SHANGHAI

CBD Grade A Office – Dynamic year, with influx of new buildings and widespread withdrawals

The Shanghai CBD Grade A office market was dynamic in 2016. The city’s strong service industry, which grew by 10.3% YOY in the first three quarters of 2016, according to the Shanghai Statistics Bureau, supported demand from a number of industries, though widespread withdrawals from peer-to-peer (P2P) lending companies vacated large amount office space. These retreats, combined with new supply, led the average vacancy rate in the CBDs to spike by 5.3 percentage points YOY to 10.2% by end-2016. Correspondingly, many landlords in Shanghai, who are typically sensitive to market movement, became more flexible in rental negotiations. In the investment market, 38 large-scale deals totalling more than RMB70.6 billion were completed during the year.

Shanghai’s CBD Grade A office property market received 11 new office buildings during 2016, including HKRI Centre Taikoo Hui Tower One, a prime project in the Nanjing West Road area of Jing’an; the north block of Bund Finance Centre in Huangpu; and Century Link T1 in Pudong’s Zhuyuan. The completion of these and other projects represented the highest full-year supply in five years, and total stock expanded by 7.4% YOY to approximately 6.13 million sq m in 2016.

While these new projects eased the tight supply situation in some locations in CBDs, widespread retreats of the P2P lending companies were seen in 2016. These companies, who were particularly active in seeking prime office space in the city during the 2013 to 2015 period, vacated a significant amount of office space in 2016. Correspondingly, net absorption totalled just more than 113,000 sq m, significantly lower than the average annual level of 400,000 sq m in the previous five years (from 2011 to 2015). These factors led the average vacancy rate in CBD to increase to 10.2% by the end of 2016, up 5.3 percentage points YOY.

By area, the average vacancy rate in Pudong increased by 2.0 percentage points YOY to 6.8%, primarily due to the major projects completed in Zhuyuan; in comparison, the vacancy rate in Puxi increased from 5.1% in 2015 to 11.5% in 2016, given the P2P issue as well as new supply. Nonetheless, Shanghai’s CBD remained attractive to numerous occupiers, including domestic companies, financial and professional companies, co-working space operators, and companies from emerging industries, such as “internet plus”.

In May 2016, China’s new VAT tax structure was expanded to the real estate industry. This led some landlords to increase rents as the VAT tax (either 5% or 11%) can be deducted from the tenants’ leasing cost in most cases. However, in response to the increasing vacancy rate in buildings, many landlords in Shanghai offered incentives to attract occupiers, which constrained the annual rental growth rate. As of end-2016, the average rent in CBDs grew by 3.1% YOY to
RMB10.4 psm per day. By area, the average rent in Puxi, where P2P companies were particularly active in the past and competition from decentralised areas was strong, increased by 0.7% YOY to RMB9.5 psm per day; in comparison, Pudong saw the average rent increase by 6.2% YOY to RMB11.9 psm per day amidst solid demand for this area.

The Shanghai office sector remained the most active investment market in China in 2016. Thirty-eight large-scale transactions totalling more than RMB70.6 billion were completed during the year. Domestic end-users, and domestic and foreign investors were all active in Shanghai. This was driven by various factors, including strong demand for self-use in Shanghai; largely stable asset performance; the need to deploy funds; pressure on currency depreciation; higher transparency relative to many cities in Shanghai; and the relative ease of divesting, given the strong investment appetite for such buildings. However, investors are becoming increasingly sensitive to the large amount of new supply scheduled for completion in 2017, which should result in stronger leasing competition and limited rental growth in the short to medium term.

