Hong Kong Retail & Office Market and Beijing Office Market Overview

By Savills (Hong Kong) Limited, 31 March 2015

1. HONG KONG ECONOMY

According to Hong Kong's Census and Statistics Department, the Gross Domestic Product (GDP) of Hong Kong increased moderately by 2.3% in 2014, compared to a 2.9% increase in 2013, on the back of a subdued trade performance. The GDP of Hong Kong is forecast to increase by between 1% and 3% in 2015, while the growth of the Hong Kong economy is forecast at 3.5% per annum from 2016 to 2019. Tourist arrivals in Hong Kong remained strong, with 60.8 million visitors in 2014, a 12% growth on the 2013 figure of 54.3 million. Retail sales performance was largely stable for 2014 as a whole; the value of total retail sales was HK$493.3 billion, a decrease of 0.2% in value and an increase of 0.6% in volume when compared with 2013. The labour market in Hong Kong is strong, with the unemployment rate remaining at a low level of 3.3% at the end of 2014. Private consumption was also stable with 2.7% growth being recorded in 2014.

2. HONG KONG RETAIL MARKET

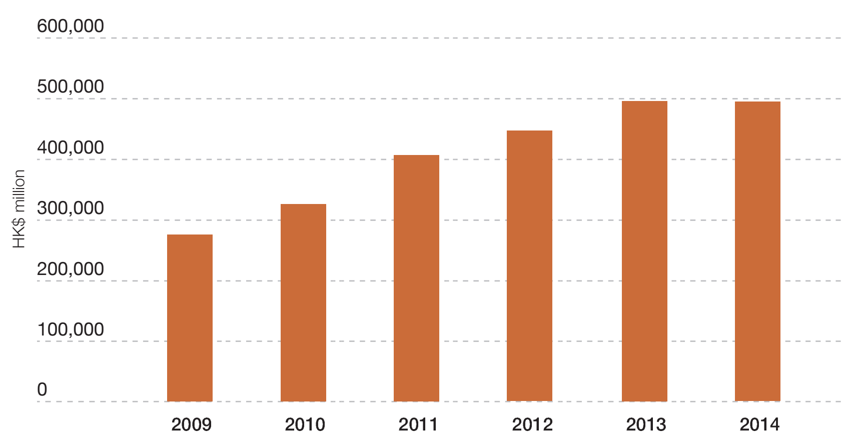
Hong Kong's retail market is diverse, with global and luxury brand names complementing local retailers. The retail sector is supported by a large tourist market and robust domestic retail sales.

2.1 Demand

The retail market in Hong Kong is supported by a strong inflow of visitors and the expansion of

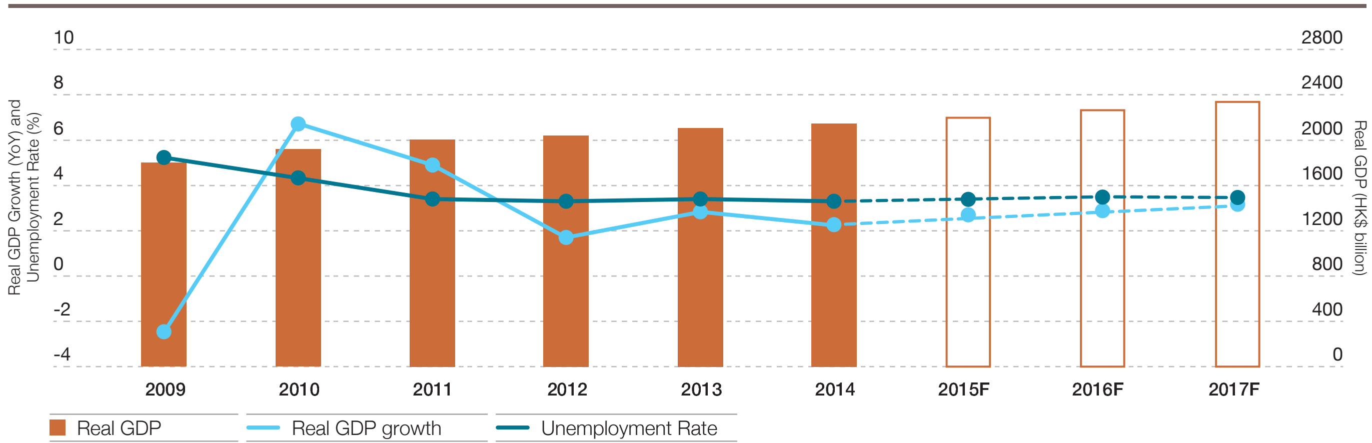
> **"Savills expects Hong Kong retail sales to remain broadly stable in 2015 and to rise gradually from 2016 to 2019."**

Retail Sales Value, 2009 – 2014



Source: Census and Statistics Department, FocusEconomics.

Hong Kong GDP Growth and Unemployment Rate, 2009 – 2017F



Source: Census and Statistics Department, FocusEconomics. **Note:** Figures for 2015 to 2017 are based on forecasts.

