MARKETSCORE

The Key to Investing in China

OFFICES

CHINA Q1 2014

GLOBAL RESEARCH & CONSULTING

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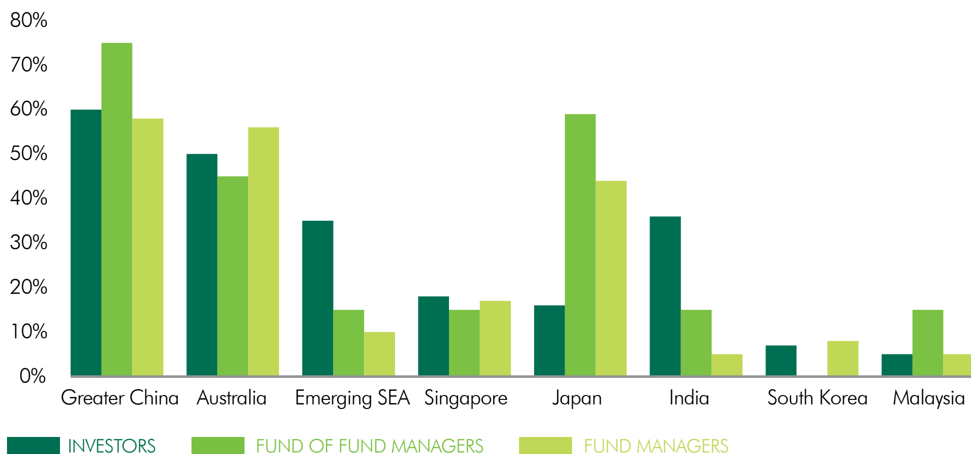
Introduction

China has emerged as a major investment target for global real estate investors thanks to its rapid economic growth and growing strategic importance as the world's second largest economy. According to ANREV's investor intention survey 2013, Greater China is the most preferred location in the Asia Pacific for real estate investment, with as many as 59% of the respondents naming it the top destination.

Preferred country and sector in Asia Pacific for real estate investment



Source: ANREV investor intention survey 2013

While there is no shortage of interest in investing in China, investors, especially foreign ones, face multiple challenges as they formulate their investment strategy and execute their acquisitions. China has over 90 cities with an urban population of over one million, far more than the total in the US and Europe combined. After over thirty years of rapid economic growth, the country is highly diversified, and regional economic growth and social development is seriously imbalanced. The rapid transformation of the urban landscape along with increasing urbanization and improving infrastructure are also making the country ever more complex.

To help investors cut through this complexity, CBRE has developed a strategic framework to evaluate real estate investment potential across 15 Chinese major cities in the office, retail and industrial sectors according to their risks and returns. The scoring exercise aims to identify the most attractive real estate market from an investor's perspective, based on the fundamental drivers of each sector. In evaluating those factors, CBRE not only considers quantitative indicators such as rental growth and yields that we gather across these cities on a regular basis but incorporates qualitative indicators such as expected change in market status. **In Part I of this series, we will focus on the office sector, followed by retail and industrial in subsequent issues.**

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Methodology

The objective of the MarketScore is to identify factors that are fundamental drivers of the decision to invest in real estate. These will direct the investors where and when to invest, and what to buy. Based on the data available, as well as the market knowledge of CBRE professionals, each city-sector is "scored" on a 1 to 10 scale for each of these factors (1 being the worst and 10 the best).

We group these factors into two categories: Risk and Return. Under each category, we have identified a number of key drivers that we believe are most relevant in driving the performance of each asset type. Besides macro factors such as GDP growth and employment growth, we acknowledge that the key drivers for each asset type could be different. For example, the number of Fortune 500 companies that have a presence in each city and the development of tertiary industry have a significant impact on office demand, while domestic retail sales growth will affect demand for retail space.

To evaluate the attractiveness of the major office markets that we cover in China, we have chosen a combination of macro indicators as well as office-specific indicators. The key indicators adopted include tertiary industry development, investment liquidity, historical vacancy rate, future supply, forecast rental growth, office rental yield and a change in city status, among others. The table below summarizes the variables employed in our scoring exercise for the office sector.

Key indicators for CBRE's MarketScore - Offices

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To produce a single total score for each city/sector, each score is assigned a weight. In our base case scenario, we have assigned a weighting of 40:60 to Risk and Return. These weightings can be adjusted based on each individual investor's risk appetite. Moreover, our MarketScore framework can be customized to more closely reflect individual funds' investment strategies, objectives, and competitive advantages. For example, individual weighting on each driver can be adjusted to reflect investors' preference. Underlying drivers can also be changed based on investors' views on the market. There are 15 Chinese cities under study covering their office, retail and industrial sectors.

Markets covered in our MarketScore analysis

Source: CBRE Research

It is important to note that the ranking from MarketScore is based on the overall market level. Hence an excellent quality asset in a low ranking city might still be worth exploring, while an average property in a high ranking city might not be worth pursuing. We believe MarketScore will provide a basic framework for investors to conduct top-down analysis, but encourage investors to do bottom-up analysis at the project level in reaching their investment decisions.

