China Real Estate Market - 2020

Reimagining Real Estate 2020

This Publication

This document covers the real estate markets of 16 Chinese cities and was published in Jan 2020. All 2019 data is preliminary figures and may be subject to minor changes.

Foreword

China's conventional real estate wisdom has served the country well in the past, helping to propel China to global prominence, but it now seems to have run its course. As the domestic market matures, the global economy slows and demographic undercurrents weigh on the economy, a new approach to real estate and the built environment needs to be taken.

Traditional asset classes—office, retail, residential, hotel and industrial—have in many instances seen supply outstrip demand, pushing up vacancy rates, while values have exceeded rents, pushing down yields. Many projects were outdated and unfit for purpose by the time they were completed as developers and planners continued to adopt tried-and-tested approaches to new builds. These developers failed to grasp that society evolves and did not keep pace with regulatory and market changes.

Activity levels are picking up in niche asset classes such as logistics and data centres, as well as in healthcare, educational facilities, galleries, sports facilities and projects with specialised anchors such as training centres, helping to bolster demand and increase catchment areas.

Development of new projects needs to consider local differences, changing tastes, societal needs, state-of-the-art technologies and latest and best practices. At the same time, a better understanding of all project stakeholders is essential—government, developers, financiers, tenants, community—while also considering the triple bottom line or ESG (Environmental, Social and Governance).

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Growth slows as the market matures

Brought on by the financial de-risking campaign waged over the last two years and outside factors such as a slowing global economy and trade disputes, 2019 has been a challenging year for China, with economic growth rates falling to the lowest levels in 30 years. Nevertheless, a slowdown has always been on the cards as the economy matures, and China remains committed to structural reforms and staying the course on defusing potential risks to the nation's economic health and prosperity.

China has continued to invest heavily in key industry sectors such as AI, sustainable energy, advanced manufacturing, pharmaceuticals and others, while also opening its market to more foreign competition through the reduction of industries on the negative list, allowing majority ownership in the financial and automobile sectors. Chinese securities and bonds are now included in global benchmarks while the arrival of the STAR board opens new sources of financing for start-ups. The government judiciously decided to forgo a massive stimulus package in favour of adopting a business-friendly approach, streamlining procedures, reducing VAT and encouraging bank lending to the SME sector.

Reimagining future fundamentals

Office

Despite pro-growth policies, the immediate impact on the business community has been muted—stabilising growth versus stimulating it. Businesses, uncertain about the economic outlook and seeing their margins squeezed, have opted to scale back investment, avoid unnecessary expenditures and cut costs, directly impacting the office market with fewer companies expanding and more lease renewals or relocations to lower-cost space. This comes at a time when many cities are seeing significant amounts of new supply come to the market, resulting in vacancy rates reaching multi-year highs and rents coming under pressure. The outlook for next year remains in question, though it would seem unlikely that there will be a significant rebound in demand and, as such, the market will continue to struggle with oversupply.

Retail

The retail market has performed admirably in 2019. The Chinese market is incredibly important for international retailers, with retail sales forecast to eclipse that of the United States in the coming years. Success has proved elusive for some retailers and fickle for others, and could be even more uncertain in the coming years as domestic companies continue to eat away market share by competing on not just cost but also quality. These companies are showcasing an awareness of evolving tastes and speed to market while appealing to national pride and local cultural heritage. New product categories, distribution channels and engagement methods continue to complicate matters while enabling more nimble, savvy start-up brands to emerge. The divergence in mall performance continues to widen with the only commonality of success being well-proportioned malls with proactive, knowledgeable asset managers that are not afraid to try something new. Next year may prove more challenging with slower wage growth expected and higher household debt burdens.

Residential

In the past, when economic growth has slowed, restrictions on the property market have been relaxed to spur investment and support economic growth. The authorities have neglected to do so this time, conscious of deteriorating affordability in the residential market and the prospect of asset bubbles should they not change tack. Household debt has also increased steadily over the last three-to-four years with a significant portion going to home purchases. Banks have been given window guidance to control total exposure to this sector and ensure borrowers are not overextended. Some developers, who are cash-strapped or are looking to boost their sales before year-end, have started discounting prices to offload stock. Sustained pressure on developers has led to an acceleration in the consolidation of the industry.

Capital markets

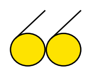
Despite a flurry of activity towards the end of 2018 and the start of 2019, the market has remained challenging. Buyers have turned cautious while others are waiting to see if cash-stressed sellers might discount stock. Many sellers, however, are not willing to make significant concessions, hoping that the government will eventually relax monetary policy to support the economy. Investors in traditional asset classes are pulling back to first-tier city markets, while others look for opportunities in the debt markets or growth in niche sectors that have government support. With underlying growth unlikely to rebound in the short term, a pickup in volumes is only likely to come from an adjustment in seller expectations, either as financing situations become more acute, or they come to the belief that the slowdown may be more protracted than they previously envisaged and, therefore, it is best to sell now than wait any longer. Activity levels should pick up next year as companies are forced to make decisions and as greater clarity on the economic and financial markets surfaces.

Other important markets

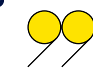
Often overlooked, the hotel market is undergoing a quiet revolution. Projects have been converted to office and rental apartments, operators/platforms are bringing together fragmented non-branded sectors, and investors are looking at how to extract greater value from hotel facilities by converting business centres to co-working spaces and kitchens to cloud kitchens. New brands are looking to slice and dice markets, localise content and provide tailored services and price points to the growing number of increasingly experienced domestic travellers. Tourism and entertainment facility investments, whether they be theme parks, sports stadiums or e-sports complexes, are being supported to encourage domestic tourism and consumption as well as promote the services sector.

The logistics market continues to see interest from many corners, with e-commerce reaching close to 25% of retail sales, though an overall slowdown in consumption growth could put a dampener on things. Specialised facilities in bonded zones for cross border e-commerce, cold chain storage for rising online grocery sales and highly-automated centres are particularly popular. Data centres continue to appeal to investors, especially those close to the key business and finance hubs of Shanghai, Beijing and Shenzhen, where there is a sizeable shortfall in capacity. The adoption of 5G devices, autonomous vehicles (AVs), cybersecurity laws, and online streaming will continue to drive demand for more servers.

Education and healthcare, two significantly underinvested sectors with strong drivers, have also seen a boom in development over the last year as private and international companies gain greater access to the market. The multi-family market has seen sentiment cool as operators overstretch themselves and depth of demand is left wanting. Small scale redevelopments are seeing steady continuation that looks to generate returns through added value. Senior housing continues to be a sector with interest as there have been several new projects announced, most notably Lendlease's project in Shanghai, though concerns about operational profitability, licencing and market acceptance continue to hinder the market.



The proportion of healthy service industry of total GDP will exceed 8% by 2020.



China is facing phenomenal demographic and environmental challenges. As a result of continued economic prosperity, food consumption has shifted to more calorific diets as well as more meat, fast food, and sugar-rich soft drinks. At the same time, a shift to professional and consumer services are resulting in less active, more sedentary lifestyles resulting in rising obesity levels. Economic growth and the manufacturing miracle has resulted in increased soil, water and air pollution, as well as strains on finite natural resources. The One Child Policy, while saving China from a demographic crisis in the 1980s, has resulted in a rapidly ageing society, exacerbated by the fact that people are living longer. This will be a massive strain on the state pension and healthcare systems as dependency ratios increase dramatically.

The government is actively taking steps to counteract some of these factors. The Healthy China 2030 features many initiatives, among them increasing health education in schools, promoting healthy lifestyles, encouraging exercise, enhancing universal healthcare access, improving the service quality of healthcare providers as well as reforming health insurance, pharmaceutical and medical instrument systems. There is particular attention focused on the elderly, women, children and the disabled.

There has been a noticeable shift in priorities over the last five years, but it is not all about a transition to services, or quality before quantity. Wellness is gaining momentum across the country. The real estate implications are wide-ranging as wellness can touch on every aspect of life and, consequently, the built environment.

