SHANGHAI

CBD Grade A Office – Vacancy Rate Spiked amidst P2P Retreats

Shanghai’s tertiary industry grew by 11.5% YOY in the first quarter of 2016, according to the Shanghai Statistics Bureau. Despite this stable economic indicator, widespread retreats from tenants in the peer-to-peer lending (P2P) sector and new supply led the overall vacancy rate in the CBD to spike in the second quarter. Correspondingly, the average rent faced a correction in the second quarter. In the investment market, 14 transactions totalling more than RMB15 billion were disclosed during the first half. Notably, a new VAT structure in the real estate industry was implemented in May, though the effect to date has been marginal.

Four buildings with a total office GFA of 121,000 sq m quality office space were added to the city’s CBD Grade A office leasing market in the second quarter. As a result, the total stock increased by 2.1% QOQ or HOH to approximately 5.8 million sq m as of end-June. Three of the new buildings were completed in Pudong (two in Zhuyuan and one in Lujiazui), pushing up the average vacancy rate in this area by 3.9 percentage points QOQ or 3.5 percentage points HOH to 8.3% by end-June. At the same time, Puxi’s average vacancy rate climbed by 2.7 percentage points QOQ or 1.4 percentage points HOH to 6.4%. This was the result of widespread retreats from tenants in the P2P lending sector, which came under scrutiny from the government in recent months. As a result, net absorption turned negative for the first time since the 2008 to 2009 financial crisis, at negative 69,000 sq m, and the overall vacancy rate in the Shanghai CBD Grade A office market increased by 3.2 percentage points QOQ or 2.2 percentage points HOH to 7.2%. Nonetheless, new demand continued to come from the legal, finance, IT and professional services sectors, with a notable number coming from the domestic companies.

In response to the retreats at many buildings, some landlords became more flexible in rental negotiations, and the average rent in Shanghai’s CBD Grade A office market declined by 0.5% QOQ in the second quarter to RMB10.3 psm per day (this represented a 1.2% increase on a semi-annual basis). The correction was strongest in Puxi, where P2P tenants have clustered in the past two years. As such, the average rent in this area declined by 1.3% QOQ or 0.4% HOH to RMB9.4 psm per day by end-June. A rental correction was also observed in Pudong, though this was primarily the result of below-average rent at the new supply in Zhuyuan. As a result, Pudong’s average rent edged down by 0.2% QOQ to RMB11.6 psm per day in Q2, though properties in both Lujiazui and Zhuyuan (in Pudong) continued to achieve average rental growth amidst strong demand for these areas.

The new VAT tax structure was expanded to the real estate industry in May. However, it is too early to assess what long term impact the change will have on landlords and tenants. In the short term, most landlords elected the 5% rate available to landlords of properties completed before May 2016, which limited any significant effect on their assets or tenants.
The investment market was active, with 14 transactions totalling more than RMB15 billion disclosed in both CBD and decentralised locations during the first half. In CBD, headline transactions included 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) and Real Power Capital’s purchase of Evergo Tower in Huangpu from Chinese Estates for RMB1.22 billion (RMB49,481 psm). In the decentralised market, most buyers acquired assets for self-use, though certain established locations such as Changfeng and North Sichuan Road remained attractive to both domestic and foreign investors.

Shanghai’s GDP is set to grow at 6.5% per annum from now until 2020. Though this is a slowdown from previous years, the city’s large service sector, and growth within many industries in this sector, should underpin continued demand for office space in Shanghai. In the second half of 2016, the CBD market is expected to see more than 676,000 sq m of new office GFA (including the skyscraper Shanghai Tower), the highest half-year total in the past decade. The wave of new supply will lead to a further rise in the vacancy rate and constrain the rental growth over the next two quarters.

In the short term, the government’s strict control of the P2P industry and the resulting widespread retreat of such tenants will continue to pose a challenge for a number of landlords, who saw an unexpected spike in their vacancy rate in the first half of 2016. This will present opportunities for certain tenants, who may gain a stronger negotiating position with landlords of desirable buildings. In the coming quarters, however, this vacant space is expected to be easily absorbed by other sectors of the finance industry (banks, securities companies, and wealth management firms, among others), professional service companies, and growing sectors such as shared office companies and “internet plus” businesses.

Retail – Investment Picked Up and Children’s Care Sector Active

Shanghai’s retail sales grew by 7.1% YOY during the first five months of 2016, decelerating 0.9 percentage points compared with the same period in 2015, according to the Shanghai Statistics Bureau. This slowdown was reflected in the delay of grand openings for several projects which began trial operations in late 2015 or early 2016. One new project, Sincere Plaza, opened during this half, and total stock increased by 2.0% HOH to approximately 4.5 million sq m.

