COLLIERS OUTLOOK

SHENZHEN | 07 JANUARY 2019

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SHENZHEN MARKET OUTLOOK 2019

A YEAR OF CHALLENGES AND OPPORTUNTIES

Summary & Recommendations

We believe foreign investors should take advantage of the current softening market and look for good investment opportunities in Shenzhen.

We expect the office rent to decrease by 4% and the vacancy rate to increase to 30% in 2019 due to expected large supply.

Rents for logistics properties should continue to grow by 8% in 2019 given a very low vacancy rate and strong demand.

Emerging office districts will offer affordable space for occupiers and long-term investment opportunities for investors.

In addition, we expect the retail sector to attract more interest due to rising disposable household income while the long-term residential leasing market has emerged as a new investment category.

		Rental Market	Vacancy	Capital Value
Office	> The rental market should experience downward pressure due to temporary oversupply. We expect the large supply in 2019 to drive city average rent down by 4% and the vacancy rate up by about 14 percentage points to 30%.	-4%	+14.0pp	–
Industrial	> Strong demand and limited supply should drive up the rent of logistics properties by a further 8% in 2019.	8%	–	5%
Retail	> We expect that the heavy new supply due to enter the market in 2019, especially in emerging areas, will drive up the vacancy rate and drive down average rent.	-5%	+15.0pp	-5%
		Office Gross Yield	**Industrial Gross Yield**	**Retail Gross Yield**
Investment Sales	> We foresee that the market will provide more en-bloc office investment opportunities in both prime areas and decentralised business districts with restrictions on strata-title sales. There should also be more transactions in the retail sector in 2019.	0.1%	–	–

Source: Colliers International
Note: USD1 to RMB6.89 as of end-Q4. 1 sq m = 10.76 sq ft

SLOWER GROWTH IN 2019 WITH HIGHER GEOPOLITICAL UNCERTAINTY

The geo-political uncertainty derived from China-US trade tension has had a limited impact on Shenzhen's economic performance so far. In Q3 2018, Shenzhen recorded 8.1% YOY real GDP growth. The services sector also recorded strong real GDP growth of 7.8% YoY. Real estate investment showed 17.4% growth YoY, 7.0 percentage points less than in Q3 2017. The Total Domestic Consumption Index increased by 8.2%; however, the pace of growth slowed by 0.9 percentage points from Q3 2017.

Despite the strong economic performance in 2018, the possibility of a further 25% extra tariff on Chinese exports to the US and consequent reduction in import/export activity have cast a shadow over the business confidence in Shenzhen. The high technology, advanced manufacturing, and finance sectors have been the economic engines of Shenzhen's growth. However, enterprises from these sectors have become more cautious about further expansion. The professional services industry will also be adversely impacted by the slowdown in the manufacturing and high tech sectors.

Shenzhen's Grade A office market has been under pressure since Q3 2018 and we believe office rent will decline by 4% in 2019. On the other hand, the rent for logistic properties should continue to see stable growth due to a lack of new supply and very low vacancy. In the property investment market, we expect that the long term residential leasing market and the retail sector will attract more interest from overseas investors while new en-bloc office investment opportunities in both prime locations and emerging areas will start to emerge.

Population

3.9%

By end-2017, Shenzhen population increased by 3.9% or 550,800, with an estimation of a 750,000 increase per year over the next three years

GDP Growth

8.1%

In Q3 2018, real GDP growth reached 8.1% YOY, much higher than the national level of 6.7%

Tertiary Industry

59.7%

By Q3 2018, tertiary industry (i.e. services) accounted for 59.7% of total GDP with a 0.7% YOY increase

Tertiary Industry Investment

21.1%

The yearly growth of tertiary industry investment dropped from 27.2% in 2017 Q3 to 21.1% in Q3 2018.

