CBRE RESEARCH

SHENZHEN OFFICE INVESTMENT

STRATEGIES FOR ACCESSING CHINA'S FASTEST-GROWING CITY

CBRE

INTRODUCTION: SHENZHEN AS A DRIVER OF FUTURE ECONOMIC GROWTH

Already one of China's main centres for innovation, Shenzhen specialises in the production of smart phones, 5G R&D, flexible screens and robot manufacturing. Supported by the presence of industrial giants such as Huawei and Tencent, Shenzhen is home to a large number of small and medium-sized technology companies with significant development potential. Recent years have also seen foreign companies expand their presence in the city, with the likes of Boston Consulting Group and Accenture establishing R&D centres.

Despite the impact of the COVID-19 pandemic, Shenzhen's GDP grew by 3.1% y-o-y in 2020, reaching just under RMB 2.8 trillion. Growth was underpinned by the expansion of strategic emerging industries, which accounted for 37% of GDP, the highest proportion among China's major cities. The number of national high-tech enterprises in Shenzhen exceeded 18,500 in 2020, second only to Beijing.

During the 14th Five Year Plan period from 2021-2025, Shenzhen aims to establish itself as a global technology and innovation centre. By 2025, authorities expect R&D investment to account for 5% of GDP growth, the digital industry's value-added share of GDP to reach 31%, and the number of national high-tech enterprises to exceed 22,000.

Table 1: Shenzhen Main Economic and Social Development Goals During 14th Five-Year Plan Period

	2025	Growth Rate VS 2020
GDP Growth Rate	6.0% （14th Five-Year Plan Period）	n.a.
Modern Service Industry in Service Industry (%)	77%	1.0 ppt
R&D Input	5.0%	0.07ppt
Value-added of Strategic Emerging Industry	≥1.5 (Trillion)	46%
GDP Share of Value-added of Core Digital Industry	31%	n.a.
Number of National High-tech Enterprises	22,000	19%
Social Retail Sales	RMB1.25 (Trillion)	44%
Import and Export Trade (US$)	USD 500 (Billion)	13%
Container Throughput	33 million (TEUs)	24%
Airport Passengers	70 million	85%
Surveyed Unemployment Rate	≤ 5%	n.a.
Average Years of Education of the Working-Age Population	12.5 (years)	0.64 (years)
Per Capita Disposable Income (RMB)	> RMB90,000	39%

Source: Shenzhen National Economic and Social Development in 2020, The "14th Five-Year Plan" for Shenzhen, Shenzhen Bureau of Statistics, CBRE Research, June 2021

As China's Pilot Demonstration Zone and a pioneering city for reforms and opening-up, Shenzhen possesses one of the country's most open and investor friendly business environments. While institutional, tariff and currency-related issues still pose a challenge to the growth of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA), many of these concerns are expected to be resolved by the forthcoming completion of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone.

Reflecting its healthy business and employment fundamentals, Shenzhen continues to attract substantial population inflows. According to the city's seventh population census released this year, the number of permanent residents in Shenzhen reached 17.56 million in 2020, representing an increase of 7.13 million over the previous decade, making it China's fastest growing city. Growth prospects remain upbeat, with the city's working-age population aged from 15 to 59 accounting for around 80% of the overall population, and Shenzhen forecasted to be home to the largest number of the Gen Z cohort in China by 2030.

As a pilot demonstration zone for socialism with Chinese characteristics and the core city in the GBA, Shenzhen will remain one of China's most dynamic cities in the coming decade, solidifying its appeal to real estate investors. Incentive policies, the presence of high-quality innovative industries and huge demographic dividend are set to generate additional interest in commercial property, particularly in the office sector.