Limited new supply and active new opening activities in new shopping centres launched in 2015 led the overall vacancy rate to decrease by 1.9 percentage points HOH to 9.8%. Most these projects are located in non-prime retail areas, and the vacancy rate of this segment decreased by 3.2 percentage points HOH to 9.9%. In the prime retail area, internal adjustments at projects including Plaza 66, Zendai Thumb Plaza and Super Brand Mall drove a 0.6 percentage point increase in the vacancy rate.

The below-average rent at the new supply had a limited impact on the city’s average level. Rental adjustments in certain projects, including annual increases and increases following the completions of trade and brand mixes adjustments, led the average rent for ground floor property in Shanghai’s mid- to high-end shopping centres to increase by 1.0% HOH to RMB39.3 psm per day by end-H1 2016. By segment, the rent in the prime and non-prime retail areas increased by 1.4% and 1.5% HOH to RMB57.4 and RMB30.4 psm per day.

Notably, the children’s care sector has been a source of strong demand. In H1 2016, the proportion of this sector in the average trade mix in Shanghai’s retail properties increased by 0.8 percentage points HOH to 3.7%, with openings and leases from the first China Legoland Discovery Center at Parkside Plaza; the first Global NBA Play Zone at Corporate Avenue Mall; and Golden Ballet Dance at Laya Plaza.

Shanghai’s retail real estate investment market was active in H1 2016, with two en bloc sales announced. Both deals were structured as asset transfers. China Everbright Group purchased Orstar City from Star Capital in Q1 for approximately RMB2.9 billion and Xujiahui Center Group acquired Bestbuy Xujiahui Store from Bestbuy in Q2 for approximately RMB384 million. Developments with stable leasing agreements in prime locations and communities with high population density and value-added potential remained attractive.
Thirteen new projects with over one million sqm of retail GFA are scheduled for completion in H2 2016. As a result, the total stock of the city’s retail real estate market is expected to increase by 22% HOH to approximately 5.5 million sqm. More than 90% of the new supply will be located in the non-prime retail area. This will inevitably lead to a temporary increase in the vacancy rate.

The expected below-average rents at the large volume of future supply in non-prime locations will pull down the city’s average ground floor rent in H2 2016. However, this negative effect will be limited by rental adjustments in certain existing projects. In the prime retail area, rental level will remain buoyant for the remainder of 2016, given the limited supply and strong demand from domestic and international retailers for both new stores and expansion.

**Residential – Market Slowed Down amidst Policy Changes**

Shanghai’s Bureau of Housing and Urban-Rural Development, along with other three government agencies, tightened the city’s house purchase restrictions in March, in an attempt to cool the residential property market. The new policies raised the minimum down payment for second homes from 40% to either 50% or 70% (depending on the case), and increased the tax payment threshold for non-local buyers. In line with this government direction, both home buyers and developers became more cautious, and the sales volume slowed in H1 2016. However, the average sales price remained at a high level, supported by transactions of high-end projects.

The supply of Shanghai’s new commodity residential properties decreased by 39.9% HOH to approximately 4.3 million sq m as developers sought to clear existing stock. By category, more than 90% of the new supply was in the apartment format. Villas and apartments recorded a decline of 49.0% and 38.8% respectively, compared to H2 2015.

Purchase sentiment cooled. The sales volume in the first half of 2016 recorded 6.8 million sq m (54,489 units), though this diverged sharply following the government announcement: in the first quarter, the sales volume was 4.3 million sq m (34,389 units); in the second quarter, it declined to 2.5 million sq m (20,100 units). The largest decline in sales volume was seen for low- to mid-end homes, which declined 25.5% HOH to approximately 4.9 million. In the high-end and luxury markets, the transaction volumes declined by 17.8% and 17.0% HOH to 1.8 million sq m and 1.2 million sq m.

Despite the slowdown in volume, the average sales price continued to increase. Sales of high-end properties pulled up the city’s average sales price by 3.4% HOH to RMB35,056 psm. In the high-end and luxury markets, the average sale prices increased 3.4% and 8.3% HOH to RMB65,664 psm and RMB77,960 psm. In the low- to mid-end sector, the average price edged up by 1.2% HOH. By geographic area (determined by the city’s ring roads), the sales price within the inner ring road continued to see the fastest growth at 18.4% HOH to RMB89,000 psm, 15 percentage points higher than the growth of the city average. By category, the average sales price of villas declined by 0.3% HOH to RMB35,293 psm, while apartments increased by 4.0% to RMB35,009 psm.

