SHANGHAI

Office (CBD Grade A) – Asset performance remained solid, diversification persisted

Shanghai’s service sector continued to outperform other industry sectors, with the value of tertiary industry accounting for 67% of the city’s GDP in 1Q15, compared to 1Q14’s 61.4% and 2014’s 64.8%, according to the Shanghai Statistics Bureau. Echoing that fundamental, leasing demand was solid, reflected in a negligible increase in the overall vacancy rate (up 0.5 percentage points h-o-h to 6.2% by end-1H15) despite the five new completions this half with a combined GFA of more than 210,000 sqm. However, all but one project were completed in Puxi, and supply in Pudong remained tight. New demand came primarily from domestic enterprises, and particularly the finance sector. By end-1H15, the average rent increased by 4.7% h-o-h or 6.1% y-o-y to RMB9.7 psm per day. Many landlords raised rents as they secured the renewals of major tenants and availability was limited in many submarkets. Rental growth in Pudong continued to outpace that in Puxi, on the back of strong demand from the finance industry and extremely tight supply in Pudong.

The office real estate investment market in Shanghai picked up in 1H15 from 2H14, with seven en bloc sales transactions recorded. Notably, five transactions were for properties in decentralised areas. Overseas investment funds and institutional investors showed strong enthusiasm towards the CBD areas, though transactions were constrained by availability and a difference in expectations between buyers and sellers. By contrast, end-users have become increasingly attracted to quality office properties in decentralised areas, as infrastructure in these locations improves.

The service sector in Shanghai, which is strongly correlated with office demand, has grown quickly in recent years, and no major slowdown is forecast for the coming half-year. However, a large amount of new supply is scheduled for 2H15, which will place upward pressure on vacancy rates in the coming quarters. Nearly 60% of the new supply will be completed in Pudong’s Lujiazui and Zhuyuan, where supply is currently tight. Strong demand for these areas from finance companies, which typically have above-average leasing budgets, will support a moderate annual increase in the city’s average rent by end-2015. In the investment market, capital values will ramp up and yield should remain largely stable in the near-term.
Retail – Non-prime areas outperformed prime areas

Shanghai’s retail sales grew by 8.0% y-o-y during the first five months of 2015, accelerating 0.5 percentage points compared with the same period in 2014, underpinning the stability of the city’s retail real estate market. No new supply was completed in 1H15 and total stock remained unchanged at approximately four million sqm. By end-1H15, the non-prime retail area accounted for 65% of the total stock, compared to just 41% in 2006. This reflected a shift in population, as more residents moved to non-prime areas on the back of infrastructure improvements. This was followed by the development of new retail properties in order to serve these growing communities.

Given the limited supply in the prime area and the population growth in non-prime areas, several retailers chose to open new stores in developments outside the traditional CBDs, and the gap in the vacancy rate between prime and non-prime areas narrowed by 3.6 percentage points h-o-h to just 0.6 percentage points during this half-year. As a result, the overall vacancy rate decreased by one percentage point h-o-h to 9.7% by end-1H15.

In line with this trend, the rental gap between these areas narrowed as well, from RMB28.1 psm per day in 2014 to RMB27.5 psm per day in 1H15. Rental adjustments in certain projects, including annual adjustments and increases following the nurturing period at new projects, led the average fixed rent for ground floor property in Shanghai’s mid- to high-end shopping centres to increase by 1.9% h-o-h to RMB40.0 psm per day by end-1H15. In the non-prime area, rental growth was 2.7% h-o-h, though this was partially an effect of starting from a low base.

Seven new projects with 437,500 sqm of retail GFA are scheduled to launch in the second half of 2015. As a result, the total stock of the city’s retail real estate market is expected to increase by 10.9% h-o-h to approximately 4.4 million sqm. The new supply will be split approximately 35%/65% among prime and non-prime retail areas. The high pre-commitment at several new projects will limit their impact on the overall vacancy rate, and the completion of trade and brand mix adjustments in the coming quarters at several projects will have a positive effect on occupancy rates. As a result, the rise in the average vacancy rate is expected to be limited to one to two percentage points.

The large volume of future supply in non-prime areas, where rents are forecast to be below the market average, will constrain the city’s average ground floor rental growth. However, rental growth for prime assets is expected to remain buoyant for the remainder of 2015, given the tight supply and strong demand from domestic and international retailers for both new stores and expansion.