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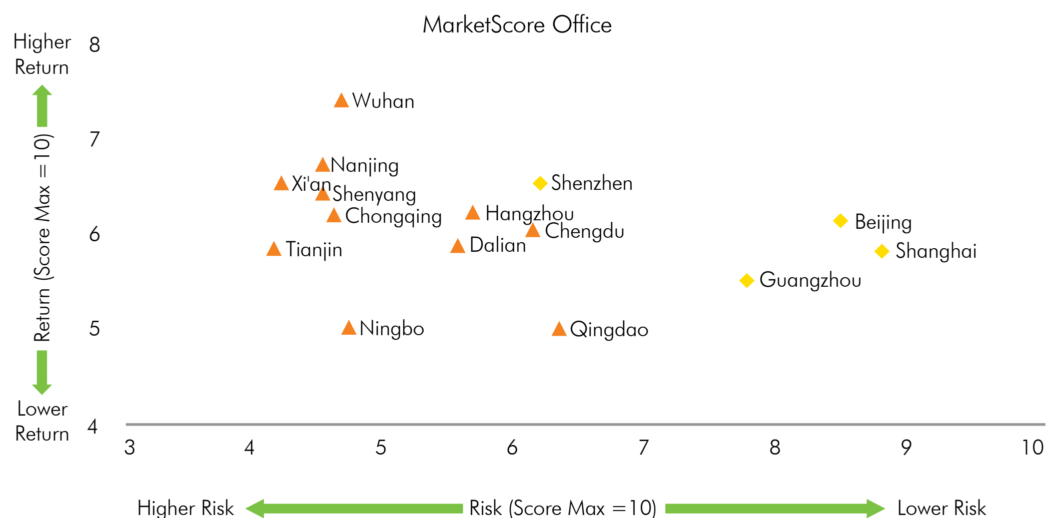
Office Investment

Market Summary : Tier 1 Cities Remain the Preferred Destination

As discussed in our recently published report "China Offices: Reality Check", China office market, especially those in a number of Tier 2 cities, will face challenge from abundant supply in the coming years. With this in mind, Tier 1 cities naturally rank higher in our MarketScore study with Beijing and Shanghai topping the list. These two cities are expected to deliver stable returns with a low level of risk, underpinned by a well-developed market and resilient demand from both foreign and domestic occupiers. Tier 2 cities are generally more risky as most of these markets are still at an early stage of development that is characterized by uncertainty. The other key challenge for investors is a lack of market depth in most of these Tier 2 markets. While there are more properties available for sale in these markets, high quality projects are not easy to find. Furthermore, market liquidity is generally poor, which makes it more difficult for investors when they want to exit.

This does not necessarily rule out opportunities in the Tier 2 cities. Tier 2 cities generally hit a higher return score compared to Tier 1 cities thanks to a low base effect, better growth prospects and a more attractive yield. Among all the Tier 2 cities, Wuhan stands out thanks to policy support from the central government and its strategic geographical location. In contrast, some Tier 2 cities that have attracted attention in recent years emerged at the lower end of our MarketScore system, such as Chongqing and Tianjin. The key challenge for most Tier 1 cities is aggressive pricing, as net yield for office investment in these cities ranges from 4.4% to 5.1%, according to data compiled by CBRE Research.

Risk/Return profile of 15 major cities in China



Source: CBRE Research

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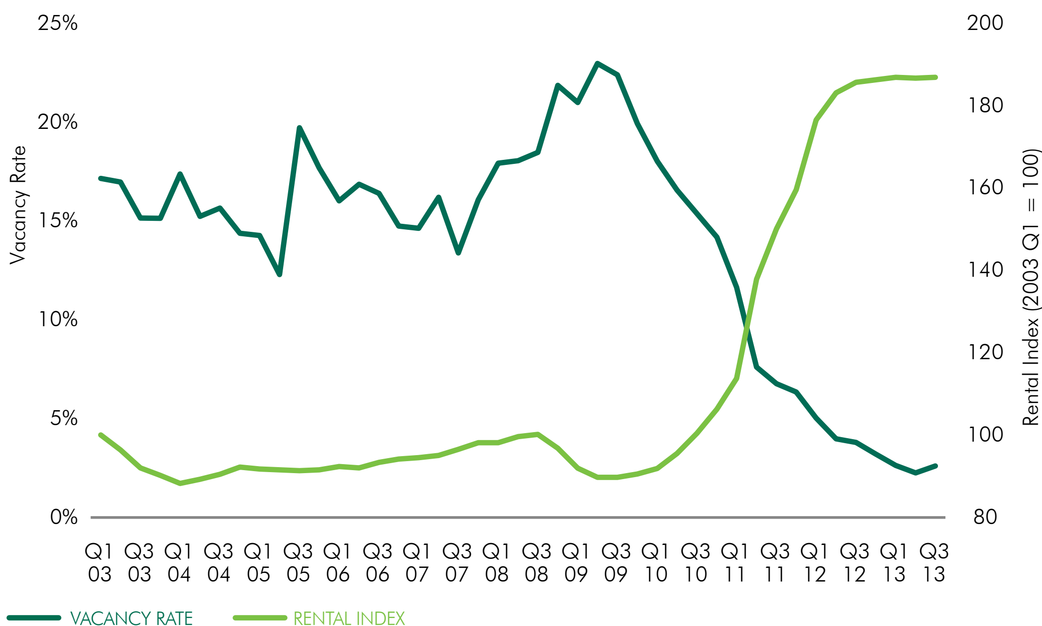
City Highlights

Beijing: Market Outlier

Beijing tops the office ranking thanks to its strong fundamentals. The city stands out in a number of indicators such as historical rental growth, vacancy rate and future development pipelines. In contrast to most office markets we studied which are exposed to the risk of oversupply, the Beijing office market is characterized by a lack of new supply, soaring office rents, and extremely low vacancy rates. Since the global financial crisis in 2008, the average new supply was approximately 240,000 sm pa, while average net take-up reached 593,000 sm pa. As a result, vacancy has fallen dramatically from 23.0 % in mid-2009 to a record low of 2.3% by Q2 2013. Over the same period, Beijing office asking rent more than doubled to RMB 410 psm per month.