In line with the limited land supply in the first half of 2016, the total transaction area declined by 55% HOH to 757,871 sq m. Nevertheless, the closing of several land transactions with high premiums pushed the average accommodation price to a new high at RMB25,033 psm, up 27.4% HOH. Cinda Real Estate paid the highest price for a single site, acquiring a site in Baoshan district for RMB5.8 billion, or an accommodation value of RMB36,383 psm, at a premium of 303%. This was followed by Poly’s purchase of a residential site in Pudong’s Zhoupu town for RMB5.45 billion or RMB43,607 psm, the highest accommodation price this half.

In the second half of 2016, the transaction volume of Shanghai residential market is expected to rebound after the slowdown in Q2 2016 and new supply is expected to be in line with levels in H2 2015 (approximately 7 million sq m), as developers prepare for the traditional sales season in September and October. The average sales price for Shanghai’s residential real estate market is expected to grow, supported by transactions of high-end properties. No major changes to the government’s purchase restrictions are expected in the coming half. In the land market, an increase in the numbers of transactions is expected, in line with a 27% increase in the amount of land offered for sale in 2016, compared to the previous year.
Business Park – Leasing Slowed but Investment Remained Strong

Shanghai’s business park real estate market slowed in H1 2016 after a particularly strong year in 2015, though still registered a notable amount of activities. Three new projects, located in the Linkong, Yangpu and Jinqiao submarkets, were completed in the first half, adding a combined GFA of 199,000 sq m to the total stock. Net absorption moderated by 51% HOH or 62% YOY though still totalled 236,596 sq m. The apparent slowdown is a result of an extremely active H2 2015, a decline in new supply and a mild reduction in leasing demand during the second quarter. Nevertheless, the overall vacancy rate edged down by 0.7 percentage points HOH, underpinned by expansions in certain submarkets and fast absorption at new completions. Biotechnology, IT and other high-tech industries were the key demand drivers this half.

The average rent in Shanghai’s business park market increased by 2.1% HOH or 5.5% YOY to RMB3.86 psm per day. This growth was primarily driven by renewals, expansions and rental adjustments in the first quarter by certain landlords that have achieved high occupancy rates in their projects. In the second quarter, rental growth slowed to just 0.1 percentage point QOQ, in line with the slowdown in demand. By area, rental growth in Lujiazui Software Park, Caohejing and Yangpu submarkets outpaced that in other submarkets, on the back of the tight supply and their mature business ambiance. The VAT reform, implemented in May 2016, had a limited effect on the rental level during this half.

After a record high number of investments in 2015, the business park real estate investment market slowed in H1 2016, though in the real term, the market was active compared with other real estate sectors. Four en bloc sales transactions were successfully closed during the half. In particular, end-users sought vacant buildings as headquarters or R&D centres. In March, an end-user bought a 25,690 sq m business park property in Zhangjiang from Wilson Engineering. In May, Quick Pharmaceutical sold a business park project in Linkong to an end-user from Beijing, with an aboveground GFA of 25,945 sq m. In June, Honeywell purchased one bloc of the C-9-6 Project in Zhangjiang Central Zone from Zhangjiang Group for self-use. The building has a total GFA of 19,392 sq m. Meanwhile, funds, REITs, business park developers and other institutional investors continued to seek suitable targets in Zhangjiang, Jinqiao and Caohejing. This was evidenced by Pudong Jinqiao’s purchase of the Chuanqiao Road Project (previously the Xinhua Garment Factory), with an aboveground GFA of 16,958 sq m.

The contracted FDI flowing into the science and technology service sector (primarily for R&D) spiked by nearly 900% YOY in the first five months of 2016, as 19 new regional headquarters, seven investment-type companies, and five R&D centres were established in Shanghai by multinational corporations during the period. In the second half of 2016, approximately 920,000 sq m of new supply is scheduled to complete; 80% of this new supply will be located in the Zhangjiang and Caohejing submarkets. As a result, a short-term increase in the overall vacancy rate and a concurrent slowdown in rental growth are expected in the near term. Nevertheless, the investment sentiment is expected to be strong in the next half, as several deals currently in the negotiation stage are expected to conclude.

Industrial (Logistics & Manufacturing) – Surge in Supply, Matched by Demand

Shanghai’s industrial real estate market was active during H1 2016, with more than 468,000 sq m of new supply and strong demand. Developers Goodman, GLP and Vailog all opened new properties during the half, including the largest logistics development in Puxi (GLP Park Yuepu). Demand from the medical, electronics, e-commerce and retail sectors drove net absorption to 406,000 sq m, the highest level since H1 2010. Despite the volume of the new supply, the vacancy rate remained largely unchanged from the previous half at 14.5%. By area, Pudong’s vacancy rate decreased by 3.4 percentage points HOH to 15.4% while the figure in Puxi increased by 8.3 percentage points to 14.0%. In the logistics sector, the average rent increased by 3.4% HOH or 5.2% YOY to RMB1.28 psm per day.