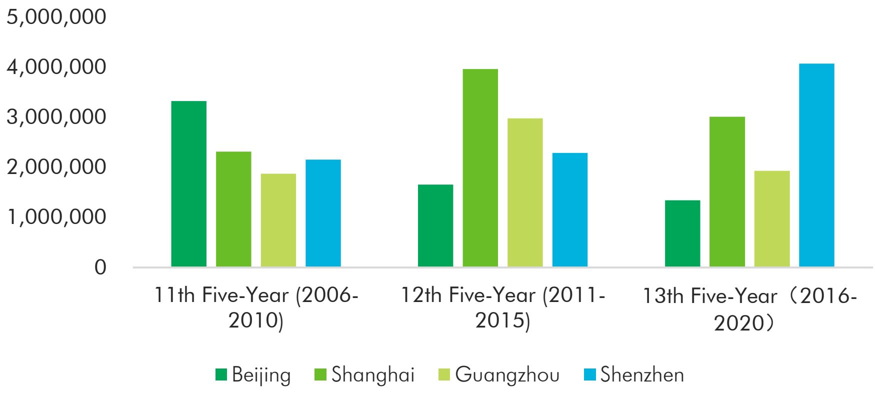
CHINA'S MOST ACTIVE OFFICE LEASING MARKET

Launched in 2014, China's Mass Entrepreneurship and Innovation Initiative put innovation at the core of the country's development strategy during the 13th Five-Year Plan period from 2015-2020. As one of China's most dynamic innovation hubs, Shenzhen has benefitted immeasurably from the initiative, with its number of national high-tech enterprises rising three-fold from 2015 to reach more than 18,500 in 2020. **Shenzhen's number of registered enterprises stood at 3.5 million in 2020, the most of any major city in China**, marking an increase of 1 million from 2015.

As Shenzhen's economy booms, so is its office market. **Between 2016-2020, the city registered more than 4 million sq. m. of net absorption, the highest of any city in China** and an increase of nearly 80% on the period from 2011-2015. Demand has been led by the TMT sector, which accounted for 49% of overall net absorption in 2020, compared to just 27% in 2018.

Other drivers of office take-up include the financial sector, which contributed just under 25% of net absorption over the past three years, primarily in the city's Hi-tech Park.

Figure 1: Office Net Absorption in Tier 1 Cities



Source: CBRE Research, June 2021

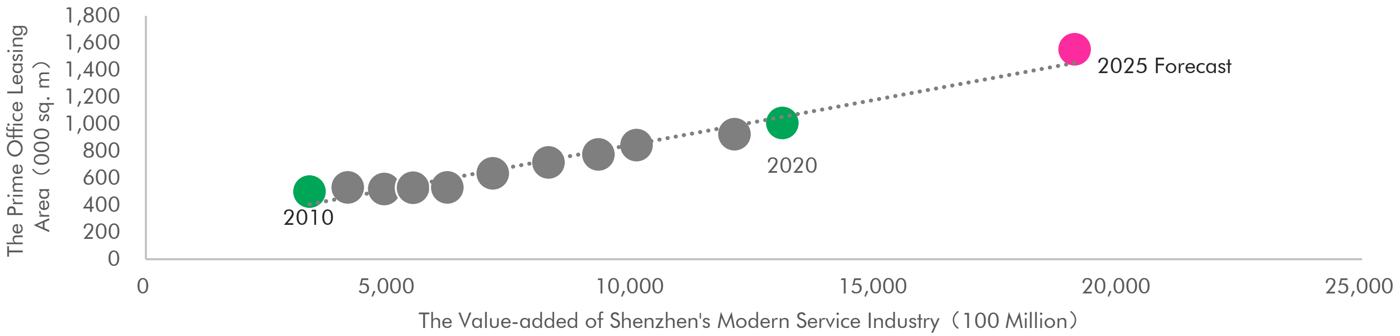
Table 2: Recent Major Office Leasing Transactions in Shenzhen by TMT and Financial Companies

Occupier	Industrial Sector	Property Name	Occupied Space (sq. m, GFA)	Submarket	Year
OPPO	TMT	China Resources Tower	42,000	Houhai	2018
OPPO	TMT	CR Qianhai Building T2	96,100	Qianhai	2020
ByteDance	TMT	Shenzhen Bay Innovation & Technology Center	100,000	Houhai	2020
Futu Securities	Finance	Kexing Hi-tech Park Ph.2	40,000	Hi-tech Park	2019
Merchants Union Consumer Finance	Finance	Kexing Hi-tech Park Ph.2	30,000	Hi-tech Park	2019
CCB Wealth Management	Finance	PingAn IFC North Tower	16,000	Futian CBD	2020

Source: CBRE Research, June 2021

CHINA'S MOST ACTIVE OFFICE LEASING MARKET

Figure 2: Shenzhen Modern Service Industry Value-Added Vs. Prime Office Leasing Area (2010-2025)



Source: CBRE Research, The 14th Five-Year Plan for Shenzhen, Shenzhen Bureau of Statistics, June 2021

The modern service industry has been Shenzhen's major source of office leasing demand in recent years, with CBRE data showing a strong correlation between the growth of modern service industry value-added and office leasing volume from 2010-2020.