Beijing office rental growth and vacancy rate



Source: CBRE Research

The rapid rental growth has raised concerns about the sustainability of Beijing office market. According to "Prime Office Occupancy Costs", a research report published by CBRE in June 2013, Financial Street and Beijing Jianguomen - CBD, two of the major office submarkets in Beijing, were ranked as the third and fourth most expensive office markets globally in terms of occupancy cost. Along with a subdued domestic economy, market activities have slowed down markedly since 2012, with rental remaining flat for the last four quarters. Besides concerns over the sustainability and affordability of office rent in Beijing, air pollution and traffic congestion have had more undesirable effects on the market.

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Prime office occupancy costs

1	Hong Kong (Central)	235.2
2	London - Central (West End)	222.6
3	Beijing (Finance Street)	194.1
4	Beijing (Jianguomen - CBD)	187.1
5	New Delhi (Connaught Place - CBD)	179.0
6	Hong Kong (West Kowloon)	173.9
7	Moscow	165.1
8	Tokyo (Marunouchi/Otemachi)	161.2
9	London - Central (City)	132.9
10	New York (Midtown Manhattan)	120.7
11	Mumbai (Bandra Kurla Complex)	119.9
12	Paris	119.3
13	Sydney	119.2
14	São Paulo	118.9
15	Shanghai (Pudong)	117.7

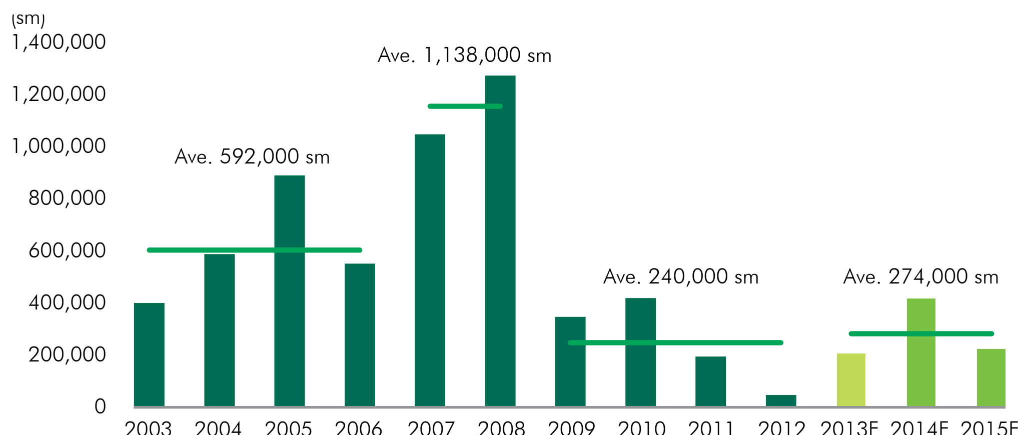
Source: CBRE Research
Notes: the unit for cost data is USD/sq. ft./annum, as of Q1 2013

Notwithstanding these challenges, we believe the long-term fundamentals of the Beijing office market remain sound. The recent slowdown in market activities was driven not only by a sluggish economy, but a lack of supply in the office market as well. Beijing, as the capital of China, will remain one of the key destinations for MNCs when they look to enter the country or expand existing operations.

As China's political center and the location of most of the countries' national regulatory bodies, most SOEs and a number of MNCs still prefer Beijing as their national/regional headquarters. As the domestic economy stabilizes and office availability gradually improves, we expect office demand will gradually recover to normal levels in the coming quarters. Overall demand for office, in our view, will remain resilient, well supported by a diversified industry profile. Traditionally, financial services, business services and consulting firms have been the key demand drivers for the Beijing office market. This is supplemented by further demand from energy firms in the CBD and IT enterprises in the Zhongguancun submarket.

On the supply side, the tight situation will be partially alleviated in the coming years but overall vacancy rate is expected to remain below 5% for the foreseeable future. According to CBRE data, the average new supply between 2013-15E will stay low at around 274,000 sm pa, well below the long term average net take-up of 588,000 sm pa. The lack of supply in core locations is particularly acute and we believe landlords will be under very little pressure to reduce rents.

Office new supply: Beijing



Source: CBRE Research

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Shanghai: Low Risk, Stable Return

Compared to Beijing, Shanghai office market is more driven by MNCs demand. Unlike Beijing's skyrocketing office rent, Shanghai's office market has been relatively stable since 2009. On average, office rents grew by 5.4% pa over the 3-year period between 2010 and 2012 with a low vacancy rate. While demand was robust during the same period, registering an annual net take-up rate of 848,000 sm, there was no shortage of supply. On average, new supply during the period reached 678,000 sm pa. This has helped bring the city's average vacancy rate down from 16.0% as at end of 2009 to 8.0% by end 2012. A more balanced demand-supply dynamics has capped the rental growth in the Shanghai office market.