Business Park – Active market with a number of investment transactions

Supply and demand were both strong in Shanghai’s business park real estate market during 1H15. Leasing activities picked up, with net absorption surging by over 400% y-o-y to 576,622 sqm, the highest level in the past four years. As such, the citywide vacancy rate edged down by 0.6 percentage points h-o-h to 14.3% as of end-1H15 despite eleven new completions with a combined GFA of approximately 626,000 sqm. Strong growth in demand was primarily driven by the finance, internet, e-commerce and IT related industries. The improved building quality and options for large spaces attracted existing tenants to consolidate their offices and upgrade to
new facilities. Most companies chose to remain in their submarket, in order to benefit from established industry clusters. Domestic companies, many of whom have relatively fast decision-making abilities and strong rental affordability, gradually took the lead from MNCs. As a result of these factors, the average rent in Shanghai's business park market increased to RMB3.66 psm per day by the end of 1H15, up 2.0% h-o-h or 3.7% y-o-y.

Shanghai’s business park investment market was very active during 1H15, with five en bloc sales transactions concluded. Higher returns than the CBD area and growing capital values attracted both overseas and domestic investors, and especially large-scale funds and industrial park developers. Maiden acquisitions in Shanghai during 1H15 included Mapletree Greater China Commercial Trust’s purchase of Sandhill Plaza in Zhangjiang from MSREF VII LEAPHART BV for a total of RMB1.8 billion, and Beijing Science Park Development Group’s acquisition of Ranking Hongqiao Business Square in Linkong for an undisclosed price. Meanwhile, end-users increasingly sought vacant or under-construction properties to use as regional headquarters, evidenced by Jinshan Development Construction’s purchase of one bloc in IBP Phase II from the New Changning Group for self-use for RMB204 million.

The surge in FDI flowing into Shanghai’s Free Trade Zone and the designation of Zhangjiang, Zizhu, Yangpu and Caohaijing as global “innovation clusters” will underpin sustained demand for quality business park space, and the outlook of Shanghai’s business park real estate market is expected to remain positive in the remainder of 2015. The citywide vacancy rate is expected to see a short-term increase amidst large upcoming supply, but the average rent will maintain its upward momentum as improvements in building quality, infrastructure and services support higher rents. Both institutional investors and end-users will continue to seek investment opportunities in this market, given its rapid growth and strong fundamentals. Capital value is expected to edge up and yield should remain largely flat in the short term.

**Industrial (Logistics & Manufacturing) – Net absorption decreased as industrial economy growth slowed**

Shanghai’s industrial real estate market was less active than previous years during 1H15, amidst a slowdown in China’s industrial economy. Only one new standard logistics property, with a 74,000 sqm two-storey warehouse for lease, was completed in Shanghai. Net absorption decreased 7.1% h-o-h or 38.4% y-o-y to 152,000 sqm. As a result, the average vacancy rate decreased 1.4 percentage points y-o-y to 12.1%. By area, Pudong’s and Puxi’s vacancy rates decreased by 0.3 and 3.0 percentage points h-o-h to 15.0% and 5.5%, respectively. In the logistics sector, the average rent increased by 1.5% h-o-h or 2.5% y-o-y to RMB1.22 psm per day.

Certain developers began offering value-added logistics services including short-haul transport and equipment leasing (such as forklifts and storage racks), in a bid to attract potential occupiers who tend to focus on light-asset logistics operation, and to better compete against future supply. Landlords in port areas, particularly Fengxian, extended their rent-free periods amidst weakening exports.
In the manufacturing sector, average rent for standard workshops increased by 5.9% y-o-y to RMB0.98 psm per day. The official expansion of Shanghai’s FTZ to include Pudong’s Zhangjiang, Jinqiao and Lujiazui had a noticeable impact on Jinqiao in 2Q15. Shanghai Jinqiao Group, the management company of the Jinqiao Development Zone, began work to convert a large percentage of former workshops in the zone into office buildings and business parks, in anticipation of future demand related to the area’s new FTZ status.

The investment sentiment for the industrial real estate market was muted in 1Q15 but picked up in the second quarter, with several fundraising activities by international investors. Ascendas raised USD248 million for a private real estate fund for industrial and business park assets in April, KaiLong Real Estate Investment closed a USD238 million fund targeting industrial parks and commercial properties in May, and RRJ Capital invested an additional USD250 million in an affiliate of logistics developer Yupei Group in June.

