Colliers Outlook

BEIJING | H1 2018 MARKET REVIEW & H2 OUTLOOK

24 July 2018

Accelerating success.

Diversified demand to support property market

North China Research

The office sector is the only sector to welcome a large quantity of future supply, which we expect to push up the overall vacancy rate and put modest pressure on rents. However, supported by solid demand from diversified industries, many office landlords are still very confident, especially those seeing good pre-leasing of new projects. The retail and industrial markets should enjoy the benefit of low vacancy rates with steadily increasing rents, especially the very active industrial sector. We advise investors to seize the good opportunities in 2018 to purchase property at reasonable prices given that more tradable properties have emerged in the market, notably in the decentralised office, business park, and underperforming retail sectors.

Summary of forecasts for Beijing property markets for H2 2018

Figure 1: Rent outlook*

Grade A Office	-0.9%
Retail	+0.3%
Industrial	+2.7%

Notes: *compared with Q2 2018

Source: Colliers International

Figure 2: Vacancy outlook

Grade A Office	+3.1 ppts to 11.2%
Retail	-0.2 ppt to 2.4%
Industrial	To stay at 0.0%

Notes: *compared with Q2 2018

Source: Colliers International

Firmer economic forecast to support future growth in the property market

Beijing's GDP growth rate was 6.8% YOY in Q2 2018, up 0.1 ppts compared with the growth rate for 2017 as a whole, indicating a stronger economy. The growth rate of the services sector continued to be much faster than the overall GDP growth rate, reaching 7.2% in Q2 2018, the same as the growth rate for the entire year 2017. Within the services sector, the growth rate of the information technology sector jumped to 18.3% YOY, up 5.7 ppts compared with the figure for the entire year 2017. Considering Beijing's municipal government is boosting the development of the high-tech industry in Beijing, we expect the rapid growth rate of the sector to strongly support the growth rate of the office market.

The growth rate of retail sales decelerated to 4.4% in H1 2018, down from the 5.2% for the entire year 2017. However, the consumer confidence index was 114.6 in 2Q 2018, the sixth consecutive quarter that the figure was higher than 110, showing the strong confidence of the consumers in the future. We expect this to support the future growth of the retail sector.

In its June 2018 report[1], Oxford Economics increased its GDP forecast for Beijing in 2019 and 2020 to an annual growth rate of 6.5%. This is an increase of 0.2 percentage points compared to the figure in December 2017. The research firm also maintained its estimate of the GDP growth rate for 2021 at 6.0%. In the latest figures released on 12 June 2018, based on Oxford Economics' belief that the momentum of the services sector should be much stronger than overall GDP growth, the research firm increased its estimated growth rate for the services sector by 0.2 to 0.3 ppts for 2019 to 2022. We expect this to strongly support the future growth rate of Beijing property market.

Diversified en-bloc targets in H1 2018

Eleven en-bloc transactions were disclosed in H1 2018 for total consideration of approximately RMB8.7 billion (USD1.3 billion). Although investors are still most interested in office properties, only one office transaction was disclosed. Hotels (including serviced apartments) and retail developments recorded the highest transaction value, accounting for 42% and 31% of the total respectively. More than 60% of transacted properties are inside the Fourth Ring Road and most of these projects are planned to be upgraded by the buyers.

Foreign investors are still eager to purchase properties in the Beijing market. However all the deals in H1 2018 were closed by domestic investors as domestic investors tend to make decisions more rapidly.

Noteworthy en-bloc transactions in H1 2018 included:

- China Lodging Group cooperating with TPG to purchase the Novotel and Ibis Sanyuanqiao Hotels in Chaoyang district with a total consideration of RMB1.2 billion (USD194 million). The project has a GFA of 32,900 sq m (354,132 sq ft). [2]
- Wumart purchased a supermarket portfolio from Lotte Group with a total consideration of RMB1.5 billion (USD243 million). With this deal, Wumart acquired 21 stores in Beijing.[3]

More investment deals are expected in H2 2018

As the liquidity and leverage ratios continued to decline, as evidenced by the figure of aggregate financing to the real economy for whole China (released by the People's Bank of China) [4]declining by 18% YOY in H1 2018, many landlords are considering selling their properties to finance their business. As a result, we expect more transactions in H2 2018. However, squeezed credit can also limit the capital source for some investors. Therefore, for well capitalised investors and those not subject to these controls, this is a good opportunity to purchase properties with reasonable pricing.