Notable investment deals disclosed during 2016 included: Pramerica’s purchase of Waterfront Place Bloc E and G in Putuo’s Changfeng from ARA Asset Management for RMB760 million (RMB27,333 psm); Sino-Ocean’s purchase of East Ocean Centre (including Phase II and a small volume of office space in Phase I) in Huangpu from CLSA for RMB2.39 billion (RMB48,000 psm); Real Power Capital’s purchase of Evergo Tower in Xuhui from Chinese Estates for RMB1.22 billion (RMB58,104 psm); Guohua Life Insurance’s purchase of SOHO Century Plaza in Zhuyuan from SOHO China for RMB3.3 billion (RMB76,751 psm); V-Capital’s purchase of Central Plaza in Huangpu from Carlyle Group for RMB2.38 billion (RMB 59,038 psm); and SDIC’s purchase of Shanghai International Shipping Service Centre Tower One in Hongkou from Jinmao for RMB5.29 billion (RMB81,999 psm). Out of the total 37 deals, four were for mixed-use properties: including ARA Asset Management’s purchase of Century Link in Pudong’s Zhuyuan from Cheung Kong Property Holdings for RMB20 billion or RMB74,543 psm (office GFA of 137,000 sq m, retail GFA of 138,000 sq m).

Shanghai’s economy is in transition to a service-led growth. The city’s strong tertiary industry, including the finance sector, will continue to support growing demand for office space in 2017. However, 1.1 million sq m office GFA is scheduled to complete in Shanghai’s CBDs alone in 2017(with more than half in Pudong), including the skyscraper Shanghai Tower. Meanwhile, the CBD market will also face strong competition from the decentralised areas, and especially from office clusters in close proximity to the CBDs. This massive expansion will outpace the city’s ability to absorb office space, and in turn, lead to a further spike in the average vacancy rate in 2017. Correspondingly, landlords are expected to offer a more flexible incentive scheme, and a rental correction is expected in the short term.

**Retail – Markets Mature, Investors Buy In**

Shanghai’s retail property market was active in 2016, with seven new projects, a boost in net absorption and nine en bloc investment transactions. The growth was supported by the increasing
retail sales of consumer goods, which grew by 7.8% YOY in the first 11 months of the year, according to the Shanghai Statistics Bureau.

Decentralisation was a major theme in 2016. Six of the seven new projects (90% by GFA) were in non-prime areas such as Qibao and Daning catchment, and these markets accounted for 70% of the city’s total retail stock by the end of 2016. Total stock, in both prime and non-prime areas, grew to 5.1 million sq m. Qibao, in particular, was attractive to developers with new projects by Vanke (the company’s first shopping centre in Shanghai) and Powerlong.

In spite of the large amount of new supply, the city’s vacancy rate increased by just 0.3 percentage points to 12.1% by the end of the year. This was due to strong demand for the new properties, with many achieving occupancy rates of 80% or more at opening. As a result, net absorption spiked to 580,100 sqm in 2016, more than twice the level of 2015. Demand was also strong for existing projects. Excluding 2016’s new supply, the average vacancy rate declined by 0.8 percentage points to 10.9%, as retailers absorbed space in projects completed in 2015 such as Corporate Avenue Mall and Bauhinia Square.

New demand during 2016 came from the traditional fashion and F&B sectors, though several new trends in these categories emerged. In the fashion sector, casual sportswear became popular, as American brand Under Armour opened five new stores in Shanghai and ArcTeryx opened three new stores. Fast fashion continued to be popular, with expansion by well-established brands such as Uniqlo, as well as the entry of Korean brand 8seconds, which leased 3,500 sq m on Middle Huaihai Road for its first overseas flagship store, and four new stores from domestic brand Urban Revivo.

In the F&B sector, several brands rapidly expanded their footprint in Shanghai. Ge Lao Guan, a Chongqing hot pot chain, opened four new stores, all in non-prime locations; Japanese-style noodle chain He Fu Noodle opened five new restaurants; and Korean-style chain James Cheese opened nine new restaurants in mid- to high-end shopping centres.

Retailers that cater to children and their needs were also popular with landlords for their ability to attract footfall from neighbourhood families. Such brands ranged from retailers of children’s clothing and toys like Lollipop and Balabala, to retailers that offer activities or education such as Golden Ballet Dance and Gymboree Play & Music, and indoor playground brands such as Yoyotu.

In other sectors, Apple opened three new stores in Shanghai during the year, bringing its total to seven, the highest in any city in Asia-Pacific. Vanguard launched its first “second-generation” blt supermarket at Hopson One and its first blt express at Joy City Phase II, and landlords sought virtual reality (VR) entertainment brands, which proved extremely popular among consumers. Blended concepts remained popular, and bookstore/café brands Sisyphe and Yanjiyou both opened multiple stores, after entering the market in late 2015.

