Advance

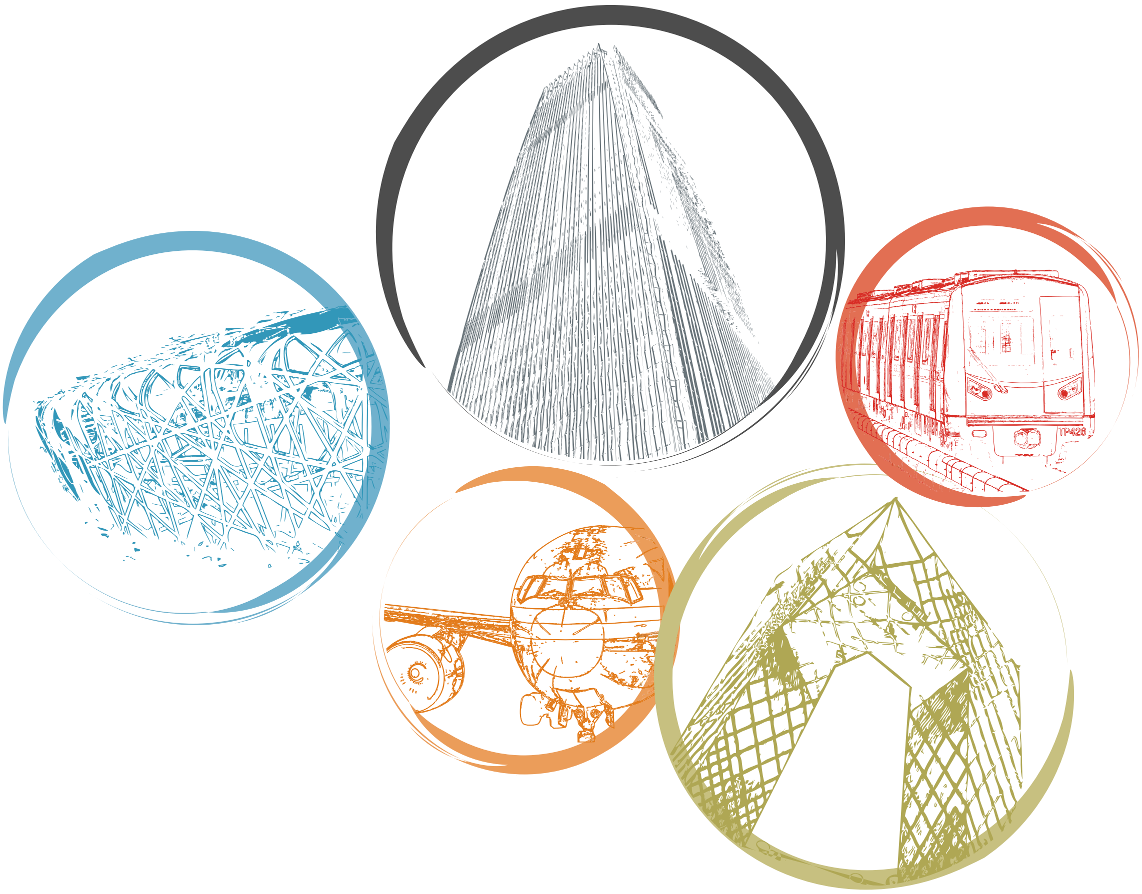
Research Report

August 2013

Real value in a changing world

Five years after the Olympics

– Growth in Beijing has continued, what to expect next?



Executive Summary

It has been five years since the Beijing Olympics. The capital city of China has continued to develop its economy and expand its commercial real estate footprint, leveraging extensively on its improved infrastructure that has been constructed over the last decade.

There are studies predicting that Beijing will eventually become one of the largest city economies in the world. The goal of the Chinese central government to turn Shanghai into a global financial centre by 2020 will also require other major Chinese cities to deregulate their financial and related services industries; the process of which will yield significant workspace demand growth. As the capital city, Beijing will definitely follow that route and will likely remain as a preferred office location for enterprises.

A closer look into Beijing's commercial workspace sectors however; highlights a prevailing low vacancy environment and the need to build new satellite townships that can accommodate a larger workspace stock to support long-term economic growth for the capital city.

The government has a blueprint to facilitate such a development strategy for Beijing and it will also serve as a key driver of economic and real estate sector growth for the city in the next one to two decades. The future growth of Beijing will mainly be driven by:

- An expansion of the city's office stock in and around the established core commercial districts;
- Development of new satellite townships in fringe locations to extend the footprint of the city core; and
- Ongoing improvement in infrastructure to accommodate population and commercial activity growth.

As the world turned its attention to Beijing in the lead up to the Olympic Games in 2008, the capital city of China dedicated unprecedented resources to preparing for the event, including the construction of world-class stadiums and other sports venues, building highways and extending its subway system. These initiatives attracted massive investments and created a huge ripple effect on the economic growth of both Beijing and China.

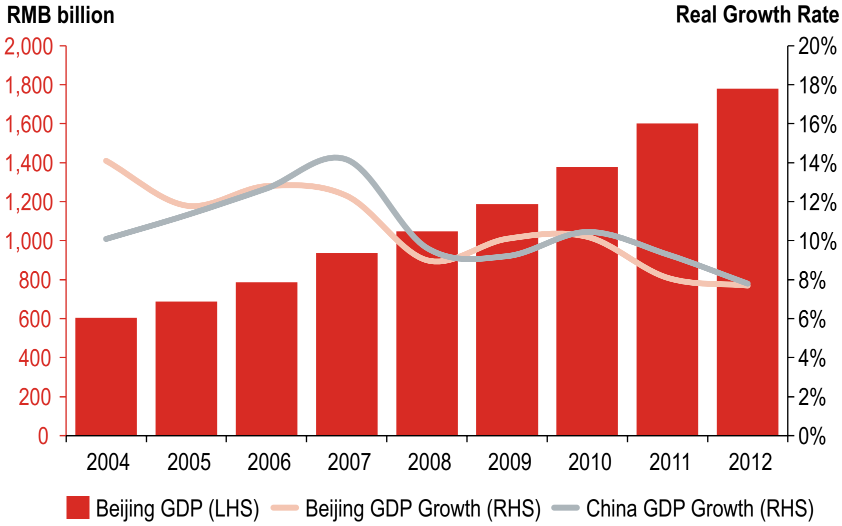
It has been five years since the Beijing Olympics and if there has been a 'post-Olympics' effect for Beijing, it was a rather positive one. Following on from the pre-Olympic facelift to the city's living and business environment, Beijing has continued to experience tremendous growth although various nationwide economic issues and more importantly a spill-over effect stemming from the deterioration in the external economic environment, contributed to a slowdown in momentum recently. The city continues constructing world-class infrastructure networks and commercial real estate offerings, paving the way for its transformation into one of the world's largest city economies.

Many are aware of the rapid growth of the Chinese economy over the past five years and Beijing has been a significant driver of that growth. In 2012, Beijing recorded a GDP of RMB 1,780 billion making it the second largest city-level economy in China. Growth of the capital's economy has largely mirrored that of the nation over the past five years with Beijing posting average annual growth of 9.1%. (see Figure 1).

Home to the World's Largest Enterprises and Wealthy Chinese Individuals

The strong growth that China has experienced domestically in recent years and the rising presence of 'Made in China' products in the world, contributed to the increasing number of Chinese enterprises ranked on the Global Fortune 500 list (the List). In 2007, there were only 29 pan-Chinese companies on the List but this number sharply increased to 89 at the end of 2012, most of which are state-owned enterprises (SOEs). Close proximity to the Chinese Central Government and other regulatory bodies has made Beijing a strategic choice in which to locate for these top global Chinese enterprises. At least 81 of these top Chinese enterprises on the List have offices in Beijing and 48 of them also bear their headquarters functions (see Figure 2). This makes Beijing the city with the most headquarters on the List, just ahead of Tokyo. All 29 pan-Chinese firms on the List in 2007 had offices in Beijing. Indeed, having a Beijing address is not exclusive to the SOEs; many of the foreign firms on the List also have a presence in the capital city of China. If accounting for all companies on the List, at least 345 of them have a China office, with a minimum of 123 of them chose to have their Chinese headquarters in Beijing.