Both third party companies and e-commerce companies are expanding to new or upgraded facilities to serve needs for background data processing, cold chain logistics and traditional warehousing. This was evidenced by the renovation of a 10,000 sq m traditional warehouse into facilities for cold storage this half by a domestic third party logistics company.
This upgrading of former manufacturing facilities into higher-value uses such as R&D centres continued to be an ongoing trend in Shanghai’s industrial market. Shanghai Jinqiao Export Processing Zone Development (Pudong Jinqiao) purchased a 17,000 sq m former garment workshop in June, which it plans to renovate into offices. In the second half of the year, similar projects by Vanke (a 100,000 sq m project in Minhang) and a joint venture between Vanke and the Zhangjiang Hi-Tech Park Administration (E-Park, a 94,000 sq m project in Zhangjiang Hi-tech Zone), are scheduled to open.

The manufacturing property market was stable in H1 2016. Activity was limited by low available stock. Annual rental adjustments pulled up the average from RMB0.98 psm per day in H2 2015 to RMB1.03 psm per day as of H1 2016. Pudong continued to have the highest rental level at RMB1.41 psm per day, representing a growth rate of 5.3% YOY. This was followed by Minhang, with an increase of 8.0% YOY to RMB1.35 psm per day.

The investment market was active in H1 2016. In the logistics sector, logistics developer The Redwood Group merged with e-Shang, a Shanghai-based logistics developer, in January. Dutch pension fund PGGM invested a further USD160 million in the Redwood China Logistics Fund in February, following its USD144 million investment in H2 2014. In the workshop sector, industrial 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.

Cross-border e-commerce continued to expand in H1 2016, supported by the successive policies released by government at both city level and national level. The Shanghai government continued to support the expansion of D.I.G, a store selling imported goods and the first cross-border e-commerce demonstration park was launched in Waigaoqiao.

In the second half of 2016, three new projects, developed and operated by GLP, Vailog and ABM, are expected to be completed. The new supply will lead to a temporary rise in the average vacancy rate but will also support a moderate rise in the average rental level, given their locations. The average rent for Shanghai’s bonded logistics market is expected to increase in H2 2016 with a concurrent decline in the vacancy rate amidst limited supply and sustained demand for bonded warehousing space.

**SECOND-TIER CITIES (SUZhou, HANGzhou, NANNING, WUHAN and XIAMEN)**

**Office**

Six projects were completed in these cities during H1 2016, with a total of 247,735 sq m of office GFA. All cities except Wuhan received at least one new project. In Xiamen, two new projects with a total of 658,212 sq m were launched, accounting for approximately half of the total new supply in all five cities in terms of office GFA. By the end of H1 2016, these cities had a total stock of nearly 10 million sq m of prime office real estate.

All cities were affected by stricter government supervision of the internet financial industry, and especially the peer-to-peer lending sector, though the degree varied from city to city. In all cities except Hangzhou, the average vacancy rate decreased. Xiamen was particularly active, with net absorption reaching its highest point since H2 2013 and the vacancy rate declining by three percentage points HOH to 21%, its lowest level since 2009. This mainly due to the tenants’ relocation from Xiamen Software Park I to Guanyin Mountain submarket for higher quality office space followed the expiration of their contracts. In Wuhan and Suzhou, sustained demand led the vacancy rate to decline to 19.0% and 17.0%, respectively. By contrast, the new supply in Hangzhou drove the vacancy rate to increase slightly from 20.2% to 20.8%.

Most cities recorded rental growth in H1 2016, mainly attributed to rental increases at individual buildings and/or high-quality new supply. In Xiamen, a new project located in an emerging area set its rent at a similar level to projects in prime locations, which led the city’s average rent to increase by 2.6% HOH. By contrast, landlords of certain projects
in Wuhan offered rental discounts to compete with the new projects or projects with higher specification and the rent declined by 0.4% HOH. Nanjing continued to have the highest rent of the five cities at approximately RMB4.4 psm per day, followed by Hangzhou (RMB4.1), Wuhan (RMB3.2), Suzhou (RMB2.7) and Xiamen (RMB2.3).