Landlords were able to achieve rental gains during the year, and the average rent (excluding the effect of new supply) increased by 4.2% from 2015. Gains were seen in both the prime market (from RMB 56.7 to 57.4 psm per day) and the non-prime market (from RMB 30.0 to 32.1 psm per
Including new supply, where opening rents were typically below the market average, the citywide average rent declined by 4.0% YOY to RMB 37.3 psm per day.

In the investment market, nine en bloc sales transactions were completed, compared to just one in 2015. Notably, three of the acquisitions were made by domestic companies, as they move into the capital markets. China Everbright Group acquired Orstar City and the Shanghai Xujiahui Center Group acquired the former Bestbuy Xujiahui store. Silkroad, CSI, Blackstone and ARA all acquired properties in prime retail areas (retail podium of Century Palace, retail podium of Richgate, Snow Leopard Mall and retail podium of Century Link, respectively), while the Chongbang Group and COFCO acquired community-focused properties, the Lifehub at Jinqiao and Parkside Plaza, respectively.

The coming year will be extremely active in the retail property market. More than 1.5 million sq m of new retail property at 17 different projects is scheduled for 2017, including landmark projects HKRI Taikoo Hui, a joint venture by Hong Kong Resort International Limited and Swire, and Raffles City Changning, the second Raffles City in Shanghai.

More than 1.4 million sq m of the new supply will be in non-prime areas. In Minhang alone, three large-scale projects with a combined retail GFA of 430,000 sq m are scheduled, and total stock will exceed one million sq m. In prime areas, only two new projects are scheduled, and the vacancy rate will remain low in the coming year, as retailers compete for limited space. In the non-prime area, the wave of new supply will lead to a rise in the vacancy rate, though it will vary substantially by district, catchment and project.

Rental growth in prime catchments will remain buoyant in 2017, as landlords make trade and brand mix adjustments, and are able to achieve gains. This will be seen in Xujiahui at both Metro City and Grand Gateway 66, which undertook internal and external adjustments in 2016, as well at Plaza 66 and Citic Square in the West Nanjing Road catchment.

Residential – Sales strong despite government intervention

Shanghai’s residential property market was dynamic in 2016. Government intervention, in the form of stricter policies towards down payments and higher requirements for buyers not from Shanghai, led to major shifts in buying activity. Nonetheless, the market was strong, with demand far outpacing supply, and annual sales reaching the second-highest level in the past nine years, after a record high figure in 2015. Developers remained confident in the city’s long-term prospects, as seen with a transaction in August that broke the national record for average accommodation price.

Demand for first-hand residential property was strong in 2016, with sales totalling approximately 13.6 million sq m (106,793 units) by the end of the year. This was the city’s second-highest annual sales figure in the past nine years after record performance in 2015, when sales totalled 15 million sq m. Notably, the 2016 sales figure was achieved despite a 37% decrease in supply to 7.6 million sq m (65,033 units), as developers slowed the pace of project launches.
The sales volume varied dramatically throughout the year, echoing the implementation of increased government restrictions on buyers. Sales were robust in the first three months of the year, and peaked at 2.2 million sq m (17,524 units) in March, the highest monthly sales volume since January 2008. This record high came as buyers moved to close sales in anticipation of a further round of purchasing restrictions. Indeed, Shanghai’s Bureau of Housing and Urban-Rural Development announced two changes at the end of March, raising the threshold for non-local buyers (who must now show proof of tax payments for the previous five years) and increasing the minimum down payment for second homes from 40% to 50% or 70% (depending on the case).

Following the March announcement, the sales volume fell to just 972,100 and 987,900 sq m in April and May, a 21.8% and 30.6% decrease from the previous year. Buying sentiment continued to improve through the summer and into the second half, peaking again in August at 1.9 million sq m (13,650 units) and remaining strong through the traditional “Golden September, Silver October” sales season. The monthly sales volume declined again in November as developers sharply reduced supply, from 1.5 million sq m in November 2015 to just 603,500 sq m in November 2016, though demand outpaced supply. On November 28, city authorities raised the minimum down payment for a first home from 30% to 35%. In December, developers again reduced supply and the sales volume declined to 345,500 sq m (3,058 units), compared to 1.9 million sqm (15,449 units) in the previous year.

