China Research - 2024

SPOTLIGHT

Savills Research

China Real Estate Outlook

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Contents

Living

Are further declines expected in 2024?

Historically, China's residential policies have predominantly emphasized demand-side controls. However, there has been a recent shift in focus towards supply-side reform. The gradual introduction of detailed policies for affordable housing development is expected to transform China's residential market into a dual-track system, encompassing social housing and commodity housing. Notably, in the 14th Five-Year Plans of the four first-tier cities, affordable rental housing constitutes over 40% of the new residential supply. Similar to global markets, the affordable housing system, inclusive of rental housing, is tailored for low-income households facing limited housing options, particularly in major urban centres. Concurrently, market-oriented housing targets enhanced needs and offers an improved living environment.

Residential properties have been a cornerstone of real estate development investment over the past three years, contributing significantly to the overall real estate market and the broader economy. Given the substantial size and importance of the residential sector, an immediate transformation is improbable, and the current scenario is anticipated to endure for several years. Despite this, the industry is undergoing a paradigm shift, moving away from the traditional high-turnover and high-debt model towards a more sustainable, high-quality, and dual-track system.

75%

Residential ratio in overall property investment volume in past three years

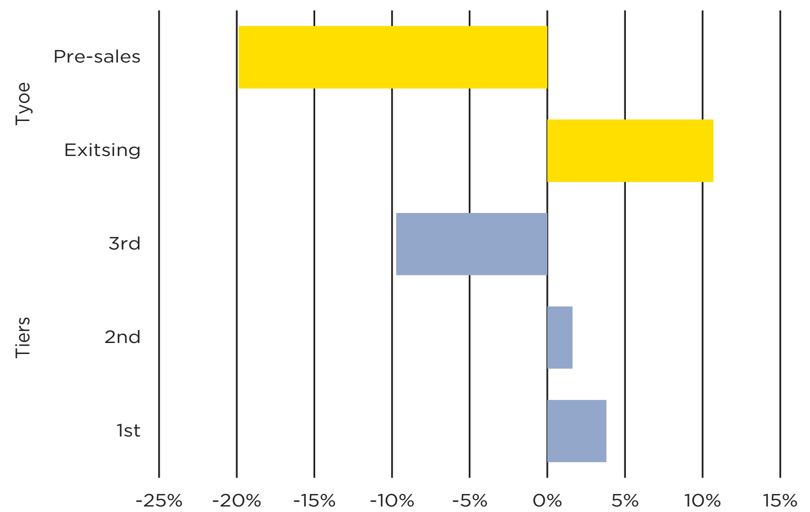
Investment in residential development, new project commencements, and transaction volumes have all witnessed a decline since the second half of 2021. Nationwide residential sales volumes have experienced year-on-year declines for 26 consecutive months up to October 2023.

- While the overall market exhibits a decline, there are variances, notably in first-tier and strong second-tier cities, where transaction volumes have increased. Shanghai, a first-tier city, and Xiamen, a strong second-tier city, recorded growth rates exceeding 9%. However, third-tier city transaction volumes are generally down significantly, particularly in fourth- and fifth-tier cities.

- The transaction volumes of completed homes increased by 11% year-on-year, outperforming the overall market and constituting 18% of the total.

Sales performance has not witnessed significant improvement yet; however, policy relaxations and support measures for both supply and demand sides are beginning to take effect. Recent measures, including the lowering of minimum down payment requirements for second homes to 40% in Guangzhou and Shenzhen, and the removal of purchase restrictions in many second-tier cities such as Nanjing, Suzhou, and Qingdao, indicate a positive trajectory. Overall, residential sales performance is poised for a moderate improvement in 2024. Developers, particularly State-Owned Enterprises (SOEs), with exposure to the better-performing first and second-tier cities, are expected to lead the market.

Figure 1: Residential sales area YoY growth, 1-10/2023



Source CEIC, Savills Research

Why are investors piling into the rental housing market?

China's population growth has plateaued, but urbanization remains a prominent trend, drawing individuals to key economic hubs in pursuit of job opportunities and economic prosperity. The floating population in China, totalling 376 million, accounted for 27% of the national population in the 2020 census, marking a 70% increase from 2010. This continual influx of labour to economically dynamic regions will sustain robust, long-term demand for the residential rental market. Beyond economic migrants, diverse groups such as students, couples, families, and the elderly also contribute to the demand for rental properties, presenting a spectrum of opportunities for developers, investors, and operators capable of meeting varied needs.

Affordable rental housing plays a pivotal role in the real estate market's transformation. Consideration of eligibility for subsidies and special tax treatment, known as "Nabao (纳保)" is crucial for investors. Approximately nine million units of affordable rental housing are slated for completion from 2021 to 2025, significantly expanding institutional rental housing. Of these, newly constructed rental apartments constitute just one million units or 11% of the total. The remainder is expected to result from asset revitalization, repurposing, centralizing lease management, asset M&A, refurbishment, and urban village redevelopment, creating a more diversified supply structure.

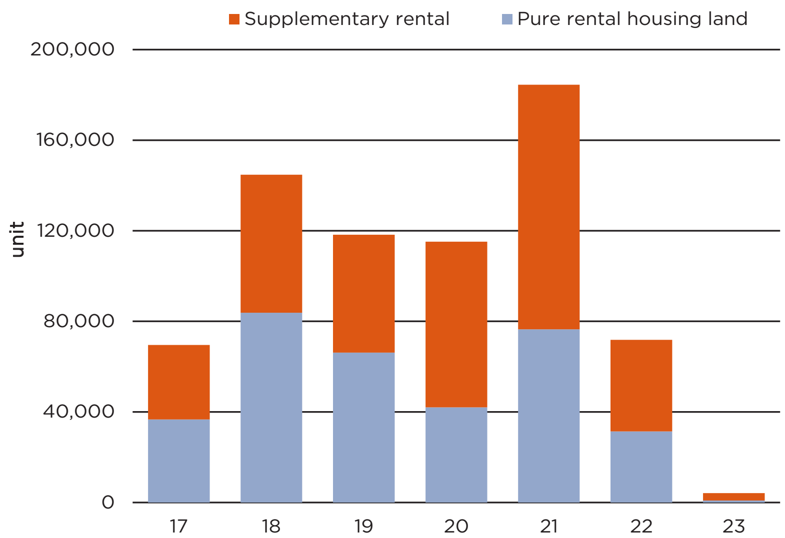
Real estate developments vary widely, from single 50-unit tower blocks to large-scale communities with thousands of units, presenting distinct challenges and opportunities for operation and management teams. Rental apartment net yields generally exceed 4.0%. The success of a project in achieving rent growth and higher renewal rates hinges on the operator's ability to control costs, provide tenant services, and deploy effective management skills.

A diversified product range necessitates comprehensive market studies, strategic promotion, and appropriate positioning. Significant variations in supply, demand, and rental profiles across cities and sectors must be considered by investors when determining a project's target tenant profile, rental levels, and operational costs. Market-oriented leasing apartments must offer beyond-standard services to differentiate and justify premium costs, potentially including additional services, facilities, and amenities to meet tenant needs and desires and enhance revenue streams.

4%

Expected rental return in residential leasing market

Figure 2: Residential leasing land sold by number of potential units, 2017-2023



Source CEIC, Savills Research

How are demographics shaping future housing trends?

Demographic changes in China, characterized by increased life expectancy but lower birth rates, are steering the nation towards slower population growth and an eventual decline. The global population aged over 50 is projected to reach 28.4% by 2033, with 47 countries expected to surpass 40%. China is anticipated to experience a 17-point increase to 43% within the next decade.

These profound demographic shifts signal a considerable shift in future housing demand compared to the rapid real estate development witnessed in the past two decades. Upgrade demand, constituting over 60% of the demand in 2021 according to Everbright Securities, emerges as a primary driver for first-hand homes. Despite a decline in year-to-date residential development investment volume since 2022, investment in units larger than 144 sqm has proven more resilient than smaller units.

Older generations, typically more affluent, prioritize living standards and their primary residences. Over 70% of China's housing stock was built after 2000, meeting the basic housing needs of most individuals, particularly in urban cores of first- and second-tier cities. Future developments are strategically targeting upgrade demand, necessitating higher standards and designs to provide homeowners with a comfortable and healthy environment, complemented by comprehensive supporting facilities.

Mature and affluent buyers form a diverse group, encompassing busy working parents and carefree retirees. Middle-aged buyers, more technology literate, may favour smart homes for greater convenience, while more mature residents may seek larger communities with enhanced accessibility features such as lifts, wheelchair ramps, non-slip floors, and onsite medical facilities.

In the evolving landscape, future developments cannot overlook the importance of Environmental, Social, and Governance (ESG) and carbon reduction standards. A move towards sustainability and incorporating natural elements into urban settings is becoming imperative. Future developments will not only adopt more sustainable and wellness strategies but will also seek certifications such as LEED and green building certification for effective marketing, potential subsidies, and alignment with national reduction targets.