Figure 1. Beijing GDP, Real GDP Growth Rates for Beijing and China

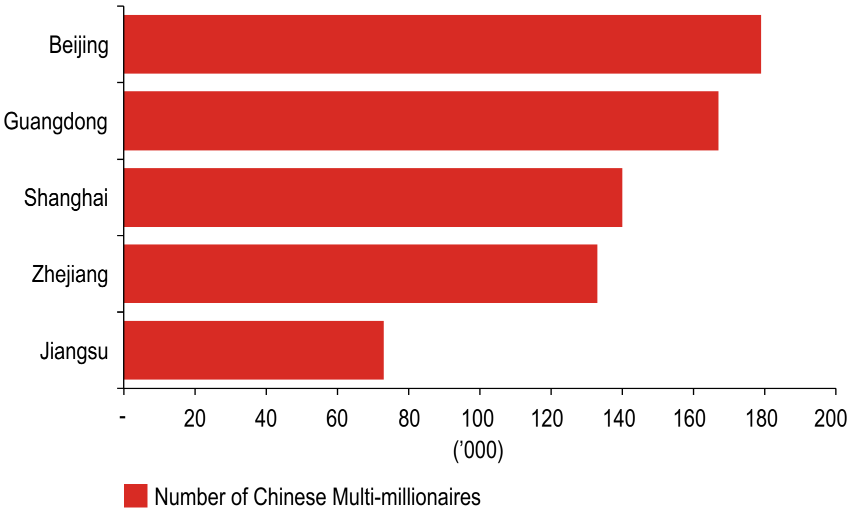


Source: National Bureau of Statistics of China

Figure 2. Cities with the Most Fortune Global 500 Companies by Headquarters Location

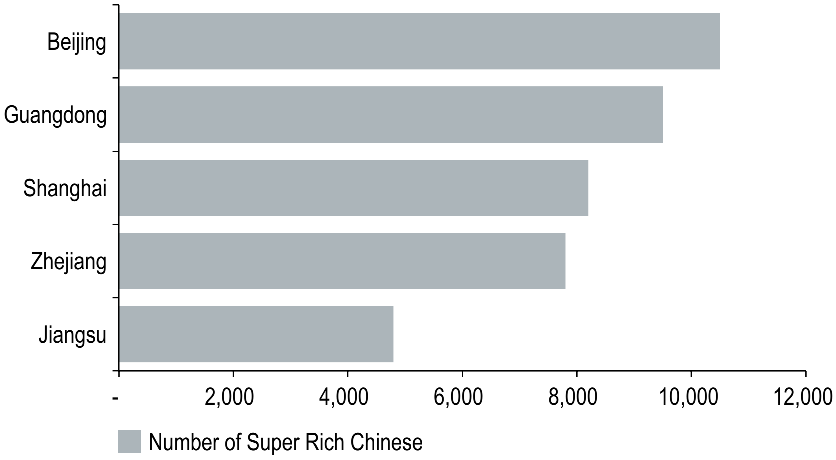
Source: Fortune Magazine

Figure 3. Top Five Chinese Prefectures where Chinese Multi-millionaires Reside



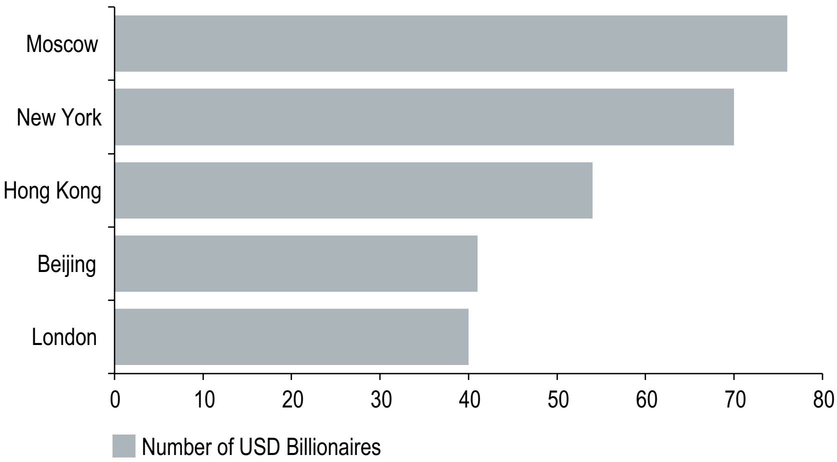
Source: The Chinese Millionaire Wealth Report 2012

Figure 4. Top Five Chinese Prefectures where Chinese 'Super Rich' Reside



Source: The Chinese Millionaire Wealth Report 2012

Figure 5. Top Five Global Cities where USD Billionaires Reside



Source: Hurun Global Rich List

A strong presence of top enterprises and company headquarters suggests a fast accumulation of high-income executives and high net-worth individuals in Beijing. According to The Chinese Millionaire Wealth Report 2012, 17.5%, or about 179,000, of the identified multi-millionaires in China with total assets of over RMB 10 million live in Beijing, the most for any city in China. The same story applies to what the report defines as 'super-rich' individuals with total assets of over RMB 100 million. There were some 10,500 'super-rich' individuals in Beijing, accounting for 16.5% of China's total. The addition of 36,000 people to Beijing's multimillionaire population between 2009 and 2012, as compared with 24,000 in Shanghai and 30,000 in all of Guangdong Province, also highlights Beijing's prosperity in recent years. If we extend the comparison to cover billionaires (in USD) across other world cities, Beijing (41) ranks in the top five behind Moscow (76), New York (70), Hong Kong (54) and ahead of London (40) (see Figure 3, 4 and 5).

This group of wealthy individuals, although meaningful in quantum, is still a minority in Beijing's total population. In the lead up to the Olympics, there was a spike in the city's population from about 15 million in 2004 to close to 18 million in 2008. A big portion of this population growth was associated with the accelerating trend of non-Beijing hukou[1] permanent residents over the period. As Beijing is now a more costly city to live in and the career prospects in many Tier 2 cities have continued to improve, growth of the migrant worker population has slowed in recent years.

Today, Beijing has a total population of 20.7 million, the third most populous city in China after Chongqing and Shanghai. Over 17 million people live in the city's urban areas. The sheer size of Beijing's population, which is also backed by a hefty pool of wealthy individuals, has bolstered the largest retail market in China, a trend which began when Beijing eclipsed Shanghai for the first time in 2008. In 2012, total retail sales of consumer goods in Beijing totalled RMB 770 billion, 4.3%

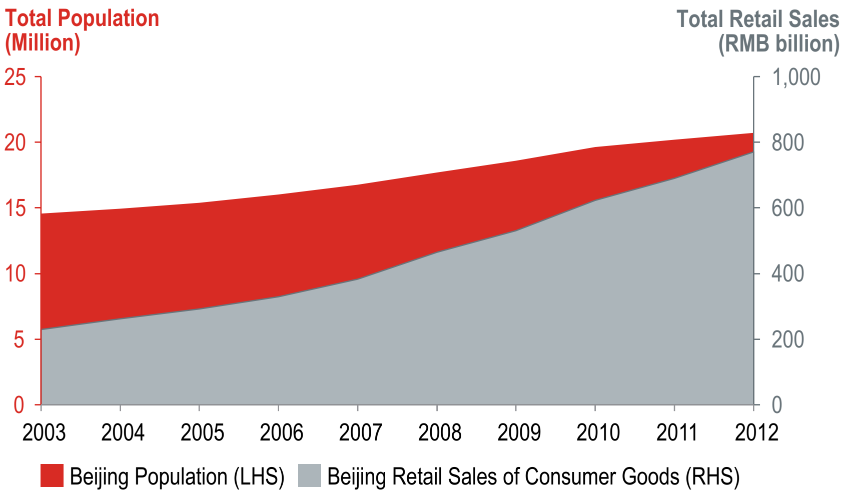
1. A hukou is a required household registration which identifies a Chinese citizen as belonging to a particular city or region in China.

higher than Shanghai's RMB 738 billion and 28.9% higher than Guangzhou's RMB 598 billion, which came second and third in the national ranking, respectively (see Figure 6 and 7).