By category, nearly 90% of the new supply was in the apartment format. By geographic location (determined by the city’s ring roads), the sales volume was strongest in the area outside the suburban ring road (3.5 million sq m; 29,790 units), followed by the area within the Inner Ring (1.3 million sq m; 7,717 units).

The average sales price grew by 19.0% in 2016 to RMB38,300 psm. This rapid growth was attributed to the substantial increase in sales of high-end and luxury properties. In the past two years, the proportion of high-end properties sales (all properties above RMB40,000 psm) has increased from 19% in 2014 to 32% in 2016, in turn pulling up the city’s average price. However, there was a significant divergence in the performance between the low- to mid-end sector and the high-end and luxury sector. The average price of low- to mid-end homes (below RMB39,999 psm) edged up by just 0.1% to RMB22,794 psm, while the average sales prices of homes above RMB40,000 psm and RMB50,000 psm increased 11.3% YOY to RMB67,505 psm and 9.9% YOY to RMB77,821 psm, respectively.

Developers continued to show a sustained appetite for land acquisition and development in Shanghai, though supply was sharply limited from 54 sites (3.0 million sq m) in 2015 to 34 sites (1.72 million sq m) in 2016. Several sites attracted high bids from developers, resulting in a spike in the average accommodation price, which grew by 87% to RMB32,035 psm. The most notable transaction was Rongxin Group’s purchase of a 30,000 sq m site in Jing’an District in August for RMB11 billion or RMB100,000 psm, a national record for accommodation price.

Looking forward, no major policy changes to the government’s purchase restrictions are expected in the near future. The high-end and luxury markets will continue to be active, supported by the confidence of many home buyers that there is still room for upward growth. New supply is expected
East China Real Estate Market
2016 Review and 2017 Outlook

to be in line with 2016. In the land market, government announcements have suggested that the supply of residential land for development will increase in 2017 after the limited number of sites in 2016.

Business Park – Leasing Slowed but Rent Remained Stable

Shanghai’s business park real estate market slowed in 2016 after a particularly strong year in 2015. The average vacancy rate increased amidst 13 new completions, while the average rent continued to see upward momentum with improvements in the quality of new projects. In the investment market, six en bloc sales transactions were announced this year.

The Shanghai business park real estate market received 13 new completions with a combined effective GFA of 824,000 sq m in 2016. As a result, the total stock increased by 10.6% YOY to approximately 8.6 million sq m. However, nearly 80% of the new supply was handed over in the second half-year and is still being absorbed.

Accordingly, the average vacancy rate was pushed up by 5.3 percentage points to 15.3% as of end-2016. After a particularly strong 2015, the overall leasing demand was less active in 2016, with net absorption shrinking by 75% YOY to 290,000 sq m. Nevertheless, demand was solid in certain submarkets with mature amenities and professional management, such as Caohaijing, Zhangjiang and Lujiazui Software Park. Companies from the IT and biomedicine sectors were the main demand drivers. Notable leasing transactions included: Shengyu Information Technology leased approximately 24,000 sq m in Haiqu Park as headquarters; PPTV consolidated their Shanghai offices and leased approximately 8,700 sq m in Lujiazui Software Park; Pfizer relocated from German Center to Ascendas Lotus Business Park and leased an 8,500 sq m en bloc building; and Janssen (China) Research & Development Center, the Biotech laboratory of Fudan University, Amgen Biotechnology and ZAI Lab set up R&D centres in Jinchuang Plaza.

The relative softening of leasing demand had a limited impact on the average rent, as most of the new completions had above-average rents. In many projects, high occupancy rate and stable tenant mix supported an annual increase. As a result, the city’s average rent increased by 6.5% YOY to RMB4.03 psm per day as of end-2016, topping the RMB4.0 psm per day mark for the first time since 2006.