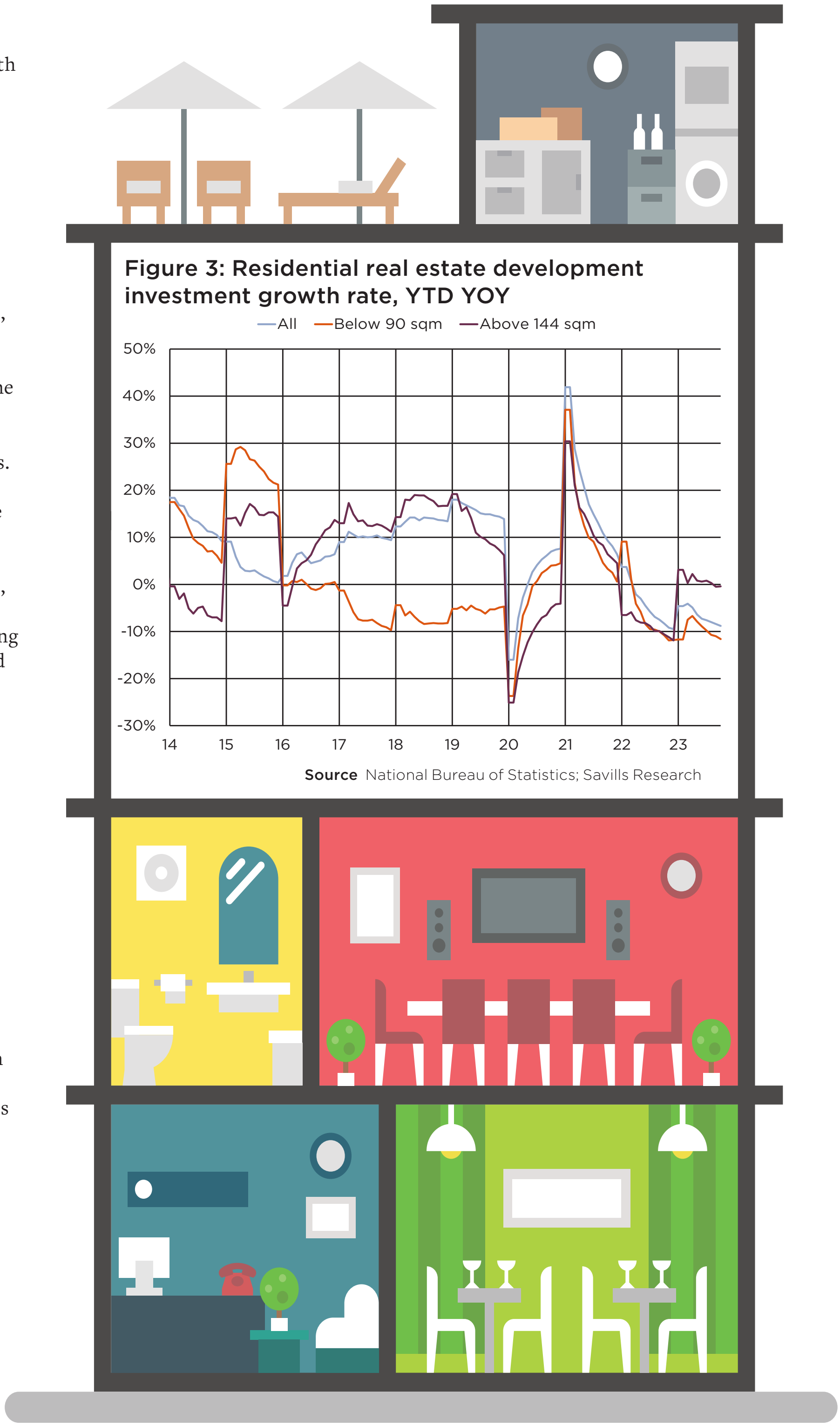


Figure 3: Residential real estate development investment growth rate, YTD YOY

Source National Bureau of Statistics; Savills Research

Working

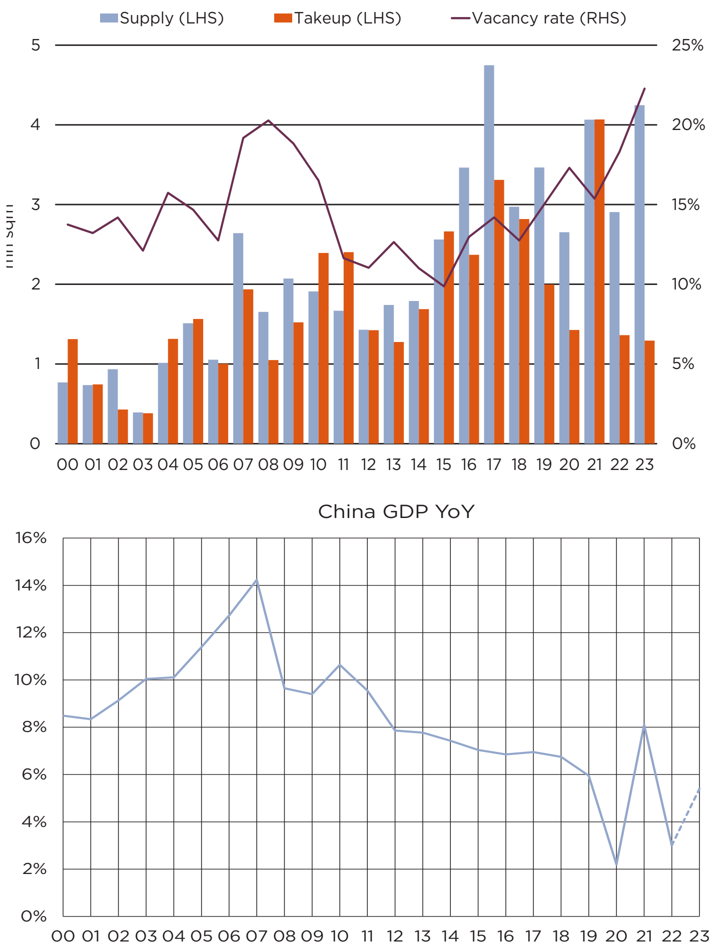
When will the office market start to recover?

The relaxation of COVID-19 restrictions has indeed marked a new phase; however, the expected resurgence in the Chinese economy and office market has unfolded at a more gradual pace than initially projected. This sentiment is underscored by the findings of AmCham Shanghai's latest China Business Report (June 2023), wherein a mere 52% of surveyed companies conveyed optimism regarding the five-year business outlook—a historic low since the report's inception in 1999.

Upon closer scrutiny, a significant portion of the net office space absorption observed in early 2023 can be attributed to pent-up demand from the preceding year, predominantly 2022. Consequently, lease renewals have dominated the market landscape, overshadowing new leases and relocations, both of which have experienced a pronounced downturn. While the prospect of relocation crossed the minds of some companies, the convergence of favourable renewal terms from existing landlords, cost-prohibitive relocation expenses, and ongoing economic uncertainty collectively dissuaded them from pursuing such a course.

In contrast to the structural shifts in office demand witnessed in several countries due to the widespread adoption of remote work, China confronts a more traditional challenge—a convergence of oversupply and sluggish demand. The trajectory of the market cycle hinges on two pivotal factors: the resurgence of demand and the stabilization of supply. These factors are intricately linked to the broader economic climate. As the economy rebounds, businesses expand, recruitment intensifies, real estate budgets flourish, and office space absorption increases. Only then, with supply and demand restored to equilibrium, can a sustainable upward trajectory in rental rates be anticipated.

Figure 4: Market cycle & GDP



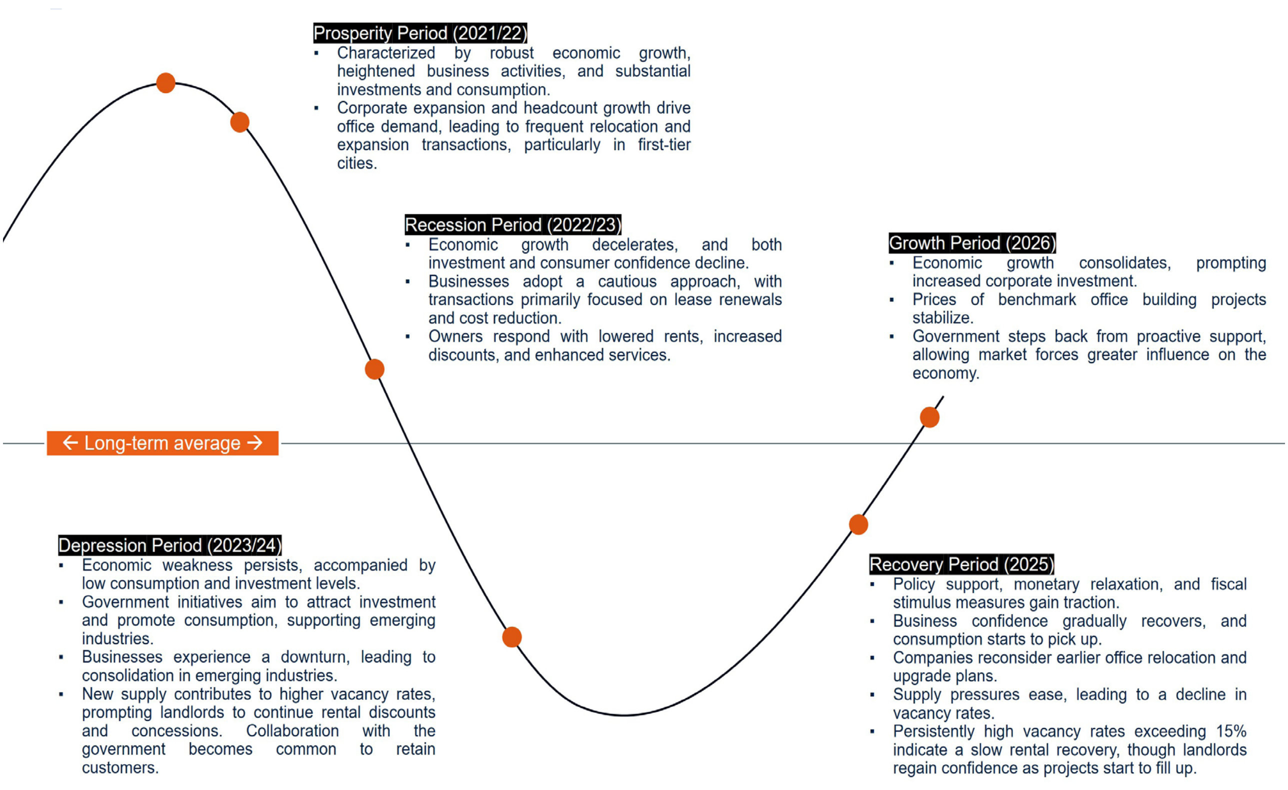
Source International Monetary Fund; National Bureau of Statistics; Savills Research