Sophisticated Infrastructure to Support Growth in Urbanization

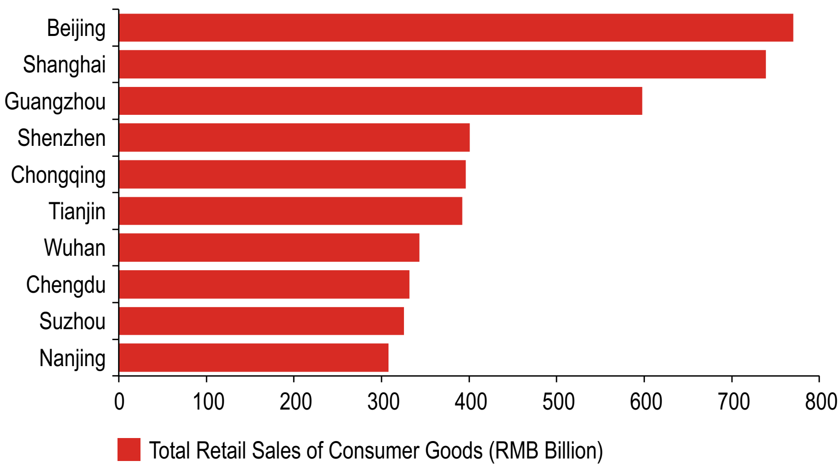
A very logical consequence of experiencing such a massive population growth is the potential stretch of the city's infrastructure to capacity. As such, Beijing has been investing heavily in expanding its subway system since the earlier part of the last decade, to cater to the growth in population and tourist arrivals before, during and after the Olympics. The last decade saw the subway track in Beijing quadruple in length to reach the current 456 km, making it one of the longest for a single city in the world. Indeed, over half of this track length (about 280 km) was only opened after the Olympics, highlighting the government's continuous efforts in improving the intra-city connectivity of Beijing and to also facilitate sustainable development of decentralised areas. The plan does not stop here but rather the city will continue to see its subway track length extend to over 660 km in 2016, broadening its footprint to cover an estimated area of about 1,100 sq km. Current expansion plans indicate the subway network has the potential to reach 1,000 km in length by 2020.

Figure 6. Beijing Population and Retail Sales of Consumer Goods



Source: Beijing Municipal Bureau of Statistics

Figure 7. Top 10 Largest Retail Markets in China, 2012



Source: National Bureau of Statistics

In view of the growing population, mounting road congestion and the thinning land suitable for commercial development, Beijing has been pushing for 'decentralisation' and this stands in contrast to many of the Tier 2 cities where local governments are paying great efforts to craft CBDs of their own. The aim is to build a sustainable land bank to accommodate the growing economy or else real estate and infrastructure limitations will cap the city's long-term growth potential.

The Beijing Subway

It only took Beijing slightly over 40 years to build its subway system to the current stage from scratch. At present, the subway has a passenger capacity of about 8.7 million passengers per day but this will be expanded to over 10 million by the end of 2016, making it one of the most travelled subway systems in the world alongside the sophisticated networks in Tokyo, Seoul and Moscow.

A decade ago, each kilometre of subway track served some 100,000 urban residents in Beijing and by the time of the Olympics this number had declined to about 75,000. Further growth in recent years pulled the ratio down to an estimated 40,000 urban residents by the end of 2012. The existing subway system, however, is still insufficient to adequately alleviate the chronic road traffic congestion and air pollution problems in Beijing. Thus, another 250+ km of track is currently under construction, and total track length is expected to reach close to 700 km by the end of 2016 and according to plans, it may further extend to 1,000 km in 2020. An extra one million residents are likely to have regular access to the Beijing subway in the next three years, and the expansion is expected to be a catalyst for the further development of decentralised areas.

The subway network now forms an integral part of the city's infrastructure, and it is expected that by 2016, 90% of the area within the Fourth Ring Road will be no more than 15 minutes from a subway station on foot. By 2020 that figure is expected to reach 95%. Today, it consists of a total of 269 stations, extending to the Changping District in the North via the Changping Line and Line 5; the Shunyi district in the Northeast via Line 15; the Tongzhou District in the East via the Batong line; the Yizhuang area in the Southeast via the Yizhuang Line; the Daxing area in the South via Line 4; the Fangshan area in the Southwest via the Fangshan Line; the Pingguoyang and Yongdinghe areas in the West via Lines 1 and 14; and Haidian Distict in the Northwest via Line 4.

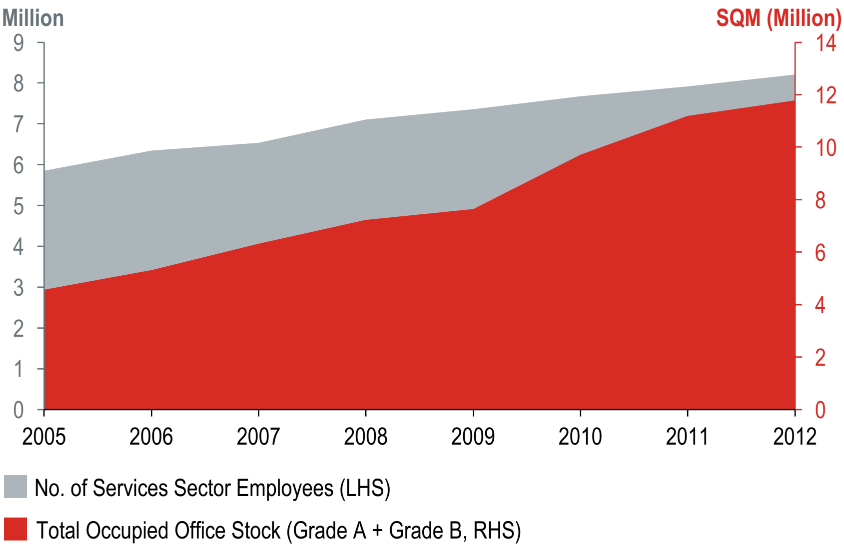
Line 8 North is scheduled for completion in 2H13 and will connect Zhuxinzhuang with the rest of the existing network. By the end of 2014, Line 6 will be extended to the Dongxiaoying area in Tongzhou.

Map 1. Existing and Planned Beijing Subway Lines (as at June 2013)

Source: Jones Lang LaSalle

A Need for Decentralisation and Workspace Growth

Figure 8. Growth of Occupied Office Stock and Services Sector Employees in Beijing



Source: Beijing Municipal Bureau of Statistics, Jones Lang LaSalle estimates

While companies from different sectors have occupied commercial workspace (refers to office buildings and business parks in this context), historically the services sector is the most important driver of demand. Indeed we have seen strong growth in the number of services sector employees, rising from some 6.5 million in 2007 to an estimated 8.2 million in 2012, representing a Compound Annual Growth Rate (CAGR) of 4.6%. This is one of the reasons behind the strong office demand in Beijing in recent years (see Figure 8).

In a statement made by former Prime Minister Wen Jiabao, "…fostering growth in the services sector is the main direction for China's economic transformation and restructuring…", the importance of the services sector as a driver for China's future economic growth was highlighted. The government's agenda to push for opening up competition in China's services sector suggests that there are boundless growth opportunities for new and upgrading demand for the country's commercial workspace. As the capital city, Beijing will likely remain as a preferred option for enterprises and therefore a need exists for the city to build a land bank to facilitate future growth.

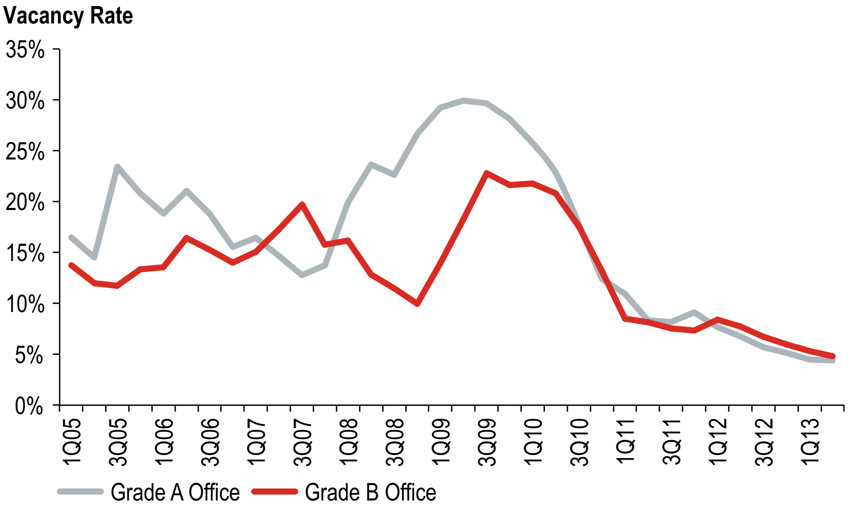
Self-use Space as Key Demand and Supply Drivers for Beijing

In spite of a strong growth in the city's office stock over the last five years (total Grade A and Grade B office stock has grown from 7.4 million sqm at end-2007 to 12.5 mil sqm at end-2012), Beijing has been running on very tight office vacancy rates in recent years, due mainly to strong occupier demand and relatively thin new stock for lease. Although once nearly 30% in 2009, overall vacancy for Grade A space slid to a single-digit level by mid-2011 before arriving at the most recent 4.4% (see Figure 9). A total of 2.2 million sqm of Grade A office space was completed after the Olympics (i.e., between 2009 and 2012) but only half of this was for lease in the private market; the rest being self-use office space purpose-built for SOEs (see Figure 10).