After a record high number of investments in 2015, the business park real estate investment market slowed in 2016, though six en bloc sales transactions were completed. Both institutional investors and end-users actively sought suitable acquisition targets in Zhangjiang, Jinqiao and Caohaijing. Notably, foreign funds, domestic institutions and RMB funds were keen on assets either with high occupancy rates and a high-profile tenant mix, or value-add projects with the potential for renovation. In June, Pudong Jinqiao purchased the Chuanqiao Road Project (previously the Xinhua Garment Factory) for a total consideration of RMB120 million (RMB7,076 psm). In November, Carlyle Group sold Changxing Tower in Zhangjiang to BOCGI for a total consideration of RMB810 million (RMB33,000 psm). In the same month, Ascendas Reit sold A-REIT City@Jiniao to China Vanke for a total consideration of RMB1.08 billion (RMB13,500
East China Real Estate Market

2016 Review and 2017 Outlook

psm). Meanwhile, end-users continued to acquire vacant buildings as headquarters or back offices, evidenced by Union Pay and Honeywell’s separate purchases of Wison Science Park and Ke Xian Park Building 1 in Zhangjiang.

As one of the most important market fundamentals for the business park real estate market, the increasingly convenient metro connections have largely facilitated the accessibility of many business parks in the past few years. This is expected to continue in 2017, when Line 9 Phase 3, Line 8 Phase 3 and Line 13 Phase 3 are completed, connecting Jinqiao, Pujiang and Zhangjiang, respectively. Accordingly, the improvement in infrastructure is expected to drive growth in demand for nearby properties.

In 2017, approximately one million sq m of new supply is scheduled to complete in Shanghai’s business park real estate market. Nearly 70% of the new supply will be located in mature submarkets such as Zhangjiang, Caohejing and Lujiazui Software Park, where demand was historically strong, but has been pent-up in 2016. This will translate into leasing demand, though the average vacancy rate is expected to stay flat or edge up, given the significant volume of new supply in the pipeline.

In terms of rent, the new projects will have higher specifications and improved amenities, supporting buoyant rental growth in 2017, though rental performance will vary by submarket and project. Nevertheless, the plentiful available space will provide more choices for tenants, and some landlords will become more flexible in rental negotiations.

Industrial (Logistics & Manufacturing) – Robust demand, very active investment market

China’s industrial economy showed tentative signs of stabilisation in the second half of 2016, with both official and Caixin manufacturing PMI showing growth. Shanghai’s logistics property market continued to be robust in 2016, underpinned by a positive outlook towards retail sales and other sectors that typically require logistics property.

Seven high quality logistics developments were completed in 2016 with a total GFA of 624,800 square metres, the highest annual supply since 2008. All the completions were multi-storey and non-bonded warehouses. Notably, the location of the new supply shifted from 2015, when 85% of new supply was in Pudong, to 2016, when nearly 85% of new supply was in Puxi, Jinshan and Fengxian.

Demand for standard logistics property was strong in 2016. Net absorption totalled nearly 640,000 square metres and the overall vacancy rate decreased by 1.6 percentage points YOY to 13.0% by the end of the year. Approximately 60% of net absorption was at the new completions. In the non-bonded warehouse market, demand from 3PL, retail, e-commerce and automobile companies led the vacancy rate to decline by 4.1 percentage points YOY to 14.9%. By contrast, the leasing demand for bonded warehouse moderated and the vacancy rate edged up by 0.5 percentage points YOY to 10.8%, as certain tenants withdrew from the market. In addition, a new tax policy for goods

7
imported and sold through cross-border e-commerce platforms was released in April 2016, which increased pressure on the margins of companies in this industry. At the time, a stricter policy towards the supervision of cross border e-commerce is expected in 2018. As such, some companies have taken a wait-and-see attitude to business decisions, including their leasing needs.

Strong demand and limited available leasing space resulted in sustained rental growth. The average rent of Shanghai’s standard logistics property increased by 4.4% from 2015 to RMB1.29 psm per day, up by 1.1 percentage points. The above-average rent offered by the new supply also contributed to the rental growth, including projects in Qingpu, Minhang and the Pudong PVG submarket. The manufacturing property market was stable in 2016. Given the limited industrial land supply, the average rent increased by 3.9% YOY to RMB1.02 psm per day. The Pudong submarket continued to have the highest rent at RMB1.41 psm per day, followed by Minhang at RMB1.30 psm per day.