Examining past challenges is a prerequisite for anticipating the future. In 2008, China's economy and real estate market faced considerable hardships in response to the global financial crisis. In a swift response, Chinese authorities implemented a RMB 4 trillion stimulus package, effectively stabilizing the financial market, enhancing domestic demand, and supporting infrastructure construction. As the policy effects materialized, consumer confidence surged, the job market improved, and China's economy underwent a gradual recovery. Concurrently, the government aimed to augment investments in high-tech and innovative industries.

Historical economic cycles typically endure for about four to six years, contingent upon specific contextual factors. The current cycle commenced in 2022/23, marked by the challenges posed by COVID restrictions and lockdowns, influencing consumer sentiment as well as business and economic prospects. In 2023, the government introduced a series of stimulus measures to bolster domestic demand, albeit the overall impact has been relatively moderate, necessitating additional support in 2024.

The trajectory of recovery remains uncertain and elusive. The duration of the economic and business sentiment's recovery will significantly impact the emergence of supply and demand imbalances. Prolonged recovery periods would exacerbate these imbalances, leading to an extended timeframe for vacancy rates to reach healthier levels.

Figure 5: Market Cycle



Source Savills Research

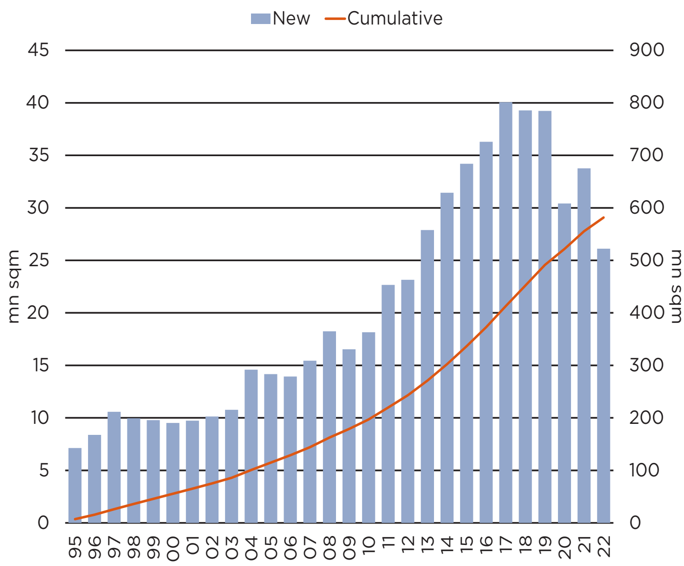
What are the prospects for Grade B offices given the surge of new high-spec supply?

As urbanization progresses, new office towers continue to shape city skylines. The classification of a building's grade involves a combination of empirical and subjective factors. It considers building specifications, encompassing aspects that are hard or costly to upgrade, and management and operations, including the adoption of PropTech, property management standards, ownership structure, and tenant quality. Generally, Grade B rents are 30-40% lower than Grade A rents within the same business district.

According to the Shanghai Statistical Yearbook, the total office stock in Shanghai, spanning all grades, amounted to 104 million sqm in 2021. In contrast, Savills tracked 26 million sqm of Grade A office stock, inclusive of self-use and business parks. This implies that Grade A stock constitutes approximately 25% of the total office stock. In Hong Kong, the total office stock is reported to be 12.9 million sqm, with Grade A accounting for 8.5 million sqm, according to the Hong Kong Rating & Valuation Department. This indicates that Grade A stock constitutes around 65% of the total office stock.

Anecdotal evidence suggests that the percentage of Grade A stock in lower-tier cities might be lower than in leading cities, reflecting the general stratification of stock and a lack of institutional investment. According to the National Bureau of Statistics, 581 million sqm of office space has been completed over the last 27 years up to 2022. Assuming that only 15-20% of the country's office stock is Grade A, this suggests that approximately 465 million sqm of space is of lower-grade quality.

Figure 6: China office completions



Source National Bureau of Statistics; Savills Research

Table 1: Push-pull factor for Grade B offices

	Tenant Characteristics	Details
Sticky Tenants	Limited rental affordability coupled with a preference for central locations.	Rent savings.
	Long-term tenancy, often affiliated with the landlord.	Owner services and targeted discounts.
	Consumer Service Companies (e.g., Medical Beauty)	Unable to secure leases in Grade A buildings.
	Sales Offices	Reduced security hurdles and streamlined entry/exit processes for sales staff.
	Business Registration Place	Registration address remains consistent, with minimal on-site staff.
	Private Firms with Strong Fengshui Beliefs	Strong historical performance linked to the fengshui of the premises.
Move Out Tenants	High Growth Companies	Grade B buildings pose difficulties for expansion due to smaller floor plates and subdivisions.
	Cost-Conscious Companies Aiming to Improve Efficiency	Counterintuitively, moving from downtown Grade B to decentralized Grade A could save costs, enhance efficiency, and boost morale (especially in a tenant-favourable market).
	Owner-Occupier Companies	Move or integrate into a self-owned headquarters.
	Corporates with Higher ESG and Employee Wellness Standards	Potential relocation to higher specification buildings to align with corporate ESG targets.

Source Savills Research

Just because a project is classified as Grade B does not necessarily preclude it from attracting quality tenants. Grade B projects in city centre locations can achieve similar occupancy levels to similarly situated Grade A projects, thanks to competitive pricing strategies while offering the same convenient transportation and surrounding amenities. While project specifications may not be adequate for some tenants, responsive leasing teams and well-run property management can contribute to tenant stability.

Supply levels in the market remain elevated, and newly constructed buildings predominantly adhere to Grade A standards. Older buildings face significant challenges when compared to new projects, particularly concerning project specifications. While stratified projects may encounter difficulties addressing these issues, single-ownership assets have the potential for improvement. This improvement can focus on enhancing common areas and optimizing underutilized spaces, potentially transforming them into shared amenities or conveniences. Landlords should also evaluate strategies to reduce operational costs and enhance energy efficiency and sustainability standards during these upgrades.

However, landlords should be mindful that, given the escalating competition even within the Grade A space, any increase in rental income may be marginal. Upgrades are primarily essential to retain tenants and sustain occupancy rates. Therefore, capital expenditure on upgrades demands vigilant monitoring.

Green Building Initiatives:
Engaging a third-party consultant to scrutinize project standards and operations can yield valuable insights and recommendations for potential improvements and energy/cost savings. If significant energy savings are achievable, there may be an opportunity to attain certification as a "green" building.

Third-Party Cooperation:
Consider the introduction of co-working/business centres through lease and sublet models, profit-sharing arrangements, or management agreements.

Shuttle Bus Services:
Implementing shuttle buses can provide a cost-effective benefit to tenant employees, especially for projects lacking convenient access to public transportation, such as metro access.

Commercial-Office Linkage:
Enhance synergies between office and retail amenities by offering office tenant employees discounts in participating retail stores and preferential terms for consumer brands occupying office space.

Conversion to Better and Higher Use Case:
In cases where renovations may not sufficiently revive the asset's viability, landlords must contemplate whether the project could be more valuable in another capacity. While this is a costly, risky, and time-consuming endeavour, there may be an opportunity to convert assets into multifamily developments, particularly in cities facing affordability challenges. Instances of such conversions have already been recorded in first-tier cities like Shanghai.

Table 2: 10+-year-old office building with high occupancy rates

Project	Business District, City	Age (Years)	Occupancy rate	Rental premium newer buildings
Ruijin Building	Huaihai Road Middle/ prime, Shanghai	37	95%	25-30%
Guangzhou Int'l Electronics Tower	Yuexiu/prime, Guangzhou	27	90%	15-20%
Western Tower	Renmin Road South/ non-prime, Chengdu	20	90%	15-25%
Vantone Centre, Tower D	CBD/prime, Beijing	14	90%	20-25%

Source Savills Research INKC

What are the future office needs of various industries?

Office tenants in China represent a diverse array of backgrounds and industries and shifts within the economy and industry-specific trends hold the potential to reshape the office market.

The economic landscape of China is expected to encounter challenges in 2024, encompassing issues within the real estate market and local debt concerns. Local authorities are actively seeking foreign investment and concurrently offering policy support to domestic enterprises. The slow recovery of domestic consumption and services is underway. Simultaneously, the evolution of emerging industries and the ongoing green transformation will enhance the quality and sustainability of economic activities.