Total Domestic Consumption

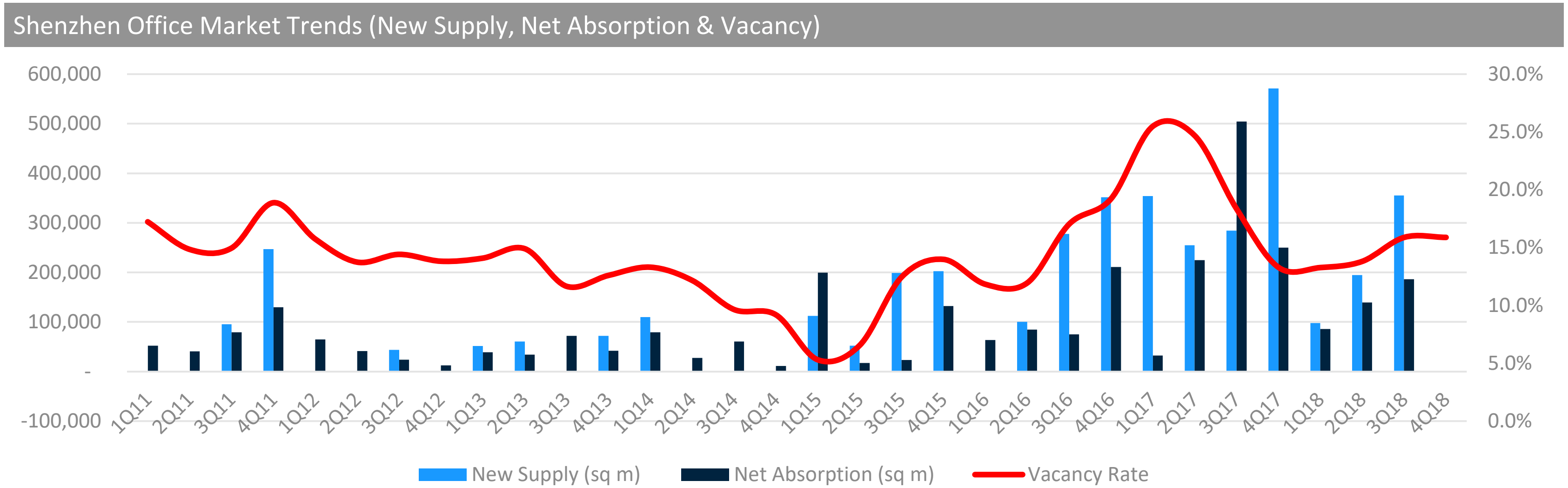
8.2%

The total domestic consumption growth has dropped from 9.1% in 2017 to 8.2% in the first nine months of 2018

Real Estate Investment

17.4%

The YOY growth of real estate investment has dropped from 24.4% in Q3 2017 to 17.4% in Q3 2018



Source: Colliers International

OFFICE LEASING

Vacancy rate stabilised while new supply slows

By end-2018, Shenzhen's Grade A Office stock had reached 5.8 million sq metres (62.4 million sq ft) with a YoY growth of 12.6%. It was the first time since 2016 that the supply growth rate was below 20% and there was no new supply during Q4 2018. The Q4 vacancy rate was the same as Q3 2018 at 15.9%. Among all districts, Qianhai had the highest vacancy rate of at 49.8% due to new supply between Q1 and Q3.

