# HONG KONG | OFFICE

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# Expansionary business cycle drove leasing demand

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**The office leasing market regained momentum in Q4 2017, with net take-up moving back to the positive territory. Rents in Causeway Bay and Island East recorded strong QOQ increases, up 2.4% and 6.4%. The new quality office buildings have set a higher benchmark for the districts, with good amenities, tenant profiles, and management. 2018 will have 3.1 million sq ft of new office space completed, almost 50% higher than the annual average over the past two decades. Rents on Hong Kong Island should not feel much pressure due to the fast take up rate of new buildings. Kowloon East rents should stay firm, as low rents are attractive for relocation amid the rising rents and low vacancy on Hong Kong Island.**

## Forecast at a glance

### Demand

Central and Sheung Wan remained popular among PRC financial companies. Flexible workspace expanded quickly. TMT companies were active in Kowloon.

### Supply

3.1 million sq ft (288,000 sq m) of office space should be completed in 2018, almost 50% higher than the 20-year annual average. 45% and 48% will be on Hong Kong Island and Kowloon, respectively.

### Rent

Despite the increasing amount of new supply, we expect overall rent to increase 6.5% between 2017 and 2019 due to firm business sentiment, before turning down gradually in 2020 and 2021.

## Regained leasing momentum

Demand for office space remained strong in Q4 as companies were in expansion mode, with the overall net absorption at 321,450 sq ft (29,864 sq m). A strong year was recorded in 2017, with an annual net take-up of 959,172 sq ft (89,110 sq m), up 458% YOY.

Hong Kong Island recovered from the negative net take-up in Q3, with a positive net take up at 231,696 sq ft (21,525 sq m). Although Admiralty recorded a negative net take-up due to companies relocating to other districts, total net take-up in Central/Admiralty stayed positive at 17,140 sq ft (1,590 sq m) thanks to the strong demand for Central offices. Wan Chai / Causeway Bay and Island East stood at 196,876 sq ft (18,290 sq m) and 31,111 sq ft (2,890 sq m), respectively. 18 King Wah Road in North Point and Lee Garden Three in Causeway Bay, which obtained their occupation permits in September and November respectively, added a total of 694,210 sq ft (64,495 sq m) of net floor area of new office space on Hong Kong Island. These buildings have attracted strong interest from tenants for pre-commitment and recorded fast take up rates.

Overall vacancy increased to 4.9% from 4.5% in Q3 due to the completion of new supply. The vacancy rate of Central/Admiralty fell 10 basis point to 2.3% as Central vacancy rate fell below 2%. The vacancy rate in Causeway Bay increased to above 5% due to the completion of Lee Garden Three which was about half leased upon completion.

Kowloon East's vacancy rate declined further to 8.3%. 1.6 million sq ft (148,700 sq m) of gross floor area of new office space which was supposed to be completed in 2017 has been delayed to 2018.

| Submarkets | Q4 Grade A Vacancy | Q4 Grade A Net Effective Rents (HKD / sq ft / month) | QOQ Rental Change | 2018 Rental Forecast | 2018 YOY Change |
|---|---|---|---|---|---|
| Central / Admiralty | 2.3% | $118.9 | 0.2% | $125.7 | 5.7% |
| Wan Chai / Causeway Bay | 4.1% | $70.1 | 2.4% | $74.0 | 5.6% |
| Island East | 4.2% | $51.7 | 1.0% | $54.1 | 4.6% |
| Tsim Sha Tsui | 1.8% | $54.3 | 2.7% | $55.7 | 2.5% |
| Kowloon East | 8.3% | $34.7 | 0.8% | $35.0 | 1.0% |
| Overall | 4.9% | $73.7 | 0.9% | $76.5 | 3.8% |

## Rents increased amid tight supply

Overall Grade A office rents increased 0.9% QOQ. Despite low vacancy, rents in Central/Admiralty stayed the same with most landlords increasing rent-free periods to three months or longer. Causeway Bay and Island East recorded strong QOQ increases, up 2.4% and 6.4%. The new quality office buildings have set a higher benchmark for the districts, with good amenities, tenant profiles, and management.