Cross-border e-commerce continued to grow in 1H15, particularly in Shanghai and Hangzhou, supported by the relaxation on foreign investment regulations for online transaction or data processing businesses in Shanghai’s FTZ, and the establishment of China (Hangzhou) Cross-Border E-commerce Comprehensive Pilot Zone, both announced in 1Q15. E-commerce and retail companies including Alibaba, Shanghai Esen Agro, Suning and JD.com continued to accelerate their logistics expansion during 1H15. Together, the continued development of China’s retail market, both online and offline, is expected to drive a mid- to long-term increase in demand for bonded warehousing space in Shanghai and Hangzhou.

The State Council announced a ten-year plan for the future of China’s manufacturing in May, named “Made in China 2025”. According to the plan, 40 advanced manufacturing R&D bases will be developed across China by 2025. Related policies at the city level are expected to be drafted in the short- to mid-term. Shanghai’s FTZ and other FTZs with strong industrial fundamentals are likely to see more new set-ups from the manufacturing sector, which will benefit the industrial real estate market.

Approximately 670,000 sqm of new supply is scheduled to launch in Shanghai in 2H15. Nearly 40% of the new warehousing space will be located in Waigaoqiao’s and Lingang’s bonded areas. As a result, a short-term increase in the average vacancy rate and a concurrent slowdown in rental growth in both bonded and non-bonded logistics sectors are expected.

Residential – Market picked up amidst policy changes

Shanghai’s residential real estate market recovered during the first half of 2015 after a downturn in 2014, in response to several policy changes announced this year, including the reduction of a minimum down payment, and three reductions in the benchmark lending interest rate between March and June.

These policies were seen by a majority of home buyers as a sign that the government is attempting to stimulate the residential real estate market, and this sentiment translated into a boost in the sales volume of high-end and luxury residential property markets in 1H15. In the high-end residential market, the sales volume increased by 77% y-o-y to 1.28 million sqm (7,656 units), while in the luxury residential market, the sales volume increased by 122% to 714,842 sqm (3,894 units). First-home buyers were also active, and the low- to mid-end
residential market saw a significant pickup in sales volume in 2Q15, increasing 68% q-o-q to approximately 2.63 million sqm (22,931 units). Overall, the sales volume of Shanghai’s new commodity housing in 1H15 totalled 5.47 million sqm, a y-o-y increase of 34.8%. Begonia Bay, a residential project between the outer ring road and the suburban ring road in Pudong’s Nanhui area, recorded the highest sales volume at 88,043 sqm (592 units) in 1H15, at an average sales price of RMB19,618 psm.

Developers boosted new supply in 2Q15 in anticipation of growing demand, and the total new supply in 1H15 recorded approximately 4.6 million sqm (38,867 units). However, this represented a slowdown from 1H14, when new supply totalled approximately 5.3 million sqm (43,075 units), and reflected developers’ intention to reduce inventory. Songjiang District recorded the highest supply volume at 810,377 sqm, followed by 689,211 sqm in Jiading District. King Wai City Oasis, an apartment project between the middle ring road and the outer ring road in Baoshan District, had the highest volume of new supply in 1H15 at 88,792 sqm (958 units).

The sales price of Shanghai’s new commodity housing averaged RMB31,615 psm by the end of 1H15, a half-year increase of 10.7% or an annual increase of 19.0%. The second quarter saw the highest quarterly price growth (10.9%) since 2009, buoyed by a strong pickup in the sales of the mid- to high-end sector. The sales price of the high-end sector recorded a half-year increase of 6.9% or an annual increase of 8.4% to RMB59,528 psm, primarily due to a strong increase in the transactions for a number of high-end projects in 2Q15 including Jin Mao Palace, Shanghai Albany Oasis Garden Phase III and Baohua Jakaranda Garden. By geographic area, the sales price within the inner ring road saw the fastest quarterly growth at 17.5%, 6.6 percentage points higher than the growth of Shanghai’s average price. This was followed by 11.5% q-o-q growth in 2Q15 in the area between the inner ring road and the middle ring road.