Over the past five years, prime office leasing GFA per RMB 100 million of modern service industry value-added has been relatively stable at 760-860 sq. m. Assuming this trend continues, CBRE expects Shenzhen office net absorption to reach 4.5-6.5 million sq. m from 2020-2025, equivalent to 900,000 – 1.3 million sq. m. of net absorption per annum. Growth will be underpinned by the city's strong industrial structure, which is expected to remain stable during the 14th Five-Year Plan period, coupled with the expansion of modern service industry valued-added to 77% of the city's GDP in 2025. Reflecting the current healthy state of the market, prime office net absorption totaled 530,000 sq. m. in H1 2021.

The TMT and finance industries are expected to remain as the main growth engines of Shenzhen office demand in the coming years. A substantial portion of new office demand will be generated by China's leading technology companies such as Huawei and Tencent, which continue to expand rapidly. Public information show that 1 million sq. m. of new office demand alone will originate from the 13% per annum growth in Tencent's number of employees projected to occur between 2020-2027.

Shenzhen's large talent pool and industrial clustering will also attract overseas TMT companies while accelerating the growth of local small and medium size enterprises in accordance with the further development of the Shenzhen-Hong Kong cooperation Zone and Guangzhou-Shenzhen-Hong Kong Technology Corridor.

Financial sector office demand is expected to strengthen further due to the continued development of Shenzhen's finance industry, supported by opening-up policies implemented through Qianhai and the Shenzhen Stock Exchange. According to the 14th Five-Year Plan, Shenzhen finance industry added value is expected to account for 15% of the city's GDP by 2025.

AN INCREASINGLY ACTIVE INVESTMENT MARKET

Shenzhen's rapid economic development and robust leasing demand have attracted growing attention from investors in recent years. Investment volume reached RMB 100 billion in the period from 2016-2020, an increase of 500% from the figure registered between 2011-2015, marking the strongest rate of growth among all tier 1 cities.

CBRE's 2021 Asia Pacific Investor Intentions Survey found that Shenzhen ranked among the top ten most popular outbound investment destinations for the first time since surveys began, reflecting investors' increasing interest. Offices have historically been the most traded asset class in Shenzhen, with investment volume exceeding RMB 10 billion yearly over the past three years, and office deals accounting for more than 50% annually over the same period. Despite the more active investment market, institutional investors in particular have found it challenging to locate suitable investible assets, primarily due to the following reasons.

Firstly, self-use buyers dominate the market. From 2016 to Q1 2021, a total of 42 office transactions were recorded in Shenzhen, of which 50% were for self-use. Based on the transaction price of the properties acquired for self-use and the estimated rent for comparable projects in the same area, the net yield of these transactions ranged from 2.5% to 3.0%. These levels are significantly lower than institutional investors' expected yields, which according to CBRE Research's Q1 2021 Asia Pacific Cap Rate Survey stood at 4.0-4.5% for core areas and 4.25%-4.75% for non-core areas.