Geographically, the Shanghai office market is divided into Puxi and Pudong by the Huangpu River. Pudong has enjoyed stable rental growth in the last few years thanks to robust demand from financial institutions and a lack of new supply since 2010. The vacancy rate in Pudong was as low as 3.5% by Q3 2013. Puxi, on the other hand, has seen increasing supply during the same period, and reported a higher vacancy rate at 8.7% as of Q3 2013. New supply in Puxi will also remain abundant over the next 2-3 years. In contrast, except Shanghai Tower in Lujiazui, the tallest building in China scheduled for completion in 2015, there is limited new supply in the pipeline in Pudong. In view of that, we believe the Pudong office market is likely to outperform Puxi in coming years.

Office new supply: Puxi vs. Pudong

Source: CBRE Research

Nanjing West Road in Puxi and Lujiazui in Pudong are regarded as the two most important office submarkets in Shanghai, where over half of Grade A offices are clustered. Nonetheless, the two office submarkets have very different tenant profiles and as a result different demand drivers. Traditionally, the Nanjing West Road submarket is home to companies from luxury retailers, professional services, and pharmaceutical sectors, while banks, financial institutions, and security firms are the key demand drivers in Lujiazui.

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Current major tenants in Nanjing West Road Sumarket and Lujiazui Submarket

COMPANY	INDUSTRY	OFFICE	OCCUPIED AREA (SM)
Nanjing West Road Sumarket			
KPMG	Professional Services	Plaza 66	22,000
LVMH	Luxury Retailer	Plaza 66	18,000
Sanofi-Aventis	Pharmaceutical	Jing An Kerry Centre	13,000
BMS	Pharmaceutical	Wheelock Square	8,000
MSD	Pharmaceutical	Park Place	8,000
Chanel	Luxury Retailer	Plaza 66	6,000
Coach	Luxury Retailer	Wheelock Square	3,000
Takeda	Pharmaceutical	Wheelock Square	2,600
Bain & Company	Professional Services	Plaza 66	2,200
Ferragamo	Luxury Retailer	Wheelock Square	1,500
De Beers	Luxury Retailer	Park Place	1,100
Lujiazui Submarket			
COMPANY	INDUSTRY	OFFICE	OCCUPIED AREA (SM)
HSBC	Financial Institutions	Shanghai IFC	40,000
Standard Chartered	Financial Institutions	SCB Tower	22,000
Citibank	Financial Institutions	Citigroup Tower	20,000
DBS	Financial Institutions	DBS Tower	10,000
Deutsche Bank	Financial Institutions	Shanghai IFC	6,000
BNP Paribas	Financial Institutions	SWFC	6,000

Source: CBRE Office Services

Decentralization has been an increasing trend in the Shanghai office market since 2008, which accelerated in 2011 and 2012. With rapidly improving accessibility and increasing supply of high-quality office buildings in decentralized areas, it has become a more viable option for occupiers, in particular those from low margin or cost-sensitive industries, to relocate from traditional core areas to decentralized areas. Currently, moving from Grade A office buildings in downtown to decentralized buildings with similar specifications could save up to 35% rental costs for occupiers. Looking ahead, we expect to see an influx of 1.9 million sm of new office supply in decentralized areas between 2014-15 in Shanghai. In view of this, we believe the decentralization trend will further evolve in Shanghai. On the other hand, the glut of new supply is likely to exert downward pressure on office rents in decentralized areas in the near term.

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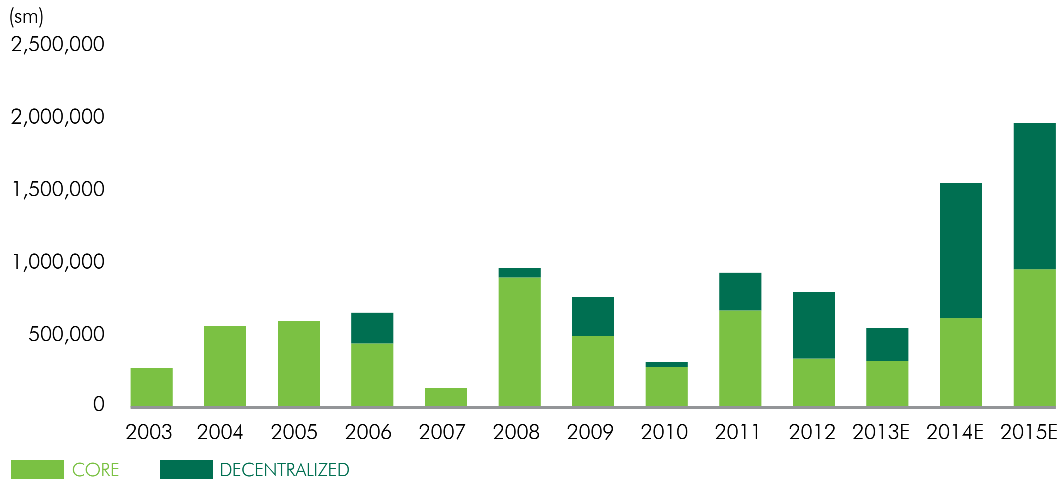
Shanghai office new supply: core area vs. decentralized area



Source: CBRE Research

In our MarketScore system, Shanghai topped all other cities in risk score, thanks to strong investment liquidity, a low vacancy rate as well as strong net take-up. Shanghai has been a hot destination for property investors. Over the past three years, total office deals closed hit RMB 16 billion pa, accounting for over 45% of the total transaction volume of 15 major cities included in our study. The recent establishment of the first Free Trade Zone in Pudong is expected to further consolidate Shanghai's status as China's global financial center. This will certainly attract more tenants, both from MNCs and large domestic companies to the city. Having said that, rental growth in the medium term is likely to be muted in view of the abundant new supply in the pipeline. According to CBRE data, new office supply between 2013 and 2015 will amount to around 4 million sm.