The investment market remained attractive for logistics property developers and institutional investors in 2016, with a considerable amount of activity. In January, logistics property developer The Redwood Group merged with e-Shang, a Shanghai-based logistics property developer. In February, Dutch pension fund PGGM invested a further USD160 million in the Redwood China Logistics Fund. In July, logistics property developer Logos Property Group closed its second joint venture with Ivanhoé Cambridge and CBRE Global Investment Partners, with the goal of investing approximately USD400 million into acquiring and developing logistics facilities in Shanghai and neighbouring cities. In August, GLP established a long-term strategic partnership with China International Marine Containers to build and acquire logistics properties around the country. Separately, China Logistics Property Holdings was successfully listed on the main board of the Hong Kong Stock Exchange, raising around USD460 million.

In the manufacturing sector, industrial property developer D&J Industrial Property announced a further USD220 million joint equity investment from Warburg Pincus and D&J’s founder Sun Dongping in February. Manufacturer Lung Kee Group sold an industrial land site (and the existing properties) in Songjiang (GFA 19,500 sq m) to industrial park operator Liando Group for RMB90 million. In a larger transaction, Kerry Properties invested RMB2.4 billion to acquire an 18.9% share of a large industrial site in Pudong’s Houtan area. Kerry Properties plans to redevelop the site into a mixed-use commercial and residential property after obtaining permission to convert the land usage rights, according to a company filing with the Hong Kong Stock Exchange.

Industrial land supply in 2016 increased by 11.0% from the previous year, but totalled just 2.1 million sq m, compared to 7.5 million sq m in 2014. Half of the land sites were under 20-year use terms, though the influence on the average land price was limited and the price varied by location.

Over 700,000 sq m of standard logistics property is scheduled to complete in 2017, with nearly 60% (by GFA) in the Pudong area. Vacancy rate would increase and rental growth would be constrained in short term.

Though the leasing demand of cross-border e-commerce temporarily slowed, the city’s and nation’s support for cross-border e-commerce is strong, as seen with the establishment of a Shanghai
cross-border e-commerce demonstration zone and a pilot zone in early 2016. In November, the government postponed a new and stricter supervision policy on cross-border e-commerce imports until the end of 2017.

Shanghai released two plans in 2016 regarding the restructuring and upgrading of the manufacturing industry and industrial zones. The plans aim to develop advanced and high-end manufacturing, and call for the manufacturing sector to account for 25% of the total GDP in 2020, compared to 28.5% in 2015. In addition, one of the plans sets a limit for industrial land at 550 square kilometres (until 2020), which is in line with Shanghai’s Implementation Measures (formally implemented in 2016) for revitalizing industrial land sites.

SECOND-TIER CITIES
(SUZHOU, HANGZHOU, NANJING, WUHAN and XIAMEN)

Office

Twenty-one projects were completed in these five cities in 2016, or more than one million square metres of office space. In most cities, the majority of new projects are located in mature areas. Xiamen was the only exception, with four of its six new projects in emerging submarkets. Wuhan had the highest level of new projects, with six developments or a combined GFA of 427,300 sq m, making it the largest office market (2.6 million sq m) among these five cities for the first time in seven years. In total, the five cities had a combined stock of 10.4 million sq m, 11% higher than 2015.

Demand was roughly in line with previous years. Net absorption across all five cities totalled 684,200 sq m, compared to an annual average of 736,800 sq m between 2010 and 2015. Finance and real estate companies remained the primary sources of demand, though withdrawals by the peer-to-peer lending sector amidst stricter government supervision had an effect in all cities. The average vacancy rate fell in Hangzhou, Nanjing and Xiamen. In Xiamen, relocations to newer, higher-quality properties drove the vacancy rate down to 22.3%, the lowest level since 2010. In Suzhou and Wuhan, the vacancy rate grew, up 3.9 and 7.2 percentage points to 21.9% and 27.7% respectively, the highest level in both cities since 2010. In Wuhan, this increase was partially the result of timing, as 90% of the city’s new office space was launched in the fourth quarter.