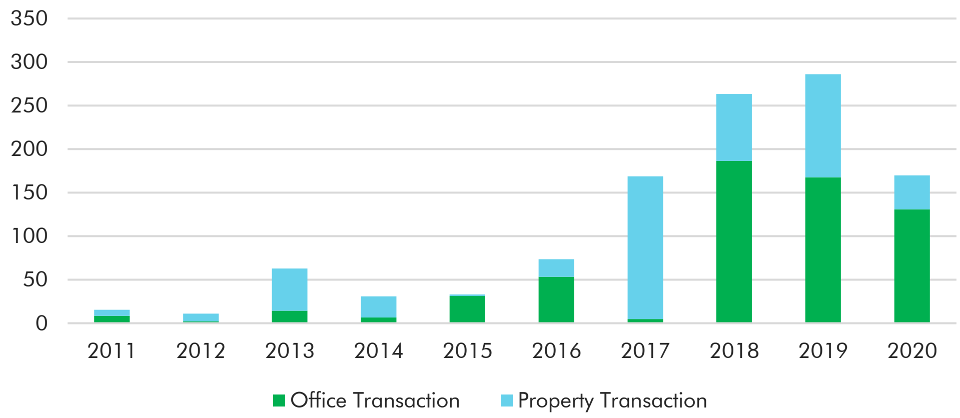
Secondly, the number of investment grade properties remains limited. CBRE data show that 40%-50% of office stock in Shenzhen is strata-titled, while a substantial portion of properties under single-ownership are headquarters buildings that are highly unlikely to ever be made available for sale. In addition, the land-use term of plots for headquarters projects has recently been reduced to 30-40 years, which has reduced these assets' appeal to investors. In terms of future supply, a large number of properties in the pipeline are unlikely to be sold on an en-bloc basis due to restrictions related to the terms for self-use and other aspects. Office prices in Shenzhen are relatively high compared to those in other cities due to the active strata-title market, an issue that has further impeded investors.

Thirdly, around 6 million sq. m of new supply is due to be completed over the next five years, exerting pressure on rental growth and cap rate to a certain extent.

CBRE nevertheless believes that Shenzhen's rapid economic growth, burgeoning office demand and positioning as one of China's main economic growth engines will ensure a bright future for the city's office investment market.

However, owing to the challenges identified above, investors seeking to increase their exposure to the Shenzhen office market are advised to adopt more nuanced investment strategies focusing on specific types of office assets in certain areas. These include prime offices in core areas, business parks in industrial clusters, and offices situated on M0 (new industries) land.

Figure 3: Shenzhen Investment Transaction Volume (2011-2020)



Source: CBRE Research, June 2021

SHENZHEN OFFICE INVESTMENT STRATEGIES

Option 1：Prime Offices in Core Areas

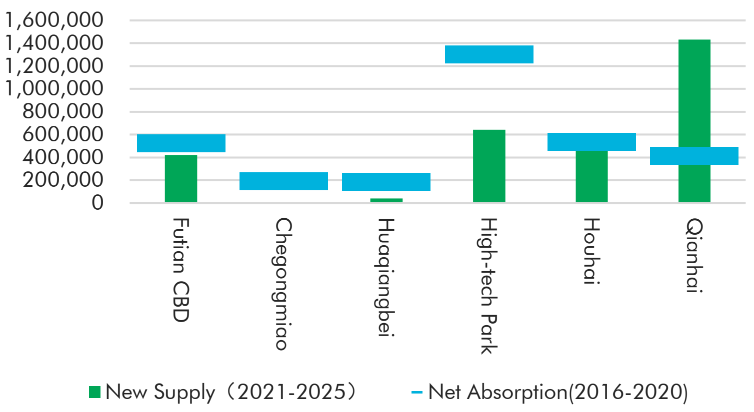
Despite abundant supply due to come on stream over the next five years, the bulk of new office stock in Shenzhen will be concentrated outside the city's core areas. New supply in the Futian CBD over the next five years totals less than 400,000 sq. m., well below the volume of stock scheduled for sub-markets in Nanshan district.

However, owing to the presence of the Shenzhen Stock Exchange and Futian High-speed Railway Station, the Futian CBD will remain the preferred location for many finance companies. The lack of new supply will ensure the vacancy rate in the district gradually falls below 10% over the next five years, with requirements from the financial sector supported by innovation policies and the growth of the headquarters economy, coupled with professional services demand, adding to downward pressure on vacancy. This will provide a solid foundation for average rents in the Futian CBD to return to growth after 2022.

Prime office demand will continue to strengthen as Shenzhen solidifies its status as an important global financial hub. Shenzhen's total market capitalisation and IPO financing volume in 2020 ranked 5th and 6th globally, respectively, behind New York, Hong Kong, Shanghai, Tokyo and London. The city is home to one of China's two stock exchanges and rose to 8th in the 2020 rankings of global financial centres. CBRE data show that Grade A office rents in the Futian CBD possess significantly higher growth potential than those in other global financial centres (Figure 5).