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Wuhan: Stay Low, Aim High

With intensifying competition and compressing yield in Tier 1 cities, there are an increasing number of investors who shift their attention to Tier 2 cities. Yet most investors have been focusing on cities like Chengdu, Chongqing or even Tianjin, while Wuhan is less likely to be within investor's radar. However, Wuhan's low profile should not obscure its potential, largely derived from solid market fundamentals and its strategic geographic location. The office rent in Wuhan increased at a CAGR of 7.4% during the last decade, the highest among the 15 major cities that are included in our study.

Wuhan, with its nickname as "the thoroughfare of nine provinces (九省通衢)", is situated in the center of China. With the rapid development of high-speed rail, Wuhan has become more strategically important as a transportation node linking China's south to its north, as well as the east to the west. Situated astride the Yangtze River, the city also enjoys well-developed river transportation. The city's GDP has been growing at mid double-digits in recent years thanks to the central government's policy to support "The Rise of Central China (中部崛起)". Industries including auto, electronics, and pharmaceutical grew rapidly, benefiting from the city's industrial base and abundant human capital educated by top local universities.

Wuhan: China's center

Strategic Position	
1. HIGH-SPEED RAIL (HSR) HUB TO KEY GATEWAY CITIES	
Wuhan to Beijing by HSR	5 hours
Wuhan to Guangzhou by HSR	4 hours
Wuhan to Shanghai by HSR	5 hours
Wuhan to Chengdu by HSR	5 hours
2. KEY WATER PORT ON YANGTZE RIVER	
Freight Traffic (2012, million tons)	104
3. KEY INLAND AIRPORT HUB	
Domestic Airlines (2012)	184
International Airlines (2012)	19
Air Passenger Throughput (2012, million)	14

Source: Wuhan Statistical Yearbook 2012

Moreover, unlike most coastal cities in the east of China, where they have to compete fiercely with peer cities in the region, or in West China, where Chengdu and Chongqing are competing head-to-head for resources or investments, Wuhan has almost no rivals in the central region. The economic power or development in other provincial capital cities in Central China, such as Changsha, Nanchang and Hefei, lags far behind Wuhan. With fewer competitors but more cooperators, Wuhan has naturally become a regional hub.

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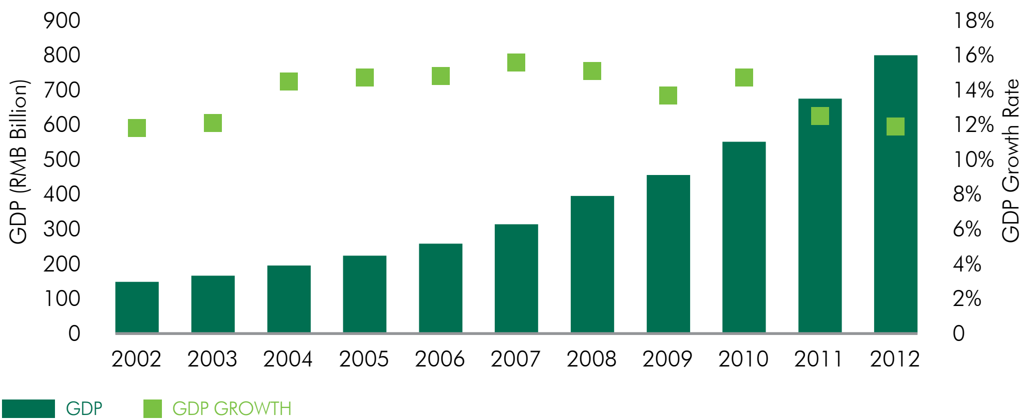
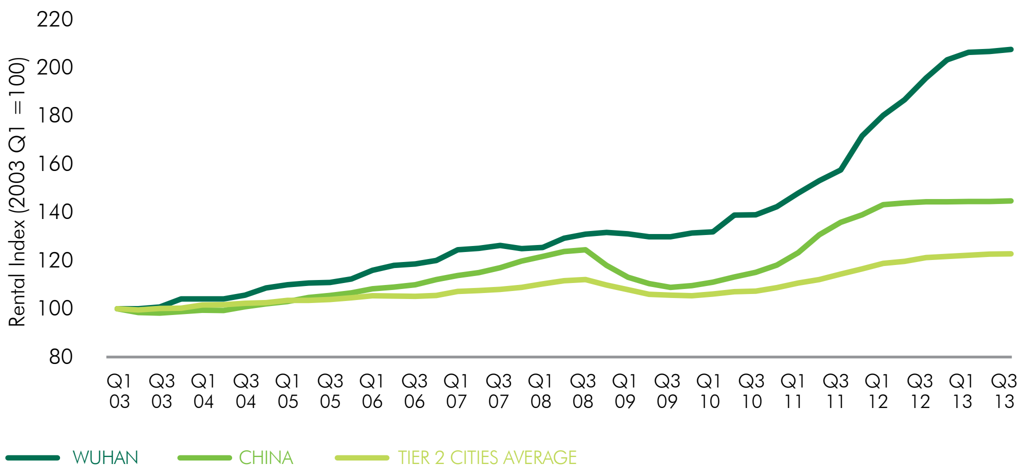
Rapid economic growth in Wuhan