A more diversified tenant mix

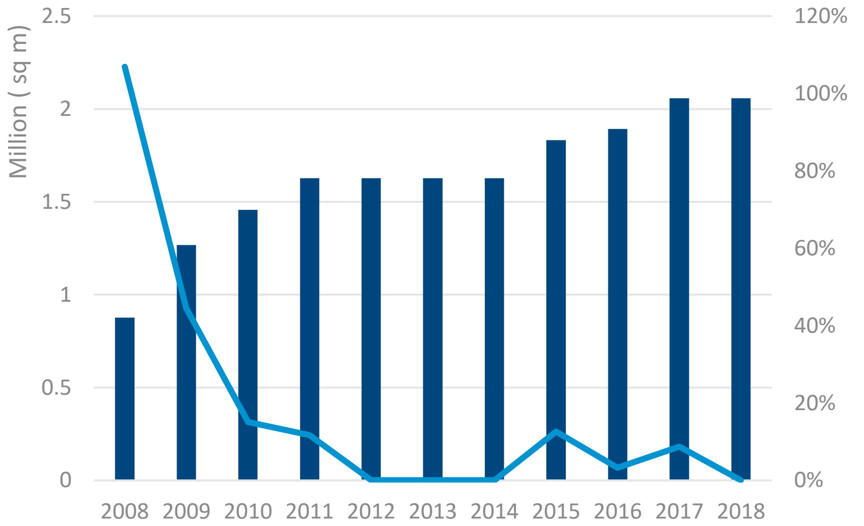
We have observed a more diverse Grade A office tenant mix in 2018. Other than the traditional pillar industries, such as the finance and tech sectors, the professional services and advanced manufacturing sectors have become the main drivers of office space expansion.

Outlook: 2019 and beyond

Due to a worsening economic outlook and new supply in Qianhai, Shenzhen's office rent showed a 1.9% QOQ and 0.6% YOY drop to RMB237 (USD34.5) per sq metre per month in Q4 2018. We expect office rent to fall by a further 4% in 2019 before recovering in 2020 when the economy stablises, and as the impact of new supply in Qianhai starts to ease. Total net take-up in 2019 should also be lower than 2018. For the period 2019-2023, we expect the average annual rent growth of 3.0% per annum.

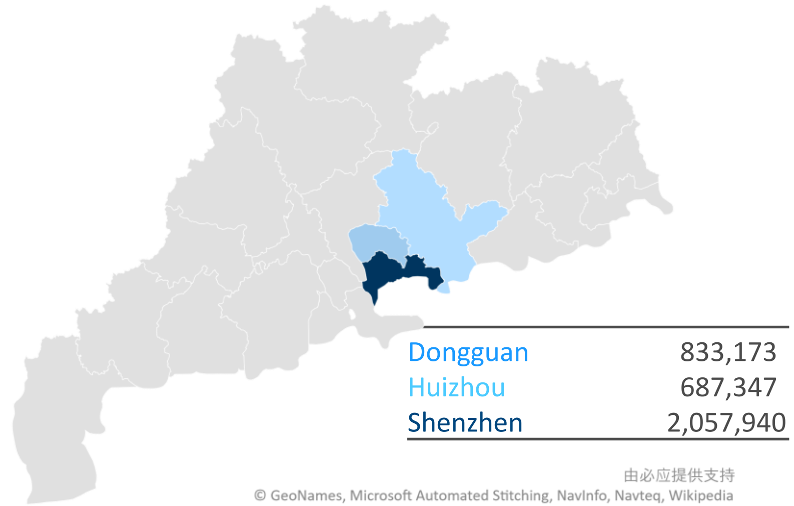
Up to now, we have predicted 5.4 million sq metres (58.1 million sq ft) of new supply in Shenzhen over the five years from 2018 to 2022. While we have not yet finalised our forecasts for 2019-2023, the latest market indications suggest that total new supply may be higher. The new supply should be heaviest in 2019, over which we expect the vacancy rate to rise from 16% to 30%. However, 80% of the new supply will be concentrated in Qianhai District and Nanshan district in the next five years. We expect Qianhai to have a limited pressure on the other established office markets, while Nanshan, with its strong economic growth momentum, has the potential to absorb the new supply gradually.

Shenzhen Logistic New Supply 2008-2018



Source: Colliers International

Logistic Supply (sq m) in Shenzhen, Dongguan, and Huizhou 2018



INDUSTRIAL

Logistics activities continue their outflow to Dongguan and Huizhou

Despite the robust market demand in logistics, Shenzhen has not recorded any new supply in 2018. A lack of new supply has driven the demand for new space to Dongguan and Huizhou. At present, the total logistics/ warehouse stock in Dongguan and Huizhou is 15.1 million sq metres, 75% of the existing supply in Shenzhen.