HEALTHY CHINA

A change in priorities sees the market transition towards a more healthy and sustainable development path, impacting every aspect of work and life.

Technology

Technological advancements in the healthcare sector that can allow in situ care for elderly citizens, image recognition for scans, pharmaceutical and vaccine advances, WeDoctor, AI-powered medical clinic booths and fitness apps.

Sustainability & Air quality

Better air quality, emissions standards, renewable energies (now 20% of energy generation, and solar is now grid equivalent) and NEVs (~50% of global annual sales).

Overweight* population

China	32%
USA	68%

* BMI>25; WHO data for 2016

Healthcare

A pickup in investment of healthcare facilities, doctor training programs, insurance coverage, medical tourism and assisted living.

Master Planning

In city master planning schemes, Wellness means more public green areas, renovation of disused or underutilised locations, better access to public transportation, cycle lanes, schemes that encourage walkability, smart cities that promote better allocation of resources and more feedback loops, though much more needs to be done in developing projects at a human scale.

Consumer

Re-adoption of cycling thanks to shared bikes, public transportation usage, marathon running, gym membership, sports venues, healthy eateries, organic produce, vegetarian lifestyles, smoke-free indoor venues and wellness retreats.

Built Environment

Building standards, not just the LEED certifications and three stars, but also in terms of WELL certified buildings, indoor environment controls, interior design and ergonomic furniture.

Food

Food supply chains using blockchain to check providence and conveyance, drones to survey and manage, automation and upgraded logistics, vertical farms and many others.

Retail

Wellness in retail is the most noticeable. The success of athleisure brands like Lululemon, the growing preponderance of healthy eateries and the rapid expansion of gym chains are changing the face of retail. Qingcheng Tech Company, a Chinese gym operating system service provider, estimated the number of gyms increased 31% to 98,000 locations in 2018. There is also the specialisation and fragmentation of the sector with new activities emerging—from CrossFit, spinning classes, boxing and martial arts to pole dancing, archery and rock climbing.

WELL

Well certified, pre-certified and registered buildings

120
100
80
60
40
20

Shanghai
Guangdong
Beijing
Hong Kong
Jiangsu
Shanxi
Zhejiang
Tianjin
Hubei
Henan

Structural Changes Start

Demographic dividends have been the wind in China's sails for the past four decades, but the country's changing demographic structure is starting to impact society.

China is the most populous country in the world, and its population determines a lot of the broad direction of the country. As the percentage of the total working-age population grew from 44.6% in 1970 to 66.4% in 2015, there was a seemingly endless supply of relatively inexpensive labour which meant that China was the world's go-to manufacturing hub.

However, this trend is set to reverse as the country ages. In 2015, the elderly population accounted for just 9.3% of the population as opposed to 14.6% in the United States. This figure is expected to grow rapidly as people in China born in the 1960-70s start to retire, reaching 29% of the population by 2055, compared to 23.1% in the United States. This will place a significant burden on the state, while wage inflation could increase as demographics limit workforce capacity.

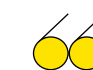
At the same time, we are seeing changing tides in the pace of urbanisation. According to the UNDP, peak levels of urbanisation occurred in the five years to 2010 when 107 million people moved to cities; ever since then, the pace of urbanisation has been declining. In the five years to 2020, it is expected that the inflow to cities will fall to 99.7 million, then 81.5 million for the next five-year period and so on. This has implications for the economy as urban dwellers tend to be more productive, but will also affect the demand for housing and other aspects of the built environment.

Within national-level data, there is scope for many regional variances that are hard to ascertain except with access to a more in-depth national census, which is carried out every decade and is next scheduled for 2020. There are many interesting conjectures about demographic changes that may be confirmed or disproved when the results come out.

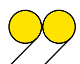
One of the key conjectures from demographic sampling is that there seems to be an increasing number of cities where populations are shrinking, as single-industry towns are exposed to shifting economic structures and, as a result, there is a lack of employment opportunities. What should local governments do to entice jobs back to these cities and what happens if they can't? What does this mean for urban planning, new property constructions and disused buildings? How can they be repurposed and find a new lease on life?

There is a widening demographic divide between the young and old, the city and countryside, the wealthy and poor. How will this all play out? The older generation is still largely about working hard, saving, investing in homes and taking care of the family. The younger generation is more independent, want to marry later in life, will postpone or forgo having a child to have a career and life experiences, or even feel that having a child is not affordable. The younger generation also tends to spend tomorrow's salary today by utilising new credit facilities; they will flit between jobs frequently, prioritise growth opportunities over stability and excitement over security. Many are also forging their own businesses, given the opportunities presented by online platforms, or turning to the gig economy for temporary work.

How will this new generation be able to get on the property ladder without savings or a steady, well-paying job? Do they want to work in a traditional office space? Do they still need a workstation now that so much work is done on the go? Do they need as many physical malls when they can buy on mobile phones via recommendations from friends online, in group purchases or flash sales?



The elderly population in China will account for 29% of the population by 2055, compared to 23.1% in the United States.



Registered population changes, 2015 vs 2017

-1,548,000 | 2,073,000

No data available

Source CEIC, Savills Research

The Next Chapter

As China's internal drivers and priorities evolve, so too will the real estate market, land planning and design.

As the last year of the 13th Five Year Plan arrives, China in 2020 is expected to see a GDP of over one trillion RMB. The year will also see the establishment of a national housing registration system and national land planning, marking a new era for planning and the real estate industry for sustainable and systematic development.

The last three decades have been a mad rush to build enough real estate to accommodate the growing urban population and fuel the country's phenomenal economic expansion. Consequently, this largely unfettered growth imposed significant change upon cities, and urban planners are rethinking their efforts to build more sustainable, resilient and adaptable cities.

Some cities continue to see record levels of migration. Over 1.0 million people moved to Shenzhen and Xi'an during 2017-2018. Other cities have stricter population caps (Shanghai – 25 million people and Beijing – 23 million in 2035), while yet other cities are seeing populations shrink. How should planners deal with the dynamic and nuanced issues facing different cities? Planners must be more creative in their approaches and responsive to the changing needs of the city.

Planning

Mature cities

For bigger cities, the priority must be restricting continued urban sprawl and limiting growth in total construction land while also reclaiming city-centre locations for public space and re-greening. In Shanghai, construction land should be kept within 3,200 square kilometres by 2035 while the city has made plans to build a city park network with some 400 parks by 2020, from just 157 in 2012. We have also seen the greening of the riverfront with prominent locations being Houtan, Qiantan and North Bund.

To achieve these goals, larger cities will have to more efficiently utilise the existing built space to ensure that residential units and buildings are not left vacant or under-utilised. In 2017, Shanghai had 1.32 billion sq m of built space, of which 673 million sq m was residential space; with a population of 24.2 million people this equates to 27.8 sq m per capita. While this may be adequate, there is certainly room for improvement.

City planners could do this by encouraging the growth of the leasing market, through the continued development of intermediary asset managers, launch of lease-only residential land and assigning a cost to the ownership of properties.

Authorities could also promote the continued development and adoption of shared spaces such as co-working or co-living concepts. These often have the added benefit that they feature adaptive reuse of existing structures, something else that authorities will have to embrace. Authorities are starting to push this now, primarily through applying pressure to state-owned enterprises with large swathes of land to regenerate or risk losing these sites.

Growth cities

China is no stranger to growing cities, and the country has learned lessons from previous experiences—standards, technologies and practices have moved on, and new challenges have emerged.

Cities will likely still look to developing new business districts outside the city core or satellite business hubs to reduce the strain on public transportation networks. However, most emerging business districts are struggling with high vacancy rates. Qianjiang New City in Hangzhou managed to record the lowest vacancy, around 14%, but it has already experienced over ten years of development. Instead of traditional planning with large plots and wide roads, new designs should emphasise public transportation, cycle lanes and walkability, something that has been actively promoted by planners world-wide for health and economic benefits. More variance in use is also needed to make schools, libraries, hospitals/clinics, galleries/museums and others more closely intertwined with offices, retail centres, and homes. Transit orientated developments are also important to deliver utilities and services efficiently by targeting high footfall locations at key infrastructure nodes.