Source: Wuhan Statistical Yearbook

Sound economic fundamentals and strong growth prospects have ensured resilient office demand from various industries including finance, business service and IT, which has led to the second highest rental growth of 12.6% pa on average between 2010 and 2012 and the vacancy rate dropping steadily from 2006 to 2011. A rise of new supply in recent quarters has seen vacancy rate spiking up rapidly to over 20% by Q2 2013. While we acknowledge the supply surge will put a cap on office rental growth in the near term, the new supply of high-quality office buildings will certainly redefine the local Grade A office market, provide the international office accommodations for local tenants and have a positive impact in the long run.

Wuhan's office rental growth far outpaced other Tier 2 cities



Source: CBRE Research

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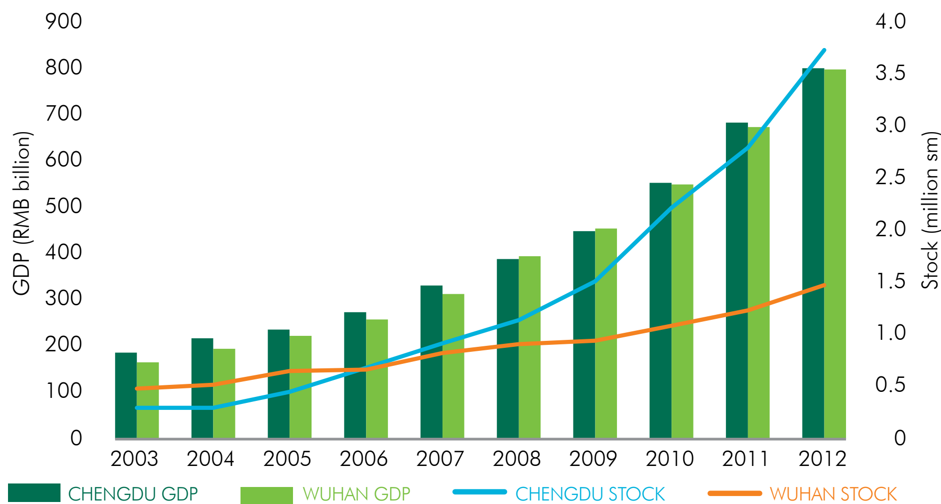
With increasing importance as a regional hub in central China, we believe the Wuhan office market has significant room for growth in coming years. According to CBRE data, the current office stock in Wuhan is approximately one third of that in Chengdu, while the two cities have similar economy size with their GDP standing at around RMB 800 billion as of the end of 2012, as well as the size of tertiary industry.[1] The rapid economic growth in Wuhan since 2012 has attracted more and more MNCs and large domestic companies to establish their presence in the city. By end-2012, over 190 Fortune Global 500 companies, including a number of well-established banks and financial institutions, had settled down in Wuhan.

Similar economies, different office stock: Chengdu vs. Wuhan



Source: National Bureau of Statistics, CBRE Research

[1] *The size of tertiary industry for Chengdu and Wuhan was around RMB 400 billion and RMB 387 billion respectively by the end of 2012, according to the statistical yearbook for Chengdu and Wuhan.*

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Chengdu: Opportunities and Challenges

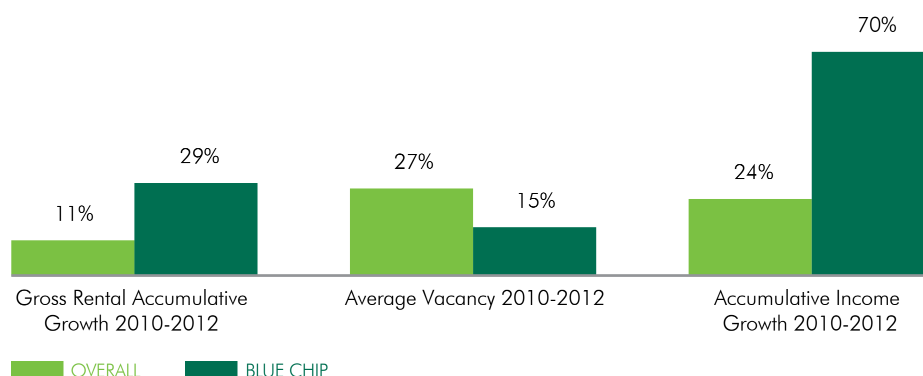
Chengdu has been one of the key beneficiaries of the central government's "Go West" policy. With well-developed infrastructure and a huge talent pool, Chengdu is the natural choice for MNCs and large domestic corporations when they set up their Western China regional office. As a result, Chengdu has seen its office market flourishing in the last decade supported by robust demand. The average net take-up in Chengdu reached 442,000 sm pa in the past three years (2010-2012), far above the average of 169,000 sm for the Tier 2 cities that CBRE tracks during the same period. The strong demand comes on the back of robust economic growth, especially the rapid development of the tertiary industry. By end 2012, Chengdu has attracted nearly half of the Fortune Global 500 companies. Despite substantial increase in office demand, supply has been growing at a faster pace. Over the last three years, there was a total of 2.7million sm of new office space delivered to the market, pushing the vacancy rate to over 40% by Q3 2013. As a result, rental growth has been stagnant for the past three years. In particular, average rental started to decline since Q1 2013. Office developments in the emerging submarkets, where business environment is premature and infrastructure is still under development, are likely to face more headwinds.