Rental growth in Tsim Sha Tsui accelerated by 0.7%. Despite some existing tenants relocating to Kowloon East for rental savings, leasing demand was well supported by companies setting up new offices, flexible workspace operators, financial companies, and insurance companies. Rents in Kowloon East, which has the largest amount of new supply, have stayed firm as the large rental difference with Hong Kong Island has tempted occupiers to consider Kowloon East for relocation. Buildings, such as Millennium City, which adjoin MTR stations were popular, and landlords have maintained a firm asking price amid the increasing demand. However, developments located further away from the MTR stations have maintained higher vacancy levels.

## Expansionary business cycle drove leasing demand

The positive net take-up indicates that the market has regained its growing momentum. Central and Sheung Wan are still popular among PRC financial companies, but new leases signed are mostly medium sized with space of about 4,000 sq ft (370 sq m) or smaller, as large floor spaces are hard to find. Huarong Group has leased a floor in the Bank of China Tower, while China Minsheng Bank has leased multiple units in AIA Central.

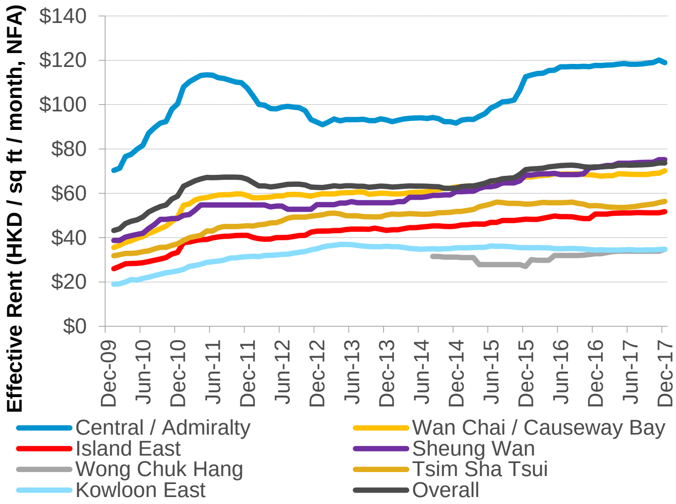
New developments being completed in Q4, or to be completed in 2018 on Hong Kong Island have been popular as they provide good amenities and quality tenant profiles. One Taikoo Place in Quarry Bay and Lee Garden Three in Causeway Bay have achieved over 50% of pre-commitment as of the end of 2017.

Flexible workspaces expanded quickly in Q4. They have been actively exploring Kowloon, where large floor areas with affordable rents are easier to find.

Atlas Workbase, a new coworking operator, leased 47,210 sq ft of gross floor area in Tsim Sha Tsui. WeWork, the world's leading coworking operator, leased 71,560 sq ft of gross floor area in Mapletree Bay Point, a new development to be launched in 2018 in Kwun Tong.

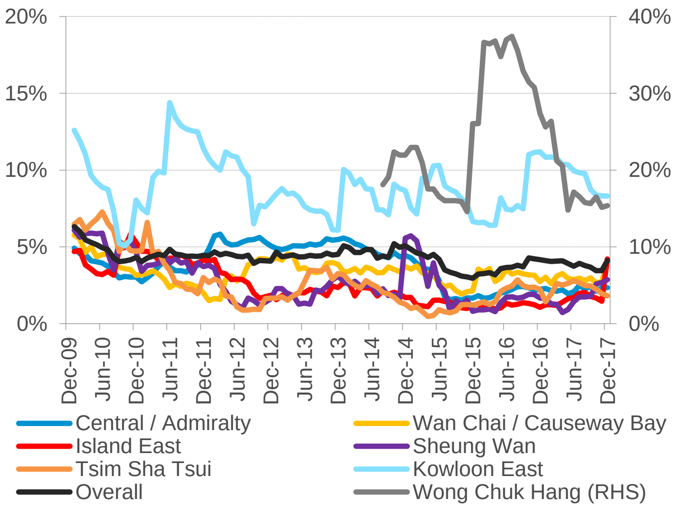
With the technology sector emerging fast in Hong Kong, TMT companies have taken the top share of new leased space in Kowloon, notably Kowloon East. Lazybug, a local software development company, has taken 29,735 sq ft of gross floor area in Two Harbour Square.