We recommend paying attention to the following sectors in H2 2018:

- Office properties in emerging areas, such as Tongzhou, Lize and Fengtai, considering Beijing aims to develop decentralised areas, relocating enterprises and people in the process.
- Business parks: yields range from 4.2% to 4.8%, and rents should rise further due to policy support and growth in the TMT sector.
- Logistics market are always the very attractive sector.
- Underperforming retail properties with the potential to be refurbished.

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[1] Source: "City Economic Forecast: Beijing, June 2018" by Oxford Economics, published on 16 July 2018

[2] Source: http://ir.huazhu.com/news-releases/news-release-details/china-lodging-group-limited-announces-acquisition-beijing

[3] Source: http://www.chinadaily.com.cn/a/201804/27/WS5ae25ae7a3105cdcf651ac4f.html

[4] Source: http://www.pbc.gov.cn/diaochatongjisi/resource/cms/2018/07/2018071911183728209.htm

Firm demand energised office leasing market

In H1 2018, three projects were completed and entered Beijing's Grade A office market. Their combined leasable GFA was around 250,000 sq metres (2.7 million sq ft) and thus expanded the city's total stock to 6.6 million sq metres (71.2 million sq ft), an increase of 4.0% HOH. Due to the healthy economic conditions, the IT, finance, professional services and real estate sectors performed actively and generated robust leasing demand for office space. Net absorption in H1 2018 reached about 244,000 sq metres (2.6 million sq ft), with the vacancy rate being dragged down 0.2 ppts HOH to 8.1%.

In H1 2018, the city's overall average rent remained flat at RMB331.7 (USD53.80) psm per month, compared to that at the end of 2017. Although landlords of older properties in certain submarkets have been under pressure and became more flexible in rental negotiations, the submarkets with tight supply continued to see rents increasing.

Supply peak to lead to challenges and opportunities

We expect 2018 to see the all-time supply peak for Beijing's Grade A office market. Approximately 660,000 sq metres (7.1 million sq ft) of new supply is scheduled to enter the market in the latter half of this year. By the end of 2018, Beijing's total stock should grow to around 7.3 million sq metres (78.3 million sq ft), an increase of 9.9% HOH. Several upcoming projects have already seen high pre-leasing due to their high quality, prime location, and early marketing. For example, in CP Centre, located in the CBD, Yinke Law Firm has preleased 17,000 sq metres (182,985 sq ft) and Zhonglun Law Firm has preleased 11,000 sq metres (118,405 sq ft). For landlords with tenants considering relocating, they are upgrading their properties and services, while also actively securing existing and new tenants. Thus, most landlords are still showing confidence in their properties.

Buildings that are older, located in emerging submarkets, or have not started pre-leasing, should see lower occupancy due to the supply peak. The city's vacancy rate should thus be pulled up from 8.1% at Q2 2018 to around 11.2% by the end of 2018. Despite this, we expect the city's average rent should only decrease by about 0.9% HOH to RMB328.7 (USD53.30) by the end of 2018. This is based on the firm demand for office space, the tight supply in certain submarkets, and the high achievable rents that we expect to be recorded in some upcoming superior projects.

Therefore, with respect to the supply peak, we believe that:

- Based on the tenants' industry and reputation, landlords should be flexible in offering customised leasing terms and rental packages to create a win-win situation. Landlords also have the opportunity to develop a healthier tenant mix.
- Tenants should establish strategic plans, taking advantage of this opportunity if they are price sensitive or plan to upgrade to better locations or higher quality buildings.

Limited supply with strong demand to drive down retail vacancy rate

In H1 2018, only one new shopping centre entered the Beijing market and total stock slightly increased to nearly 5.7 million sq metres (61.4 million sq ft).

Landlords of existing projects continue to attract popular brands and new brands continue to make their projects unique to attract customers. With vacant space of existing projects continuing to be absorbed, the overall vacancy rate decreased to 2.6% by end-Q2 2018, a decrease of 0.5 ppts HOH.

Demand from fashion brands has seemed to recover in the past several quarters after several years' weakness due to the impact from sales online and while travelling. According to the report by CITIC Securities, the fashion brands' sales of 100 department stores in China rebounded to 4.3% YOY in 2017 from a negative growth rate in 2016, with the same trend recorded in H1 2018. The improved business performance also reflected on the expansion of the stores. Sportswear, designer brands, and niche brands are the most active categories. International brands Dover Street Market and Laruta De Via and domestic sportswear Particle Fever opened their first stores in Beijing in H1 2018. F&B continue to be the one of the most active demand drivers. In addition, the lifestyle sector has been in active H1 2018.