Key preferential policies for Western China

1. **Funding:** increased funds from central government and bank loans to support infrastructure development and key energy projects in Western China, and raise the subsidies for local social welfare, education, technology etc..
2. **Tax incentives:** domestic and foreign firms in targeted industry were entitled to a deducted corporate income tax of 15% between 2001-2010 (versus 25% in Eastern China).
3. **Foreign investment:** allow foreign banks and retailers to operate, and lower requirements for registered capital to RMB 30 million (versus RMB 50 million in Eastern China) and the operation length to extend to 40 years (versus 30 years in Eastern).

As China continues to shift its growth focus from east to west, Chengdu will become strategically more important. We expect demand will continue to grow as more companies look to set up their regional hubs in western China. On the other hand, new supply will remain abundant in the next 2-3 years, with the majority of the new supply coming from Tianfu New District. Hence investment opportunities will become more readily available but the rental outlook will be affected by concerns over over-supply, especially in the emerging CBD area. Having said that, we believe that high quality developments in mature core areas are likely to fare better and investors are more likely to find suitable investment opportunities there. According to the analysis in our report, "China Offices: Reality Check", Blue Chip office buildings tend to outperform the overall market. As shown in the chart below, Blue Chip office buildings reported accumulative income growth of 70% during the period of 2010-2012, compared to 24% growth in the overall market during the same period.

Blue Chip office outperforms market in Chengdu



Source: CBRE Research

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Local Rivals: Chengdu vs. Chongqing

Chengdu and Chongqing are regarded as two most important cities in West China and have drawn enormous attention nationwide, or even worldwide. Historically, Chongqing was under the authority of Sichuan Province until 1997, when it was upgraded to be a province-level municipality and broke away from Chengdu to direct its own way to prosperity. Nonetheless, the competitive advantages of Chengdu, particularly in infrastructure, talent pool and tertiary industry development, makes Chengdu a more preferred destination for a lot of MNCs when they set up their regional office for West China.

Chengdu vs. Chongqing

	Chengdu	Chongqing
ECONOMY		
GDP (2012, RMB billion)	814	1,146
GDP per Capita (2012, RMB)	57,624	39,083
Disposable Income per Capita (2012, RMB)	27,194	22,968
Tertiary Industry as % of GDP (2012)	49%	38%
FDI (2012, USD billion)	9	11
Number of Fortune 500 (2012, est.)	245	230
INFRASTRUCTURE		
Passenger Traffic by Rail (2012, million)	40	30
Air Passenger Throughput (2012, million)	32	22
Length of Metro Lines (2012, est., km)	130	143
HUMAN CAPITAL		
Population (2012, million)	14	29
Percentage of Population with Higher Education (2010)	17%	9%

Source: National Bureau of Statistics. CBRE Research, Number of Fortune 500 is from government press release 2012 Q3

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First, there is a major gap between Chengdu and Chongqing in terms of infrastructure and accessibility. Chengdu, as the long-term regional node of West China, enjoyed well-developed infrastructure and good accessibility. In particular, Chengdu Airport is the fourth largest airport nationwide and Chengdu is the railway hub in West China. While large-scale investment in Chongqing's infrastructure only started about a decade ago after it became a provincial-level municipality, the city has made remarkable progress in terms of subway development and river transportation. Nevertheless, the mountainous landscapes in Chongqing have to some extent made it more complicated for the city to develop its infrastructure.

Furthermore, there is a difference in terms of the talent pool. Approximately 17% of the population in Chengdu has received higher education, compared to less than 9% in Chongqing according to the national census data in 2010. Also, Chengdu has four universities that are included in Project 211, a program that was initiated by the Ministry of Education to identify the top universities in China. On the other hand, Chongqing, as a new member of the country's group of provincial-level municipalities, only houses two universities which are ranked in Project 211.

Finally, from an investment perspective, the very aggressive price expectation by vendors in Chongqing also makes investment in the city more challenging. A few numbers will explain why this is the case. Both Chengdu and Chongqing average office rent stood at approximately RMB 95 psm per month as of Q3 2013. However, the average sales price for strata-titled office was around RMB 20,000 psm in Chongqing, compared to approximately RMB 14,000 psm in Chengdu. This translated into a net yield of 4.6% for strata-titled office investment in Chongqing. As strata-titled office sales still dominate the Chongqing office market, most en-bloc vendors usually demand aggressive prices by benchmarking against the prevailing price in the strata-titled office market. Most institutional investors will find it challenging to accept such returns in Tier 2 cities, unless there is some form of guaranteed return provided by the vendors.