### Hong Kong Grade A Rental Trend




Source: Colliers

### Hong Kong Grade A Vacancy Trend




Source: Colliers

| Tenant | Building | District | Floor Area (sq ft) | Transaction Type |
|---|---|---|---|---|
| BNP | Lincoln House, Taikoo Place | Island East | 109,195 (L) | New Letting |
| UrWork | One8One Queen's Road | Central | 15,451 (G) | New Letting |
| Garage Society | Beverly House | Wan Chai | 16,496 (G) | New Letting |
| Naked Hub | Two Harbour Square | Kwun Tong | 55,867 (G) | New Letting |
| VF | Mapletree Bay Point | Kwun Tong | 107,250 (G) | Relocation |
| Wework | Mapletree Bay Point | Kwun Tong | 71,558 (G) | New Letting |

Source: Colliers

## Office rents to rise amid a positive business outlook

Results of Colliers' Occupier Survey 2017 suggest that occupiers are getting more optimistic about their business prospects. PRC companies are the most confident about their business outlook. Thus, Hong Kong's office market should benefit from this expansionary cycle. The banking and financial sectors, and the TMT sector should be the strongest driver of rental growth in 2018 amid the positive business outlook and increased adoption of technology in business and daily lives. Given the current low vacancy rate against strengthening leasing demand, we expect overall rent to increase 4% in 2018.

Hong Kong Island office rents should benefit from stronger demand despite higher supply in 2018. Rents in Central will remain firm as demand from PRC companies remains strong. Amid positive business sentiments and expanding global economy, multinational companies will be less likely to downsize despite staying cost conscious.

More tenants started to feel the pressure from increasing rents on Hong Kong Island, we expect the relocation trend across the harbour to continue in 2018. The Kowloon East office market is becoming more widely accepted due to factors such as the significant cost savings from the huge rental gap, limited availability for expansion space on Hong Kong Island, and improving amenities in Kowloon East. A strong demand is likely to offset the large amount of new supply regarding the pre-commitment rates in new office developments such as Two Harbour Square and Mapletree Bay Point. Kowloon East rents should start gaining momentum again, and so we expect rents there to increase by 1% in 2018.

## Spotlight on Quarry Bay

Our latest update suggests that 2018 will have 3.1 million sq ft (288,000 sq m) of office space to be completed, almost 50% higher than the annual average over the past two decades. Unlike the past few years as well as next year, new supply will be more evenly distribute across the harbour, with 1.4 million sq ft (130,060 sq m) on Hong Kong Island and 1.5 million sq ft (139,355 sq m) in Kowloon to be completed in the year.

Among all new offices, the spotlight in 2018 will be on One Taikoo Place in Quarry Bay. With a total GFA of 1 million sq ft (92,900 sq m). We expect Quarry Bay to reinvent itself as a new premium business district for finance and professional services, with improved connectivity via the Central-Wanchai bypass, better business amenities, and new quality offices. We believe office rents in Quarry Bay will rise the fastest of all sub-markets in Hong Kong.

## Flexible workspace is expanding, but over-expansion is a risk

Flexible workspace/co-working operators took up more than 250,000 sq ft (23,250 sq m) in 2017 and landlords are making use of co-working operators to revamp their tenant profile or reposition their properties. We expect new players with different backgrounds to enter the market, for example Tencent will open its first "Makerspace" in 2018 to accommodate 200 start-ups. The government has also thrown its weight behind co-working spaces to recharge Hong Kong's economic future. With a growing start-up community, demand for incubation, and co-working spaces should increase. However, operators will have to differentiate themselves from competitors in an increasingly crowded landscape.