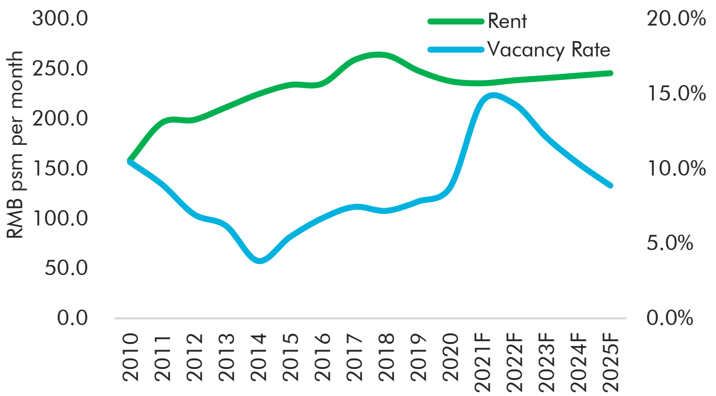
The anticipated steady increase in office rents and prices resulting from the tight supply in core locations will lure investors seeking stable cash flows, have the financial capacity to make large-sized acquisitions, and are willing to hold assets in the medium to long term. Besides the Futian CBD, CBRE expects the Hi-tech Park to emerge as another target submarket for investors owing to its clustering of technology companies and rapidly improving supply and demand.

Figure 4: Office Supply and Demand in Shenzhen's Major Office Submarkets



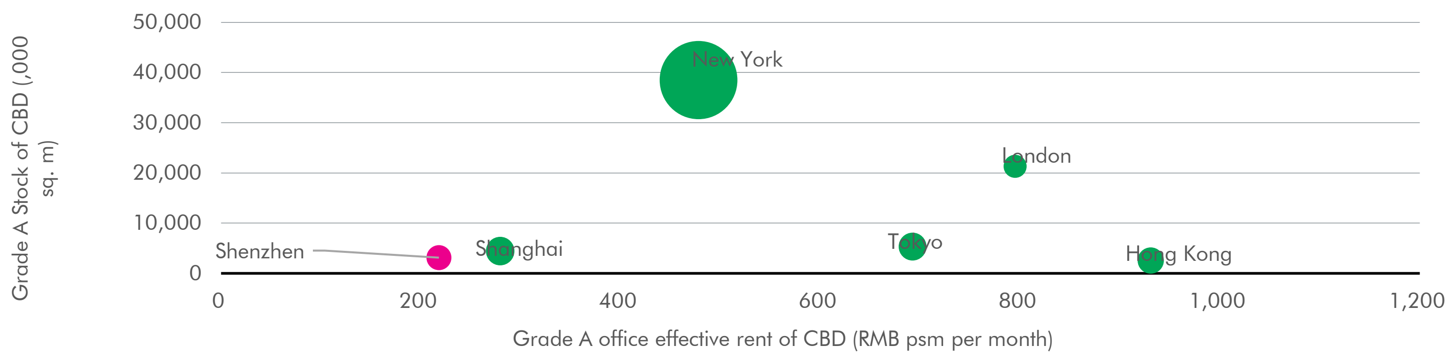
Source: CBRE Research, June 2021

Figure 6: Futian CBD Rent and Vacancy



Source: CBRE Research, June 2021

Figure 5: Comparison of CBD Office Stock, Rents and Stock Exchange Market Value in Major Global Financial Centres



Note: The size of the bubble represents the market value of each cities' securities market.
Source: The official websites of each stock exchange, WIND, CBRE Research, Dec 2020

SHENZHEN OFFICE INVESTMENT STRATEGIES

Option 2：Business Parks in Industrial Clusters

With China's focus on innovation as a core component of development strategy having spurred the growth of innovative industries, demand for suitable office space has accelerated rapidly. In Q1 2021, nationwide business park investment volume reached RMB 14.5 billion, the highest quarterly total on record.

As one of China's key innovation centres and home to leading technology and high-end manufacturing industry clusters, Shenzhen has seen strong demand for business parks. Between 2015-2020, average business park rents increased by 17.6%, and were largely unaffected by the onset of the pandemic. In contrast, average office rents declined from 2019-2020 due to the impact of large new supply and measures to contain the spread of COVID-19.