All cities recorded rental growth in 2016, primarily driven by gains associated with the high quality of the new buildings. In Wuhan, this led the average rental to grow 12.3% from 2015, while Suzhou achieved 4.8% annual rental growth. Notably, rent in existing projects remained largely flat or declined slightly as some landlords offered incentives in order to compete with 2016’s new projects. Nanjing continued to have the highest rent of the five cities at approximately RMB4.5 psm per day, followed by Hangzhou (RMB4.1), Wuhan (RMB3.7), Suzhou (RMB2.8) and Xiamen (RMB2.4).
The investment sentiment for en bloc sales market in these second-tier cities was active in 2016, with five transactions completed. All of the transactions were for buildings under construction. In Hangzhou, Vanke acquired a 51% stake in a complex named Huanglong International Center from Hangzhou Canhigh Center for RMB789 million, and the Postal Savings Bank of China acquired Tower 6 of CICO (office GFA of 55,125 sq m) in Qianjiang New City from Zhejiang Communication Investment Real Estate Group for RMB1.5 billion. In Nanjing, Bank of Beijing purchased Tower 3 of Walsin Plaza (office GFA of 60,571 sq m) in Hexi from Walsin Linwa Group for RMB1.05 billion. In Xiamen, a large-scale Chinese developer acquired an office building in the Cross-Strait Financial Centre for RMB990 million. In Wuhan, Citic China purchased two office buildings at Wuhan Tiandi (A1 and A3) from Shui On Land for RMB1.13 billion and RMB3.36 billion respectively.

China’s economic growth is slowing after two decades of double-digit gains. However, behind the headline figures of GDP growth, the country’s economy is shifting in a way that will benefit office property markets across the country. Major infrastructure projects are under construction or have been completed, including Metro systems (two new lines in Hangzhou, four new lines in Nanjing and eleven lines in Wuhan, all added in 2016), the Jinji Lake Tunnel in Suzhou and a new airport expressway in Xiamen, among others. At the same time, the service sector is developing quickly, as seen with figures for tertiary industry growth, which is strongly correlated with demand for quality office space.

Developers have responded in kind, and 28 new developments with a combined office GFA of approximately 2.1 million sq m are scheduled for 2017, nearly twice the level of 2016. Wuhan will again be the recipient of the most new supply (780,000 sq m). In Nanjing, which will have the lowest volume of new supply (144,000 sq m), that still represents nearly three times the volume of new supply in 2016. This massive expansion will lead to a spike in the vacancy rate in all cities in 2017, as they begin to absorb the new projects.

Accordingly, a period of oversupply and rental corrections can be expected in most cities. Landlords of existing projects are likely to offer discounts and incentives to win tenants in a highly competitive market. However, new projects with high-quality construction and management in CBD areas may command above-average rents, particularly in Suzhou and Nanjing.

Retail

Retail sales of consumer goods for the first three quarters of 2016 grew by double digits and picked up from the previous year in most monitored second-tier cities. This growth continued to attract both domestic and international developers and retailers, who see strong potential in east China’s second-tier cities. In many of these cities, the prime retail locations are relatively saturated, at the same time that major infrastructure projects are making once-neglected neighbourhoods more readily accessible. Both of these factors have driven the development of new retail property markets outside the city centres, a theme that became increasingly clear in second-tier cities during 2016.
Ten new developments, or 968,000 sq m of retail GFA, were completed in the five cities, about half of 2015’s level. Eight of these new projects were completed in non-prime areas. Wuhan continued to have the largest stock among these cities at 3.1 million sq m, or nearly 30% of the total stock which had grown to 10.5 million sq m by the end of 2016.

Leasing demand came from the traditional fashion and F&B sectors, as well as from lifestyle, entertainment and consumer electronics brands, and many landlords adopted new retail formats in order to win footfall.

In the fashion sector, two themes emerged this year: the expansion of “affordable luxury” brands and increasing competition in the fast fashion category from Chinese brands. In the former category, Diane von Fürstenberg, Club Monaco (owned by Ralph Lauren) and Parisian brand Sandro all opened their first stores in Nanjing during 2016. In the latter category, domestic brands Urban Revivo and MJ Style expanded their footprints in multiple second-tier cities. International brands were also active, with Abercrombie & Fitch and Forever 21 entering the Nanjing market, as did British department store House of Fraser, which opened 28,500 sq m in Xinjiekou at the end of December. (The Sanpower Group acquired the British department store brand in 2014.)