Indeed, SOEs (and other local enterprises) have become an increasingly important source of office demand in Beijing. In the same four years between 2009 and 2012, about 35% of the 2.9 mil sqm of total Grade A office net take-up can be traced to self-use space for SOEs. The growing scale of SOEs and their increasing influence in both the domestic and global economies leads us to believe that they will continue to play a vital role in the Beijing office market (see Figure 11).

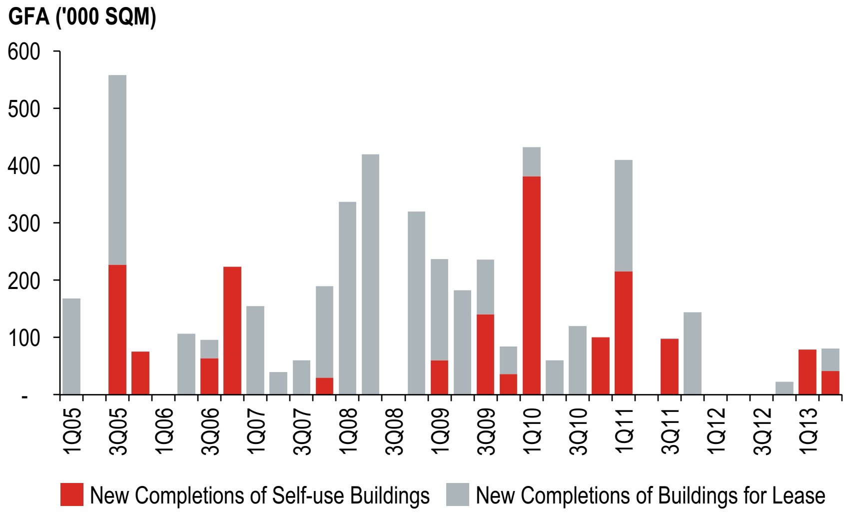
The high proportion of owner-occupied buildings has also kept en bloc investment stock at a thin level, and this has contributed to a relatively low investment sales volume in Beijing. In the five years to end-2012, only 61 sales transactions of office buildings and business parks with a total consideration of at least USD 5 million were recorded in Beijing, compared with 107 transactions in Shanghai. There is never a lack of investment interest in the Beijing market and Jones Lang LaSalle has seen institutional investors competing for exposure to the commercial real estate market in the capital city.

Figure 9. Beijing Office Vacancy Rates



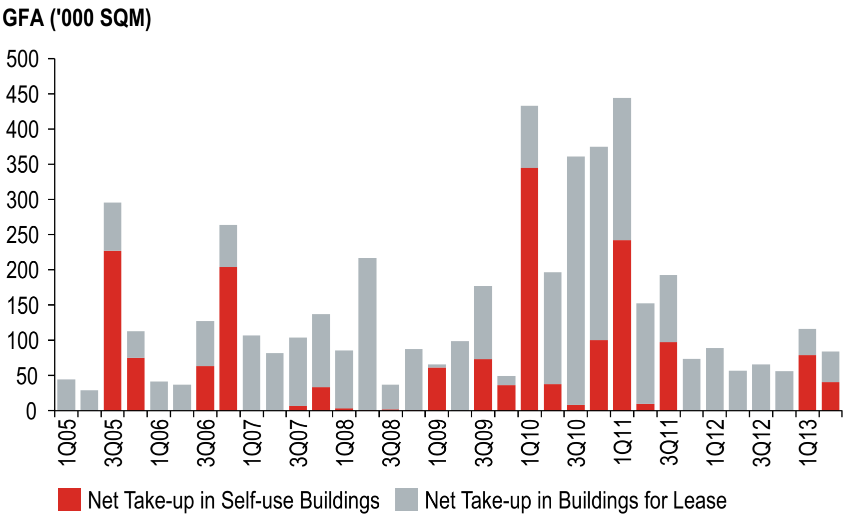
Source: Jones Lang LaSalle

Figure 10. Grade A Office Completions in Beijing



Source: Jones Lang LaSalle

Figure 11. Grade A Office Net Take-up in Beijing



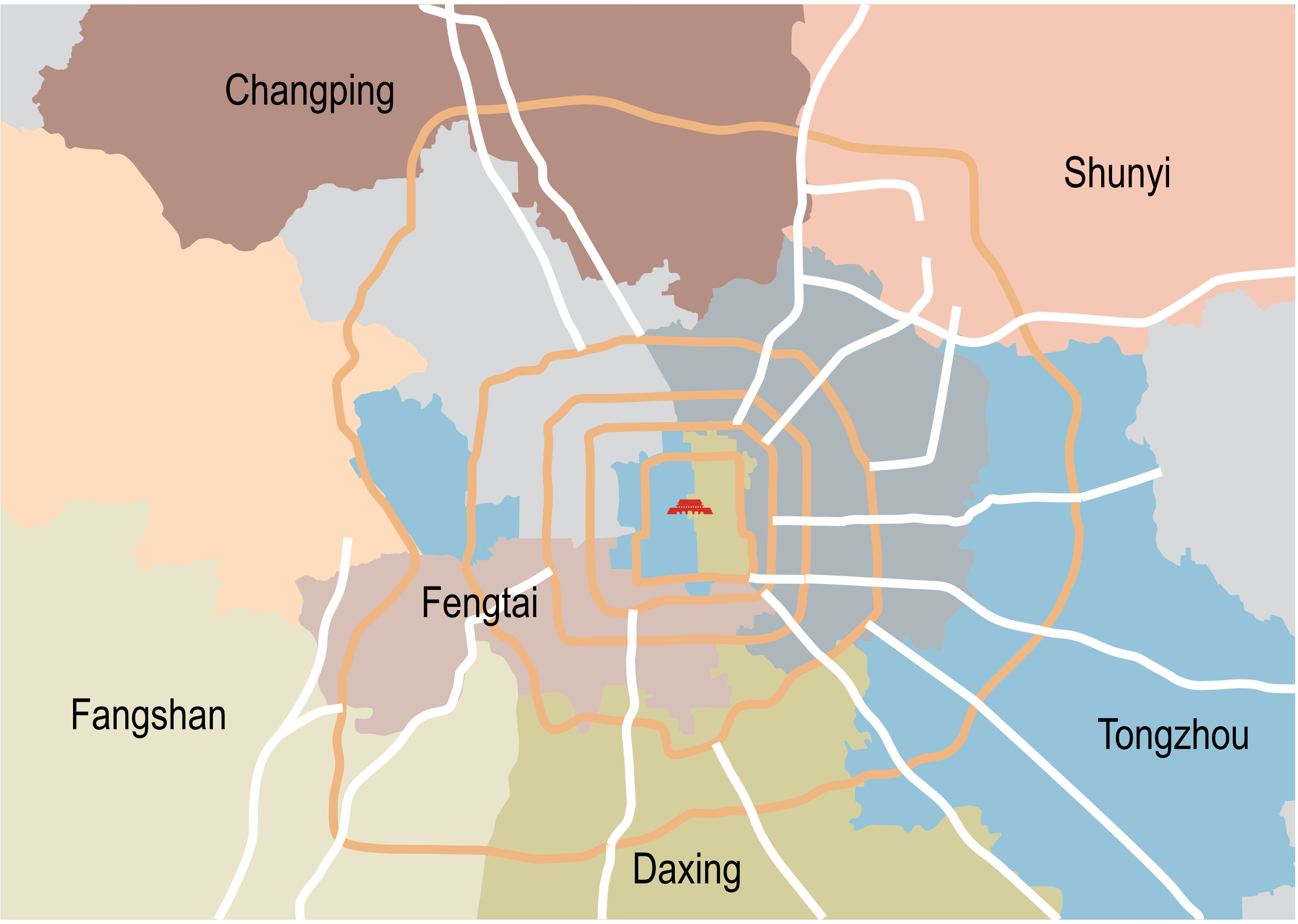
Source: Jones Lang LaSalle

Decentralisation as a Way Out

The need for extra commercial workspace is apparent but a maturing city such as Beijing must ponder the scarcity of developable land in and around the existing core locations. There will be an expansion of the current CBD to the east of the China World complex but this will only comprise about 2.4 mil sqm total GFA, a large portion of which is also expected to be owner occupied. Although there is a long-term plan to extend the CBD to the Fourth Ring Road, it is potentially insufficient to build a more sustainable long-term commercial land bank for Beijing!