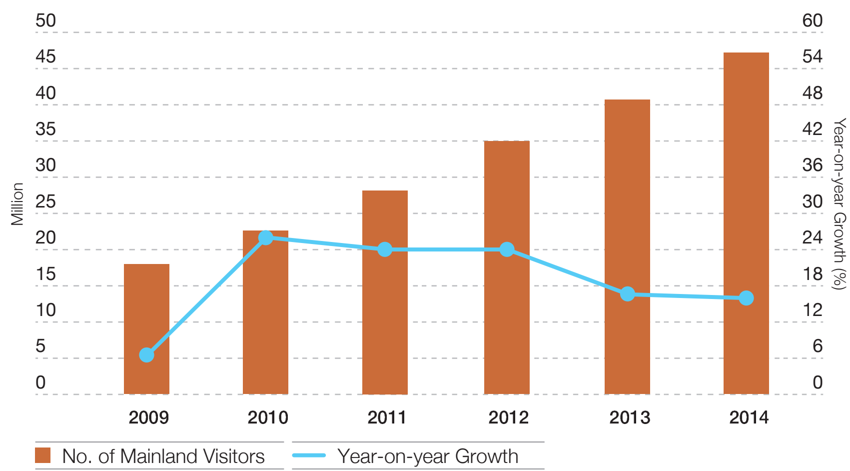
international brands. Jewellery, watches and clocks, and valuable gifts are the top retail categories[1], although some growth momentum was lost in 2014 due to the shift in shopping patterns of Mainland visitors away from luxury goods towards mid-end products. However, consumption demand was strong with consumer durable goods and clothing, footwear and allied products[2] sales rising by 2.3% and 4.1% respectively, supported by robust local demand.

Mainland tourists continued to be the main visitors to Hong Kong in 2014. The increasing spending power of Chinese visitors and the appreciation of the Renminbi against the Hong Kong dollar in recent years have provided strong incentives for Mainland visitors to come to Hong Kong. Of the 60.8 million visitors who came to the territory, 47.2 million (78%) came from Mainland China in 2014, a 16% increase compared with the 40.7 million Mainland visitors in 2013.

The anti-corruption campaign in the Mainland, the shift of Mainland visitors' preference towards mid-end products and the appreciation of the Hong Kong dollar towards the end of the year all led to a 2.6% decline in per capita overnight Mainland visitor spending, down to HK$8,703 compared with 2013.

In 2014, same day visitors from Mainland China accounted for 28.2 million or nearly 60% of visitors from Mainland China. These visitors usually do their shopping in non-core areas and stay close to the MTR line, while their shopping items are mainly biased towards foodstuffs and personal care items. The per capita spending for same day Mainland visitors stood at HK$2,701 in 2014.

Mainland Tourist Arrivals, 2009 – 2014



Source: Hong Kong Tourism Board.

The growth of same day visitors from Mainland China has increased the proliferation of brands in decentralised shopping malls. This has allowed Mainland shoppers to shift their shopping destinations to non-prime retail areas such as Kowloon East and the New Territories.

While Mainland tourists' shopping spending slowed in 2014 and "Occupy Central" dampened retail sentiment towards the end of 2014, the stable local economy provided a solid platform to sustain local retail spending in 2014. The competition from e-commerce to the physical retail market has so far been minimal as the bulk of local online purchases are still focused on low-cost items and products not easily accessible in the local market.

Government investment in transportation infrastructure has improved accessibility for locals and tourists alike. The upcoming transportation infrastructure plans and the expansion of the Hong Kong International Airport, as well as the addition of mass rapid transit lines will all increase the accessibility of non-prime areas. Tourism projects, like the cruise terminal at Kai Tak, will contribute to the growth of Hong Kong as a tourist destination in Asia.

The Hong Kong and China governments have adjusted the policy on one-year, multiple-entry Individual Visit Endorsements (IVS) to one visit per week for Shenzhen residents. This is aimed at regulating the number of Mainland Chinese visitors to alleviate the strain on Hong Kong's infrastructure.

2.2 Supply

Supply of large-scale shopping malls (gross floor area over 200,000 sq ft) remains limited, with only five malls opening between 2011 and 2013. Projects completed in 2014 are smaller-sized projects with a gross area of less than 150,000 sq ft. Most of these malls are positioned at the mid-to-high end and are located in non-prime retail locations in Kowloon (San Po Kong and Yau Tong) and the New Territories (Tseung Kwan O and Tuen Mun).

1 Source: Hong Kong Census and Statistics Department.
2 'Clothing, footwear and allied products' include wearing apparel, footwear and other clothing accessories (Hong Kong Census and Statistics Department).

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2.3 Rents and Cap Rates

Rents for shopping malls have increased by 6.4% in 2014, compared with 9.2% in 2013, with the uptrend continuing into the first quarter of 2015 with an increase of 1%[3].

Cap rates (taking private retail yields from the Rating and Valuation Department as a proxy) remained low at 2.4% in Q4/2014 and with interest rates expected to increase mildly this year and next, cap rates in the retail sector are expected to remain low in the near future.

2.4 Outlook

In the short term, the robust retail market in Hong Kong will be challenged by the revision of the policy on one-year multiple-entry IVS and the economic slowdown in China. The shift of preference of Mainland visitors towards mid-end products and away from luxury goods will force retail landlords to change their tenant mix to meet the new demand.

The rise of the non-prime shopping mall retail market, together with robust demand for retail space by international retailers and improving transportation, is expected to strengthen the suburban retail market. Limited supply in prime areas in the future will also benefit the non-prime areas.

Between 2015 and 2018, there are five large-scale retail malls in the pipeline. Most of the projects are located in non-prime locations in Kowloon (Nam Cheong) and the New Territories (Yuen Long, Tsuen Wan and Tung Chung) and are expected to position themselves as mid- to high-end projects. In Kowloon East, the Government has a long-term plan to transform the area into a second Central Business District ("CBD2"), alongside proposed retail and hotel developments.