Land transactions for commodity housing were limited in 1H15, as the Shanghai government tightened land supply. The average accommodation price hit a record high at RMB24,052 psm, as several land sites designated for mixed-use (including a residential component) in Yangpu, Zhabei, and Baoshan districts transacted at relatively high accommodation prices.

In the second half of 2015, purchase sentiment is expected to further improve in anticipation of additional government stimulus. Developers will continue to reduce inventories throughout 2015, and new supply is expected to be in line with levels in 2H14.
SECOND-TIER CITIES (SUZHOU, HANGZHOU, NANJING, WUHAN AND XIAMEN)

Office – A dramatic divergence in vacancy rate between submarkets

The total stock of the prime office real estate market in these five cities expanded by 5.7% h-o-h to nearly 9.2 million sqm, with a total of nine new completions across Wuhan, Hangzhou and Xiamen. Wuhan received four new projects with a total office GFA of 239,810 sqm, accounting for nearly half of the total new supply in all five cities.

The new supply pulled up an already-high average vacancy rate. In Wuhan and Hangzhou, the vacancy rates increased by 3.8 and 3.3 percentage points h-o-h to 22.8% and 22.1% respectively. In Xiamen, however, demand was strong for projects completed in 2014, resulting in a 1.1 percentage point half-year decrease in the average vacancy rate in spite of the new completions. Notably, a dramatic divergence continued to exist in Hangzhou and Xiamen between mature submarkets and emerging areas, with vacancy rates differing by 29.7 and 30.5 percentage points respectively.

Despite the new supply, stable demand and rental adjustments at some sophisticated developments drove rental growth in most markets in 1H15. By the end of the half, Hangzhou continued to record the highest rent among the five cities, at RMB4.4 psm per day, followed by Nanjing (RMB4.2), Wuhan (RMB3.2), Suzhou (RMB2.6) and Xiamen (RMB2.4).

Thirty-one projects are scheduled to enter these markets in 2H15, with a total office GFA of approximately 1.7 million sqm, more than three times the volume completed in 1H15. This volume of supply will outpace average levels of demand in all cities, driving up the vacancy rates. In Hangzhou and Xiamen, the majority of the new supply will be concentrated in emerging areas, leading the divergence in vacancy rates to widen even further.

This high level of new supply will put strong downward pressure on rental growth, and the below-average rents offered in emerging areas will pull down average rents in many cities. However, a considerable proportion of new supply in Wuhan and Nanjing will have high specifications and be completed in prime locations, and rental growth is expected to continue in these markets.

Retail – Decentralisation continues

Nanjing, Wuhan and Suzhou all received one new project during 1H15, and the total stock of the mid- to high-end shopping centre market in the five cities expanded by 4.8% h-o-h to nearly eight million sqm. Wuhan continued to have the highest total stock at approximately 2.6 million sqm.

All of the new projects were developed by experienced, well-known companies, who were able to achieve high occupancy rates upon launching. As a result, the impact of the new supply on their respective market’s vacancy rate was limited. All cities saw half-year declines in vacancy.
rates, as internal trade and brand mix adjustments completed and supply remained limited. By the end of 1H15, the vacancy rate of these five cities averaged just 5.7%.

Most new projects were located in decentralised retail areas, where rents are below the city average, pulling down the average rent. However, this was offset by rental adjustments at sophisticated projects in most cities. Nanjing was the only city to record a rental decrease in 1H15, with a 0.6% h-o-h decline. Wuhan’s average rent remained the highest of these cities at RMB22.6 psm per day as of end-1H15, though this was inflated by a single downtown project where rent is tremendously higher than the rest of the city.

The mid- to high-end shopping centre market in these cities will expand further in 2H15, with a total of nearly 2.4 million sqm scheduled to launch. Nanjing is expected to receive the highest volume of new supply, with approximately 800,000 sqm over 10 projects, increasing the city’s total stock by nearly 51% h-o-h. By contrast, Xiamen will receive just two projects with 74,653 sqm of retail area.

The huge amount of new supply will increase the vacancy rate, despite high pre-commitment levels at certain projects. Most of the new supply will be located in decentralised areas, pulling down the average rent. Xiamen is expected to be an exception, as both properties scheduled for 2H15 are high-quality, and will support rental increases. Despite the forecasted decline in average rents among most cities, existing projects can continue to expect stable rental growth, underpinned by solid economic fundamentals.