A way out is to expand the geographical boundaries and develop more satellite townships for Beijing. There are plans for different new and emerging areas, from the Olympic Area and Changping in the North, to Wangjing and Shunyi in the Northeast, Tongzhou in the East and Lize, Daxing, Yizhuang, Fengtai and Fangshan in the South. These are township developments and will involve different types of land usages. They will either form an extension to what has been developing in recent years (such as Wangjing and the Olympic Area) or be created as completely new clusters (such as Lize and the southern suburbs).

Map 2. Key New Development Areas in Beijing



Source: Jones Lang LaSalle

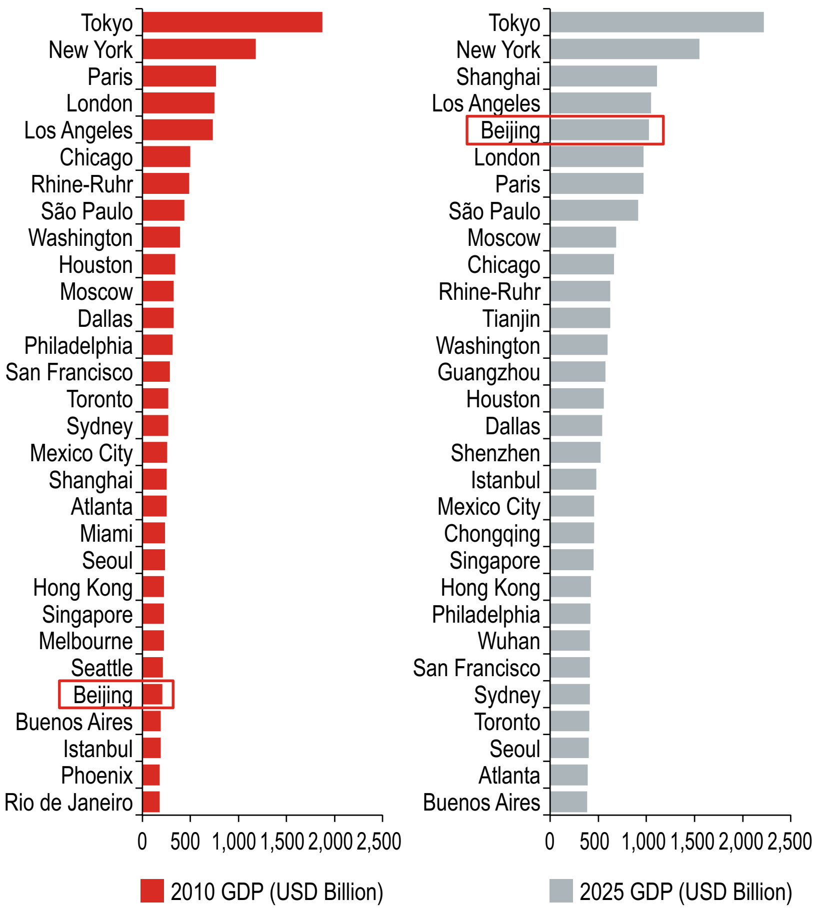
It is not our plan to give micro details for each of these new development areas in this paper, but they combine to broadly encompass a total development land area of over 500 sq km. These places will yield much of the city's future commercial and residential land bank for the coming decades, providing a platform to facilitate sustainable growth opportunities for different industries in Beijing. Their paths to maturity will also make significant contributions to the city's fixed asset investment growth.

Getting Prepared to Accomodate a Larger Economy

In a nutshell, Beijing is a mega city on its own and while the historical supply of commercial real estate was constructed surrounding the city core within the Fourth Ring Road, future development momentum will primarily gather in peripheral locations. The new shape of Beijing will not be formed overnight and by the time of delivery of the expanded commercial core, China and correspondingly Beijing will already have much bigger economies than today and will have a larger appetite for commercial workspace and relevant amenities.

According to a report by Foreign Policy, leveraging on statistics from McKinsey Global Institute (MGI) in 2011, Beijing had the 26th largest city-level economy, just behind Seattle and Melbourne. However, with an estimated USD 821 billion increase in nominal GDP (representing a 400+% growth from 2010 in USD terms), Beijing is expected to eventually become the world's fifth largest city economy in 2025 (see Figure 12). Moreover, while Shanghai will also be ranked one of the top five largest city economies, Beijing is the only current Tier 1 Chinese city that is listed among their top ten fastest growing economies in the world.

Figure 12. World's Largest City Economies in 2010 and 2025

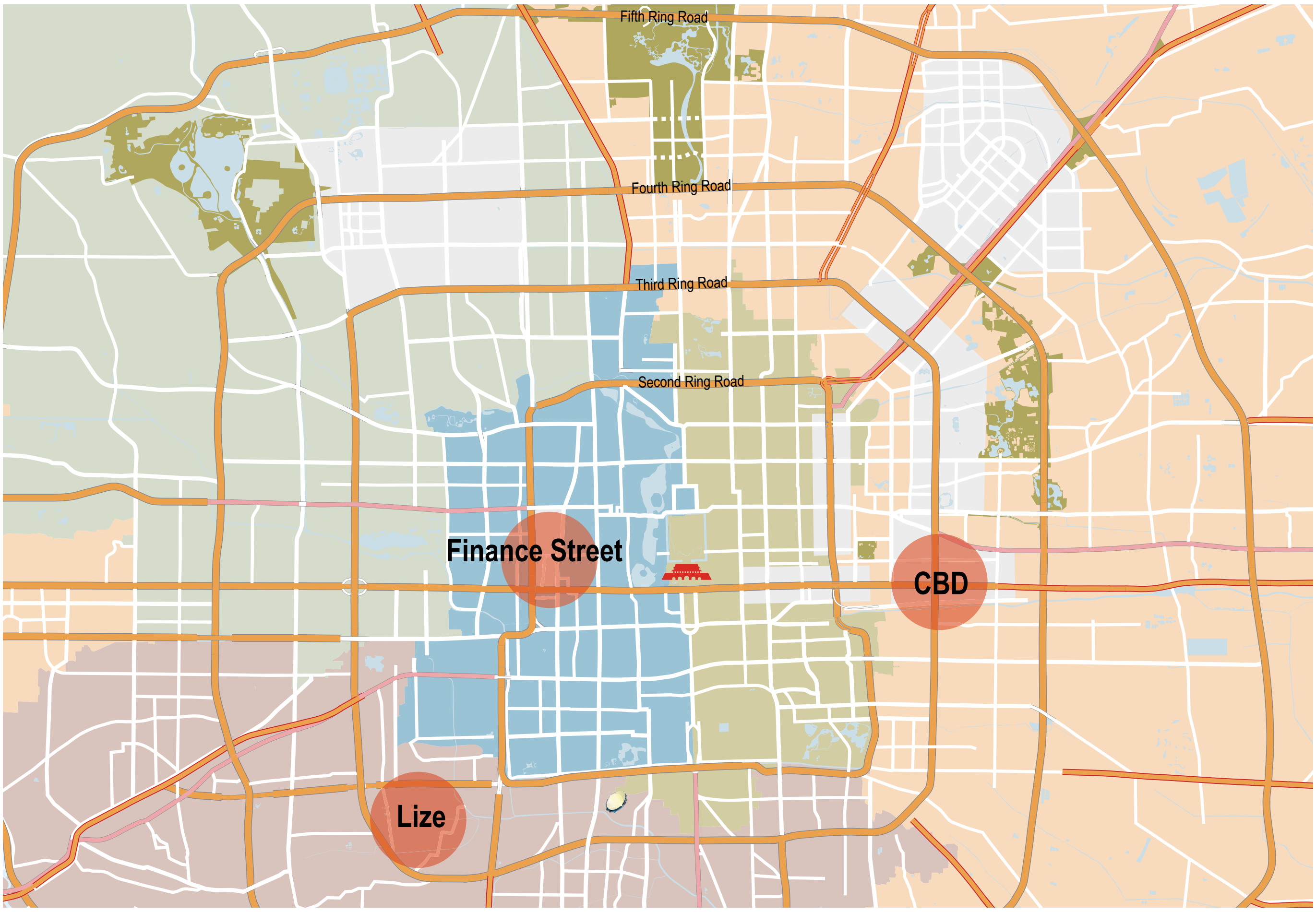


Source: Foreign Policy and McKinsey Global Institute

The plan to have Shanghai developed into an international financial centre will also require more sophisticated financial market operations across China. It makes sense to expect that financial market reforms will also take place outside of Shanghai, at least in Beijing and other Tier 1 cities as well as some leading Tier 1.5 cities[2]. The huge pool of top enterprises and high net-worth individuals in Beijing suggests that the capital city will become a treasure trove of business opportunities for banks and other financial institutions once the Mainland financial sector is more deregulated.

