Colliers Outlook

SHANGHAI | H1 2018 MARKET REVIEW AND OUTLOOK

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Solid Fundamentals Buoy Steady Performance in Shanghai's Property Market

Shanghai's property market remained healthy, buoyed by strong economic fundamentals. Net absorption grew further and drove down vacancy in the office, retail and logistics sectors. Meanwhile, rental growth in business parks was the highest in a year in Q2 2018.

In the investment market, the Shanghai government announced a plan to create an international consumer city, following which the retail sector attracted significant attention from investors and ultimately seven major deals were transacted during H1 2018. In the meantime, office properties remained the most active sector for en-bloc transactions. RMB funds, together with foreign investors, stayed active in seeking value-add projects with a large rental upside.

In H2 2018 we expect:

1. In the office market, sustained new supply should push up vacancy slightly while average rents will probably show modest growth in mature business districts as demand from finance, professional services, trading, TMT and flexible workspace operators continues to expand.
2. Sustained demand coupled with limited supply in the business park sector should support its rental growth and drive down the vacancy rate.
3. In the retail sector, the vacancy rate will pick up while average rent edges down given the below-average rent of the large new supply in decentralised areas.
4. In the logistics sector, the vacancy rate should inch up as some new supply faces registration requirements and needs more time to fill. Meanwhile rental growth should be sustained by robust demand from e-commerce and third-party logistics providers.

Our predictions for developers and investors are as follows:

- With the development of technologies and infrastructure improvements, business parks will become a key sector for investors, supported by the steady rental and asset value performance.
- Due to strong fundamentals, the retail spaces in prime areas will continue to attract investors' attention.
- Value-add office projects in Pudong and other decentralised areas, such as Yangpu and New Jing'an will remain the focus amidst investors.
- Limited tradable assets for warehouses will continue to lead investors to the outskirts of Shanghai, such as Nantong, Changzhou, Wuxi and Changshu.

For occupiers, we recommend:

- Flexible workspace for a more dynamic market environment;
- The new office supplies in New Bund-Expo and North Riverfront clusters over the next 3-5 years for expansions or upgrades.

Figure 1: End-2018 Shanghai Forecast (HOH basis)

Property Type	Rent		Vacancy	
Grade A Office*	↑	0.6%	↑	1.5pps
Business Park	↑	2.8%	↓	1.0pps
Retail	↓	3.5%	↑	5.2pps
Industrial	↑	3.1%	↑	2.0pps

Source: Colliers Research, *Grade A office refers to CBD Grade A office

Economic Fundamentals Remain Solid

The PBoC has lowered the reserve requirement ratio three times by an aggregate of 200 basis points for the target industries during the first half of 2018, indicating moderate monetary easing by the government. On the back of loosened liquidity, Shanghai's economic performance remained healthy during the first half of 2018. During the period, total GDP grew by 6.9% YOY to RMB1.56 trillion (USD0.24 trillion), on par with that of 2017. Of that figure, the services sector accounted for 69.2%, and recorded YOY growth of 7.4%. The steady growth of tertiary industry has underpinned sustained demand for Shanghai's office and business park markets.

As a key driver of the economy, Shanghai's total retail sales grew by 7.7% YOY in H1 2018, surpassing the GDP growth rate by 0.8 percentage points. Of that figure, online retail sales represented 11.4%. During the same period, per capita urban disposable income rose by 7.4% YOY to RMB34,352 (USD5,205). The solid performance of retail sales is positive for the retail and logistics sectors.

Office sector remained a market mover coupled with a rally in en-bloc retail sales

The investment market in Shanghai remained active in the first half of 2018. A total of 33 deals were concluded with an aggregate transaction volume of RMB44.9 billion (USD6.8 billion). Office properties continued to lead the market for en-bloc sales, representing 40% of the total transaction volume. Domestic RMB funds and foreign investors continued looking to the projects with stable income. In addition, the Shanghai government announced a plan to create an international consumer city, which serves to upgrade the existing trade mixes and enhance shopping experience. As a result, the retail sector attracted significant attention from investors with five deals ultimately transacted in Q2 2018.

CBD Grade A office: healthy demand drove down vacancy

During the first half of 2018, the Shanghai CBD Grade A office market received three new buildings totalling 253,000 sq m (2.72 million sq ft) GFA. These projects increased the total stock of Shanghai's CBD Grade A office by 3.6% HOH or 8.7% YOY to 7.27 million sq m (78.3 million sq ft).