Investors seeking to access the business park sector are advised to **focus on areas providing high levels of industrial agglomeration, good transportation connectivity, and easy access to surrounding office buildings. The most attractive submarkets include Hi-tech Park, Xili and Liuxiandong.**

Recent business park investment transactions in Shenzhen were conducted at an estimated yield of about 4.25-5.25%, a level similar to deals in Beijing and Shanghai. Added-value refurbishment and sale leasebacks to manufacturing companies are among the potential strategies available to investors.

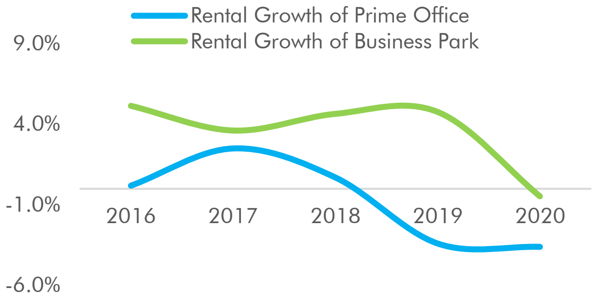
Three of the five industrial properties included in the first batch of publicly offered C-REITs in June of this year are all located in business parks (See Table 3), a trend CBRE believes will further enhance the investment liquidity and appeal of this asset class.

Table 3: C-REITs and Underlying Properties

REIT	Asset Type	Underlying Assets	Economic Area	GFA (sq. m)	Net Asset Value at the end of 2020 (RMB bn)	Capital Funding (RMB bn)	Expected Cash Available for Distribution in 2021
Bosera China Merchants Shekou Industrial Zone	Industrial	Wanrong Building, Wanhai Building	GBA	95,300	2.53	2.08	4.10%
Dongwusu Industrial Park	Industrial	Area B, Phase 5, International Science and Technology Park, Phase I & II of the 2.5 Industrial Park	YRD	561,130	3.35	3.49	4.50%
Zhangjiang REIT	Industrial	Zhangjiang Guangda Park	YRD	50,947	1.47	1.50	4.74%
Hotland Yantian Port Warehouse Logistics	Warehouse	Modern Logistics Park	GBA	320,466	1.71	1.84	4.47%
GLP	Warehouse	GLP Beijing Airport Logistics Park, GLP Tongzhou Optical electromechanical Logistics Park GLP Guangzhou Bonded Logistics Park, GLP Zengcheng Logistics Park, GLP Shunde Logistics Park, GLP Suzhou Wangting Logistics Park, GLP Dianshan Lake Logistics Park	Beijing-Tianjin-Hebei, YRD, GBA	704,989	5.35	5.84	4.45%

Source: REITs prospectus related, CBRE Research, June 2021

Figure 7: Prime Office and Business Park Rental Growth



Source: CBRE Research, June 2021

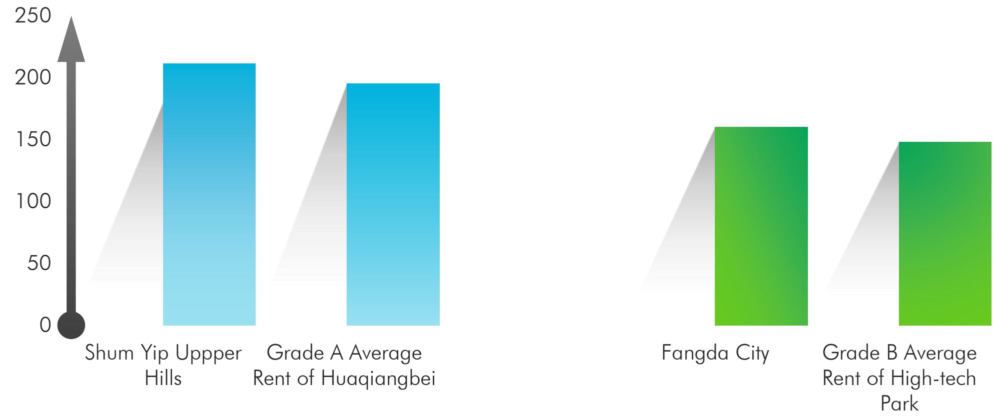
Option 3: Offices on M0 Land (New Industries Land)

To improve industrial land efficiency and intensify development, Shenzhen created a new urban land classification for public auction and urban redevelopment in 2013, known as new industries land (M0 land). Designed specifically to promote the development of selected industries, M0 land is subject to strict restrictions in terms of property transfer, eligible buyers and strata-title conversion.