We believe flexible workspace will continue to play a major role in driving new leasing demand in Hong Kong's office market. We witnessed the strong growth of the large flexible working operators in 2017, for example WeWork, Regus, TEC, Campfire, etc. We expect more new brands of co-working spaces to participate in the strong competition amid a high potential demand for co-working space. However, over-expansion remains a risk for landlords. Landlords should wisely pick the appropriate operators which can benefit their leasing portfolio in a long-term prospect.

## Kowloon West emerging as a large commercial cluster

We discussed in our Q3 report that we expect Kowloon West to reposition itself as a strong commercial hub with large amounts of new supply, high accessibility to the MTR, and its proximity to the container ports. In addition to Cheung Sha Wan, in the southern part of Kowloon West, we expect developments in West Kowloon and the adjoining Kowloon Station to become more popular. The upcoming Guangzhou – Shenzhen – Hong Kong Express Rail Link, expected to be completed in 2018/19, will improve the accessibility for the district, benefiting companies which have businesses across the border. Meanwhile, the development of the West Kowloon Cultural District will offer 810,000 sq ft (75,280 sq m) of hotel and office spaces, in addition to new arts, cultural, entertainment, and exhibition facilities. This will hugely improve the business amenities at Tsim Sha Tsui and increase its appeals to potential tenants, especially from the media and technology sectors.

## A historical quarter for investment market

Hong Kong's office investment market recorded a historical quarter in Q4 2017. Overall office investment volume reached HKD53 billion (USD6.8 billion), up 408% QOQ, 5.6x higher than the 10-year quarterly average of HKD7.8 billion. PRC investors were again behind the largest acquisitions in the quarter, spending HKD24.9 billion (USD3.2 billion) or about 47% of Hong Kong's office transactions in Q4. 75% of The Center, one of the most prestigious office buildings in Central, was jointly acquired by various local and PRC buyers for a record of HKD40.2 billion (USD5.2 billion). PRC investors accounted for approximately 55% of the acquisition. LVGEM, a PRC developer, was involved, in the acquisition of 8 Bay East, a Grade A office development in Kwun Tong, for HKD9 billion (USD1.2 billion) from Wheelock Properties

The strata title office market also marked an active quarter with more tenants looking to purchase for owner-occupation purpose amid strong rental growth. The market has maintained its momentum since the sale of the Murray Road Car Park office development site in Central. Office properties remained to be the most attractive property assets to investors. Sheung Wan, Central, and Wan Chai are still the most popular districts overall. Price tags of various Grade A office transactions have surpassed HKD30,000 (USD3,856) per sq ft in these areas, which was rare in 2016.

Thanks to the strong investment demand, the overall Grade A office price has increased 15% in 2017. Prices in Central increased 10% while Wan Chai, Tsim Sha Tsui, and Kowloon East increased 20% from 2016.

However, due to the surge of office prices, office property yield compressed further in 2017. Overall office yield compressed to 2.5% by the end of 2017, from 2.9% a year ago.

## Investment market to stay hot in 2018

The Colliers Investor Survey Report, released in November 2017, reveals that Hong Kong's investors still have more appetite for property. Half of the investors surveyed told Colliers that they would be net buyers in 2018, and more than 68% would increase their exposure in real estate. Investors will search for value-added opportunities because persistent high prices and low yields have made underwriting core or core-plus properties challenging. In the APAC context, Hong Kong based investors are still focusing on Tier One cities in China and Singapore. Office properties should remain the most popular property sector with more than 75% of respondents expressing their intention for en-bloc or strata-title office investments.

A low interest rate environment in Hong Kong should remain in 2018, even though the US Federal Reserve has indicated three interest rates hikes in 2018. We expect the investment market in Hong Kong to stay strong provided that real interest rates do not rise too quickly. We expect office price to increase about 5% in 2018, moving similarly to the growth of office rents. Office yield will stay flat based on this price prediction.

In 2017, some investors have already shifted their focus to lower Grade commercial buildings as Grade A offices have become too expensive. We expect this trend to remain in 2018 amid the very low property yield. However, Hong Kong Island should remain as a focus given the strong user demand.

There are still a few large trophy buildings on the market and PRC investors should have the resources to outbid most other investors if these properties match their investment strategies. We remain confident that more en-bloc transactions will be completed in 2018.

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