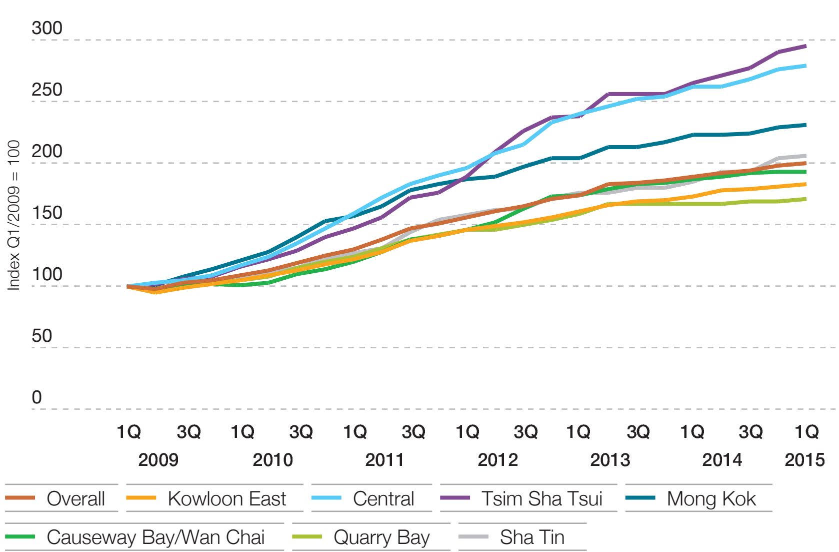
In the long term, the potential opening up of more cities in China eligible for IVS will boost the number of overnight visitors to Hong Kong, while the closer economic integration with China will benefit the local employment market helping to maintain a low unemployment rate and strong business sentiment and thus support further local spending.

The recent discussion of opening shopping malls at the border is aimed at redirecting day trippers and grey goods traders to these areas, thus alleviating the chaos created by them in suburban areas and in turn reducing tensions between locals and visitors. As the profile of tourists/shoppers to be attracted to these malls is different from those targeted by traditional shopping centres, we expect that such malls at the border will not generate direct competition to existing malls in Hong Kong.

The challenge for shopping centres in the longer term will be the penetration of e-commerce to a wider spectrum of goods and services, but as is evident from overseas experience, more online stores are now opening physical shops to provide a total shopping experience, and thus the threat of e-commerce replacing physical stores should be mitigated to some extent.

In short, Savills expects retail sales to remain broadly stable in 2015 and to rise gradually from 2016 to 2019, supported by sustained local retail spending and more spending by Mainland tourists on mid-tier shopping items. Shopping centre rents, in particular those in non-prime areas with less tourist-focus, should see a similar growth pattern over the next five years.

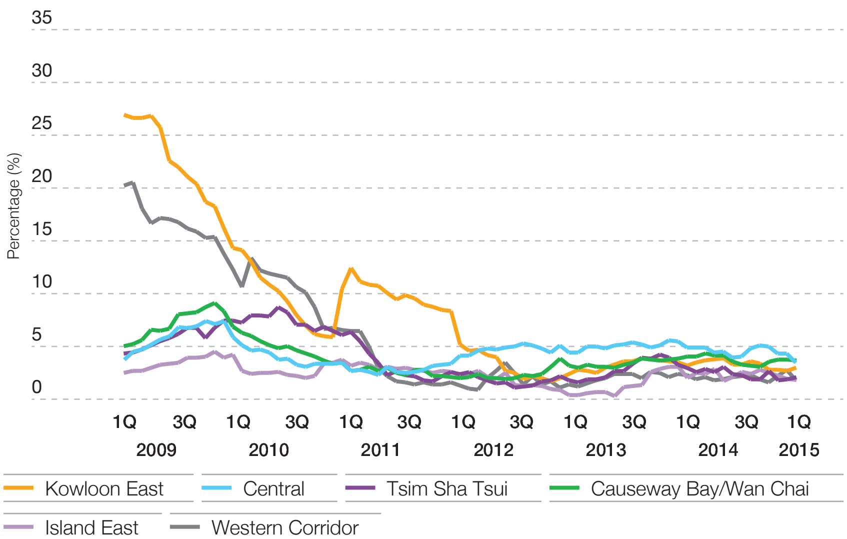
Hong Kong Shopping Centre Rental Index, Q1/2009 – Q1/2015



Source: Savills Research & Consultancy.

3 Provisional figures from Savills Research & Consultancy.

Hong Kong Office Vacancy by District, Q1/2009 – Q1/2015



Source: Savills Research & Consultancy.

> **In Kowloon East (where Festival Walk is located), demand was mainly driven by cost savings due to companies relocating from Hong Kong Island."**

3. HONG KONG OFFICE MARKET

Hong Kong is one of the key global financial centres, ranking third in the Global Financial Centres Index 17[4] after New York and London. Central is Hong Kong's administrative heart and Central Business District (CBD); Wanchai/Causeway Bay and Tsim Sha Tsui are the other two core locations. A notable trend in the office market witnessed over the past few years has been relocations to non-core areas, such as Quarry Bay, Kowloon East and Western Corridor, supported by significant rental differentials between core and non-core areas.

3.1 Demand

On the whole, Hong Kong's office vacancy rate declined slightly to 2.7% in March 2015, compared to 3.4% a year ago. Demand in core areas particularly Central, was driven by the gradual recovery of the financial sector; leasing transactions were mainly driven by the expansion of private banks and asset management firms. There was further activity in prime buildings in Central due to new leases being taken by small- to medium-sized Chinese financial corporations; all eyeing the recovering local stock market and the increasing business opportunities brought about by the Hong Kong-Shanghai Stock Connect.

In Kowloon East (where Festival Walk is located), demand was mainly driven by cost savings due to companies relocating from Hong Kong Island. The area has successfully attracted a diversified tenant profile, comprising various sectors including trading, logistics, insurance, information technology, retail and governmental departments. Some companies (who relocated a few years ago) are now expanding in Kowloon East after their first lease terms.