According to the schedule of projects due to be auctioned and released for redevelopment in Shenzhen, the supply of M0 properties will increase significantly in the short to medium term. However, the number of properties available for investment remains limited as most projects due to be auctioned are not permitted to be resold.

Investable assets will mainly originate from urban redevelopment properties, particularly those developed by high-tech, electronics and industrial companies, many of which are likely to dispose of unused portions of self-owned properties due to their lack of operational real estate experience. In the long-term, Shenzhen's Bureau of Planning and Natural Resources intends to strictly manage M0 land supply by regulating the conversion of industrial land into commercial use and strictly controlling new commercial office supply. This is likely to result in a gradual decline in M0 land supply for office development, ensuring a more equitable supply demand balance in the Shenzhen office market.

Figure 8: M0 Office Property and Commercial Office Property Rents



Source: CBRE Research, June 2021

Owing to their location within industrial clusters, high plot ratio and good building quality, M0 office properties can achieve similar rents to those commanded by traditional industrial office properties. CBRE data show that rents for completed M0 office properties in Shenzhen were largely the same as those for comparable commercial office buildings in the same area (See Figure 7). Transaction prices of M0 office properties are lower than those for commercial office buildings, primarily due to the fact that M0 land is typically 20% cheaper than that for commercial office buildings owing to its industrial classification and resulting transfer restrictions.

CBRE believes that the upcoming short to medium term supply peak provides attractive opportunities for investors. Buyers are advised to identify potential acquisitions in specific submarkets, particularly Qianhai, Houhai and Shekou in Nanshan District, and consider factors such as the regional supply and demand landscape, transportation connectivity and industrial development prospects.

The recent launch of C-REITs containing industrial properties as underlying assets provides a potential exit route for investors, with two industrial properties belonging to China Merchants in Shekou recently issued in new C-REITs. According to their prospectuses, the valued capitalisation rate of both assets was 4.4%, with estimated cash flow distribution rates of 4.45% and 4.56% in 2021 and 2022, respectively. These figures can be used by investors as pricing references when evaluating M0 office property acquisitions in Shenzhen.

Table 4: M0 Office Property Investment Strategies

Submarket Classification	Submarket	Investment Proposition	Importance
Priority Submarket	Nanshan: Qianhai, Houhai, Shekou	• Large stock of prime office properties • Can attract overflow of tenants from nearby prime office buildings	Primary focus
Secondary Submarket	Nanshan: Xili, Liuxiandong Futian: Xiangmi Lake, Meilin Luohu: Sungang	• Some stock of office properties • Can attract tenants by creating an attractive and appealing business environment	Active consideration
Tertiary Submarket	Luohu: Cuizhu, Qingshuihe Baoan: Xixiang, Xinan Longhua: Longhua Longgang: Longcheng	• Provides good transportation links and located near core business submarket • Limited stock of office properties	Opportunistic attention