In order to accommodate a larger financial sector in Beijing, the city government is now planning for a new financial business district in Lize, Fengtai to correspond with the existing Finance Street office cluster in Xicheng District. A total of 809 hectares of land are involved and 9.7 million sqm of total GFA are planned for construction. Lize is expected to have a good mixture of high-grade office spaces, shopping malls, hotels and apartments, to be developed in phases over the next one to two decades. As at mid-2013, 16 sites were sold with a total commercial GFA of 1.3 million sqm.

Map 3. Relative Location of Future Lize Financial Business District



Source: Jones Lang LaSalle

2. 'Tier 1.5 cities' is a term used by Jones Lang LaSalle in its China50 publication for cities that lie between Tier 1 and Tier 2 on the City Evolution Curve.

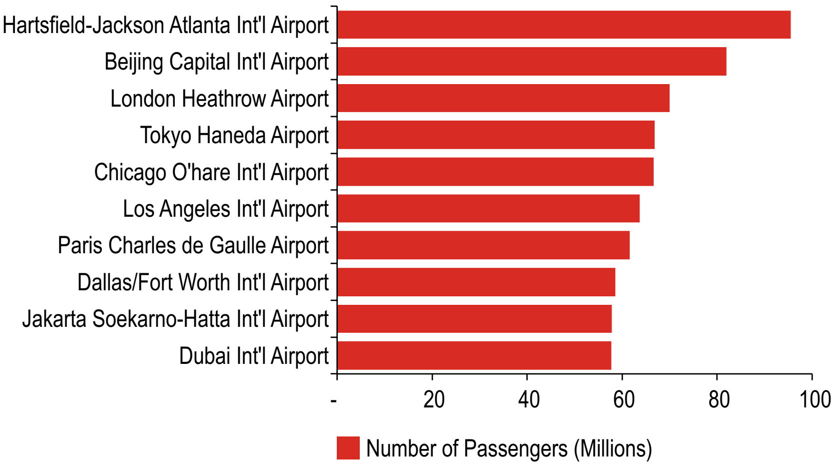
A Focus on Beijing's South and East

The transformation of Lize into a new finance sector cluster is only one part of the government's blueprint to facelift the relatively less developed southern suburbs of Beijing. The last 10 to 20 years have seen much of the city's evolution happening in the central and northern suburbs but future development will focus on the south side where more land resources and city regeneration opportunities are available. There are plans to develop Fengtai, Fangshan, and Daxing with different economic functions assigned to each of them. These economic functions span across biochemical and pharmaceutical, logistics, manufacturing and technology industries among others. There is also a plan for another major commercial hub in Tongzhou in the east to facilitate development of the business sector as well as other tertiary industries such as cultural, high-end commercial and logistics services.

In order to support growth of commercial activity in the south and strengthen Beijing's position as a truly international city, a new airport has been planned in Daxing. The hosting of the Olympics has already left Beijing with a new world-class terminal (Terminal 3) at Beijing Capital Airport (BCA), which handled 82 million passengers on 557,000 flights in 2012 making it the second busiest airport in the world behind Atlanta Hartsfield-Jackson International Airport in the United States (see Figure 13). It has reached its capacity earlier than expected as planners only estimated an annual capacity of 76 million passengers by 2015 at the time of the completion of Terminal 3 in 2008, highlighting the fast track of Beijing in becoming a major air transportation hub of China. The last five years saw total air passenger flow in Beijing (BCA and Beijing Nanyuan Airport combined) growing by a CAGR of 9.5% to reach 85 million in 2012 compared with 54 million in 2007.

The proposed new international airport in Daxing, about 48 km south of Tiananmen Square, is scheduled to open in late 2018. It is planned to have six runways for civil use and one for military use and service up to 70 million passengers per year by 2025. This will ensure that Beijing will continue to be one of, if not the busiest, airport traffic hubs in China.

Figure 13. World's Busiest Airports by Number of Passengers, 2012



Source: Airports Council International

It's a Decade-long Story, Change Will Not Happen Overnight!

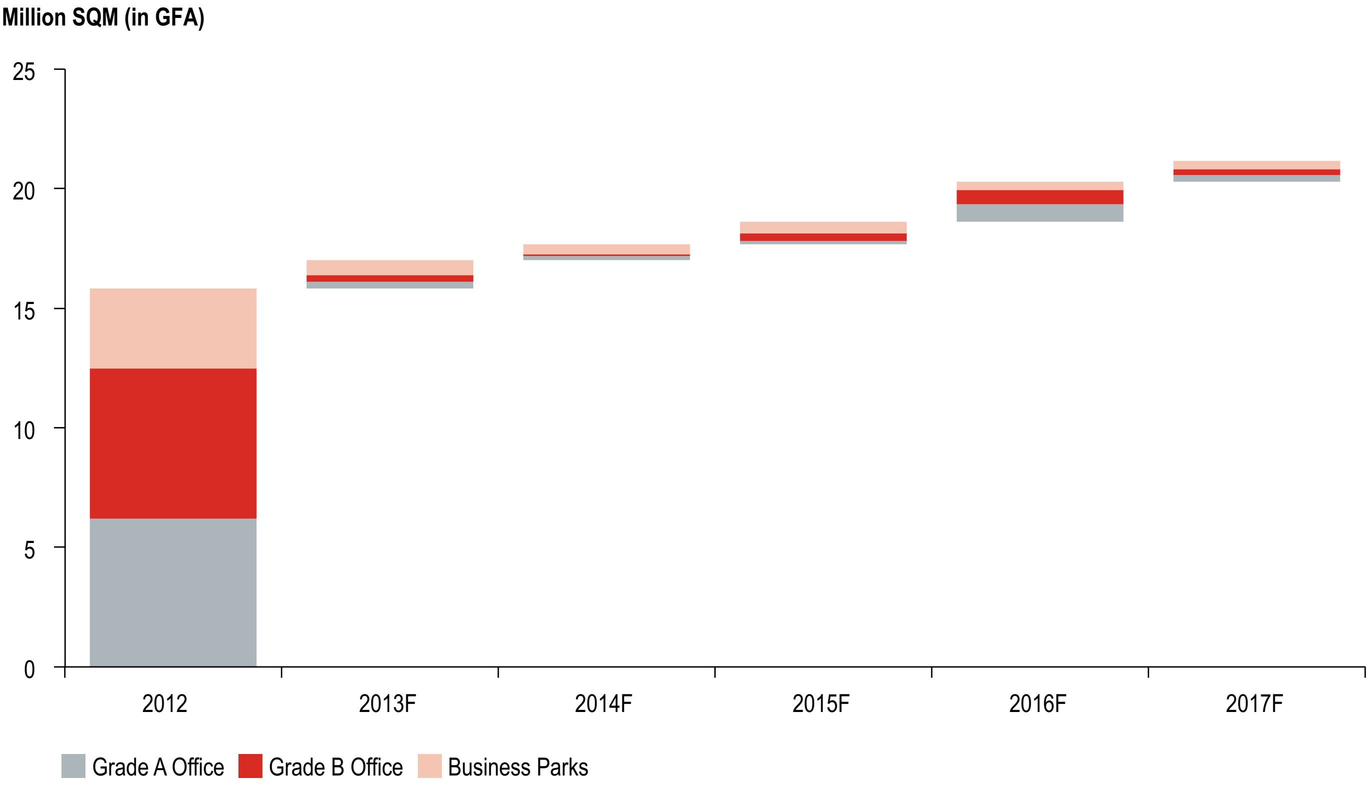
A vast portion of land developed in the aforementioned satellite townships is planned for commercial space, in the form of offices, business parks, retail malls and hotels. It will take many years for these new clusters to form (at least one to two decades) and no single cluster will be turned into physical real estate stock for lease or sale overnight. It will also require a much larger economy for all the planned spaces therein to be absorbed, but this is exactly what the Chinese government is targeting for China. The pace of growth in the Tier 2 cities has been fast in recent years but most of them are still a distance apart from having a ranking amongst the largest city economies in the world.

In contrast, already a more mature Chinese mega city, Beijing is expected to run on relatively slower growth rates that are more in line with national trends than some fast-rising tier 2 cities which will be starting from a much smaller economic base.