Urban planning and the built environment need to make the best use of the latest design principles, materials and management to build more sustainable, resilient and adaptable cities. Low-power wide-area (LPWA) sensor networks can generate data that allocates resources in real time while inputting that data into better AI-powered simulations to improve city planning. New materials and construction processes, such as prefab or modular housing, can increase the speed, quality, standardisation and sustainability of new developments. Sustainable cities can look to incorporate natural features into cities as opposed to overpowering and suppressing nature. One good example is China's 2015 launch of the sponge cities programme, where cities develop wetlands and green spaces to absorb rainwater and help citywide drainage. The target is to have 30 model cities where 20% of the built area captures, reuses or absorbs 70% of stormwater runoff, with this increasing to 80% of built area by 2030.

Shrinking cities

Shrinking cities pose one of the biggest problems to urban planners, as it is an issue many have never faced before in China. Two approaches could be taken, the first being to refuse to believe that the decline is inevitable and look to increase investment in new growth sectors. The second is through incubators which leads to the creation of start-ups actively promoted by the government.

Planners should also focus on bringing people from the outskirts to the urban core to prevent the city from hollowing out. The re-urbanisation of the city could lead to an improved sense of community and vibrancy, and the more effective utilisation of limited municipal resources. Smaller cities may survive on the support of cottage industries, the promotion of internet-supported workshops or the development of the cultural and tourism sectors—things that are very popular at the moment, actively supported by the government and potentially a significant creator of jobs.

In the United States, some smaller cities are seeing a recovery as urbanites flee bigger metropolises in search of more affordable cities, shorter commutes, better work-life balance and stronger liveability. This could potentially happen in China, though many smaller cities might not have the same modern conveniences that the bigger cities have. In China, some young professionals, after honing their skills in larger cities after graduating university, are considering returning to their hometowns to marry, buy a house, settle down, start a family or look after ailing parents.

Office

Overview

China's office market has experienced steady growth over the past decade, with strong fundamentals driving absorption and, in cases where there have not been excessive amounts of supply, there has been stable rental growth. This all started to change towards the end of 2018 and the start of 2019 as the ongoing financial de-risking started to bite and as trade disputes caused an additional drag on the economy, which had a knock-on effect on demand for office space.

Sixteen key Chinese cities saw 6.7 million sq m of new Grade A office supply added to their markets in 2019, an increase of 41% from 2018. New projects are faced with lower pre-commitment rates than earlier projects given weaker fundamentals and increased competition, which has meant more bargaining power and flexibility on lease terms. Renewals also accounted for a higher percentage of leasing transactions than in the past, while companies took longer to make decisions, with some postponing or even abandoning relocation plans. Most cities saw rising vacancy rates in 2019 with average vacancy rates of 16 cities increasing 1.6 percentage points (ppts) to 24.5%.

Beijing and Shanghai saw Grade A office vacancy rates reach 12.7% and 17.5%, respectively, by Q4/2019, while Shenzhen's vacancy rate exceeded 20%. Guangzhou was the only first-tier city to record a vacancy rate below 5%. Of the key second-tier cities, only Chongqing, Hangzhou, Fuzhou and Tianjin recorded a decrease in vacancy rates, mainly as a result of limited supply, but still not enough to support rental growth.

The shift in market sentiment was also reflected in rents. Nearly all Grade A office markets saw rents fall in 2019 (down an average of 2.6%), with landlords either offering longer rent-free/fit-out periods or directly reducing face rents. Several projects may also delay handover dates given current market conditions.

Opening up

Key sectors of China's financial market, including banking, insurance and brokerage, are dominated by local companies who have a market share of more than 90%. The government has promised to address this by opening its financial markets—such as bonds, insurance, asset management and pension funds—as well as lifting restrictions on foreign ownership of securities, futures and life insurance companies by 2020. Additional measures include removing entry barriers for insurance companies, such as a requirement of 30 years of business operations, and cancelling a 25% equity cap on foreign ownership of insurance asset management firms.

China's US$44 trillion financial sector is incredibly appealing to international firms. Bloomberg Intelligence estimates that—barring a major economic slowdown—foreign banks and securities companies could be raking in profits of more than $10 billion a year in China by 2030. International firms' entry into the market will not only have a direct impact on the office market with the expansion of these firms but will also create new avenues of financing that could provide support to the overall growth of the economy.

The opening-up of markets would attract not only financial firms but also a wide range of industries. According to the American Chamber of Commerce's 2019 China Business Climate Survey, nearly half of respondents (48%) would consider increasing investment in China if its markets were as open as those in the US. However, companies not only require easier market access but also increased market transparency, intellectual property protections and fair treatment, something that the Foreign Investment Law (FIL) to be implemented in 2020, is expected to address.

Tenant risks

WeWork's failed IPO and possible pull back in certain markets is a reminder to landlords of the vigilance when signing up new tenants. Landlords should be aware of the health of the tenant industry and individual tenant covenants and ensure that they have adequate protection against early termination while also making sure that they are not overly exposed to one industry or tenant.

Risks are not purely limited to flexible office space providers, though the mismatch between their long-term liabilities and short-term income streams and the lack of profitability should give many landlords pause. One of the other areas landlords have found themselves exposed to has been the P2P sector. The market grew unfettered from 2011 to 2015, with the number of lenders growing from 50 to 3,500 in the space of a few years. Many of these firms leased space in Grade A offices until greater regulatory oversight cooled the market and many firms, fuelled by VC money and running questionable operations, went into liquidation and broke leasing contracts. By October 2019, the number of P2P firms operating had fallen to 427, with that number expected to fall further in the coming years.

These may be extreme cases, but they are symptomatic of a new trend in the economy. Fuelled by a combination of VC/PE money, tech innovations, an entrepreneurial/cowboy spirit and the slow response from the regulatory environment, companies in new sectors of the economy are growing and shrinking at ever faster rates—whether it is shared bikes (or shared umbrellas, etc.), multifamily operators, NEVs, e-commerce platforms, app designers or others.

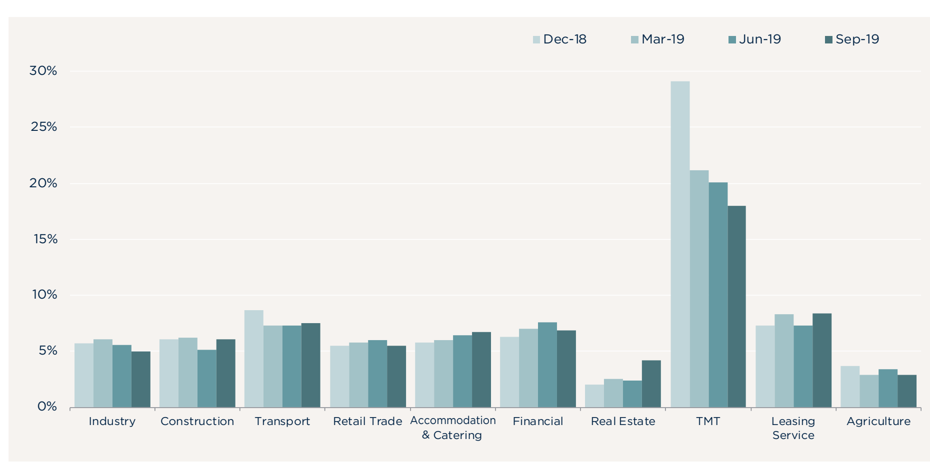
The boom-bust nature of some of these industries can make it difficult for landlords to know how to handle these types of tenants. However, as vacancy rates rise, landlords are desperate to fill vacant space with any tenant that they can, and many don't want to miss out on the possibility that these new companies might be the next Alibaba or Bytedance. Nevertheless, landlords should go into any agreement with a tenant with their eyes wide open, understanding the risks they are taking on and taking measures to mitigate these risks as best as they can.