A lack of supply has continuously driven up logistics rent in Shenzhen. By Q4 2018, the average rent of the Shenzhen logistics market had increased by 10% to RMB49.6 (USD5.6) per sq metre per month with a very low vacancy rate at 3%.

In comparison, the monthly rental in Dongguan and Huizhou was only at RMB36.0 (USD 5.3) per sq metre and RMB33.4 (USD 4.9) per sq metre respectively. The vacancy rates in these two cities were below 5%.

Outlook: 2019 and beyond

Growing cross-border e-commerce and new government policies to stimulate domestic consumption will increase the demand for logistics in Shenzhen. We expect logistics rent to increase by a further 8% in 2019 due to very low vacancy. A lack of land supply for logistics in Shenzhen should be offset by new logistics facilities in Dongguan and Huizhou, and by operation optimisation within the Greater Bay Area.

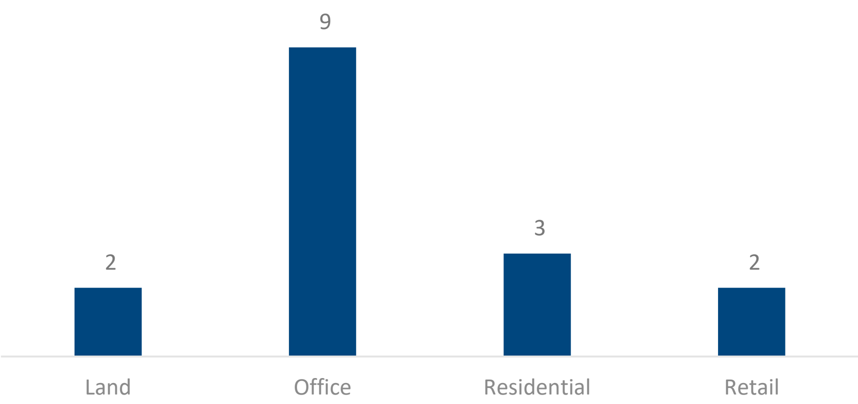
In the medium term, Shenzhen logistics industry should further integrate with other cities in the Greater Bay Area via new infrastructure. We expect new supply will be concentrated in the surrounding cities of Dongguan and Huizhou. Guangzhou and Foshan, on the other hand, should also see increased supply of 56 million sq metres and 63 million sq metres respectively over the next two to three years, representing a 40% and 39% increase for Guangzhou and Foshan respectively.

INVESTMENT

Shenzhen's property market has started to attract attention from both domestic and foreign investors since the beginning of 2018 when the city's GDP surpassed that of Hong Kong. However, the transaction volume has not picked up due partly to tightening national liquidity policy, the purpose of which was to cool down the overheating real estate capital market. In addition, the very narrow yield spread over bonds has made investors hesitate to enter Shenzhen at the moment.

Between January and November 2018, Shenzhen recorded a total of 16 large transactions, including the first en-bloc retail mall transaction in the past three years, with the transaction value of RMB211 million (USD29.0 million). We believe investors should take advantage of the current adjustment period for good long- term investment opportunities in Shenzhen.

Large Transaction Distribution by Property Type in Shenzhen 2018



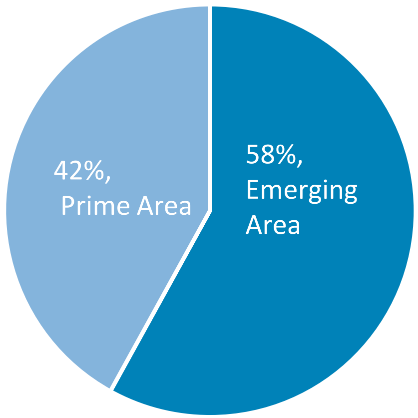
Source: Colliers International

Retail: more emerging opportunities

Historically, the retail sector in Shenzhen has been less active than in Guangzhou and Hong Kong. A limited supply of retail stock has made it difficult for investors to enter the Shenzhen market. However, competition from cross-border e-commerce activity has driven the retail sector to focus more on entertainment, lifestyle, and experiential shopping. According to the 2018 H1 Retail Report released by Izi Retail, a retail research consultancy, retailers have adopted an O2O (online-to-offline) strategy to integrate on-line and off-line shopping experience for customers.