Figure 2: H1 2018 Shanghai CBD Grade A Office New Supply

New Launches	Area	GFA (sq m)
One Museum Place	Jing'an	127,349
SB1-1 Project	Lujiazui	46,200
Pudong Financial Plaza	Lujiazui	48,000

Source: Colliers Research

Firm economic growth supported the city's demand for prime office space, evidenced by the 18.4% YOY increase in net absorption to 456,000 sq m (4.91 million sq ft). Finance, professional services, trading, TMT and flexible workspace operators were major demand drivers. Leading flexible workspace operators continued expanding aggressively in Grade A offices, accounting for 17.5% of the CBD's net take-up during H1 2018.

Driven by the continuous healthy demand, Shanghai's CBD office vacancy dropped a significant 3.3 pps HOH in H1 2018, while strong net absorption pushed average rental by 1.3% HOH to RMB10.36 psm per day (USD1.56).

In decentralised areas, seven new projects entered the market during H1 2018, adding a total GFA of 354,000 sq m (3.81 million sq ft) to the Shanghai decentralised Grade A office market. The total stock therefore was lifted by 8.4% HOH or 27.0% YOY to 4.55 million sq m (49.0 million sq ft). In terms of demand, net take-up of 372,000 sq m (4.0 million sq ft) was recorded in Shanghai's DBD market during H1 2018, representing a 14.9% decrease HOH but a 77.6% increase on a yearly basis. The overall vacancy rate dropped by 2.4% HOH or 2.0% YOY to 23.9% in H1 2018.

Figure 3: H1 2018 Shanghai CBD Grade A Office Vacancy & Rent by Area

CBD area	Vacancy rate	HOH	YOY	Rent (RMB psm per day)	HOH	YOY
Overall	10.6%	↓ 3.3 pps	↓ 2.3 pps	10.36	↑ 1.3%	↑ 0.1%
Puxi	9.3%	↓ 4.9 pps	↓ 2.9 pps	9.46	↑ 3.2%	↑ 1.6%
Pudong	12.3%	↓ 0.9 pps	↓ 1.3 pps	11.66	↓ 1.1%	↓ 1.0%

Source: Colliers Research

Figure 4: H1 2018 Shanghai DBD Grade A Office New Supply

New Launches	Area	GFA (sq m)
KIGC T1	Yangpu	28,929
JT Plaza	Yangpu	24,120
Mapletree Business City F, H, G	Minhang	101,963
CES	Xuhui	62,000
Landmark CIFI Metropolis	Pudong	26,317
Shanghai Shimao Tower	Pudong	24,000
Crystal Plaza T5	New Bund	41,390

Source: Colliers Research

The average rent in the decentralised market continued to rise during H1 2018, by 5.0% HOH or 4.6% YOY to RMB6.66 (USD1.00) psm per day, reflecting a maturing business climate and landlords' optimistic outlook for the future.

Through 2018, Colliers expects another 300,000 sq m (3.23 million sq ft) of new supply to enter Shanghai's CBD market, lifting the total stock to 7.58 million sq m (81.6 million sq ft) by year-end. Vacancy at end-2018 should rise to about 12%, and rents should see a modest growth by the end of the year.

Supply in the CBD should remain heavy in 2019 before easing in 2020. In mature office submarkets about 1.75 million sq m (18.8 million sq ft) of office GFA is scheduled to be completed during 2019 to 2022. Considering the healthy economic outlook, Colliers expects the CBD vacancy rate to decline after 2018, reaching about 9% at end-2022. Meanwhile, rents will likely increase gradually during 2019-2022 with an approximate 2% growth rate per year.

Business Parks: solid demand accelerated rental growth

The Shanghai business park market was active over H1 2018 with net absorption of 369,432 sq m (4.0 million sq ft). Companies from the technology, finance and professional services sectors continued to play an important role in business park demand. In addition to those traditional demand drivers, the medical and health industry is expanding substantially in business parks.

Echoing the solid demand, the average rent of business parks increased 2.3% HOH or 3.5% YOY to RMB4.27 (USD0.65) psm per day at end of H1 2018. Rental growth accelerated in Q2 2018, achieving the highest growth since Q2 2017. Driven by above-average rents from a new project, Zhabei achieved the highest HOH rental growth rate (3.7%) among all submarkets, followed by Caohejing (3.2%) and Zhangjiang (2.5%).

Figure 5: H1 2018 Major Leasing Transactions of Shanghai Business Park

Tenant	Building	Submarket	GFA (sq m)
AMD	Candor Plaza	Zhangjiang	20,000
IBM	ZJ Scientific Park	Zhangjiang	17,000
Sense Time	Xinzhou Building	Caohejing	22,000
Health 100	Hai Tun Wan Phase I	Zhangjiang	5,600
Yunduan Dental	Hai Tun Wan Phase I	Zhangjiang	5,000
Hospital R&D centre	Shibei Medical Research Centre	Zhabei	27,200

Source: Colliers Research

The growth of the services sector and the improvement of business parks' transportation connections are two key forces driving demand for Shanghai business parks. We expect the positive market fundamentals to continue as Shanghai implements its goal of being a global technology and innovation centre. In addition, the expansion of the metro network should further benefit business parks. Phase III of Line 13 is scheduled to be completed by this November, substantially enhancing the accessibility of Zhangjiang Central Zone, which should boost demand for nearby business parks.