Grade A Office Rental Growth And Vacancy Rates

CITY	RENTAL GRWOTH		VACANCY	
	2019	2020F	2019	2020F
Shanghai	-0.9%	↓	17.5%	↑
Beijing	-1.6%	↓	12.7%	↑
Guangzhou	-2.4%	↓	4.8%	↑
Shenzhen	-10.0%	↓	24.6%	↑
Chengdu	-0.3%	↓	21.9%	↑
Chongqing	-4.7%	↓	31.1%	↑
Tianjin	-2.1%	↓	37.0%	↑
Hangzhou	-0.8%	↓	19.1%	↑
Nanjing	-1.7%	↓	16.6%	↑
Wuhan	-2.7%	↓	33.7%	↑
Xi'an	-1.0%	↓	33.5%	↑
Suzhou	-2.1%	↓	29.0%	↑
Ningbo	-1.3%	↓	15.0%	↑
Kunming	-4.3%	↓	42.5%	↑
Xiamen	-3.7%	↓	27.1%	↑
Fuzhou	-2.6%	↓	25.1%	↑

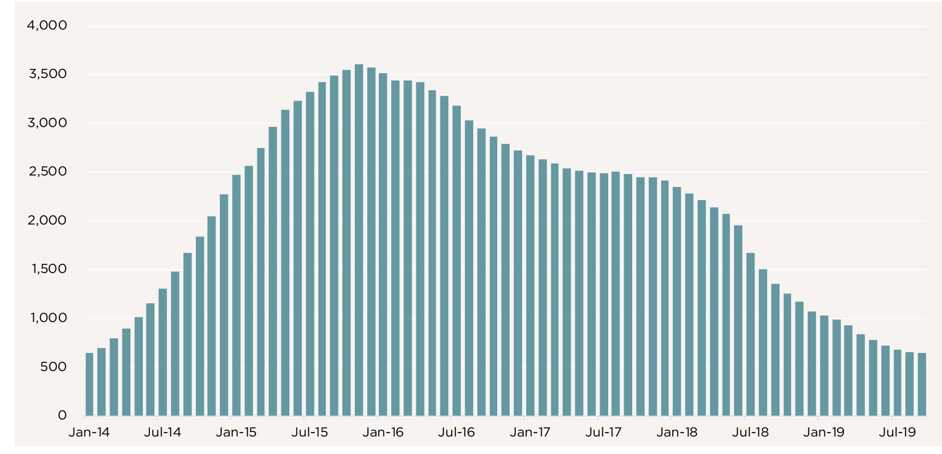
Source Savills Research

GDP Growth By Industry



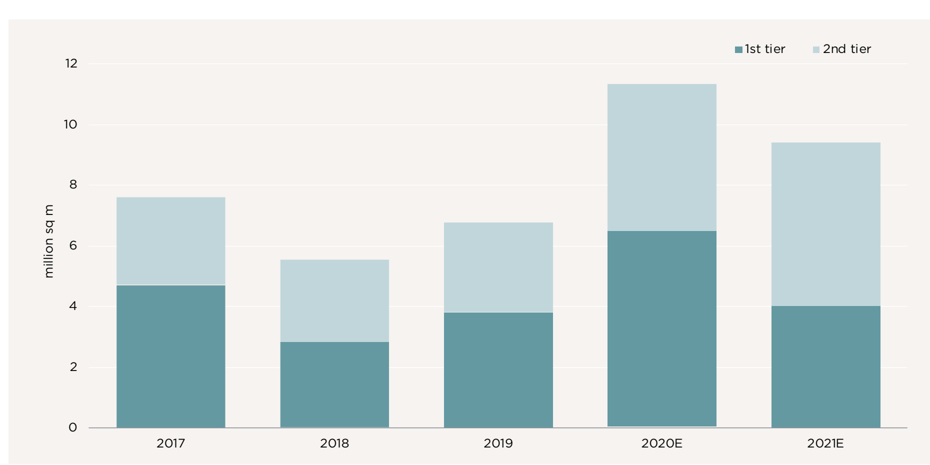
Source Savills Research

Number Of P2P Platforms In China



Source Savills Research

Grade A Office Supply In 16 Key Cities



Source Savills Research

Drivers of office demand

While demand for office space has weakened from many sectors of the economy, two industries are still charging ahead, namely the retail sector and IT industries such as AI and 5G. Rising prosperity, a growing middle class, a flourishing e-commerce market and increasing access to consumer credit have contributed to the sustained growth of the retail market in China. While household consumption only contributed 39.4% of GDP in 2018, it combined with government expenditure to contribute 76.2% to the growth of GDP. China has been historically reliant upon manufacturing, exports and fixed asset investments, but is looking to increase domestic consumption to serve as an economic driver in the future.

While international brands entered the market or aggressively expanded their China business in 2019, domestic competitors climbed up the rankings. Adidas leased a 30,000 sq m office building in downtown Shanghai for its new Asia-Pacific and Greater China headquarters. McDonald's leased 2,400 sq m of office space in Beijing as well as 15,000 sq m in Shanghai for relocation. Nestlé took up 2,000 sq m of new lease space in Guangzhou and L'Oréal expanded its premises in Shanghai and Guangzhou. As for domestic firms, Anta Sports and HLA are believed to be two of the top twenty global retail brands by economic profit, ahead of H&M, Burberry and Lululemon.

China's importance has not gone unnoticed as the 2019 China Business Climate Survey indicated that nearly 80% of consumer sector respondents ranked China as a top-three investment destination.

Emerging areas: Haste doesn't bring success

While some cities have seen improved demand for emerging business areas, others are struggling with unoccupied space, and first-tier cities are no exception. Some delays are inevitable when creating new business districts as tenants have concerns over staff retention and are unwilling to be the first one to relocate to a new area that lacks amenities. Additionally, the slowing economy and ample competition from new city centre stock are also having an impact.

In addition to weakening demand, close to 11.3 million sq m of Grade A office space is expected to launch in the 16 leading cities in 2020, pushing vacancy rates even higher. Landlords can adjust leasing and operating strategies to attract tenants to specific projects, while upgrading services and retail amenities could also prove beneficial. For emerging areas, high-spec office space alone will not be enough to attract business to set up shop, judicious master planning and local government support is also critical.

Retail

Overview

The retail market saw a resilient performance in 2019. Despite slower retail sales growth, consumer confidence remained relatively high. Several cities, including Beijing and Chengdu, released policies to boost sales during night hours and convinced retailers to open their first China stores in their cities while landlords created more innovative spaces to attract consumers.

The positive performance of the retail market comes after many years of fierce competition, the development of more seasoned teams, and more realistic senior management in terms of project launch schedules and rental targets. The pace of project completions has slowed over the last three years, while those that have eventually opened have done so with better pre-commitment levels.

Total retail supply in key 16 cities decreased 11% in 2019. Shanghai saw the largest supply of 900,780 sq m while Xi'an, Ningbo and Kunming also exceeded 600,000 sq m. However, the number of landmark projects fell compared to 2018. Notable completions were limited to the likes of Chongqing Raffles City and Kunming Plaza 66. Shanghai garnered more attention, not from new projects, but relaunches of older developments, such as Grand Gateway 66 and Times Square, with significantly improved internal flows and reinvigorated tenant profiles.

Driven by leading projects, the 16 cities saw average rental growth of 1.3% for first floors in shopping malls, while the vacancy rate increased 0.2 of a ppt to 7.3%. Shenzhen recorded the lowest at 4.3%, while Kunming saw the biggest increase of 3.4 ppts due to a historically high level of supply.

As the residential market passes its peak activity and as price growth moderates after more than a decade of spectacular increases, the government is striving to find a new driver of sustainable economic growth. Final consumption expenditure has been steadily increasing since 2010 as the economy becomes increasingly consumption-led and has accounted for more than half of economic production since 2012. The retail market still has huge growth potential with an increasingly diverse consumer market, growing demand for services and entertainment, a proliferation of payment channels, the professionalisation of marketing and the rise of more domestic brands.