Supported by solid demand, landlords of projects performing well have the capability to continually increase their rent. The average ground floor fixed rent in Beijing's mid to high-end shopping centres increased by 1.0% HOH to RMB824.0 (USD133.60) psm per month in H1 2018.

A more diversified retail market is expected

With more technology used in the operation of shopping malls and the site selection of brands, we expect landlords to be more acutely aware of customers' demands and more successful in introducing suitable brands into their projects.

On the other hand, with more brands taking advantage of new retail formats, such as Fresh Hema and Super Species, and rapidly expanding their physical stores, these new formats can support demand for shopping malls, especially new projects in emerging areas.

As a result, we expect occupancy rates and rents to increase by 0.2 ppts and 0.3% HOH in H2 2018 despite 325,000 sq metres (3.5 million sq ft) of new supply entering the market, 70% of which is in suburban areas.

Unprecedented high demand led to record high warehouse rents

In H1 2018, one prime logistics property was launched, the Zenith Beijing Logistics Park located in the Yongledian Town, Tongzhou District. This new project added around 56,000 square metres (603,000 square feet) of warehouse space to the Beijing prime logistics market.

The unprecedented high demand, which began in Q4 2017, continued in H1 2018. The overall vacancy rate remained at 0% in the first half of the year. Major demand still came from e-commerce retailers and third-party logistics (3PL) providers. Given the lack of leasable space in Beijing, demand for warehouse space spilt over to nearby cities, including Langfang and Tianjin, resulting in a sharp decline in the vacancy rate in local markets.

The average rent for Beijing's prime logistics market, given the booming demand since year-end 2017, surged by 11.7% HOH to a historical high of RMB48.0 (USD7.78) psm per month in H1 2018. By submarket, Beijing Airport Logistics Base (BALB) remained the most expensive submarket at RMB51.9 (USD8.41) psm per month. Beijing Jingnan Logistics Base (BJLB) achieved the highest rental growth rate, jumping by 13.9% HOH to RMB47.9 (USD7.76).

Buoyant demand for logistics properties to continue

In H2 2018, three projects, with a combined GFA of about 145,000 sq m (1.55 million sq ft) are scheduled to enter the market. These projects are located in the Tongzhou and Fangshan Districts. We believe that the buoyant demand for logistics properties in Beijing should continue in the coming few years, with any new supply being quickly absorbed. Colliers further believes that:

- Given the very restricted warehouse land supply as well as the improving requirements placed on logistics landlords by local district governments in Beijing, Colliers recommends that landlords strategically consider their tenant mix. Tenants should have a higher taxable capacity and also meet the requirements of the future development plans of local district governments.

- Logistics properties nationwide have become the most sought-after asset. With no new supply in H1 2018 and only two land plots in 2017, as well as very few tradable warehouse assets, we strongly recommend institutional investors expand the range of assets they invest in, keeping an eye on the Tianjin and Hebei areas. Currently, high standard warehouse properties in these cities are being chased and the price is increasing significantly given that most projects are fully occupied with long-term leasing contracts.

Moderate economic growth rate to support strong demand for the next four years

We expect currently strong demand to be consist in the next four years based on the stronger macro-economic growth rate forecast by Oxford Economics.

> In the office sector, under the background of abundant supply, strong demand from the finance and IT sectors should increase annual net absorption by 13-38% compared with the net absorption in 2017. However, as the total new supply in the next four years equals 34% of total stock compared to the end of Q2 2018, we forecast the vacancy rate to increase to 14.9% by the end of 2022. However, we expect average rents to start declining slightly from 2018, before rallying from 2021.

> In the retail sector, we expect the F&B, fashion, and lifestyle sectors to continue to be the key demand drivers for shopping malls. We expect the vacancy rate to maintain a low level of no more than 5% for the next four years. Large quantities of new supply in suburban areas should drive down average rents slightly in 2019, but rents are likely to rebound for the following three years supported by the declining vacancy rate.

> In the industrial sector, we expect undersupply to continue over the next four years, with almost no vacant space through 2021. Consequently, Colliers foresees an average annual rental increase of 4.6% YOY over the period 2019-2022.

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