In the F&B sector, domestic and international chains continued to compete with independent local brands for customers. Korean brand James Cheese Back Ribs become extremely popular, and expanded into all five cities during the year, with at least one store in each. Domestic seafood chain Shenhai 800 Mi was also popular, and opened at least one new store each in Hangzhou, Suzhou and Nanjing.

Other notable trends this year included the rise of virtual reality, or VR, high activity by cosmetic brands, "experience" stores by tech manufacturers, and the first bricks-and-mortar locations for highly popular online stores.

Most landlords incorporated VR kiosks into their properties during 2016. Though small in size, VR kiosks (and in some case, storefronts) proved popular with consumers, and helped boost footfall. In the cosmetics sector, Korean brands Innisfree, Hera and Nature’s Republic all opened new stores in multiple second-tier cities, while French brand Clarins and Japanese brand Ipsa both opened at least one new store during the course of the year. Another notable trend came from the tech sector, particularly in Hangzhou: “experience” stores by manufacturers in desirable locations. Huawei, Asus and Xiao Mi all opened new stores on the ground-floor of shopping centres. Finally, some landlords experimented with the offline-to-online format (O2O) in a bid to leverage the strong online customer base of successful online brands. The most notable case was the opening of Jooos at Hangzhou’s Star Avenue Phase II, a 2,000 sq m bricks-and-mortar store that brings several fashion brands together under one roof, following on from the store’s success on online platform TMall.

Active demand led the average vacancy rate of these five cities to decrease by 2.1 percentage points YOY to 5.0%. Net absorption totalled 1.3 million sq m. The vacancy rate fell or remained low in all cities but Nanjing, where it was pushed up slightly by two large properties outside the prime catchments, which was completed in the last quarter of the year. Suzhou recorded the largest
decrease in vacancy rate at 3.6 percentage points due to the absorption at the new development completed in Q4 2015, though the city’s average vacancy rate (6.7%) remained the highest of these five cities.

The average rent of all cities except Hangzhou declined, though this did not necessarily mean that rents declined on a project basis. Instead, the apparent fall in average rent was explained by the rapid expansion of retail developments outside of the prime catchments. These non-prime properties naturally have rental rates below the rates in traditional catchments, in turn pulling down the citywide average. On a project basis, however, rents at most existing developments in all cities were largely unchanged. In Hangzhou, the launch of Kerry Centre in Hubin catchment, which has achieved a rental rate far above average, in turn pulled up the city’s average rent.

Two major en bloc sales transactions were announced in 2016. The largest deal was Vanke’s acquisition of a 96.6% share in the SCPG Group for RMB12.9 billion in November. That transaction was for SCPG’s portfolio of properties in China, including retail projects in several second-tier cities: Suzhou Incity, Nanjing One City, Hangzhou Incity and Hangzhou Xixi Incity. Separately, property developer Fullshare acquired Nanjing’s Wonder City (100,000 sq m, completed in 2012) from Nanjing Deying for RMB1.01 billion in August.

The retail markets in all five cities are set to expand dramatically in 2017. Thirty-five new projects (3.7 million sq m of retail GFA) are scheduled. In Hangzhou alone, ten projects (1.2 million sq m) are planned in a market that totalled just 1.9 million sq m at the end of 2016.

The coming year will see the further development and sophistication of retail projects beyond the traditional catchments. Well-known developers including such as Joy City, Sino Ocean and CapitaLand will open new projects in decentralised areas: Joy City in Hangzhou’s Qianjiang New City; CapitaLand’s first project in Suzhou; and SCPG’s first Incity in Wuhan’s Qingshan catchment. The reputation and experience of these developers in China is expected to attract the interest of numerous brands, domestic and international, and will likely translate into high pre-commitment rates prior to opening. As such, they will relieve a measure of the upward pressure on the vacancy rate due to the fast increase in new stock.

All cities except Suzhou are expected to have moderate declines in the average rental rate, due to the geographic distribution of the new properties and lack of operational and managerial experience from some developers. On a project basis, existing projects in the prime area are expected to achieve moderate rental growth, though existing projects in the non-prime area are expected to main their current levels. In Suzhou, a large, high-quality project will pull up the city’s average rent.
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