Despite subdued leasing transaction volumes, traditional industries, including finance, professional services, IT, and medical health, continue to dominate office demand, representing 70-80% of leasing activity. New economy sectors, although contributing less, exhibit higher growth rates. This category encompasses high-end manufacturing (such as integrated circuits and new energy vehicles), emerging tech industries (such as artificial intelligence, big data, and cloud computing), and new energy firms (with a focus on green initiatives, low-carbon practices, environmental protection, and energy conservation). Demand from new economy sectors is marked by unpredictability, with specific industries undergoing waves of expansion and consolidation based on factors such as capital availability, subsidies, policy support, and profitability.

Forecasting demand remains a complex task due to ongoing uncertainties in the economic outlook. External factors, including trade relations, global economic strength, and interest rates, alongside internal factors such as policy support, monetary policy, economic reforms, and consumer confidence, contribute to the dynamic and changeable nature of demand projections.

Table 3: Grade A office market forecast for major cities, 2024

City	Supply (sqm)	Vacancy	Rental change
Beijing	582,900 ↓	22.4% ↑	**-3%-(-)0.5%**
Shanghai	1,906,900 ↑	23.5% ↑	**-5%-(-)3%**
Shenzhen	890,100 →	29.8% ↑	**-3%-(-)0.5%**
Guangzhou	1,077,600 ↑	24.5% ↑	**-5%-(-)3%**
Chengdu	318,800 ↑	34.0% ↑	**-0.5%-0.5%**
Chongqing	282,600 ↑	32.0% ↑	**-3%-(-)0.5%**
Xi'an	335,000 ↑	30.0% ↑	**-3%-(-)0.5%**
Tianjin	80,000 ↑	36.0% ↑	**-3%-(-)0.5%**
Wuhan	309,500 ↑	40.1% ↑	**-5%-(-)3%**
Hangzhou	0 ↓	24.1% ↓	**-3%-(-)0.5%**

Note Direction of the arrow indicates YoY movement.

Source Savills Research INKC

Table 4: Office demand outlook by key industries

	Short term demand	Long term demand	Hardware specifi -cation	Rental afford -ability	Space per work -station	Growth segments	Outlook
Finance						Insurance / Investment / Asset management	Critical importance to the broader economy Greater focus on financial stability and risk management Fintech/green finance growth opportunities.
Professional service						Law	Law firms continue to grow; Personalized and customized services; Enterprises pay attention to attracting talent
Retail and trade			Varies			General retail / E-commerce	A huge market, with weak short-term demand but still long-term potential; Retailers pay attention to supply chain and logistics efficiency; Physical retail is evolving; / Collaborations increase.
Real estate						Construction and engineering	Debt problems still exist, and support is limited Favourable policies are needed to stabilize the market; Urban Village renovation and rental apartment opportunities
Information technology						Next generation IT	Increased digital transformation drives demand but competition is fierce; Government support for scientific and technology-enabled growth Data and network security issues exist
Manufacturing						High-end manufacturing	Slowbalization – weakening political support for open trade Domestic market dominance in high-end manufacturing; Firms offer a connected operations solution
Health care						Innovative drugs / medical technology	Health awareness increases: Government prioritizes investment in the life sciences sector; The rise of medical tourism
Media and entertainment						Social Media	New technologies and channels challenge traditional firms; Evolving business models bring new opportunities; Copyright protection is of concern
Energy and raw materials						Renewable energy / Energy saving / Energy infrastructure	Energy security is a national security concern;Transition to new energy sources requires significant investment; Promotion of green/new materials
Co-working office & business centre						Not applicable	Improvement of community offerings; Data security and privacy protection issues; Landlords should be conscious of potential operator risks
Consumer services			Varies			F&B	F&B, leisure, entertainment and services are recovering; Consumption downgrade affecting some segments Personalized goods & services demand is strong.
Conglomerate			Varies			Not applicable	Anti-trust authorities still vigilant Focus on core business, reduce costs and increase efficiency; Global expansion and innovation to growth business
Transportation						Smart transportation / Express delivery	Domestic and international travel resumes; Public transportation improves and autonomous driving is promoted; Transportation infrastructure continues to receive investment but at lower levels

Note
1. The darker the more optimistic or the higher the hardware requirements/rental capacity/area demand.
2: Other office tenant industries include public institutions and public utilities
3: The forecast is based on EIU's outlook for China's key industries, 2024 and Savills Research views

Consuming

What are Chinese consumers still consuming?

There is an evident increase in consumer willingness to allocate both time and financial resources towards experiential activities such as travel, entertainment, and dining. Notably, domestic railway and air transport metrics have surpassed pre-epidemic levels. During the summer of 2023, domestic railway and air transport figures achieved unprecedented peaks, excluding national holiday periods. Conversely, the recovery in overseas travel has been more gradual due to incomplete route capacities, sustained high prices, and persistent challenges in visa applications. Consequently, international air passenger traffic remains at 50% of the levels observed in 2019.

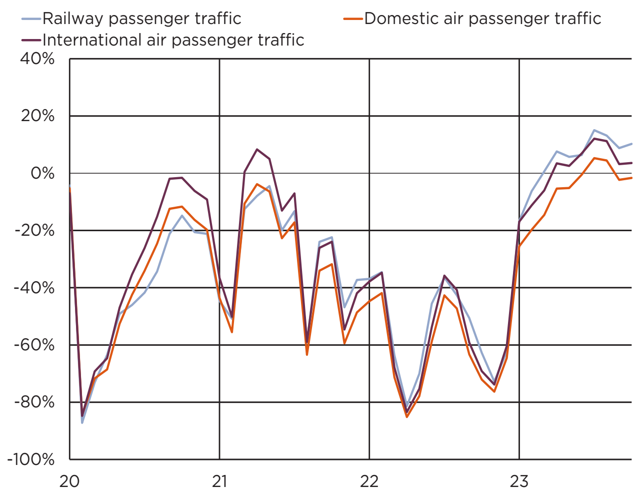
The resurgence in domestic tourism has positively influenced the retail landscape in prominent first- and second-tier cities, along with sought-after tourist destinations like Hainan and Yunnan. Recognizing this shift, leading developers are strategically directing their focus towards these popular travel destinations. Notably, Sanya has emerged as a pivotal market for developers, driven by the envisioned Hainan Free Trade Port by 2025. The introduction of several mid-range to high-end projects is poised to reshape Sanya's retail market.

- China Resources Group's Sanya MixC and Taikoo Li, a joint venture between Swire and CDF, is expected to open in phases starting in 2024
- DFS in cooperation with Shenya Group plans to complete DFS Yalong Bay Project by 2026.
- Lhasa Wangfujing Shopping Centre will become the largest retail project in Lhasa with a retail GFA of 182,000 sqm.
- Merlin Group's Legoland theme parks are expected to open in succession from 2024 in Shenzhen, Shanghai, and Sichuan, while Legoland Beijing is about to start construction. Theme parks with strong brand awareness will attract tourists.

The primary driver of offline consumption has evolved to centre around experiential offerings and heightened consumer engagement. Leisure and entertainment operators progressively command a larger share of retail space annually. In Shanghai, the percentage of leased space by such operators has risen from 13.6% in 2019 to 16.5% in 2023. Concurrently, Wuhan has experienced a rebound, surpassing pre-COVID levels to reach 16.0%. These spaces serve as hubs for diverse offline socializing opportunities and personal enjoyment.

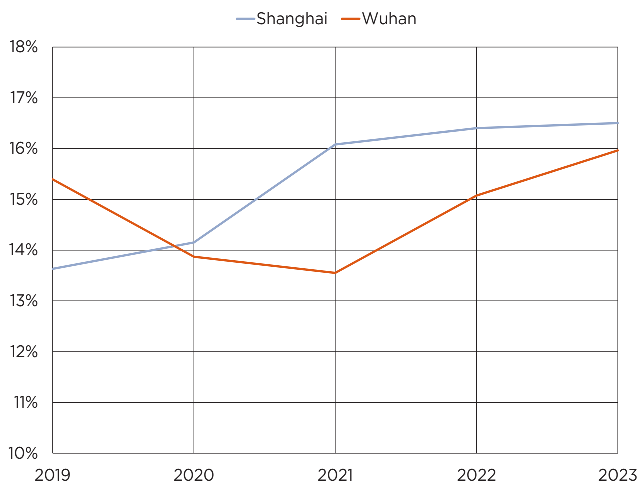
Growing concerns related to both physical and mental health are evident across various consumer demographics. Sports and activity stores are actively expanding their physical presence, introducing new and innovative concepts and brands. Consumers are increasingly prioritizing their spiritual and emotional well-being, engaging in novel activities, acquiring new skills, and expanding their knowledge across various domains. This trend has created opportunities for the growth of exhibition spaces and art galleries.

Figure 7: Rail and Air Travel compared to 2019 levels



Source CEIC; Savills Research

Figure 8: Leisure and entertainment tenants' area allocation



Source Savills Research INKC

Is the retail market facing a consumption downgrade?