Daily necessities and luxury consumption

F&B and FMCG retailers (e.g. supermarkets) tend to weather difficult times better than other segments of the retail market. Indeed, leading cities saw fast-food chains move up the value chain as higher-priced burger and pizza restaurants such as Shake Shack, Beef & Liberty and Chili's entered Shanghai and Beijing, while more mass-market chains expanded in second- and third-tier cities.

The bricks-and-mortar FMCG segment seems to have also passed the worst time. The segment was disrupted in early 2019 with the rapid expansion of several new O2O stores. Traditional operators responded with mergers between Suning and Carrefour as well as Wumart and Metro and, at the same time, new international players entered the fray with Costco and Aldi opening new stores in Shanghai.

Speciality store performances varied significantly across different sectors but generally underperformed. Automobile sales fell, but NEV firms remained upbeat and actively opened stores in key locations and prime shopping malls. Cosmetics brands remained a sector with one of the highest affordability for store locations while also recording noticeable sales growth.

The luxury sector recorded another strong performance in 2019, with some luxury projects seeing annual sales increases of 10-20%. Nonetheless, store counts remained relatively unchanged with brands closing older stores at the same time as opening new ones in the top projects; this will likely lead to a further concentration of luxury in the leading malls of each city.

Asset management and branded malls

Retail supply is expected to increase by around 45% in 2020. Shanghai and Guangzhou will see more than 1.0 million sq m completed, while Xiamen welcomes the highest growth of stock—750,000 sq m of new supply will push the city's stock up by 36%.

With rising competition and the market shifting in favour of tenants, asset management capabilities are expected to play an increasingly important role in the success of a mall, with a project's superior location no longer enough to secure the right tenants. Additionally, while first-floor rental growth might have plateaued in many malls, landlords could still gain decent overall rental growth through optimisation of blind spots, corner locations, upper floors and a forward-looking, dynamic and eye-catching tenant mix.

Luxury malls are also expected to continue to outperform the market average as Chinese consumers spend more at home in response to lower import tariffs, narrower price gaps with overseas markets, and the depreciation of the renminbi. The number of projects that will benefit from this trend, however, is very limited as luxury brands are likely to remain highly concentrated in a few key locations.

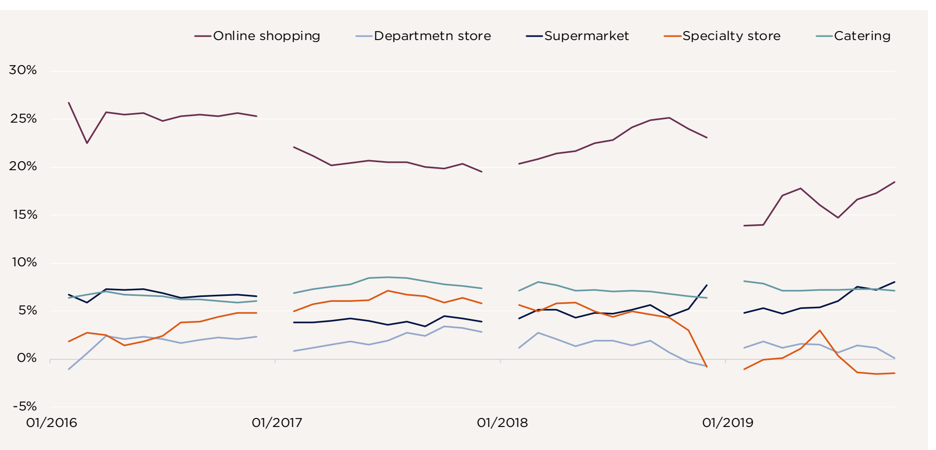
While the commercial markets remain very competitive, with some old projects closing or retail centres being converted to other uses, developers frustrated by restrictions in the residential markets and the unpredictability of sales revenues have focused on nourishing recurrent income streams from the commercial market. Developers such as China Resources and COFCO are broadening their range of retail formats to include community amenities while small- and medium-sized developers are opening flagship projects to establish their brands. Red Sun opened the 550,000 sq m RSun Mall in Nanjing while Bailian will open its first flagship mixed-use project, Bipark, in Changsha in 2020.

Retail Rental Growth And Vacancy Rates

CITY	RENTAL GRWOTH		VACANCY	
	2019	2020F	2019	2020F
Shanghai	1.3%	→	8.6%	↑
Beijing	1.5%	↑	6.5%	→
Guangzhou	4.3%	↑	8.4%	↑
Shenzhen	1.5%	↑	4.3%	→
Chengdu	0.8%	↑	4.5%	↑
Chongqing	0.1%	↓	12.0%	↑
Tianjin	1.6%	↑	11.0%	↓
Hangzhou	1.6%	↑	8.1%	↑
Nanjing	0.6%	→	5.1%	↑
Wuhan	0.6%	→	6.5%	→
Xi'an	0.4%	↑	4.5%	↑
Suzhou	-0.3%	→	9.7%	↑
Ningbo	0.6%	→	7.0%	↑
Kunming	1.3%	↑	10.5%	↑
Xiamen	0.8%	→	5.1%	↑
Fuzhou	4.3%	↑	4.9%	→

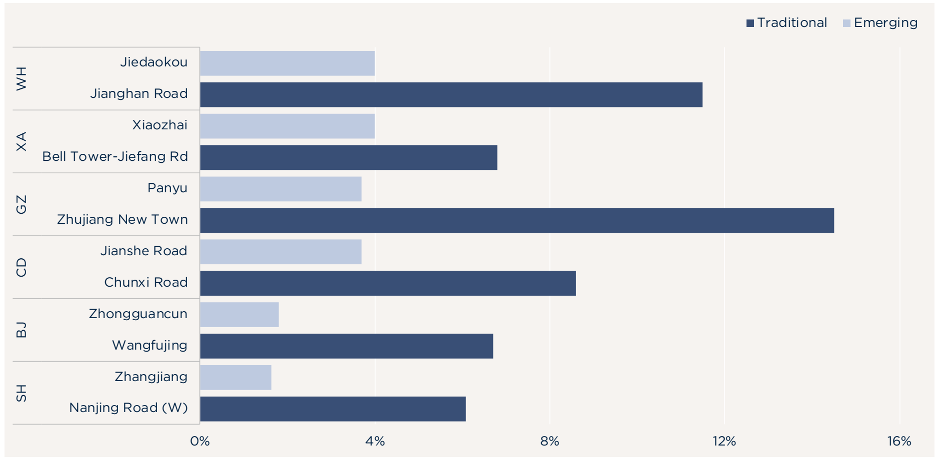
Source Savills Research

Key Retail Categories YoY Sales Growth



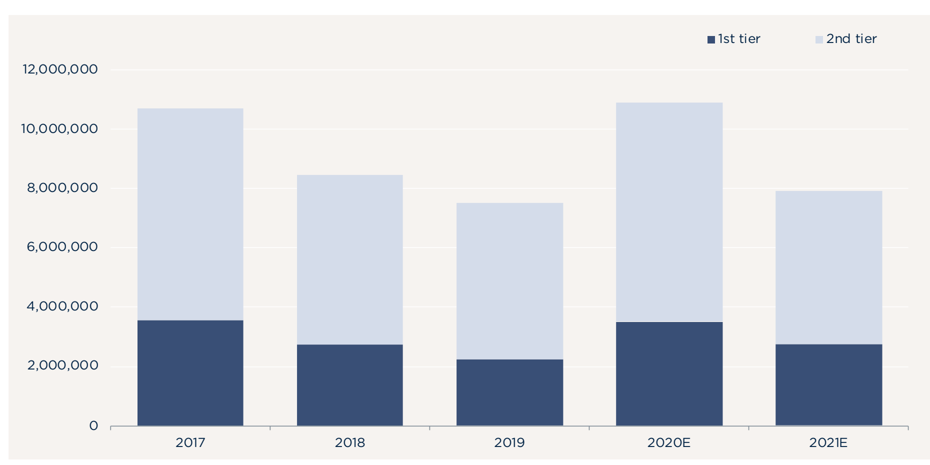
Source Savills Research

Vacancy Rates Of Selected Retail Areas, Q3/2019



Source Savills Research

Retail Supply In 16 Key Cities



Source Savills Research

Developers are beginning to learn that brand reputation in the shopping mall industry is just as important as in the retail industry. A good brand reputation is hard to maintain and easy to lose and must be defended by consistency and maintaining standards. Brands should be synonymous with high design standards, build quality, responsive maintenance and appealing tenant mixes. Once established, reputations can help developers when moving into new markets and opening new centres to attract retailers and consumers alike. It may also allow developers to achieve better terms when securitising their retail centres.

