping areas such as Shanghai's Nanjing East Road and Hangzhou's West Lake could also benefit. Landlords should take the opportunity to upgrade premises and adjust tenant mixes in preparation for the return of tourists.

Urban renovation retail projects that rejuvenate communities will also gain increasing attention. Their smaller size and adaptability may prove attractive to smaller opportunistic funds but are also a great platform for innovative operators and start-up brands to showcase their creativity and build their reputation. The success of projects such as Hangzhou's Canal World and Chengdu's Regular have shown the way for others to follow.

9 Going green

Greater China has more than 5,000 LEED-certified projects, with 1,600 newly certified in 2022 up 10% YoY.



Source: USGBC, data as of Nov 2022

ESG is a hot investment topic. Bain estimates that China's ESG investment market has exceeded one trillion yuan. The number of listed companies issuing ESG reports (including CSR reports) continued to increase in 2022, with 90% of Shanghai and Shenzhen 300 Index issuing reports but comprised only of 30% of A-share companies. 44% of developers listed on the A-share and 80% of Hong Kong-listed developers issued reports.

The release of the "China Green Bond Principles" in 2022 has brought domestic green bond standards into line with international standards and put forward stricter requirements for the release of green products, helping to limit greenwashing.

Green certifications in the real estate industry have become more mainstream and better understood. Also, as more office tenants and leading international retail brands have global mandates to reduce carbon footprints, certification is moving from a “nice to have” to a “must have”.

1,594 projects were newly registered LEED projects up 10.7% YoY, with warehouse certifications up 105% YoY, and the number of retail projects exceeding that of office projects. Brands such as Gucci are not only ensuring that new stores are fully LEED certified but are also certifying existing stores.

As ESG continues to gain momentum, more owners are expected to pay increasing attention to reducing and mitigating carbon emissions while optimising energy use. Staying ahead of future legislation will become increasingly important to ensure landlords do not own stranded assets. Meanwhile, it will also be important to develop more robust monitoring and compliance systems to be able to tap into lower-cost green financing. Leading developers, such as Swire and Shui On, have issued sustainability-linked bonds which are measured against predefined KPIs, these can help to set targets, drive change and reduce financing costs, but also reflect the company’s culture and ethos while boosting the corporate reputation.

10 Bumpy road to recovery

2023 is expected to be a year of recovery after a number of setbacks experienced last year. A slower economy and great uncertainties meant that investors adopted more conservative valuations and postponed purchases while occupiers cut costs and renewed leases rather than upgrade or expand premises.

As China reengages with the global business community and adopts more pro-growth policies, there will be more opportunities for companies and investors to re-acquaint themselves with the market and rebuild confidence.

Real estate that supports new economy industries will still be favoured given their long-term growth prospects and government support, while more traditional commercial asset classes are likely to see a boost in demand as economic activity is rekindled and the short to mid-term outlook becomes clearer.

While covid risks retreat other challenges may emerge such as a slowing global economy, deglobalisation and the repercussions of climate change, China will have to rely upon internal drivers, turning to consumers to propel economic growth. With economic growth expected to slow sharply in the developed world given high inflation rates forcing central banks to increase interest rates sharply to cool demand, China should once again become one of the fastest-growing large economies. The better short term prospects should help to encourage occupiers back to the market and boost leasing fundamentals as well as give investors more confidence.

There will be challenges with the recovery of the Chinese economy and property market, though the long term is turning more positive. The industry however is unlikely to ever return to the pre-covid era of high growth and speculation, instead being replaced by conservative, better-capitalised developers, long-term investors and asset managers seeking for incremental improvements.

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