CHINA AND HONG KONG | PROPERTY

20 July 2017

Colliers INTERNATIONAL
Accelerating success.

Faster growth to drive property

Andrew Haskins Research | Asia
Daniel Shih Research | Hong Kong

Economic growth is accelerating in China and Hong Kong, with positive implications for property in both markets. In China, it is plausible that firm growth will push up office leasing demand, limiting the adverse impact on rent growth of rising supply in Beijing, Shanghai and Shenzhen, while in Chengdu robust demand has helped the office market to stabilise. In Hong Kong, we foresee rent growth and rising capital values in most parts of the property market except retail, although even in this segment conditions are starting to improve.

China accelerating, not slowing

Announced on 17 July, YOY real GDP growth for China in Q2 2017 was 6.9%, the same as in Q1. The high figure partly reflected surprising strength in housing sales growth and housing starts, especially in smaller cities. However, resilience in residential property was not the only factor at work. Notably, goods exports growth rose from 9.6% YOY in Q1 to 10.2% in Q2, driven by firm global demand. Moreover, growth in industrial value added rose to 7.6% YOY in June, while household consumption growth and retail sales were also robust.

Following the announcement, Oxford Economics has revised up its forecast for real GDP growth for 2017 as a whole from 6.6% to 6.8%, compared to 6.7% in 2016. Certain parts of China, notably the north-east, continue to face economic pressures. However, on this basis China as a whole is accelerating, not slowing down.

Firm demand should partly offset rising office supply in Tier 1 cities

The strengthening growth outlook in China should support office leasing demand in the major cities, as well as leasing demand for industrial property. In the office sector, firmer demand may well moderate the impact of rising supply in Beijing, Shanghai and Shenzhen. We detail our assumptions for these Tier 1 cities below.

> Beijing: Six new projects with a total office GFA of 450,000 sq m (4.84 million sq ft) are due to be completed in H2 2017, pushing up total stock by 7% and boosting the vacancy rate from 8.4% at end-2016 to 13.0% by end-2019. Despite this heavy new supply, the firm economic background and the completion of certain key new projects have stimulated demand from the finance and IT sectors. Accordingly we now expect average annual rent growth of -0.3% (versus our previous assumption of -0.5-0.6%) over 2017-2020, which is almost flat. The CBD may still face greater pressure because this is where new supply is concentrated.

> Shanghai: We predict total new office supply in 2017 in Shanghai's CBDs of 1.1 million sq metres (11.7 million sq ft), or about 3x the average for the past 11 years of 362,000 sq m (3.9 million sq ft). This should push up aggregate stock by 17%, with supply staying heavy in 2018. If so, the vacancy rate should rise from 10.2% at end-2016 towards 15.3% and hover at about that level for the next couple of years.

Rising supply has pushed rent down for three consecutive quarters. In Q2 2017, the average rent in Shanghai's CBDs declined by 0.3% QOQ to RMB10.3 (USD1.52) per sq metre per day, although this represented a 0.7% increase YOY. Up to now we have been assuming a rental decline of about 4% over 2017 and 2018 as a result of the heavy new supply. However, based on Colliers data Shanghai's CBDs recorded net absorption of 261,000 sq m (2.81 million sq ft) in Q2, the highest quarterly absorption level in the past decade. This reflected strong demand across a range of sectors. Against this background our existing rental forecast may well prove cautious.

> Shenzhen: The Tier 1 Chinese city with perhaps the greatest volume of new supply is Shenzhen. By our estimate, as of end-Q1, 18 office buildings with combined leasable GFA of 968,000 sq metres (10.4 million sq ft) were due to be released over the rest of 2017. This volume of new supply would raise total stock to 5.7 million sq metres (61.7 million sq ft) by the year-end, up by just over 20% from end-Q1.

Despite the fact that Q1 also saw a high volume of new supply (301,000 sq metres or 3.23 million sq ft), average rent in that period grew by 3.2% QOQ to RMB225.6 (USD32.7) per square metre, reaching a record level. This was partly attributable to high rent in one new project in Futian District, but even excluding this factor average rent was up 0.9% QOQ. The strength in rents persisted into Q2, which saw average rent rise by 3.0% versus Q1. In view of the firm economic background and strong global conditions in the internet and technology sector which accounts for a high proportion of occupancy in Shenzhen, it is conceivable that rental growth in this market will continue to produce positive surprises.

Chengdu: robust demand supports office market

We should comment on the example of one large other Chinese city, Chengdu in Sichuan province. Western China is growing faster from a lower base than wealthier and more developed eastern China. Chengdu's GDP grew by 8.2% YOY in Q1 2017, according to the city's Statistics Bureau, while value added in the finance sector grew by 11.9%. Official data also showed that the proportion of tertiary industry (i.e. services) in Chengdu's GDP grew from 51.0% to 53.4% in Q1.