Traditional areas revitalised

Faced with a market downturn and growing competition, more and more landlords are likely to refurbish projects to breathe new life into languishing malls. A limited number of greenfield development sites also means that developers and investors are also looking to acquire assets with value-added potential such as old retail centres or podiums as well as industrial properties typically built before the 2000s.

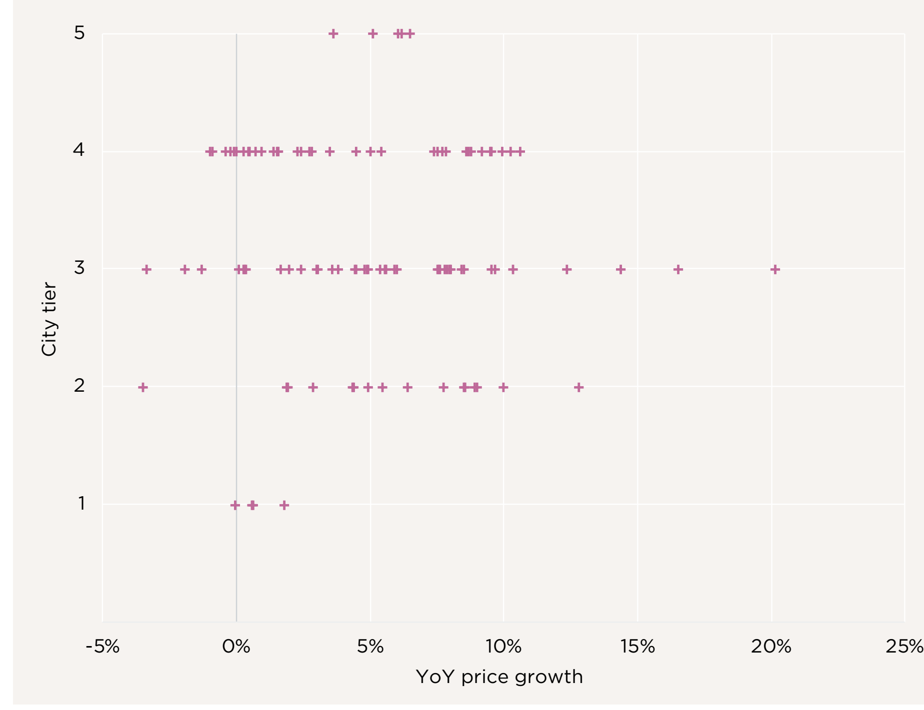
As cities continue to grow and municipal governments create new business districts far removed from original city centres, urban agglomerations are becoming more multi-nodal, creating distinct regions and making it harder to know where to open up new stores to capture the largest or most affluent populations. Traditional retail areas still record some of the highest rents in a city, but rental growth is sluggish and occupancy rates are under pressure, held back by outmoded and underperforming retail centres. Prime area vacancy rates in key cities were 2.0 ppts lower than in non-prime areas at the end of 2017, but this gap had all but evaporated by the end of 2019.

Traditional retail areas still enjoy good reputation and high footfalls, but as consumers become more sophisticated, knowledgeable and demanding, this will not always be enough. The new generation of consumers have access to information and products via a range of marketing and sales channels and are becoming experts at unearthing the best prices. Traditional retail areas can still prove to be the best places to shop, thanks to the critical mass of retail locations, range of products and services, and the variety of different price points—from a bowl of RMB20 noodles to a three-course Michelin star meal. These areas are often in the heart of the city with transportation links that stretch out in all directions, allowing people to meet up in an equally convenient location.

For renovated retail projects, it is essential to ensure that the design and tenant mix offers something different from other locations while still in keeping with the surroundings. This usually entails a distinctive architectural style, relaxed retail environment and innovative brand mix. While some of the design features may result in a reduced lettable area or an overreliance on a single retail category such as F&B or leisure, these concessions may be needed to ensure the project is distinct enough to stand out from the crowd and succeed.

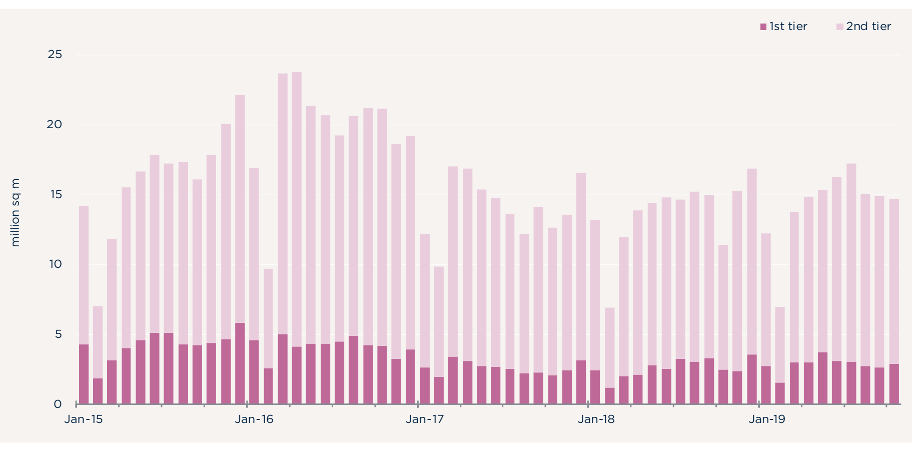
Residential

100 Cities YoY Price Growth, Sep/2019



Source CREIS, Savills Research

Transaction Area In First And Second Tier Cities



Source CREIS, Savills Research

Overview

China's overall housing market remained comparatively stable in 2019, despite the occasional news story about dramatic reductions in prices in some cities. The two sessions working report at the beginning of the year emphasised the importance of reforming and improving the housing market mechanisms and affordability while promoting housing stability. Local governments were given more freedom to tailor their policy approaches in response to local market conditions.

The overall residential market is undergoing a period of adjustment with commodity residential completion falling from its 2016 peak to 453 million sq m in the first eleven months of 2019. Despite slowing completions, sales volumes have continued to grow, reaching 1.3 billion sq m in the same period. The total sales consideration meanwhile rose by 10.7% YoY to RMB12.2 trillion, and average values reached RMB9,300 per sq m.

City residential markets have recorded strikingly different performances depending on their location, maturity, supply situation, regulations, demographics and economic/employment outlook. Overall, first-tier cities have seen steady housing prices after a long period of growth. Second-tier cities are competing in talent-attracting policies and gaining in population and purchasing power. Third- and fourth-tier city markets are considerably weakened as the economic slowdown disproportionately affects them. As third- and fourth-tier cities face lengthening digestion periods, developers have turned their attention back to first- and second-tier cities.

Cities, however, are hard to generalise merely in terms of their economic tiering. Suppressed by strict housing purchase policies, first-tier cities' average prices saw only a slight increase while second-hand prices climbed higher than that of the first-hand. For second-tier cities, Xi'an recorded a phenomenal year on the back of a strong economy, low house pricing and an influx of skilled workers. While Tianjin has been struggling with excess supply and a moribund economy in the past few years, the GDP improvement seen in 2019 should give some support to its residential market in 2020. The divergence in performance was also seen in the smaller cities—Shaoxing and Yangzhou, both in the YRD cluster. They have seen record high growth rates over the last year, possibly in anticipation that economic benefits will flow from key cities to these more affordable regions, combined with more relaxed house purchase restrictions for most third- and fourth-tier cities.