The change in the retail sector has brought new investment opportunities to Shenzhen shopping centres. The retail sector has a gross yield of 5%, one of the highest among all property types in the city. We have observed new investment interest for shopping centres in both prime locations and emerging areas. In 2019, we expect to see more than 1.4 million sq metres (15.1 million sq ft) new supply of retail space in Shenzhen, and nearly 60% of the new space should be in emerging areas. With high new supply entering the market, investors should look for existing underperforming shopping centres in prime locations for value-add opportunities.

2019 Shenzhen New Retail Supply Distribution



Source: Colliers International

Office: mature CBD vs emerging DBDs

Across all property sectors, offices have remained the most active investment market in Shenzhen. By November 2018, Shenzhen had recorded nine large transactions in the office sector with transaction volume of approximately RMB.0 billion RMB (USD1.2 billion). Although the liquidity issues led to a market slow down in H2 2018, Futian CBD and Nanshan remained the top choices for the investors.

We expect the value of offices in the Futian CBD to benefit from the Express Rail service between Shenzhen and Hong Kong, which started service in September 2018.

Longhua District Government bought two en-bloc offices near Shenzhen North Railway Station, Huide Building and Red Mountain 6979, for RMB5.4 billion RMB (USD784 million) [(1)]. These puchases accounted for 68% of the total transaction volume in the office sector in 2018. These two buildings have been made available for local SMEs at a subsidized rental level.

Meanwhile, the lower rent offered at some of the well developed industrial parks and business parks has attracted more tech sector tenants. With the expansion of greater connectivity between core and emerging areas and increasing rental cost at the existing CBDs, we expect the following three decentralised business districts (DBDs) to rise in importance in Shenzhen:

- Bao'an Centre-Airport
- Shenzhen North Railway Station Business Centre
- Long Gang University Town

The capital value of offices in the above mentioned DBDs is on average 50% less than for office buildings in the core CBD. Investors who believe in Shenzhen's long term growth prospects should study closely the investment opportunities in these DBDs.

[1] https://m.focus.cn/sz/zixun/9164bfc12bc35440.html and http://m.sohu.com/a/235135403_100186381

Long-term residential leasing – a great potential with limited entry opportunities

On 31 July, 2018, the Shenzhen government announced the so-called "731 policy" which can be summarised as follows:

1. Prohibition of enterprises purchasing residential properties;
2. Any newly purchased condominium property (i.e. commercial property that is residential in nature) cannot be sold within five years of acquisition;
3. Any newly purchased residential properties, whether first-hand or second-hand, cannot be sold within three years of acquisition; and
4. No strata-title sales of newly developed condominium properties, which must be operated and held by the developers indefinitely.

The "731" policy has strong implications for the long-term residential leasing market in Shenzhen. By August, the residential leasing market had recorded 10-30% rental increases across different districts and the number of long-term leasing operators in the market had increased significantly. Currently, we estimate that there are more than 100 active long-term leasing operators.

Despite the rapid rental growth, the market supply still lags behind demand. Approximately 75% of the total population in Shenzhen are on rents property, and for the next three years, the population could grow by 750,000 per year. While we expect more mergers and acquisitions among long-term leasing operators, the long-term leasing market still has great growth potential.

The demand for residential leasing and the restrictions on strata-title sales of condominium properties offer new opportunities for institutional investors interested in the residential rental market in Shenzhen. We expect the city government to prepare favourable regulations to facilitate the growth of the long-term leasing market. For example, the development of residential REITs products would offer new exit strategies for developers and investors. However, a lack of new supply of commercial condominium projects will limit the opportunities for investors.

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