Over Q2, Chengdu saw robust demand for new office space, coming primarily from domestic companies in the finance, technology, coworking, healthcare and insurance sectors. This demand drove net absorption of 80,990 sq metres (871,322 sq ft), up by 71% QOQ. While delays in new supply were also a factor, the city-wide vacancy rate consequently fell by 4.1 percentage points QOQ to 30.5%. Notably, the vacancy rate in the CBD submarket decreased by 5.4 percentage points to 27.7%, which was the first time in four quarters that vacancy here had dropped to below 30%. As a result, the average rent in Chengdu's prime office market increased by 1.1% QOQ or decreased by 7.2% YOY to RMB 93.9 (USD 13.86) per sq metre per month.

Chengdu still faces a challenge to absorb heavy new office supply over the coming year. For H2 2017, however, prospects appear to be improving. Faster economic growth may contribute to further such positive surprises in Chengdu and other cities in western China.

Hong Kong also speeding up

Economic strength in China will support Hong Kong, where the economy is increasingly intertwined with that of the mainland. Hong Kong reported real GDP growth of 4.3% YOY in Q1 2017, the highest quarterly figure since 2011. While the Hong Kong government has not yet announced GDP growth for Q2, recent data suggest that economic conditions remain strong.

For example, total YOY growth in imports over the January-May period was 9.1%, indicating strong domestic demand. Export growth over the same period was 8.2%, reflecting improving global demand. At the same time, tourist arrivals have recovered after lengthy weakness, helping retail sales to stabilise. The recent strength of the residential property market (see below) and the Hang Seng equity index (up 22% over the past twelve months) have probably boosted confidence in both the consumer and business sectors. Oxford Economics currently forecasts real GDP growth of 2.8% for Hong Kong in 2017, well above 2.0% in 2016.

Hong Kong: Q1 economic performance

Source: Hong Kong government

The strength of the Hong Kong economy should support rents and capital values in the office, industrial and residential property sectors in 2017, as highlighted in our Hong Kong H1 press conference on 12 July. The chief part of the property market which remains under pressure is retail, although even here conditions are starting to improve.

Improving prospects for Hong Kong commercial property

Looking ahead, these are our key forecasts for the Hong Kong property market over the rest of 2017:

> Office prices higher, driven by record sales of commercial sites: Consecutive new price records for the Murray Road Car Park (HKD23.38 billion or USD3.00 billion) and Kai Tak Area 1F Site 2 (HKD24.6 billion or USD3.16 billion) in May 2017 have demonstrated local developers' confidence in the office market in the long run. Overall office property prices have gone up further, encouraging landlords to put up

more large buildings for sale. We think the total office transaction volume will be higher in H2.

- New office districts benefiting from decentralisation: The office leasing market has become more active with decentralisation set in motion. Wong Chuk Hang and Kowloon East have seen substantial net take-up increases over the same period in 2016. With the completion of major office redevelopment in Quarry Bay will see pre-leasing activities picking up for the Island East market in H2 2017.
- A moderate residential price adjustment in H2 is possible: Hong Kong's residential property prices have gone up 100% since the 1997 handover due to ample monetary liquidity, negative real interest rates since the Global Financial Crisis and strong domestic demand. The current growth streak reached 14 consecutive months in June 2017, with average prices up by 8.5% over H1 as a whole. A 5% price drop in H2 is possible if the primary property sales market slows down in coming months. Beyond H2 2017, we expect residential prices to continue to climb.
- Newer brands taking over first-tier locations in prime shopping areas: Tourist arrivals increased by 3.2% during the first five months of 2017 while retail sales are stabilising. New brands have taken advantage of lower rents at prime street shops by moving into Tier One locations which used to be occupied by traditional luxury brands. Landlords are acting smart by accepting offers from lifestyle and novel brands that are in expansion mode.
- Warehouse still in high demand led by improving business confidence: Confidence in the logistics industry is rising due to encouraging export and import figures. Multinational logistics operators are moving into newly completed warehouses to offer better and faster value-added services. A flight to quality will support warehouse rental growth in H2.

2017 Projections

2017 RENT PROJECTION

Office (HK Island):	+4%
Office (Kowloon):	-5%
Retail (Prime Street):	-5%
Industrial (Warehouse):	+5%
Industrial (Factory):	+5%
Residential (Mass):	+7%
Residential (Luxury):	+2%

2017 CAPITAL VALUE PROJECTION

Office (HK Island):	+10%
Office (Kowloon):	+5%
Retail (Prime Street):	-15%
Industrial (Warehouse):	+6%
Industrial (Factory):	+6%
Residential (Mass):	+10%
Residential (Luxury):	+5%

Source: Colliers International

For more information:

Andrew Haskins
Executive Director | Asia
+852 2822 0511
andrew.haskins@colliers.com

Daniel Shih
Director | Hong Kong
+852 2822 0654
daniel.shih@colliers.com

Contributors:

Timothy Chen
Director | East China

Pan Li
Senior Analyst | Chengdu

Stella Liu, **Jamie Xu**
Research | Beijing

Kirsten Geng
Senior Analyst | Shenzhen