3.2 Supply

New Grade-A office supply in Hong Kong between 2015 to 2019 (refer to graph in page 48) stood at 9.2 million sq ft, or 1.8 million sq ft per annum. In terms of demand, take up from 2004 to 2013 was around 1.9 million sq ft, which is in line with the upcoming 1.8 million sq ft per annum of new supply. We also noted that much of the future stock will be strata-titled for sale, accounting for 37% or 3.4 million sq ft between 2015 to 2019.

Most of the new supply (around 85% from 2015 to 2019 or 7.8 million sq ft) will come on-stream outside the core business districts, with the largest supply to be released in the Kowloon East area, which will total 5.0 million sq ft over the next five years. This includes Mapletree Investments' Grade-A office development, which has a total GFA of 660,301 sq ft and is scheduled for completion in 2017.

[4] Z/Yen Group Limited and Qatar Financial Centre Authority, March 2015.

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3.3 Rents

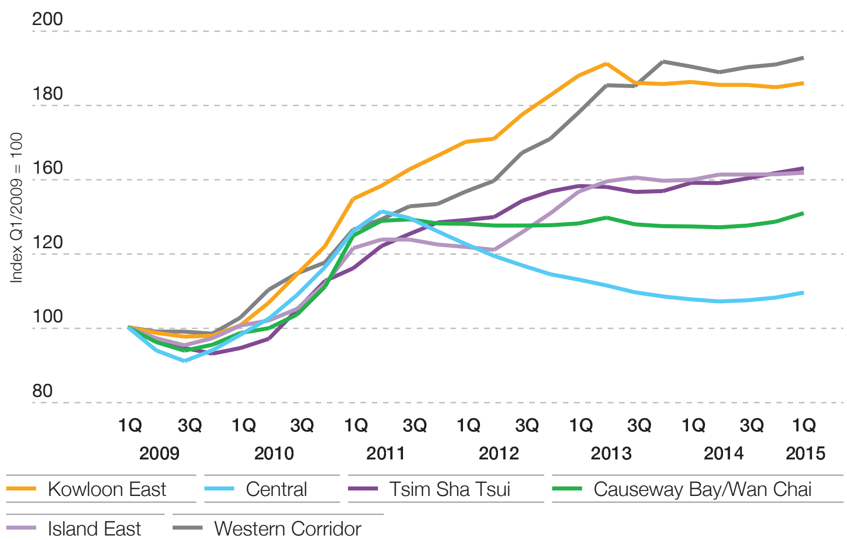
Grade-A office rents in Hong Kong enjoyed stable growth of 1.5% in 2014 and a further 1.2% increase in Q1/2015, supported by expansion demand in core areas and cost-saving relocation demand in non-core areas. At the end of Q1/2015, Grade-A office rents in Hong Kong averaged HK$59 per sq ft, net effective per month.

3.4 Outlook

Looking ahead, demand for office space in core areas is likely to recover, although expansion by multinational financial firms will remain sluggish. Demand from Chinese firms is expected to remain active; the growing cooperation between stock exchanges in Hong Kong and China looks likely to further boost demand from Mainland financial firms who wish to set up in Hong Kong. With increased demand for professional and financial services expected from Mainland Chinese firms due to the closer integration of the Hong Kong and Mainland China economies, these companies are expected to pursue expansion opportunities within the territory across all business districts. Office rents in Central are likely to bottom out this year while rents in other core areas are likely to gradually increase.

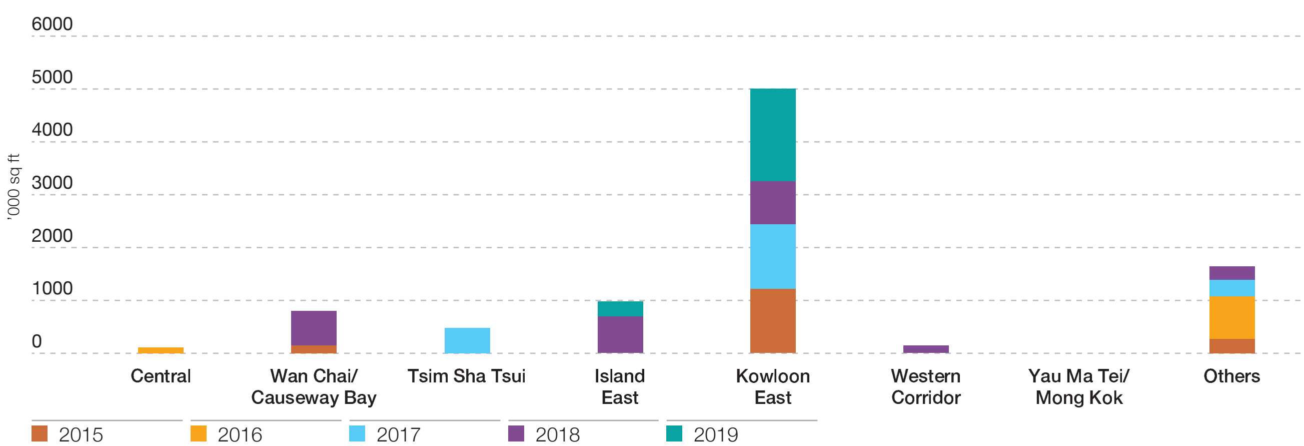
The Government initiatives for Kowloon East to become the CBD2 in Hong Kong will drive further interest from multinationals in that area. The new supply of high quality office space in Kowloon East will also attract multi-floor tenants who wish to save costs by relocating and consolidating in the area, as the large rental differentials between the area

Hong Kong Grade-A Office Rental Index, Q1/2009 – Q1/2015



Source: Savills Research & Consultancy.