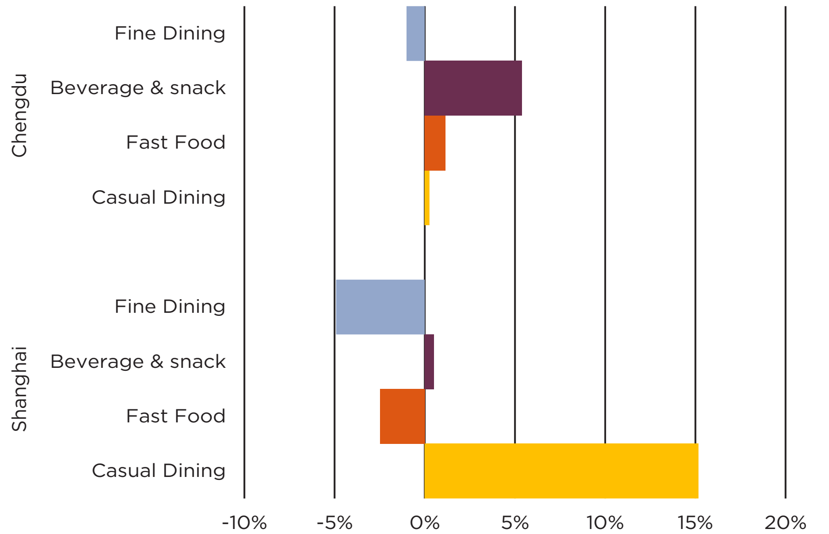
In light of an economic deceleration and heightened job insecurity, consumers are reevaluating their consumption patterns and adjusting spending habits. While some individuals opt for downgrading their consumption, choosing lower-priced or lower-quality items, or reducing purchase frequency, others are rationalizing their consumption choices, emphasizing value for money over the sole consideration of the lowest-cost product. According to iResearch, over 92% of consumers reported a more calculated and planned approach to consumption post-COVID. Simultaneously, a McKinsey survey indicates that approximately half of consumers will continue purchasing their preferred brands through lower-priced or discounted channels, seeking promotions, or exploring bulk purchase options.

Consumption trends exhibit variability based on price points, with both high-end and mass-market consumption sectors experiencing the quickest recovery. Renowned luxury brands such as Chanel and Louis Vuitton have successfully implemented multiple price increases this year, contributing to the maintenance of brand exclusivity. For everyday necessities, consumer preference is shifting towards "low-price," "discount," and "alternative" products, focusing more on product quality than brand recognition. Supermarkets, such as Hema and Sam's Club, emphasizing quality, have adopted new discount strategies to broaden their user base.

In 2023, affordable F&B outlets expanded at a faster rate than high-end restaurants. In Shanghai, casual dining witnessed a YoY increase of over 15%, while fast food and high-end fine dining experienced declines of 2.5% and 4.9%, respectively. In Chengdu, casual dining and fast food recorded moderate growth, with a decline in fine dining venues. Short-term growth is anticipated to be led by value-for-money options, specialty brands, and innovative concepts.

Beverage and snack stores in Shanghai and Chengdu malls saw increases of 0.5% and 5.4%, respectively. Recent years have seen adjustments in the distribution, design, and layouts of these stores to align with changing consumer trends. Coffee chains offering in-store consumption and affordably-priced items are rapidly expanding across malls, street locations, as well as office and residential podiums. Not confined to first- and second-tier cities or core areas, these chains are expanding aggressively into lower-tier cities and emerging regions. While independent coffee shops face increased competition, the category as a whole has gained popularity. Tea brands are also entering this dynamic landscape, leveraging franchises, expanding aggressively with smaller store sizes, venturing into overseas markets, and utilizing equity markets for funding.

Figure 9: Catering retailer leased area growth rates, 2023



Source Savills Research INKC

Consumer options outside of shopping malls?

Over the past two decades, China's physical retail landscape has undergone substantial transformation, transitioning from street stores to department stores and, more recently, to shopping malls. The pace of growth remains robust, with a significant influx of shopping mall supply anticipated in the next five years. Notably, in 2024, Shanghai, Shenzhen, and Wuhan are each expected to witness the introduction of more than 700,000 square meters of new retail space.

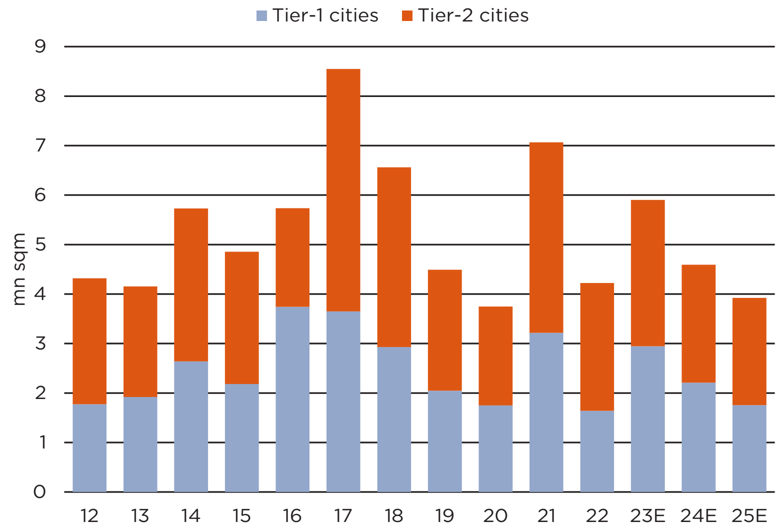
Simultaneously, the trend of urban regeneration is fostering the development of compact retail spaces in city centre locations, characterized by distinctive character and appeal. These endeavours contribute to a unique atmosphere within the market. Noteworthy is the emergence of commercial projects in unconventional locations, strategically positioned to address the daily needs of local consumers or to captivate specific buyer groups through innovative designs and thematic elements.

Non-traditional retail projects commonly embrace open-plan layouts, employing unconventional architectural designs to curate a unique and impactful sensory experience. The strategic use of large empty areas contributes to a distinctive sense of spatial awareness. These retail spaces seamlessly integrate with public areas, forming permeable membranes that connect to larger projects. In addition, they incorporate elements of leisure, entertainment, art installations, and local heritage, all aimed at fostering an emotional resonance with the project.

Emerging domestic brands often favour non-traditional retail projects, particularly for their initial stores or flagship locations. These spaces align with brand identities, offering an atmosphere that is not overwhelmingly commercial. The integration of community services, original fashion brands, flash promotions, co-branding, resource sharing, and diverse activities contributes to infusing creativity into community life. This approach helps dispel a sanitized and homogenous atmosphere, extending operational hours to enhance popularity and community influence. Retail brands can choose from various store formats, including showrooms, cafes, bookstores, and florists, strategically creating a brand buzz, and expanding their customer reach. Fashion brands, home lifestyle stores, cosmetic and perfume retailers, and even luxury brands find value in these locations, enabling them to connect with a diverse consumer base and increase the likelihood of spontaneous impulse purchases.

Several projects have become social media hits and caught consumers' attention in 2023 given their unique positioning and spatial design. Kerry's The Lightbox and C Park Haisu in Shanghai are seamless mish-mash of retail, office and public space encapsulated in a small architectural scale. Beijing's The Box and Chengdu's COSMO, focus on youth culture, while Hangzhou's BirLand, is infused with Liangzhu cultural heritage.

Figure 10: Shopping mall supply



Note First-tier cities include Beijing, Shanghai, Guangzhou, and Shenzhen; second-tier cities include Chengdu, Chongqing, Tianjin, Wuhan, Hangzhou, and Xi'an

Source Savills Research INKC

Producing

Will 2024 witness a recovery in the logistics market?

Over the last five years, the logistics sector has attracted significant attention, driven by policy support and robust fundamental demand drivers. This focus has resulted in substantial investment in development, leading to a consistent increase in the supply of non-bonded high-standard warehouses nationwide. Unfortunately, subdued consumer demand has led to temporary excess supply in some Northern and Eastern China markets, accompanied by a corresponding rise in vacancy rates. While new supply has tapered off in certain cities in 2023, markets outside the Greater Bay Area continue to face intense leasing competition.

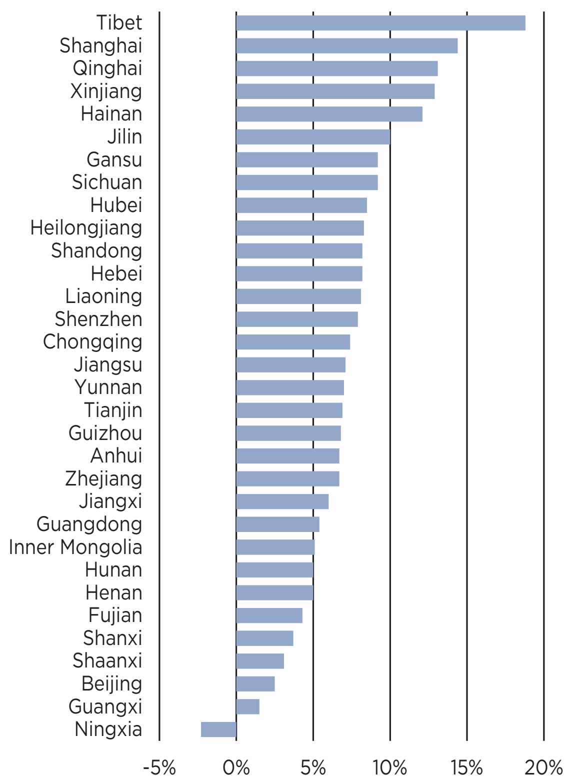
Supply levels are projected to moderate in 2024 following a recent surge in projects. As tenants confront a broader array of options and operational margins face compression, landlords are faced with the prospect of sacrificing rent growth to sustain occupancy rates. Some developers have opted to decelerate development, defer completion dates, or adopt phased completions to conserve capital, with the hope of navigating more favourable market conditions and securing a superior preleasing period to attract high-quality tenants.