The path to become one of the world's largest city economies, however, will require Beijing to proactively broaden its real estate footprint. It is now the right time to start building a bigger Beijing as stock growth in the city's commercial workspace sectors will remain manageable in the next five-year period.

The city's office stock (Grade A and Grade B combined) is expected to grow by 3.1 million sqm (GFA) between end-2012 and end-2017, averaging 620,000 sqm per annum, a much lower number than the one million sqm per annum between 2008 and 2012. The same applies to business park supply with an estimated 2.2 million sqm of new space due for completion over the same period, or 440,000 sqm per annum. These combined will see total commercial workspace grow by a CAGR of 6% to end-2017. There are downside risks to these numbers as project delays are quite common across China, either due to town planning hurdles or other technical issues that lead to 'construction slippage' and as such, actual completions may be even lower (see Figure 14).

Figure 14. Future Stock Growth of Commercial Workspace in Beijing

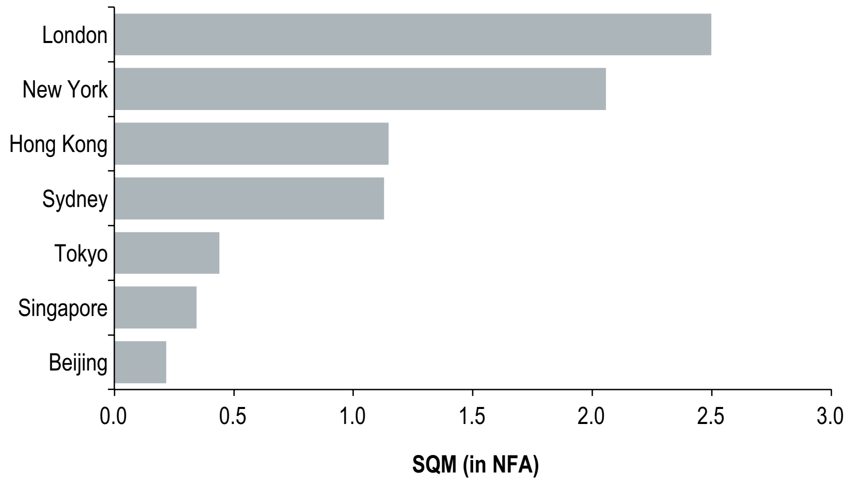


Source: Jones Lang LaSalle

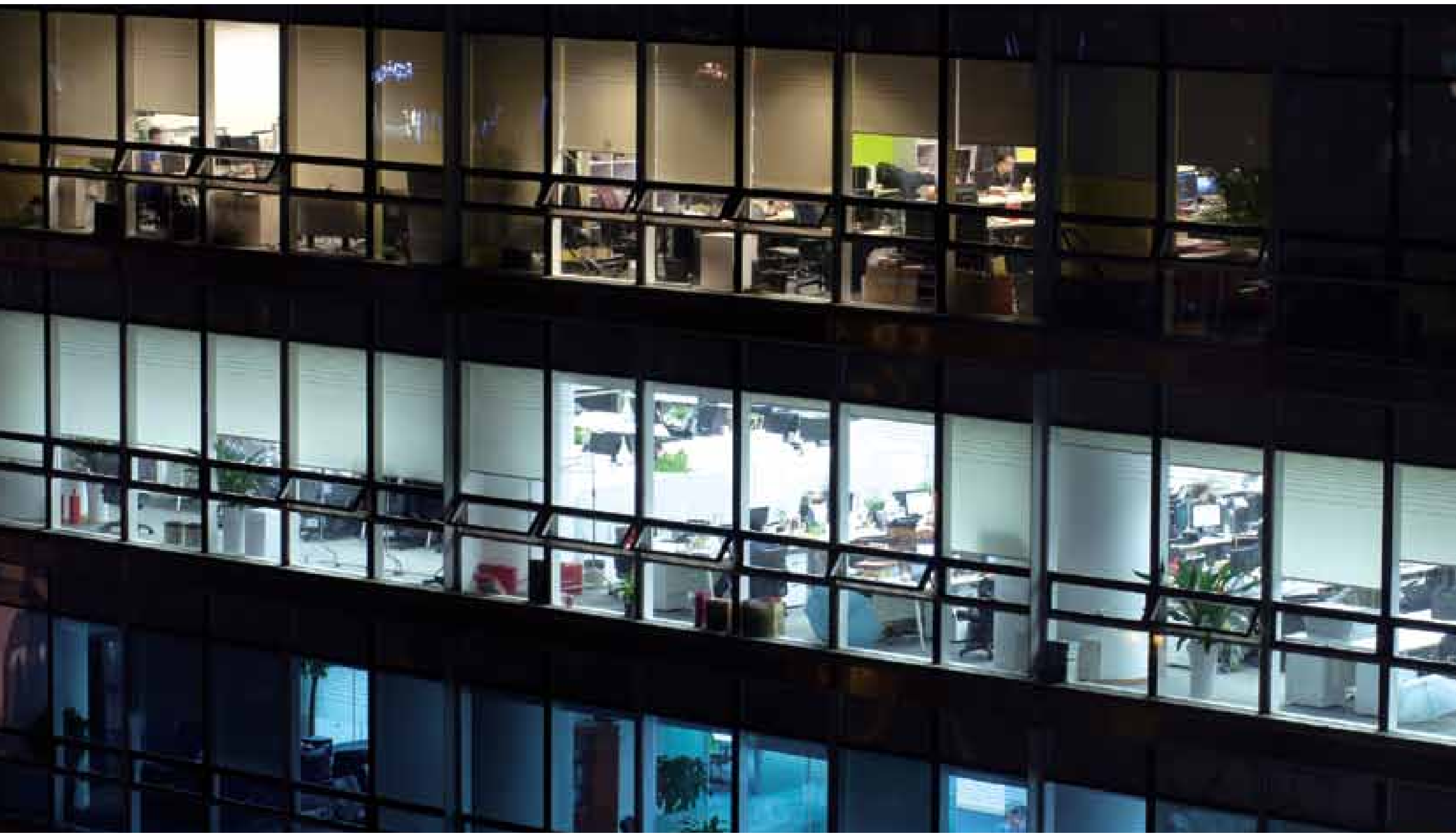
If the next five years are likely to see the Chinese economy grow by slower yet relatively healthy rates broadly in the 7% range per year and that Beijing will largely follow the national trend, a 6% annual increase in total commercial workspace does not imply much over-supply risk for Beijing, if any. In addition, there is also a pent-up demand from occupiers who have been sitting in lower-quality buildings (over 6 million sqm GFA of Grade B office stock in Beijing) looking for opportunities to upgrade their workspace. This points to a trend that commercial workspace vacancy rates in Beijing are set to remain at comfortable levels over the next few years. The gradual deregulation of the services sector will only lead to stronger demand for quality commercial workspace in the long run and Beijing is now preparing itself for this new era.

It remains an open-ended question as to how much commercial workspace is enough for Beijing. An examination of per capita office space* for some large city economies (see Figure 15), however, suggests that Beijing might have big room to grow the size of its workspace stock (at least from a Grade A office perspective).

Figure 15. Per Capita Grade A Office Stock of Selected International Cities

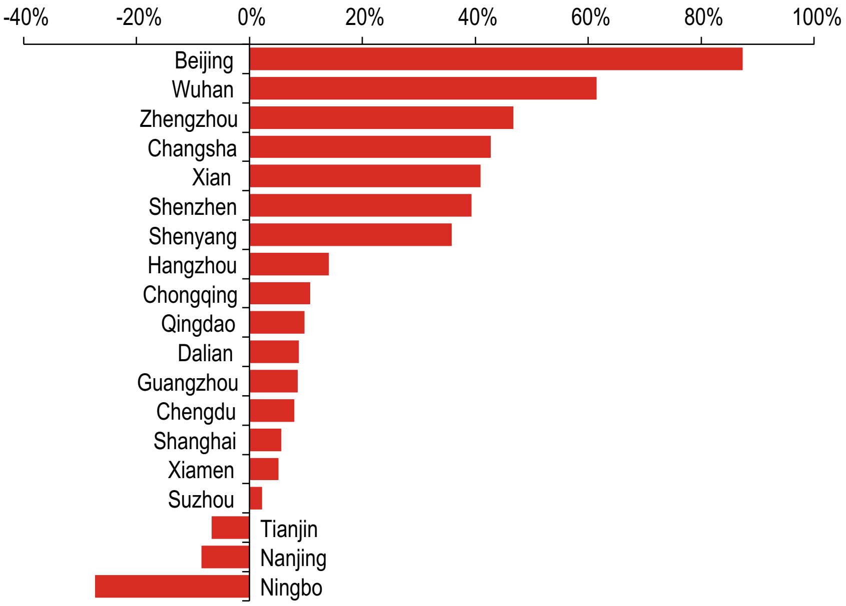


Source: Various government websites, Jones Lang LaSalle estimates



* per capita office space is calculated based on the city's total Grade A office stock and the city's total population.