Estimated Hong Kong Future Grade-A Office Supply, 2015 – 2019



Source: Buildings Department, Savills Research & Consultancy.

and core areas, as well as the availability of contiguous space would make such cost-saving consolidations feasible.

Substantial supply coming on-stream in Kowloon East will inevitably create some short term pressure on both occupancy and rental levels in the coming three years, but in the long-run, the potential clustering of high quality Grade-A offices should strengthen the area as it emerges as CBD2. Based on Savills estimates, over the long term, Kowloon East will surpass Central to account for 44% of the total Grade-A office stock in Hong Kong, upon the full development of Kai Tak and the substantial redevelopment of industrial buildings in the area into Grade-A offices.

Grade-A office market cap rates, proxy by market yields, are forecast to stay at a low level on the back of expected stable growth of prices and rents in the local office market in 2015. While any interest rate rise is expected to be mild over this year and next, we expect office cap rates to remain at fairly low levels over the next few years.

4. BEIJING OFFICE MARKET

4.1 Beijing's Economy

Beijing is the political and economic hub of China, and as a result is host to one of the most prosperous economies in the country. Historically, Beijing has maintained a GDP growth rate very similar to that of the China wide figure. A softening global economy has seen China's latest GDP figure achieve 7.4% growth in 2014 according to the National Statistics Bureau and is forecast to be 7.1% and 7.2% in 2015, by the World Bank and Asian Development Bank, respectively. The slower but more sustainable economic growth forecast is a reflection of the ongoing rebalancing and optimisation of the city's economic structure. The movement will be guided by the "One Belt, One Road" development strategy initiated by the Chinese government in 2013, which aims to give the government a larger say in global economic and political affairs, and support growth in key industries such as finance, information technology (IT) & high-tech and manufacturing.

While China has seen its economic growth rate soften since 2012 in the face of a weakening global economy, Beijing was still able to achieve a respectable GDP growth rate of 7.3% to RMB2,133 billion in 2014, according to the Beijing Municipal Statistics Bureau.

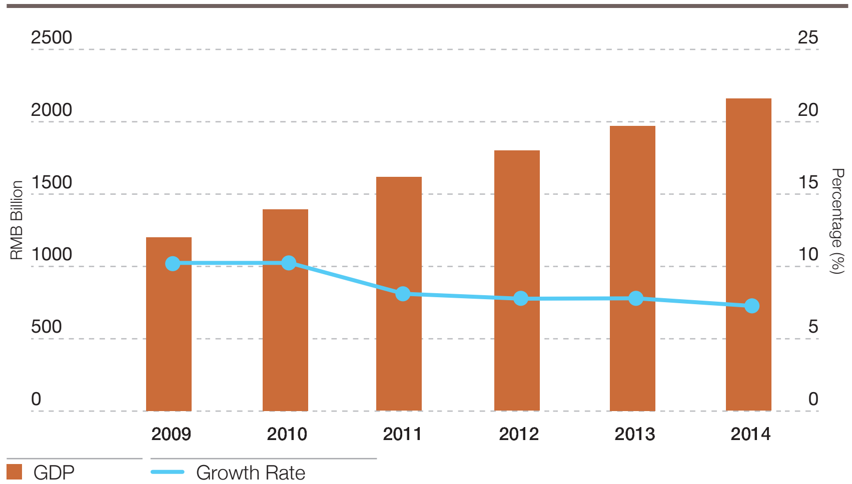
4.2 Office Market in Beijing

Beijing's office market is the largest and most expensive in Mainland China by the end of Q1/2015, with a total stock of 9.88 million sqm and average effective achievable rents of RMB320.7 per sqm per month. Beijing is also one of the tightest markets with a citywide vacancy rate of just 4.2% in Q1/2015.

Supply and Vacancy Rate

Supply continued to be limited from 2012 to 2014 (refer to graph in page 50), reaching only 269,000 sqm and accounting for 29% of the average between 2007 and 2009. However, demand began to slow down due to a slowing economy and limited leasable space in the city, resulting in a decrease in net take-up to 238,000 sqm in the period, though city-wide vacancy stabilised at 4.8% at the end of 2014 and still remains the lowest of any city in Mainland China. By the end of Q1/2015, the city-wide vacancy rate decreased by 0.6 ppts to 4.2% compared with 2014, due to positive pre-commitment rates in new projects and further absorption of vacant space in recently-launched projects. Beijing Financial Street witnessed the lowest vacancy rate of 2.0%, while other traditional business areas also recorded low vacancy rates ranging from 2.1% to 5.9% (refer to graph in page 51).

Beijing GDP and GDP Growth, 2009 – 2014



Source: Beijing Muncipal Statistics Bureau.