While the nationwide market poses challenges, Western China has shown signs of improvement, in contrast to relatively tight conditions in Southern markets. Unlike the East and North, Western China has witnessed a steady decline in new supply since 2020. Concurrently, demand is still growing, albeit at a moderated pace, driven by the region's urbanization and consumption growth, the establishment of new manufacturing bases, and the increasing consolidation of OBOR (One Belt, One Road) supply chains.

Chongqing stands out as the nation's sole "four-mode" national logistics hub, encompassing port, land, airport, and production & service capabilities. The city has experienced significant growth in import and export freight volume, fostering the development of local high-end manufacturing and cross-border e-commerce, among other trade formats.

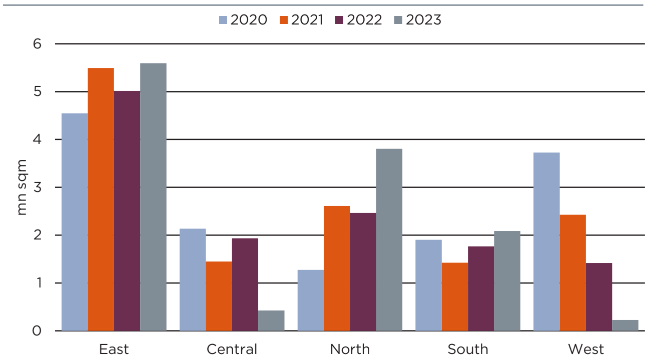
Sichuan's cultural and tourism industry has received a boost from supportive policies such as the "20 Articles," leading to a notable 9.2% increase in retail sales in the first nine months of 2023, surpassing the national average by 2.4 ppts. Additionally, the establishment of new energy vehicle production bases has contributed to a robust 22.9% growth in manufacturing investment. Notably, Sichuan has maintained an active logistics land market over the past three years, remaining one of the most dynamic regions in China and experiencing a resurgence in activity compared to pre-COVID levels.

Figure 11: Retail sales growth rate, Q1-Q3/2023



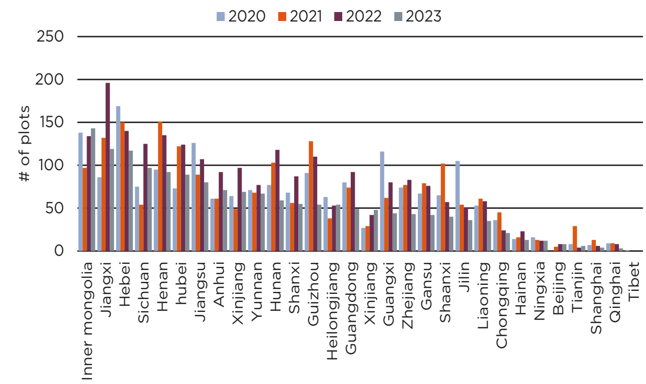
Source CEIC, Savills Research

Figure 12: China Non-Bonded Warehouse Supply



Source Savills Research INKC

Figure 13: Logistics land supply



Source Savills Research INKC

Will the demand for green warehousing continue to rise?

The heightened awareness of climate change and the imperative for sustainable development and environmental protection in the Chinese public, coupled with robust government support for environmental policies, has spurred a rapid trend in the development of green warehousing. This has led to a notable increase in the number of LEED-certified warehouses in China. Tenants benefit not only from reduced operating costs but also contribute to achieving corporate sustainability targets.

The Chinese government is earnest in its commitment to reaching its CO_2 emissions peak before 2030 and achieving carbon neutrality by 2060. Consequently, it is promoting low-carbon management standards and conducting supply chain decarbonization management across various industries, including manufacturing, light industry, and logistics. The corresponding carbon emission audits are expected to become more stringent.

As the understanding and adoption of the three carbon emissions scopes become more widespread, the logistics industry is gaining clarity on emissions produced at each stage of its operations. While businesses generally have a good understanding of scope 1 & 2 emissions (direct emissions and those from sources like electricity and heating), these typically account for less than a third of a company's carbon footprint. To reach net-zero targets, companies must consider Scope 3 emissions, associated with the organization indirectly, up and down its value chain. Warehouse tenants, retailers, and manufacturers using the services of 3PL firms that utilize a warehouse will need to consider the GHG emissions generated by that warehouse. With future requirements for corporate carbon emissions disclosure expected to strengthen, manufacturers, 3PLs, and other customers will be more cautious in selecting warehouses. Green logistics facilities that incorporate these sustainability measures now will be better positioned to capture future tenant demand.

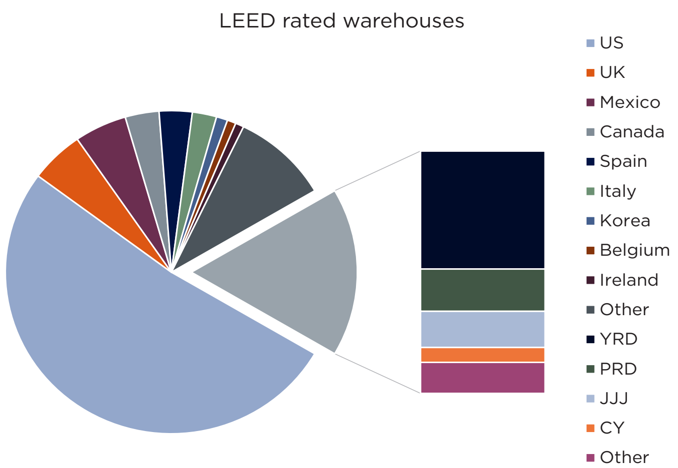
Simultaneously, the construction of sustainable high-standard warehouses is likely to be more cost-effective for developers over the long run. Although the construction of a green warehouse may entail higher initial costs than a traditional warehouse, it can potentially eliminate the need for a costly retrofit in the future, especially when new government regulations or guidelines are introduced or revenue disparities between sustainable and traditional warehouses become too significant. Additionally, there are evident operational cost savings that can be accrued over the building's lifecycle.

In the context of stable market rents, green-certified warehouses typically boast higher occupancy rates and longer lease terms, making them more attractive to investors seeking high-quality underlying assets. Despite market concerns and increased caution among investors, high-quality green warehouses have proven particularly resilient to market volatility. This resilience provides investors with a greater degree of certainty in their future exit strategies.

Despite a decline in the supply of non-bonded high-standard warehouses in 2023, green logistics has defied the trend and continued to grow. Of the nearly 800 LEED-certified warehouse projects in China, almost a third received certification in 2023 alone. The Yangtze River Delta region, recognized as a green ecological development demonstration zone and the largest logistics market in China, accounts for nearly half of the total. Leading developers such as Goodman and VX have been early adopters of this trend. VX, for instance, has eleven LEED Gold cold storage facilities, featuring distributed photovoltaics for new cold storage facilities and a commitment to 100% electric forklift use, resulting in over 30% energy savings.

China has emerged as the country with the most LEED-certified facilities outside of the United States, holding nearly one-fifth of the global market share. The number of new green logistics facilities in China is expected to continue growing due to sustained demand growth and the necessity to upgrade outdated facilities. The new generation of properties will be more intelligent and versatile, ready to meet the evolving needs of a transforming and upgraded manufacturing sector.

Figure 14: LEED-rated warehouses



Source USGBC; Savills Research

Is there still room for improvement in reverse logistics under the circular economy?

Reverse logistics encompasses activities such as product recovery, inspection, classification, remanufacturing, and disposal. In 2022, global venture capital firms invested almost US$200 million in reverse logistics startups, marking a 150% YoY increase, a noteworthy feat considering the prevailing fundraising environment, according to Bloomberg.

Characterized by complexity and uncertainty, reverse logistics typically has a processing time three to five times longer than forward logistics, creating a long-standing bottleneck in supply chain networks and hindering circularity and sustainability improvements.

Research and Markets estimate the global reverse logistics market surpassed US$600 billion by the end of 2022, projected to reach about $640 billion by the end of 2023. With China's market share estimated at 18% of the global logistics market, the Chinese reverse logistics market is anticipated to surpass US$110 billion in 2023. E-commerce platforms are expected to drive nearly half of the global reverse logistics demand, and given the high e-commerce penetration rate, this figure could be even higher in China, according to Grand View Research.

The return rate on China's leading e-commerce platforms has exceeded 10%, reaching 30-50% in certain product categories. Managing return costs has become a crucial consideration for e-commerce companies.

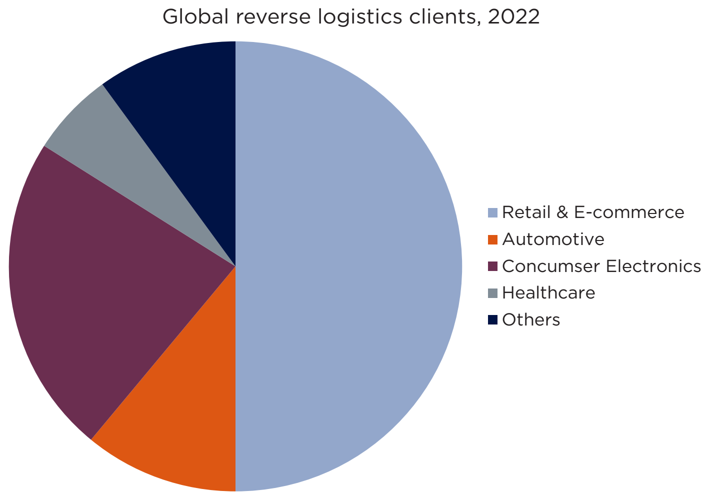
E-commerce platforms, aiming to enhance customer satisfaction and retain market share, continue to improve after-sales services, investing in more convenient return and refund processes along with higher freight insurance ratios. Simultaneously, online shopping habits have shifted from "Buy, buy, buy" to "Value for money," leading to higher return frequencies. E-commerce platforms often collaborate with third-party logistics companies to return goods to warehouses for centralized processing, resulting in new demand for sorting and storage facilities from these 3PL firms.