Active high-end market in first-tier cities

Shanghai's first-hand market got off to a slow start in the second half of the year, with pre-sale permits withheld for several development buyers focused on the second-hand market, the backlog of pre-sale permits unblocked and new supply coming to the first-hand market causing a revival in activity. Similar experiences were had in other first-tier cities. New supply in Shanghai focused on areas straddling the Huangpu River, with most units coming from new batches of existing projects. Beijing saw an influx of high-end villa supply coming from Fengtai District, while Shenzhen's still highly sought-after market saw many high-end projects complete in areas like Nanshan and Futian.

The definition of high-end properties continues to evolve in first-tier cities as new buyers come to the fore. Historically, properties have promoted their extensive clubhouse facilities and adorned their lobbies with ornate candelabras and gold trim finishes. More recently, however, properties have emphasised cultural heritage, design and liveability, and embraced new technological innovations while also highlighting best-in-class property management services.

Despite a slowing economy and industry-specific layoffs, first-tier cities and some regional capital cities have diversified economies that provide a degree of resiliency and vibrancy in their job markets. Meanwhile, as the country continues to attract MNCs and foreign direct investment with the opening of markets to international competition, first-tier cities will continue to attract new talent and create new wealth which will provide continued support of the residential market.

New brands enter the serviced apartment market

The serviced apartment market faces a number of headwinds, from a slowing economy and falling

housing budgets to an expat exodus and rising costs. Despite these challenges, there remain bright spots in China's four biggest markets of Beijing, Shanghai, Guangzhou and Shenzhen. China is actively opening up various sectors of its economy to international firms, potentially creating new sources of demand from MNCs and seconded staff. The opening of the financial services sector bodes well for Shanghai, while the automobile sector could serve as a major demand driver in Beijing. Shenzhen's continuing dominance as a tech hub and importance in the Greater Bay Area could drive demand from mainland and Hong Kong tenants.

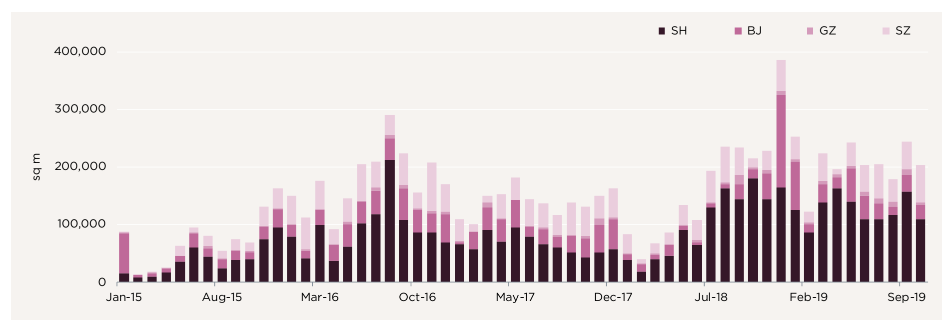
Not only are new tenants potentially arriving, but new operators are coming to market, including major luxury brands such as Rosewood and Jumeirah, both of which recently opened in Guangzhou. Additionally, Bvlgari opened in Shanghai and Conrad Residences in Tianjin. The entry of these brands speaks to continued confidence in the market and will help bring new standards in quality and service to China.

Developer financing still key

Access to inexpensive and plentiful credit lines, combined with the belief that property prices will continue to rise unabated, has fuelled the growth of the property market in the past. However, as part of the financial de-risking campaign and reducing the reliance of the economy on the property market, developer credit lines have been greatly curtailed over the last two years. This has the added benefit of removing the more speculative forces in the market as well as improving affordability. At the same time, banks have been given window guidance to control the issuance of mortgages to limit overall exposure to the property market and also ensure home buyers are not overextended (typically first-time home buyers and upgraders). Financing instead should be funnelled to the real economy and creditworthy SMEs to fuel growth.

Developers will have to better control overall debt levels by finding alternative channels of longer-term financing, divest a portion of their assets to better-capitalised developers, bring in equity partners or rely upon their ability to monetise their existing developments by selling to end-users and upgraders.

Transaction Volumes Of Units Priced Over RMB80,000 Per Sq M



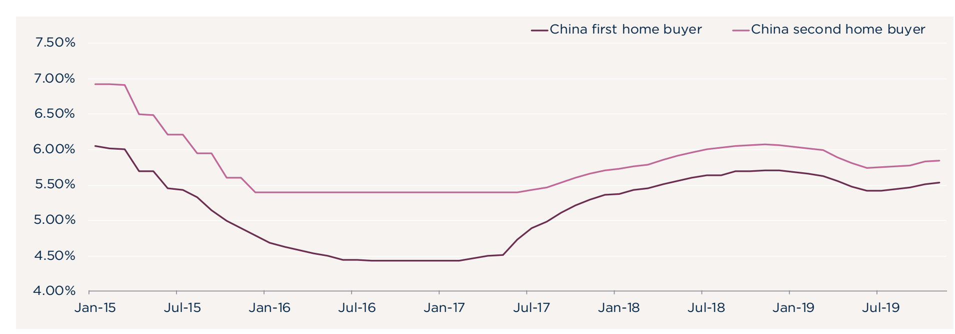
Source CRIC 克而瑞 , Savills Research

Branded Serviced Apartments Rent And Vacancy Rates

CITY	RENTAL GRWOTH		VACANCY	
	2019	2020F	2019	2020F
Shanghai	-0.7%	→	17.3%	↑
Beijing	0.8%	→	11.5%	↓
Guangzhou	-3.6%	→	19.4%	↓
Shenzhen	-0.7%	→	21.1%	→

Source Savills Research

China First And Second Housing Mortgage Rates



Source CRIC 克而瑞 , Savills Research

Investment

Overview

The investment market has proved challenging in 2019. The market had a strong opening with several large deals that had started negotiations in 2018, eventually making it across the line in Q1/2019. Increased uncertainty, a softening of fundamentals and a disconnect between buyer and seller expectations put the brakes on the market mid-year, but, by the end of the year, activity was once again picking up in the first-tier cities. Provisional, full-year figures put investment transaction value at RMB317 bn, down by 13% YoY.

First-tier cities tend to offer more liquidity, transparency and more robust occupier demand, and as such, remain the key focus for investors. First-tier cities accounted for around 71% of transaction values in 2019, with Shanghai and Beijing recording over RMB100 and 70 billion respectively.

Investors are concerned about the office market's softening fundamentals as new supply rushes onto the market and demand falters. While some sellers are reticent to lower asking prices, others that need to sell or are concerned that the market might deteriorate further may look at reducing prices to speed up disposals.

Niche sectors underpinned by structural changes in the economy, technology, society or demographics will potentially look at multi-decade growth trends, such as the data centre market, given their higher yields and long-term growth prospects. This goes double for sectors that are supported by the government, such as the multifamily market and senior housing sector, although competition may prove fierce and demand may lag supply in the short term.

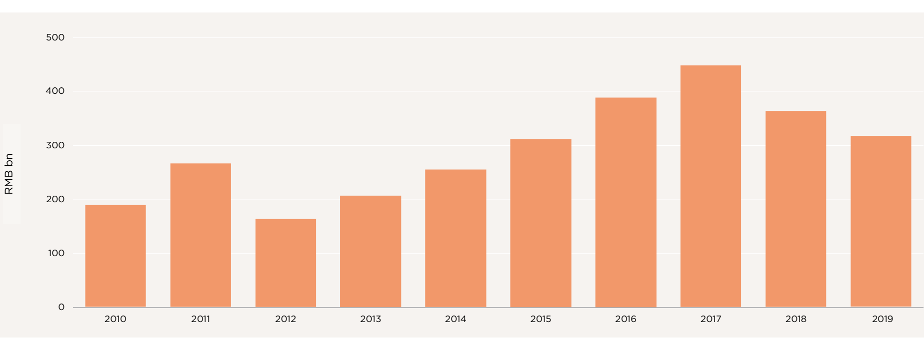
Sources of financing to be more diversified

Since the start of the financial de-risking campaign in late 2016, developers and investors have struggled to access financing with the government giving window guidance to banks to avoid overexposure in the real estate market. Bond sales, both offshore and onshore, have been restricted while investors' falling appetite has pushed up coupon rates. Meanwhile, the shadow banking sector has been curbed considerably, having a significant impact on smaller developers which relied on them heavily in the past and have few other financing channels open to them.