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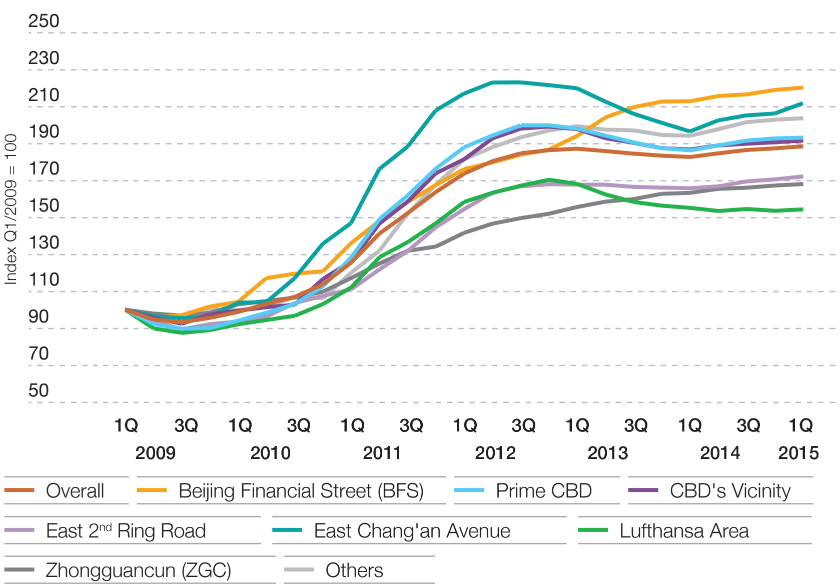
Rents

Beijing's real estate market has always operated differently from that of other cities. The majority of stock in Beijing is held by domestic developers, or has been purchased for self-use or strata title sale. A significant proportion of occupiers are large state-owned enterprises, regional financial institutions and national headquarters of companies in industries where it is important to have strong ties with the government. MNCs by contrast make up a relatively smaller proportion of total demand.

Beijing Office Rental Index, Q1/2009 – Q1/2015



Source: Savills Research.

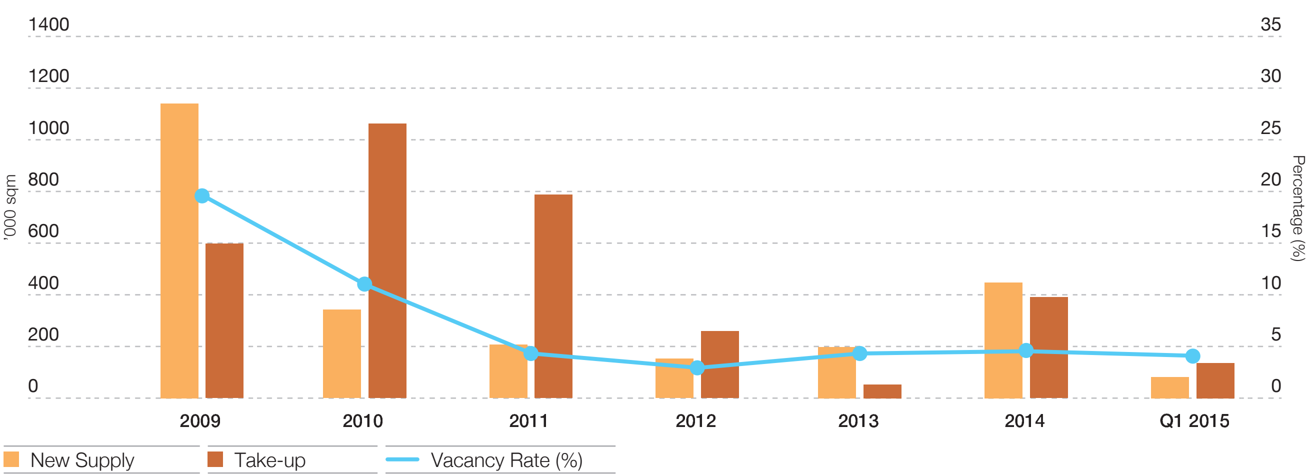
After the double-digit growth in early 2010s, rental growth began slowing in 2012, and rents decreased slightly by 1.6% in 2013. However, given an increasingly stable economy, coupled with growing confidence, demand increased and rents rebounded by 2.2% in 2014 and continued to grow by 0.6% to RMB320.7 per sqm per month by the end of Q1/2015. Beijing Financial Street and the CBD commanded the highest rents of RMB521.0 and RMB364.7 per sqm per month, respectively.

Demand Drivers

In the first quarter of 2015, financial, IT & high-tech, e-commerce and professional services companies continued to be the strongest demand drivers for Grade-A office space, taking up 73% of all the recorded transacted areas. In contrast, demand from manufacturing companies continued to decrease, accounting for just 4% of all recorded transactions (refer to pie chart in page 52).

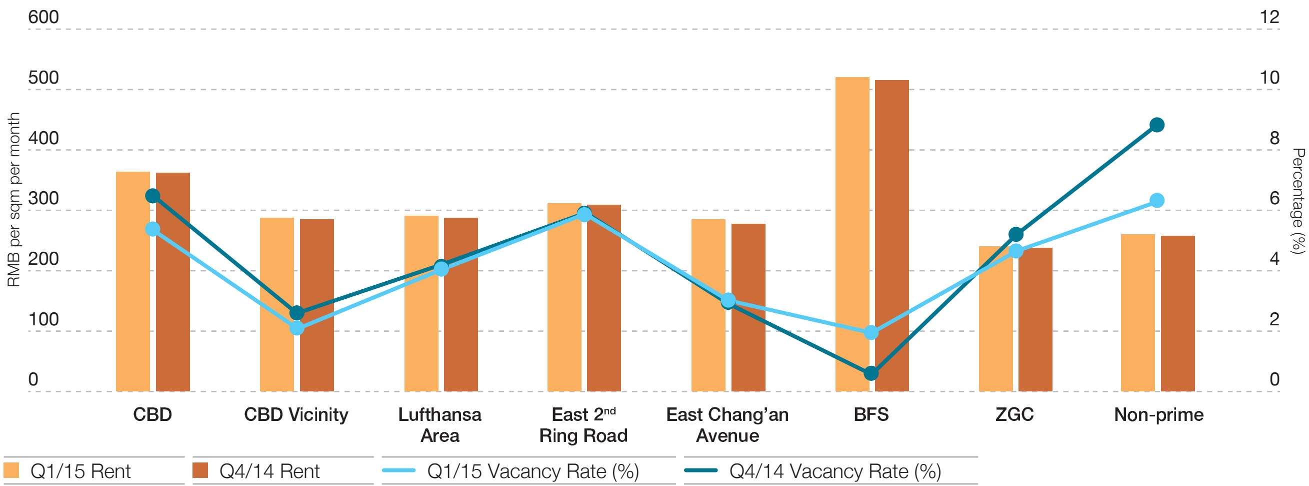
Domestic companies began to dominate demand from 2010, and continued to account for 75% of all the recorded transacted areas in Q1/2015.