The returns process can be incredibly challenging and disorderly, exacerbated by a lack of storage space and insufficient automation. Many companies have yet to establish dedicated returns areas, with insufficient space for repacking, recycling, or scrapping. Given the large SKU and dispersed nature of products, an advanced warehouse management system is essential for product information verification, quality inspection, repackaging, and inventory tracking. Older warehouses will need upgrading or replacing with more intelligent high-standard warehouses to meet the needs of flexible supply chains.

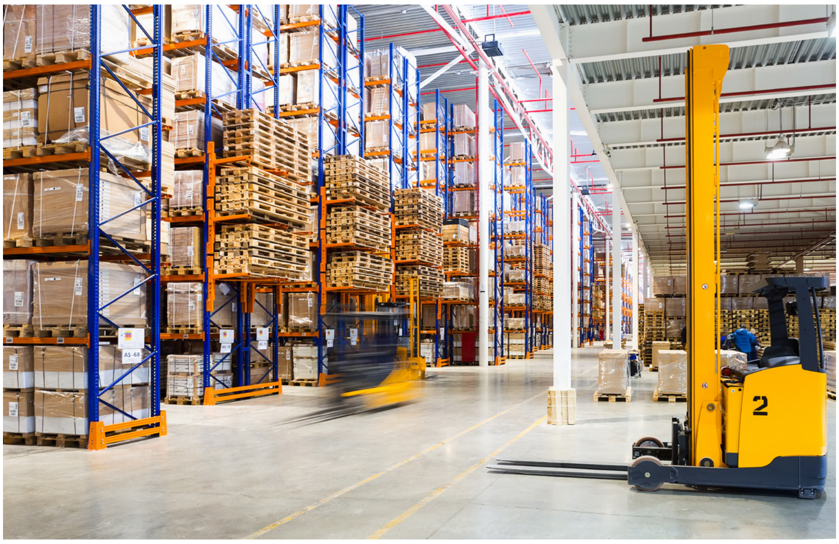
China's leading logistics companies are already developing reverse logistics warehouse networks to augment existing supply chain capabilities, serving various brand needs. In the short term, an expansion of these facilities will be required to service the broader market in the long run.

Best Express has established a dedicated reverse warehouse for its partner brands, showcasing its commitment to sustainability and improving supply chain efficiency. These warehouses utilize the firm's own warehouse intelligent management system for full-node visualization coverage, enabling clear allocation of goods based on the attributes of the brand's products. JD has established a network of seven reverse logistics disposal centres and over 40 reverse forward warehouses across the country, alongside independent inspection, and repair centres. JD's efforts extend beyond processing returns; they offer value-added services like the disposal of residual products and the realization of second-hand goods.

Figure 15: Residential 1-10/2023



Source Grand View Research; Savills Research



Will the debt crisis be alleviated in the future?

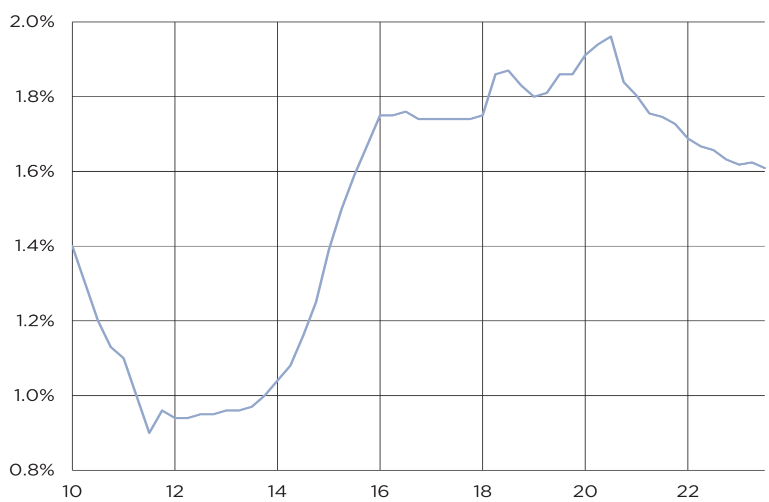
China's real estate market experienced a brief uptick in the first quarter of 2023, but sales resumed their downward trajectory in the second quarter, reflecting persistent industry sluggishness. Despite ongoing countercyclical policy measures implemented by the government, these have proven insufficient to counteract the negative sentiment stemming from declining household income expectations and the reversal of home price growth expectations.

The government's long-term efforts to adjust the industrial structure and reduce reliance on real estate have coincided with an unexpectedly rapid downturn in the entire real estate market. This confluence has exposed risks accumulated during the industry's previous boom period, raising financial stability concerns. Non-performing loans (NPLs) related to real estate held by 18 key listed banks totalled RMB 29.7 billion by June 30, 2023, a 7.6% increase from the end of 2022. This increase in NPLs has put pressure on banks' asset quality and heightened operational risks. Minsheng Bank's plans for a RMB50 billion capital raising were suspended due to safety and compliance concerns related to its real estate exposure, further exacerbating its refinancing challenges. To head off a wider debt crisis, the government is expected to continue to support housing demand enabling developers to monetise existing assets, as well as improving developer financing to stabilize market development.

Real estate developers have accelerated deleveraging efforts since 2021 to offset the tighter financing environment that has resulted in a liquidity event for some. Developer debt defaults and the downgrading of bond ratings have made it harder or at least more expensive for developers to issue new bonds. At the same time, much of the global economy has faced rampant inflation over the past two years resulting in a rapid hike in interest rates and a strengthening of the US dollar against the renminbi. This confluence of factors has elevated the risk of debt default (especially offshore debt) for some developers, with debt restructuring the only option for some firms.

In November 2023, Sunac became the first domestic real estate developer to complete its overseas debt restructuring. Its existing debt of approximately US$10 billion was replaced with a combination of new notes, mandatory convertible bonds, convertible bonds, and shares of Sunac Services. Sunac's success has established a potential model for other distressed developers to mitigate debt crises. Zhengrong, Logan, Xuhui, China Everbright Group, and Country Garden are among those actively pursuing overseas debt restructuring. However, it is crucial to recognize that debt restructuring merely defers, rather than eliminates, existing obligations. The ultimate resolution of developers' debt crises hinges on improving revenues from revitalizing existing projects, accelerating sales, and enhancing operation efficiencies.

Figure 17: Commercial Bank NPL Ratio



Source China Banking and Insurance Regulatory Commission; Savills Research

How big will the market size of C-REITs be in the future?

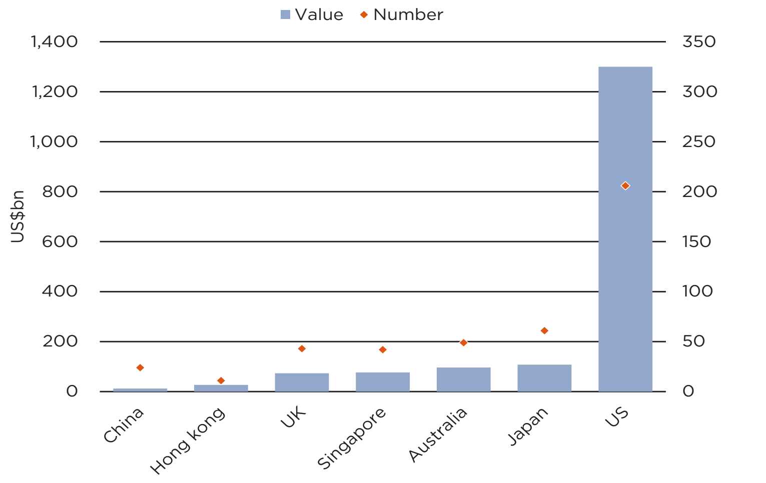
China's real estate investment trust (C-REIT) market commenced in June 2021 with the listing of infrastructure assets like toll roads, business parks, and logistics warehouses. Subsequent years witnessed expansion to include affordable rental housing and retail properties. Regulatory refinement alongside market growth ensued, resulting in 29 publicly traded C-REITs as of November 2023, raising over RMB100 billion through initial and follow-on offerings.

Only two C-REITs, however, involve private enterprises as the sponsor. This primarily stems from the characteristics of operation-rights REITs, which often involve heavy assets, stringent operational qualifications, and extended payback periods, limiting the pool of suitable projects within private entities. Simultaneously, the high eligibility standards for sponsors and underlying assets pose additional challenges for private participation in ownership REITs. The low private enterprise involvement fails to align with one of the original purposes of REITs, enabling developers to recycle capital and reduce leverage rates.

Recognizing this disparity, authorities have indicated their intention to encourage private enterprises to participate in the C-REIT market. Should private entities heed this call and inject increasing number of existing assets into the C-REIT framework, the market could enter a period of rapid growth in the coming years.