CONCLUSION

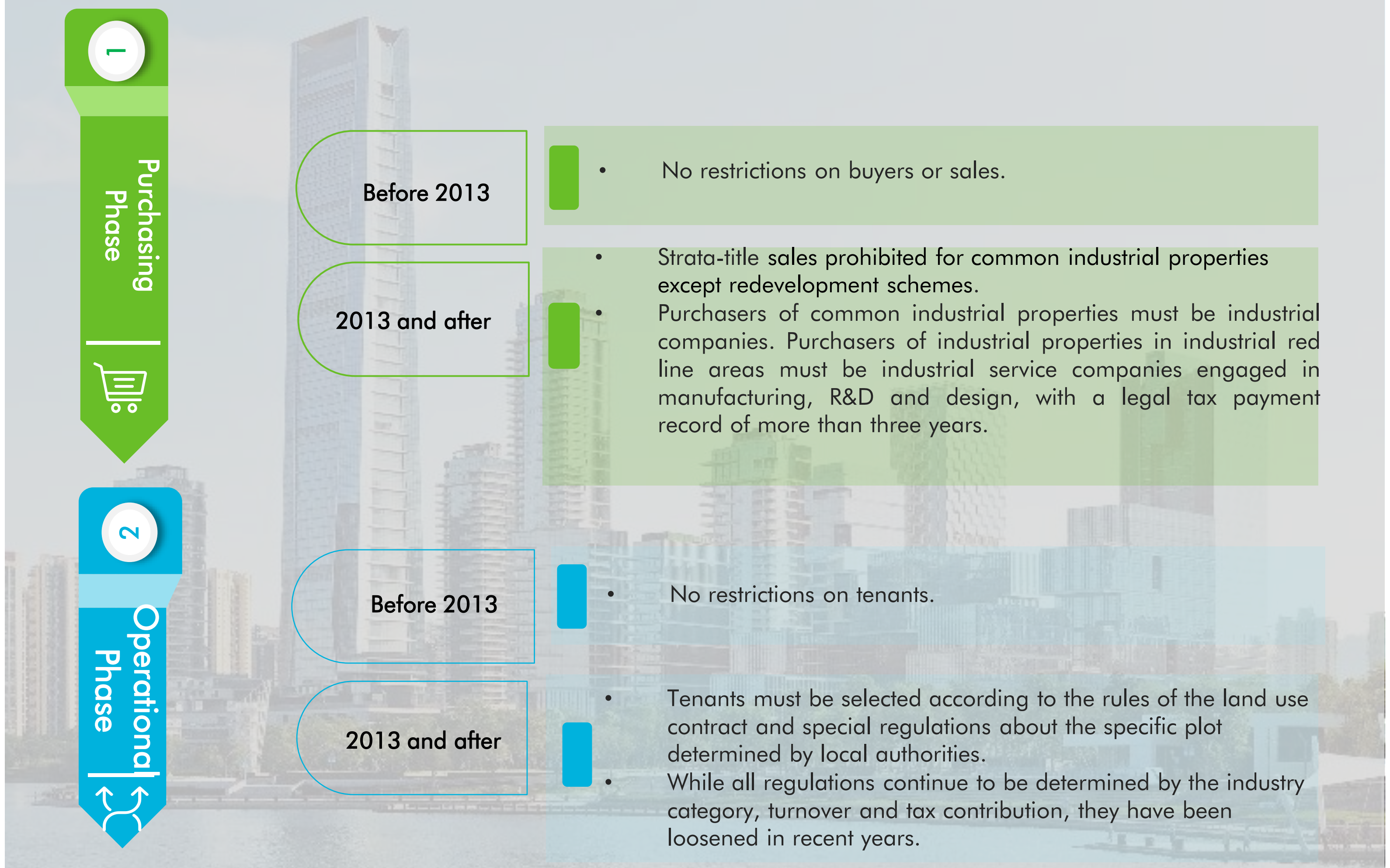
Shenzhen's bright economic prospects and status as one of China's main economic growth engines will continue to drive the rapid growth of key industries in the coming years, generating ample new demand for office space and strengthening the investment appeal of this already highly attractive market and asset class.

As detailed in this report, investors wishing to enter this lucrative sector are recommended to focus on prime office properties in the Futian CBD and Hi-tech Park, business parks located in industrial clusters such as Xili and Liuxiandong, and M0 office buildings.

As business parks and M0 office properties both fall under the industrial land use classification, properties acquired after 2013 must comply with the relevant industrial property transformation policies. CBRE advises investors to carefully consider the following issues prior to conducting any purchases.

- **Investors must gain a thorough understanding of local government industrial land policy and market entry.** Particular attention should be given to land use conditions and restrictions.
- For projects in industrial 'red line' areas that are subject to restrictions on buyers, CBRE recommends **investors pursue equity acquisitions or engage in joint purchases with industrial companies.**
- **Investors lacking leasing or other operational real estate experience can consider forming joint ventures with industrial developers.** Other strategies may include sale leasebacks with industrial developers after completion.

Figure 9: Shenzhen Industrial Property Operational Regulations



Source: Industrial policies published by the Shenzhen government.

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