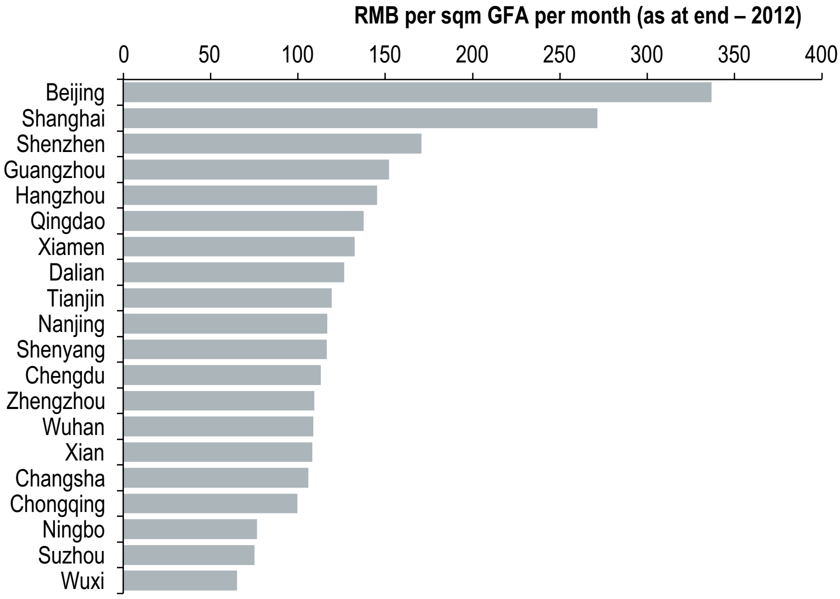
Figure 16. Change in Grade A Office Rentals (end-2012 vs. end-2008)



All figures refer to respective 'Overall' market, Shanghai denotes Overall CBD which consists of Pudong and Puxi

Source: Jones Lang LaSalle

Figure 17. Average Grade A Office Rentals

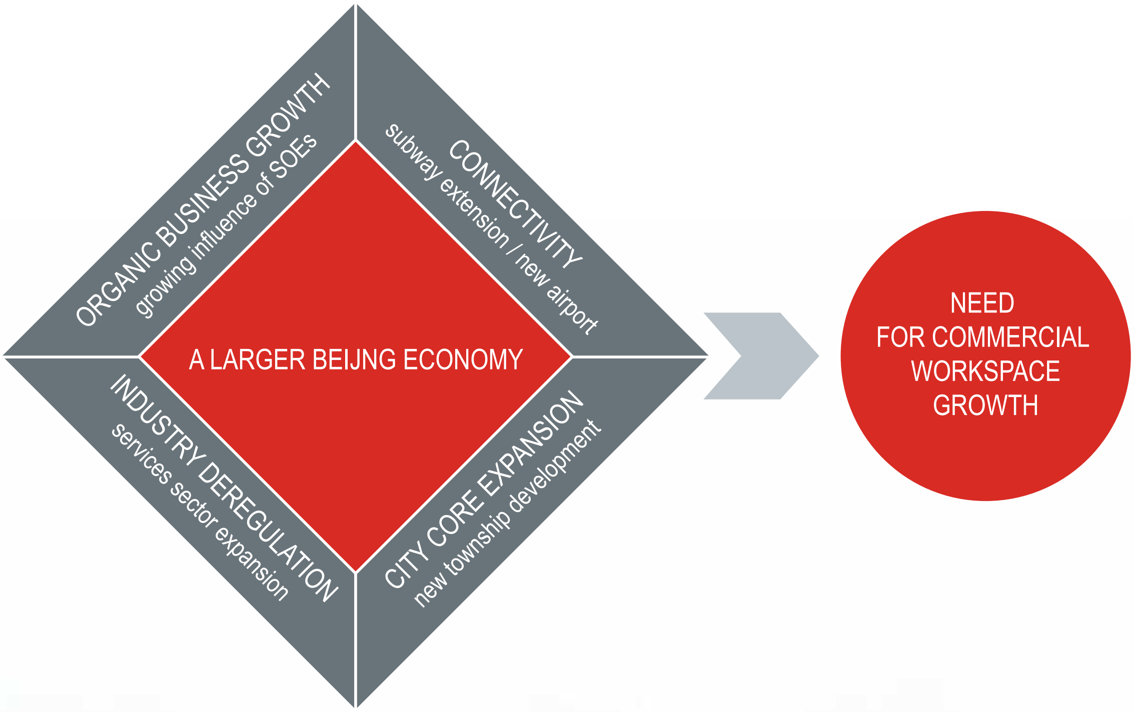


All figures refer to respective 'Overall' market, Shanghai denotes Overall CBD which consists of Pudong and Puxi

Source: Jones Lang LaSalle

A sustainable supply pipeline for commercial workspace would likely help reduce overhead costs for corporate occupiers in Beijing. In the post-Olympics era, low vacancies and strong occupier demand contributed to a spike in Beijing Grade A office rents which increased by over 80%. Thus it was crowned the most expensive office market in Mainland China (see Figure16 and 17). There is a need to provide corporate occupiers with a broader array of commercial real estate offerings across the capital city, from international-grade buildings in the core-CBD to more affordable options in fringe locations. The plan to expand the city's CBD in combination with satellite workspace clusters is therefore the right blueprint for the expansion of Beijing's commercial workspace.

As mentioned earlier, investment demand for commercial workspace has always been strong in Beijing. A boost in development and investment opportunities will help entice more experienced landlords to the capital city and eventually improve the operational environment for corporate occupiers. There is a growing number of multinational landlords in Beijing but still an insufficient number when compared with truly international cities like Hong Kong, Singapore and many western economies. The city deserves to have a stronger presence of sophisticated commercial real estate landlords who will help raise the profile of Beijing while boosting market efficiency and transparency through enhanced competition.


ORGANIC BUSINESS GROWTH
growing influence of SOEs
CONNECTIVITY
subway extension / new airport
A LARGER BEIJNG ECONOMY
INDUSTRY DEREGULATION
services sector expansion
CITY CORE EXPANSION
new township development
NEED
FOR COMMERCIAL
WORKSPACE
GROWTH

The Way Forward

As one of the most important cities for China, Beijing will play a significant role in contributing to the Chinese Central Government's national growth plan which aims to double the country's GDP by 2020. The city is now running out of commercial workspace as illustrated by its low single-digit office vacancy levels and it needs a bigger supply pipeline to support future economic growth.

The blueprint for future city development presents a tremendous opportunity for Beijing to move on to become a member of the world's largest city economies alongside Tokyo, New York, Shanghai and Los Angeles. These are plans to facilitate the long-term development and growth of Beijing, something that will be gradually realised over the next one to two decades.

The more immediate outlook will see Beijing expanding its current CBD while putting up more workspace options in emerging submarkets to accommodate the short-to-medium term office needs of the larger enterprises in the next five years. The city is expected to take on an even more international stance once the new Daxing airport is brought into operation. Its subway network will also continue to extend, making Beijing a more commutable city and contribute to the local government's efforts to tackle air pollution and traffic congestion which have increasingly become a drawback for the capital city. However, the growth the city has experienced since the Olympics and the blueprint for future evolution more than offset these drawbacks and they deserve the attention of commercial workspace occupiers and investors. Indeed, several SOEs and other enterprises have already placed their bet on the future of Beijing with the purchase of land in various new and upcoming commercial areas.

It is our view that Beijing will remain on the radar of institutional investors from China and around the world. A low office vacancy environment and a lack of investment stock on the back of pent-up demand for exposure to China's capital city will support capital values growth and yield compression in the medium-term future.

It has been half a decade since the 2008 Olympics but the evolution of Beijing has not stopped. The last five years have seen the capital city building on the legacy from the Olympic Games and paying great efforts in expanding and refining its infrastructure networks. These initiatives have set a very good platform to expand the footprint of economic activity in Beijing, which will continue to roll on in the years ahead.

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