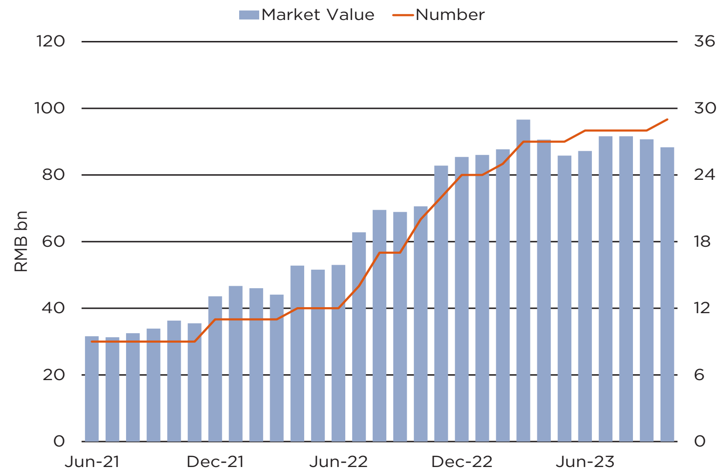
The US is one of the earliest and now largest and most mature REIT markets in the world, in 2023 the aggregate market capitalization of the over 200 U.S. REITs stood at US$1.3 trillion, roughly 3% of the total stock market cap and 7% of GDP. Similarly, the 42 Singapore S-REITs have a market cap of approx. S$100 billion, representing around 12% and 16% of its stock market cap and GDP. If China's REIT market could grow to just 2% of the domestic stock market cap in the future this would equate to RMB1.7 trillion.

Figure 18: International real estate investment trust market size, 2022



Source WIND; NAREIT; ASX; Savills Research

Figure 19: China REIT scale



Source WIND; Savills Research

Where is the next investment opportunity?

In 2023, China's commercial real estate market experienced significant price adjustments across various asset classes, creating challenges for buyers and sellers to agree on valuations and slowing down deal activity. Investors face the task of assessing the causes behind price declines, examining company liabilities, addressing building quality deficiencies, and considering economic vulnerabilities and potential policy changes. Diversification across regions, asset classes, and investment strategies (equity and debt) becomes crucial to mitigate unexpected risks. While the full extent of the price correction may not be fully realized, long-term investors may find opportunities to acquire high-quality assets at discounted valuations, providing a buffer against future uncertainties.

In the short term, a weaker leasing market and oversupply persist, coupled with a weakened economy that dampens investor confidence, fostering a strong wait-and-see attitude and prompting owners to further adjust prices. However, in the medium term, sustained economic stimulus policies by the government should stabilize leasing markets, leading to a subsequent recovery in asset valuations.

Investors are advised to remain cautious and patient, prioritizing assets aligned with government plans and offering stable rental income. It's crucial to recognize that certain niche sectors may attract excessive capital inflows, potentially inflating asset prices and compressing yields. Additionally, potential shifts in government strategies or investment sentiment may impact future investor exits.

<u>Retail: REITs Spark New Opportunities</u>
The expansion of the REITs pilot program to include department stores, shopping malls, and markets in March 2023 has led to a steady increase in retail asset investment demand. The formal approval of the first batch of retail REITs in November 2023 has further boosted investor confidence and enhanced market transparency and liquidity. The government's focus on fostering domestic demand in the short term is a positive sign for the retail industry.

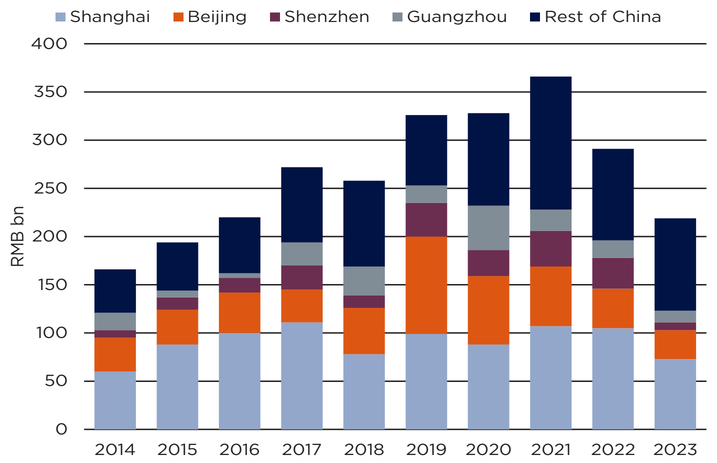
• Shopping Centres
Experienced investors with strong operational expertise can achieve significant capital gains by optimizing asset management, attracting high-calibre brands, and refining project positioning. Interest is expected to continue from insurance funds and domestic funds seeking large-scale, well-run, mature, high-quality retail assets for portfolio allocation and potential future REIT listing.

• Community Retail
Stable rental income makes community retail suitable for investors with limited capital or operational experience. Developers addressing liquidity concerns or debt obligations may offer non-core assets at opportune valuations. Opportunities also exist for acquiring older, underperforming small commercial projects, and repurposing them for alternative uses.

<u>Long-Term Rental Apartments: Boosted by Affordability and Policy Support</u>
Despite ongoing price adjustments in the national housing market, weak housing affordability and limited house price growth prospects incentivize renting. Government support for long-term rental apartments through tax incentives, loan policies, and product diversification has driven increased investment activity. The reduction in residential lease land supply in many cities in 2023 will shift focus towards revitalizing and transforming existing assets in the short term.

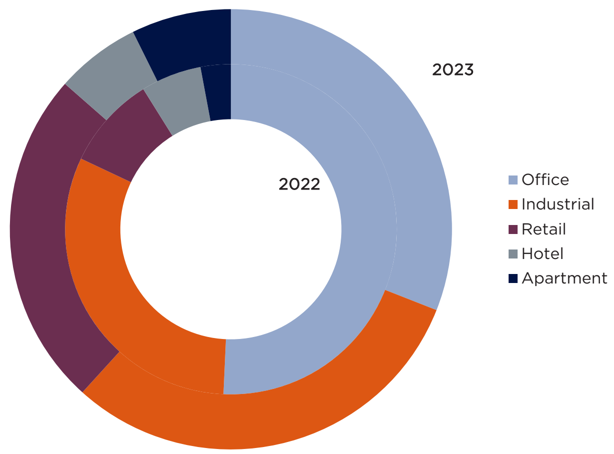
<u>"New Economy" Assets: Sustainable Development Drives Demand</u>
The popularity of "new economy" assets continues, with the sector driving demand for parks and industrial assets, including life sciences, manufacturing, R&D facilities, and data centres. Domestic "new economy" infrastructure developers, well-funded insurers, and overseas investors are actively acquiring "new economy" asset portfolios to enhance competitiveness in the market, emphasizing sustainable development.

Figure 20: China Investment volumes by region



Source RCA; Savills Research

Figure 21: China Investment volumes by asset class



Source RCA, Savills Research

Table 5: Investment trends and strategies by asset class

Sector	Short-term	Long-term	2024 Investment Strategy	Hot Subsectors in 3 Years
Retail	• REIT expansion drives demand for high-quality assets	• Government stimulates demand but oversupply remains	• Increase in less price-sensitive self-user buyers	• Community retail • Outlet malls
Office	• Large number of assets for sale but limited buyer pool	• Economic stability • REITs inclusion	• Discounted assets for long-term hold	• Prime location office buildings
Industrial / Logistics	• Strong tenant stickiness supports valuations • More portfolio in the market putting pressure on sellers	• Focus on quality and upgrade opportunities	• Focus on quality • Explore upgrade and renovation opportunities	• Life science real estate • High-standard factories
Hotels	• Rebound in demand post covid • High investment costs and low yields persist	• Further relaxations increase outbound and inbound travel	• Discounted pricing from sellers of non-core assets	• Economic hotels
Multifamily	• Housing price adjustments encourage buyers to delay • Int'l tenants slowly return • Limited land supply forces investors to look at existing assets	• Sales market takes time to stabilise • Long-term leasing demand remains strong	• Take advantage of preferential financing channels to expand and build brand	• Mid-range multifamily • Student Housing • Senior living facilities

Source Savills Research

Savills China

James Macdonald
Senior Director
Research
+8621 6391 6688
james.macdonald@savills.com.cn

Louisa Luo
Senior Director
Capital Markets, Industrial & Logistics
+8621 6391 6688
louisa.luo@savills.com.cn

Marco Meng
Senior Director
Property & Asset Management Services
+8621 6391 6688
marco.meng@savills.com.cn

Jim Wong
Senior Director
Valuation
+8621 6391 6688
jim.wong@savills.com.cn

Joey Chio
Senior Director
Transaction and Advisory
+8621 6391 6688
joey.chio@savills.com.cn

Nicky Zhu
Senior Director
Strategic Advisory Services
+8621 6391 6688
nicky.zhu@savills.com.cn

Aileen Zhong
Senior Director
Retail Services
+8621 6391 6688
aileen.zhong@savills.com.cn

Elaine Chan
Senior Director
Retail Management
+8621 6391 6688
elaine.chan@savills.com.cn

Cindy Tong
Senior Director
Japanese Business
+8621 6391 6688
cindy.tong@savills.com.cn

Shirley Tang
Senior Director
Residential Sales
+8621 6391 6688
shirley.tang@savills.com.cn

Michelle Zhou
Senior Director
International Residential Sales
+8621 6391 6688
michelle.zhou@savills.com.cn

Chris Zhang
Senior Director
Enterprise Portfolio Services
+8621 6391 6688
chris.zhang@savills.com.cn

Troy Tan
Director
Project Management Services
+8621 6391 6688
cntroy.tan@savills.com.cn

Louisa Zhu
Director
Savills Residence
+8621 6391 6688
louisa.zhu@savills.com.cn

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25th Floor, ICC TWO
No.288 Shaanxi Road
Shanghai
China