Three en bloc sales transactions were completed in H1 2016: one each in Hangzhou, Xiamen and Wuhan. All of the projects were under the construction. In Hangzhou, Vanke acquired a 51% stake in a complex named Huanglong International Center from Hangzhou Canhigh Center for RMB789 million. In Xiamen, a large-scale Chinese developer listed in Shenzhen reportedly acquired an office building in Cross-Strait Financial Centre of Xiamen for RMB990 million. In Wuhan, Citic China purchased two commercial properties at Wuhan Tiandi (A3 and A1) from Shui On Land for RMB1.13 billion and RMB3.36 billion respectively.

A total of 25 new projects are scheduled to enter these markets in H2 2016, with a combined office GFA of approximately 1.8 million sq m. This will lead total stock to increase by 18.6% HOH. Xiamen will see the highest level of new supply (658,212 sq m). Even in Nanjing, which has the lowest level of scheduled new supply (84,000 sq m), the volume will be three times the volume of new supply in H1 2016. The influx of the new supply will inevitably lead to a spike in the overall vacancy rate in all cities. In Xiamen, the average vacancy rate is expected to rise by more than 10 percentage points.

The majority of the new supply will be concentrated in emerging areas such as Hangzhou’s Qianjiang New City and Xiamen’s Wuyuan Bay. The below-average rents in these areas are expected to pull down average rents in many cities. In addition, the high level of new supply should put strong downward pressure on rental growth. However, a considerable proportion of new supply in Suzhou and Hangzhou will have high specifications and be completed in major office clusters, and moderate rental growth is expected to continue in these two cities.

**Retail**

Retail sales of consumer goods for the first quarter of 2016 grew by double digits and picked up from the previous year in most monitored second-tier cities. However, physical stores continued to face fierce competition from the growing online sales. In Hangzhou, for example, online sales grew at 44% YOY in Q1 2016, while the combined revenue of four of Hangzhou’s largest department stores dropped by 8.0% YOY in the same period, according to the Hangzhou Statistics Bureau. This shift in consumer spending was prevalent in all cities.

Only Suzhou received one new project during H1 2016. Wuhan continued to have the highest total stock at approximately 3.1 million sqm, followed by Suzhou (1.9 million sq m).

Limited new supply and stable demand led the vacancy rates to decline in all cities except Nanjing, where internal adjustments in several projects in the Jiangning catchment resulted in an increase in vacancy rate. Hangzhou saw the largest decrease at 3.1 percentage points HOH, mainly due to a number of new openings associated with the replacement of the Wanda Department Store. Children’s care retail brands accounted for a notable proportion among these new stores, including Redbaby (400 sq m), My Gym (300 sq m) and Kidswant (800 sq m). By city, Suzhou continued to record the highest vacancy rate at 8.1%, though this was a 2.2 percentage point decline, following absorption at projects completed in 2015.

The average rent increased moderately in most cities, given the rental adjustments including annual increases and increases following the completions of trade and brand mix adjustments. The largest increase was seen in Nanjing, up 3.3% HOH to RMB14.5 psm per day, followed by Hangzhou (1.2%). However, in Suzhou and Wuhan, the below-average rents at new projects in decentralised locations pulled down the average rent. In addition, the landlord of one project in Suzhou offered rental incentives to counter nearby infrastructure construction. As a result, Suzhou recorded the largest decrease at 3.5% HOH. Rents at most existing projects in all cities remained largely flat.

The investment sentiment for en bloc sales market in these second-tier cities remained sluggish. Most landlords of successful projects in all cities maintained a hold-and-lease strategy for further capital value growth. As a result,
investment opportunities remained limited. In addition, investors in Nanjing remained cautious given the large amount of new supply in the pipeline.

The mid- to high-end shopping centre market in all cities will expand quickly in H2 2016, with a total of approximately 2.7 million sq m to launch. Three cities will receive over 500,000 sq m of new supply. In Nanjing, 11 projects with approximately 960,000 sq m of retail GFA are expected to complete, and the city’s total stock will increase by over 50% HOH. More than half of these new projects will be located in non-prime locations such as Nanjing’s Hexi and Hangzhou’s Qianjiang New City, where the retail ambiance is not yet mature. The influx of new supply will increase the vacancy rate, despite high pre-commitment levels at certain projects.

In light of the below-average rents offered at new projects in non-prime areas, the average rents of certain cities are expected to decline, which will be seen in Xiamen and Nanjing. However, the projects developed by experienced or well-known landlords are expected to achieve relatively high rent, such as Hangzhou Raffles City and Kerry Central in Hangzhou and The Summit and Suzhou Center in Suzhou. Existing project with professional management and desirable locations will continue to see rental growth, though competition among landlords of new buildings will be intense.