Only three new projects are scheduled to launch over the remainder of 2018, including two new projects in Zhangjiang and one in Jinqiao. The new supply in H2 2018 is scheduled to decline substantially to169,688 sq m (1.83 million sq ft), only 29% of the level in H1 2018. Looking forward, Colliers forecasts the vacancy rate to decline, and the average rents will likely edge up, given the stable demand and the limited new supply.

Retail: experiential brands continued to expand

Shanghai's retail property market remained stable in H1 2018. Only one new project, Imixpark, opened in Daning, with a GFA of 140,000 sq m (1.5 million sq ft). The ratio of citywide prime retail to non-prime retail remained at 25:75. Strong demand continued to support rental increases in H1 2018. Imixpark opened with a high occupancy rate of 90%. The overall market recorded 332,000 sq m (3. 6 million sq ft) net absorption, with the city's overall vacancy rate dropping by 3.1 percentage points HOH to 9.5%.

Experiential consumption continued to be the trend in H1 2018. Gymnasium and bookstore brands, like Super Monkey and Zhongshuge, continued to expand. Lifestyle and new energy automobile brands were spotted acquiring retail space in shopping malls. MI's subsidiary lifestyle brand, Youshengpinjian, had its first offline shop in Shanghai in Vanke Mall.

Excluding new supply, the average rent increased by 2.2% HOH in prime markets to RMB 56.9 (USD 8.60) psm per day and 0.3% HOH in non-prime markets to RMB 27.1 (USD 4.10) psm per day. Incorporating new supply in H1 2018, the city's overall rent dropped by 0.9% HOH to RMB 34.0 (USD 5.10) psm per day. Strong demand supported rents with minor fluctuations despite the new supply and continuous revisions of the tenant mix and renovations in existing projects in prime areas.

The retail property market should be active in H2 2018. More than 10 projects are scheduled to come online, adding more than 1.2 million sq m (13.5 million sq ft) of new supply to the market including L+Mall, Century Link, The Bund Financial Centre, MIFA 1862 and Gala Evernew of Lujiazui Citic Shipyard Project. Among the scheduled new supply, more than 900,000 sq m (10.2 million sq ft) is scheduled to be released in the non-prime market. With the bulk of new supply scheduled in H2 2018, we expect the vacancy rate to grow moderately while the city's overall rent should drop modestly as the majority of the new supply is located in non-prime areas where rents are usually lower than the average.

Logistics: robust demand coupled with limited supply pushes up rental growth

A total of 170,000 sq m (1.83 million sq ft) of new supply was added to Shanghai's Grade A logistics market in H1 2018, expanding total stock to 5.85 million sq m (62.9 million sq ft). Despite the completion of new projects, Shanghai's logistics properties remained in short supply.

Demand for logistics warehouses remained strong, but vacant space is very limited in Shanghai. Moreover, two of the new projects recorded low occupancy rates as they are only available for tenants who register a legal entity in the district and pay tax obligations to the district government. As a result, net absorption reached 136,000 sq m (1.46 million sq ft) in H1 2018, and the vacancy rate dropped by 3.8 percentage points YOY to 7.8% though this was an increase of 0.3 percentage points HOH. By submarket, Fengxian had the highest vacancy rate of 36.2% due to new supply, followed by PD PVG (20.3%).

The average rent of Shanghai's Grade A logistics warehouses increased by 11.3% YOY or 5.3% HOH to RMB1.46 psm (USD 0.22) per day. Most landlords adjusted their rents with very strong power in negotiations due to the limited availability of space. By submarket, rents in Putuo and Qingpu rose significantly in first half of 2018.

The logistics investment market was very active in H1 2018, as foreign and domestic investors have been setting up investment funds with logistics developers to acquire valuable assets. The major deals in H1 2018 are:

- ✓ Vanke purchased seven logistics warehouses in Shanghai.
- ✓ ESR received a USD306 million (RMB1.99 billion) investment from JD.com.
- ✓ GLP also set up a RMB10 billion (USD1.53 billion) PE fund to invest in logistics-related business.

We expect about 500,000 sq m (5.38 million sq ft) of new supply to be completed in H2 2018. Although this should stimulate demand and increase net absorption in the second half, we expect the vacancy rate to rise to 9%-11% as some new supply with registration requirements needs time to be leased out. We expect rents to continue rising by 2%-3% HOH in H2 2018. In 2019-2020, rental growth will continue, but slow down to around 5% annually.

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