The hunger for credit, especially from small- and medium-sized developers, has given rise to a flourishing private credit sector, with some coming from overseas. According to PwC, over US$9 billion of capital was raised in private credit funds (not limited to real estate sector debt) targeting Chinese credit opportunities in 2018, the highest on record. A further US$6 billion was raised in the first half of 2019.

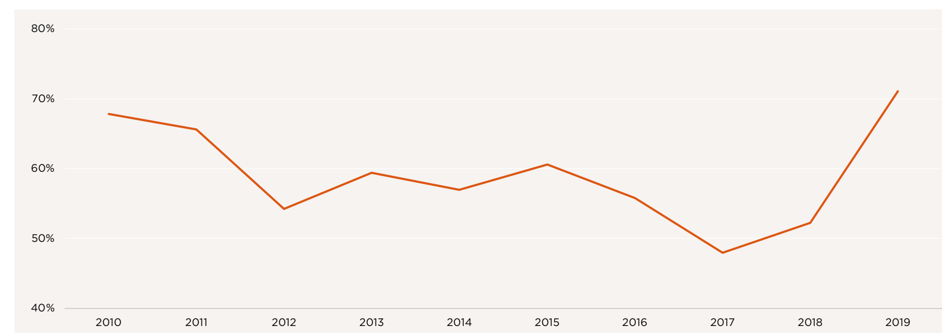
The credit crunch could also motivate China to speed up the launch of its REIT market, a regulated, income-generating and highly liquid investment medium for the real estate market, allowing developers to release trapped equity from their assets. REITs would not only provide an important source of capital but also improve the market transparency and a segment of the asset management industry.

Total Transaction Volumes Of Deals Over RMB100 Million Excl. Development Projects



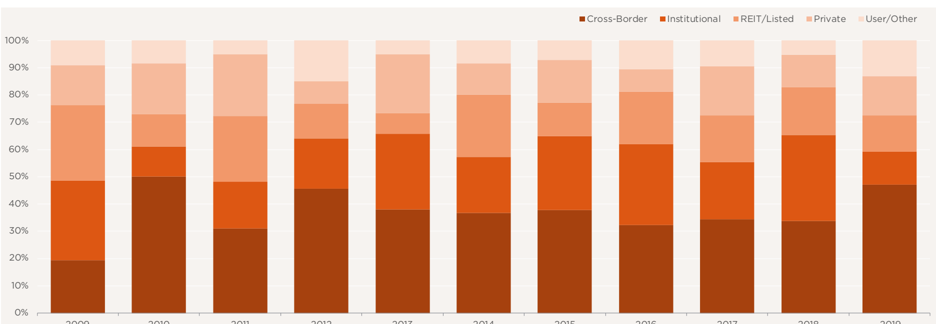
Source RCA, Savills Research

Percentage Of Deals In First Tier Cities By Volume



Source RCA, Savills Research

En-bloc Sales Market Buyer Types



Source RCA, Savills Research

Back-to-core vs distress buying

Two to three years ago, with the economy purring along and the real estate market proving relatively robust, investors had started looking beyond the increasingly pricey first-tier cities towards higher growth second-tier cities where price points were lower and yields were higher. Investors acquired retail properties in prime retail precincts in gateway cities that showed strong consumption power such as Nanjing and Chengdu. CapitaLand purchased Galleria Chengdu for RMB1.5 billion in 2016 while China Resources Land acquired Le DuHui Shopping Centre in Nanjing in 2017. However, as market uncertainties continue to grow, investors are pulling back to first-tier cities. While these markets remain expensive, there may be some room to negotiate on pricing, and while there may be some cause for concern about the new supply volume and the strength of demand, their economies and tenant bases are more diversified and so offer more support in a sector-specific downturn, in addition to greater transparency and liquidity.

While most investors, especially core, core plus and value add funds, pull back to safer markets, opportunistic investors may linger a little longer in second-and third-tier cities in the hope of snapping up heavily discounted assets from distressed or highly stressed landlords. These may be local developers that have run out of capital, owner-occupiers that need to release some equity or, in some cases, it might even be NPLs that have been processed by local AMCs. More of these opportunities are likely to emerge as the economy slows, profits fall, and debt repayments become more difficult.

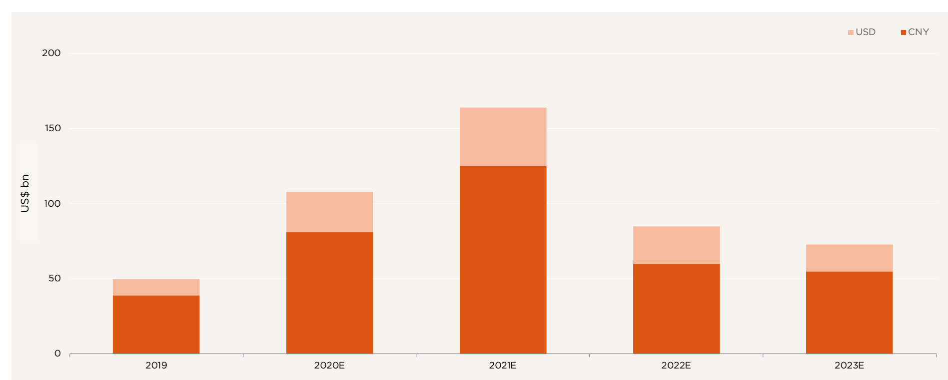
Value-added opportunities vs self-built assets

While local investors have retreated from the market, international buyers are seizing the opportunity to grab assets. To hit hurdle rates in the low-yield, low-growth market, international funds and developers are focusing on value-add opportunities, creating value through applying their international expertise and management capabilities to underperforming assets.

This strategy has become harder to apply with some properties having undergone several rounds of upgrading and having limited upside potential, especially when competing with brand new projects built to the latest specifications. Other assets may be held by family offices or legacy developments with unmotivated sellers, unwilling to part with their assets at current valuations instead looking to sell at close to fully renovated values while leaving potential investors with all the risk and hardly any upside. Therefore, investors must work hard to choose the right asset at the right price to make the strategy work.

Some investor/developers have forgone expensive core markets and highly competitive value add opportunities by instead adopting a build-to-core strategy—if you can't find anything that you want to buy, then build it instead. International developer investors such as CapitaLand and Tishman Speyer, have the reputation, the track record and the relationships to unlock opportunities where others might fail. This is of course not for everybody, given the lack of an income stream and the long payback period.

Chinese Developer Bond Maturities



*Figures are as of April 30,2019

Source Dealogic, FT, Savills Research

Build-to-core may also work for nascent niche markets, such as data centres and cold chain logistics facilities, where there the market is so small that there is no or very little investment grade stock for investors to buy.

Uncertainty continues

The year 2020 is likely to prove challenging—filled with uncertainty and change, whether it be geopolitics, regulations, financing conditions or disruptive PropTech. Capital values are expected to see further corrections in some markets and asset classes impacted by tighter credit availability, a slower economy or ample supply.

The corrections, while triggered by slower growth and tighter financing, may be the start of a transition in some markets to a more mature status (as opposed to emerging). With the high-growth days possibly behind us, new investments will have to be driven and underwritten by rental incomes and tangible value creation, compared to the continuous yield compression, especially if, as the government has indicated, monetary relaxation and sizeable interest rate cuts are off the table for the time being.

While the challenges may be greater than they have been in the past, opportunities undoubtedly exist for investors that can adapt investment strategies, identify undervalued or undersupplied sectors and markets, take countercyclical positions, have long-term staying power for structural changes in the market, tolerate a degree of risk and develop innovative financing approaches.

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