We believe the office market in Chongqing is still at the early stage of development. It will take time before it can compete with Chengdu as a regional hub for West China. In the near term, Chongqing is more likely to be regarded as a manufacturing hub given the abundance of low-cost labor and local government's preferential policies aimed at attracting investment. The differences in city fundamentals are reflected in the office market. As of Q3 2013, Chongqing's total office stock only accounts for approximately one third of that in Chengdu. In addition, Chengdu's net take-up amounted to 442,000 sm pa during the last three years, compared to 163,000 sm pa in Chongqing during the same period.

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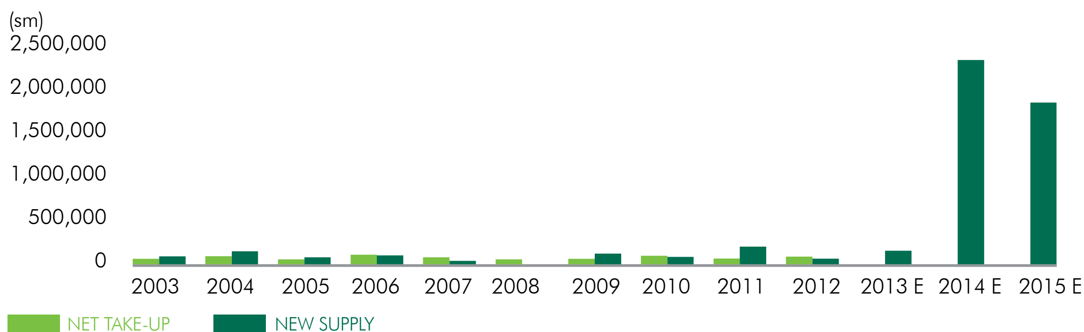
Tianjin: Elusive demand

At the turn of the century, Tianjin was touted to be the next economic miracle in China after Shenzhen in the 1980s and Shanghai Pudong in the 1990s. It was once positioned as the financial center of Northern China. But these expectations were not fulfilled. Nevertheless, the establishment of the Binhai New Area (BHNA) in 2005 has attracted overwhelming interest from both domestic and international investors. Against this backdrop, office developments started to flourish, especially in Yujiapu (于家堡) and Xiangluowan (响螺湾), two major office hubs of the Binhai New Area CBD. Based on data collected by CBRE Research, there is a total of 5.6 million sm of office space that is scheduled to be completed between 2014-2016 in Tianjin, of which 2.9 million sm will come from Yujiapu and Xiangluowan. Compared with an average annual net take-up of 79,000 sm since 2009 and an average vacancy rate of 16.8%, the amount of new supply looks extremely daunting.

Net absorption and new supply in Tianjin

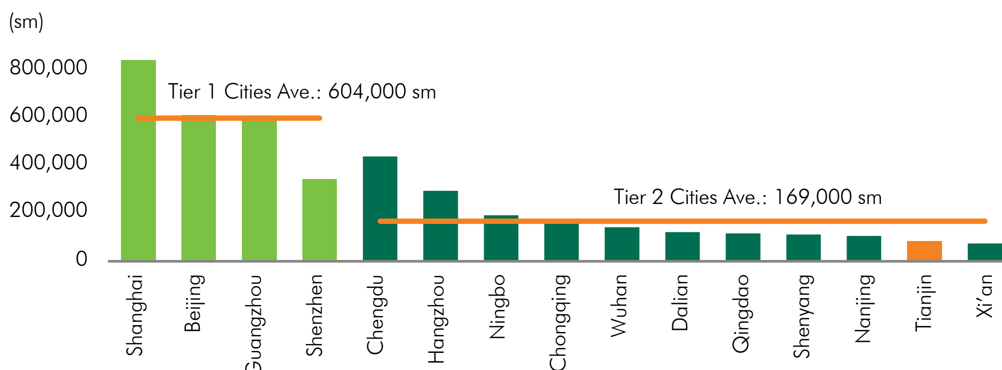


Source: CBRE Research

Although being one of China's four provincial-level municipalities, Tianjin's economic growth lagged behind most coastal cities until recent years. With preferential policies from central government and the establishment of the BHNA, the city's economy started to catch up, registering double-digit GDP growth since 2006. However, the rapid economic growth, driven by the secondary industry including electronics manufacturing, auto manufacturing and petroleum refining, has not translated into increasing demand in office market.

Among the 15 cities under this study, Tianjin office market is one of the smallest markets in terms of total net take-up. With Beijing only half an hour away by high-speed rail, we believe large corporates will continue to prefer the capital as their office base, given its large talent pool, proximity to regulators and well-developed facilities. Looking ahead, we believe Tianjin will more likely develop into a regional manufacturing hub instead of a regional financial center. From this perspective, we do not foresee a significant upsurge in office demand in the next few years. As a result of lack of demand, most of the office projects in Tianjin have put off completion and the overall slippage rate hit as high as 80% over the past four years. In the absence of a significant pick-up in office demand in the near future, we expect quite a number of office projects will continue to postpone their completion, but this is unlikely to alleviate concern arising from a very strong pipeline.

Average net absorption (2010-2012) among 15 major cities



Source: CBRE Research

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This report was prepared by the CBRE China Research Team which forms part of CBRE Global Research and Consulting – a network of preeminent researchers and consultants who collaborate to provide real estate market research, econometric forecasting and consulting solutions to real estate investors and occupiers around the globe.

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