Beijing Office Supply, Net Take-up and Vacancy Rates, 2009 – Q1/2015



Source: Savills Research.

Rents and Vacancy Rates of Beijing Office Submarkets, Q1/2015 vs Q4/2014



Source: Savills Research.

However, suffering from the slowing local economy, overseas companies took up just 25% of the total.

Lufthansa Area

The Lufthansa Area is one of Beijing's oldest and most well-known international commercial zones. As one of Beijing's first commercial hubs, Lufthansa is a mature location, with a current Grade-A office stock of 1.1 million sqm, accounting for approximately 11% of Beijing's stock.

Rising to prominence as a key commercial zone in the 1990s, the area has been traditionally a popular hub for European, and specifically German, companies. While many German companies still have a preference for the location, the area is now also heavily populated by Japanese and Korean firms. With a large commercial sector, there is relatively strong demand which has seen rents reach RMB291.3 per sqm at the end of Q1/2015. Meanwhile, steady demand from financial, professional services, IT & high-tech and industrial companies supported vacancy which stabilised at a low level of 4.0%.

With only 95,000 sqm added to the market over the preceding five years, new supply in Lufthansa Area is expected to remain limited over the next three years, with only three projects expected to enter the market, bringing an annual supply of just 76,000 sqm. Given that the area is a traditional business district with a mature business environment and is well supported by retail and hospitality sectors, Lufthansa rents are expected to remain stable over the next three years.

Business Parks

While office developments continue to be the major source of new supply, Tier-1 Chinese cities, particularly Beijing and Shanghai, have shown a growing interest in business parks in recent years. As outlined in the Government's 12th Five Year Plan, China's shift towards a more tertiary-industry based economy has seen an increase in government-backed business parks. Business parks are becoming an increasingly viable option for many companies, with demand being backed by the development of supporting facilities, improving infrastructure, relaxed polices, taxation incentives and favourable rentals. Rental differentials are a significant draw card, with business parks averaging between RMB3.0 to RMB5.0 per sqm per day, where prime office and non-prime office command RMB9.0 to RMB11.5 and RMB6.5 to RMB8.5 per sqm per day respectively.

Demand is being driven by both domestic and foreign businesses, where key emerging industries such as high-tech, IT and environmental protection are the main drivers. Mature business parks in Beijing include Z-Park and Shangdi Information Industrial Park near ZGC area, Fengtai Technology Park & Advanced Business Park and Beijing Development Area in Southern City area, and Beijing Electronic Zone in the Wangjing area. Primary business parks in Shanghai include Caohejing Hi-Tech Park, Zhangjiang Hi-Tech Zone, Jinqiao Business Park and Hongqiao Linkong Business Park.

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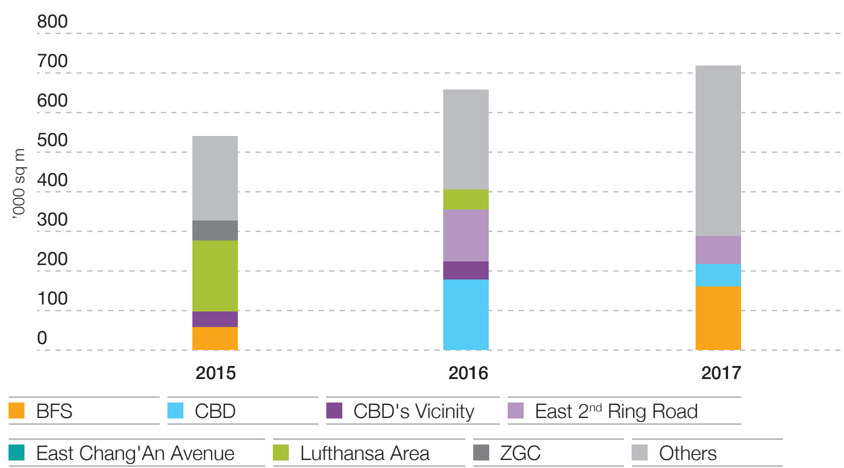
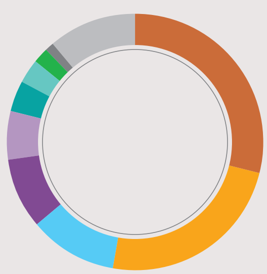
> **New supply in Lufthansa Area (where Gateway Plaza is located) is expected to remain limited over the next three years.”**

Future Beijing Office Supply by Submarket, 2015 – 2017



Source: Savills Research.

Demand Drivers (Transacted Floor Area) by Industry, Q1/2015



Finance	29%
IT & High-tech	24%
E-commerce	11%
Professional Services	9%
Media & Cultural	6%
Manufacturing	4%
Energy	3%
Conglomerate	2%
Pharmaceutical & Bio-tech	1%
Others	11%

An increasing trend for MNCs to expand their operations away from the city centre for cost savings and the ability to have customised developments such as built-to-suit, will continue to fuel the demand for business parks. While rental discounts of 50% over Grade A office space provide a strong incentive, increasing demand and improvements in building quality will see a gradual rise in rents.

Outlook

The Beijing Grade-A office market is expected to see growing supply, averaging 639,000 sqm per annum between 2015 and 2017, more than double the average supply over the past five years, but still 30% lower than the supply peak between 2007 and 2009.

As a result of elevated levels of new supply, city-wide vacancy rates are likely to increase to 7% to 9% over the coming three years, despite the fact that demand is predicted to remain stable. Meanwhile, landlords will be forced to offer rental discounts due to increased competition. Grade-A office rents are expected to decline marginally by 0% to 2% per annum between 2015 and 2017, and are anticipated to hover around RMB300 to RMB320 per sqm per month. Given that limited investment stock is expected to support capital values, Grade-A office gross yields are expected to compress further to 5.0% to 5.5% in the next three years.

Given nearly half of the new supply will be located in non-prime markets such as Wangjing and the Asia-Olympic areas, the traditional business areas such as CBD and vicinity, Lufthansa, BFS and ZGC are expected to remain stable in terms of vacancy rates and rents. On the other hand, relatively limited availability of supply in core business areas will further fuel the decentralisation trend, though non-prime markets are expected to witness decreases in both rents and occupancy rates in the short term.

5.0 BRIEF OVERVIEW OF OFFICE AND RETAIL MARKETS IN OTHER KEY CHINESE CITIES[5]

Below is a brief introduction to the office and retail markets of key Chinese cities in 2014 as well as an outlook for 2015.

City	Office Market[6]	Retail Market[6]
First Tier Cities		
Shanghai	- Grade-A office rents up 1.8% year-on-year ("yoy")[7] due to availability of high-quality projects - Vacancy rate up slightly due to more supply in Pudong area - Rents expected to decrease in 2015 due to new supply and further decentralisation	- Prime rents up 0.1% yoy - New supply of 782,900 sqm in 2014 and another 1.1 million sqm in 2015 - New projects likely to offer more incentives to retailers
Guangzhou	- Concerns on future supply led to 1.7% yoy drop in overall rents - Rental discounts expected to continue in 2015	- Rent up 0.4% yoy as projects in key areas continue to attract stable footfall - Expected 503,000 sqm of new space in 2015, 87% from emerging areas
Shenzhen	- Rent increase of 14.2% yoy due to strong demand from financial, professional and logistics sectors - Vacancy rate at 8.3% - Qianhai and Houhai are new growth areas	- Prime rents grew 6.0% - More supply in key decentralised areas
Other Key Cities		
Chengdu	- Office rents down 7.2% yoy - Oversupply with overall vacancy rate around 30%	- Prime rents up 10.0% yoy but expected to slow in 2015 - Diverse market with high-profile projects launched
Chongqing	- State-owned enterprises (SOEs) and end-users play major role in demand - New supply of around 300,000 sqm - Vacancy rate at 35.4%, one of the highest in China	- Average rents up 2.0% yoy but expected to slow in 2015 - 919,000 sqm of new space with 80% in non-prime locations
Foshan	- Stable demand from manufacturing industry and back-end offices that are benefiting from spill-over effect from Guangzhou and cheaper costs - Future supply from traditional CBD and emerging areas	- Local projects face challenge from new projects by reputable developers - Around 800,000 sqm of new space from 2015 to 2016 expected
Hangzhou	- Prime rents up 7.4% and non-prime down 2.5% - Vacancy rate fell significantly as landlords of non-prime projects lower rents - Substantial new supply expected to increase vacancy rates and soften rents in 2015	- Better performance from non-prime shopping malls while prime areas face fierce competition and e-commerce threat - Likely delay of several retail projects from 2015 to 2016
Nanjing	- Rents grew 11.2% to RMB4.71 per sqm per day despite increasing supply - Vacancy rate at 11.3% - Xinjiekou as prime area but future developments will focus in emerging Hexi CBD	- Shopping mall rents grew 9.3% due to limited supply - Prime areas enjoy highest rents - 75% of new 2015 supply from non-prime areas

5 Refer to Savills website http://en.savills.com.cn/research/office.aspx.
6 All figures are for year 2014 unless otherwise stated.
7 "Year-on-year" compares 2014 against 2013 unless otherwise stated.

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City	Office Market	Retail Market
Suzhou	- Grade-A office rents grew due to active demand especially in Suzhou Industrial Park ("SIP"); future developments will be focused in East SIP - Vacancy rate may rise due to large new supply	- Highest rents expected in Guanqian area and slight increase in SIP CBD - Strong online retail sales year-on-year
Tianjin	- Stable rents - Moderate growth in demand - Vacancy rate under 30% and expected to increase with new supply	- Growing retailer presence in 2014 due to increasing disposable incomes - Rents in emerging areas likely to fall in 2015 while rents in core areas remain stable - Shopping malls become mainstream
Wuhan	- Average rents increased moderately - Demand mainly from domestic companies in finance, insurance and professional services sectors - Supply glut in 2014; 200,000 sqm added	- Rents soften due to e-commerce and new malls in prime locations - Lower occupancy rates for less experienced developers while higher rents for prime projects with improved tenant mix - Retail market expands to decentralised areas
Xi'an	- Rents unchanged due to slowing economy and weak investment sentiment - Stable demand for Grade-A office market - South City area likely to record mild rental growth and higher occupancy rates - Substantial supply in non-prime areas	- Debut of more retail operators and retailers after renovations of prime department stores

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For and on behalf of
Savills (Hong Kong) Limited

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