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Increasing challenges for landlords amid a tenant market

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The decline in Hong Kong exports stabilised but retail sales slid at a double-digit rate in August. Warehouse demand has been softening, while factory rental growth should slow due to government review of unauthorised uses. Landlords have been offering more properties for sale with flexible price terms. We stay pessimistic on the outlook for logistics demand and expect warehouse rents and prices to fall in 2016.

Quarter at a glance

Demand
Leasing market is quiet due to slowing retail sales and fragile export figures

Vacancy rate
Vacancy rate for warehouses and factories has been rising amid shrinking logistics demand

Rent
Warehouse rent has fallen for another quarter and we expect warehouse rent to fall 4% for the whole year

Price
Landlords are disposing their industrial properties in flexible price terms

Major Industrial Market Indicators

	YOY (YTD)
Total Export (Aug 2016)	0.8%
Air Cargo Throughput (Aug 2016)	3.6%
Container Throughput (Aug 2016)	-2.9%
Retail Sales Value (Aug 2016)	-10.5%
Ramp-access Warehouse Rent	-1.1% (-0.7%)
Cargo-lift access Warehouse Rent	-1.1% (-1.1%)

Source: Colliers; Census and Statistics Department

Sentiment remained weak amid an unstable market

The warehouse and logistics industry ought to encourage by total exports in August. Hong Kong total exports (+0.8% YOY) in August stabilised for the first time since May 2015, ending a 15-month decline, thanks to a recovery of exports to China which increased 4.3% YOY in August, marking a 19-month high.

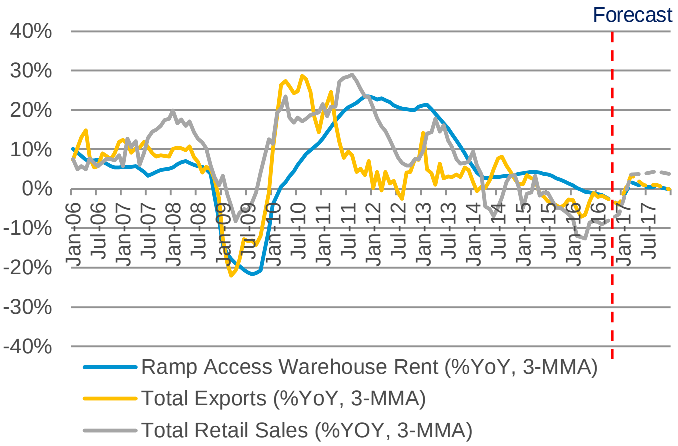
Despite the rebound in August, the aggregate volume in June and July (-1.2% YOY) was still the lowest in the same period for past four years. Meanwhile, the value of Hong Kong retail sales was still depressing with a negative 10.5% YOY growth in August whilst container throughput has fallen for 26 months consecutively with a double-digit decline in July. Warehouse demand is likely to be weak amid the sluggish retail and trading market for the rest of 2016.

Warehouse rent edging down amid subdued demand

Leasing demand for warehouses has been slowing with no significant expansion recorded in the quarter. A local logistics company committed itself to leasing the whole block of Set Win Automobile Plaza in Yuen Long with a monthly rent of HKD1.22 million due to its proximity to China and cheaper rent. The average rent was approximately HKD8.5 per sq ft per month based on a gross floor area of 144,000 sq ft. Further to the north, a 30,000-sq ft floor was leased with rent of HKD12.0 per sq ft per month in Kerry Godown (Sheung Shui).

Warehouse rent declined 1.2% YOY given the leasing demand slowing down. Some landlords have prioritise tenant retention over attracting new tenants as some existing tenants have decided not to renew or expand upon lease expiry due to gloomy business outlook.

Hong Kong Ramp-Access Warehouse Rent

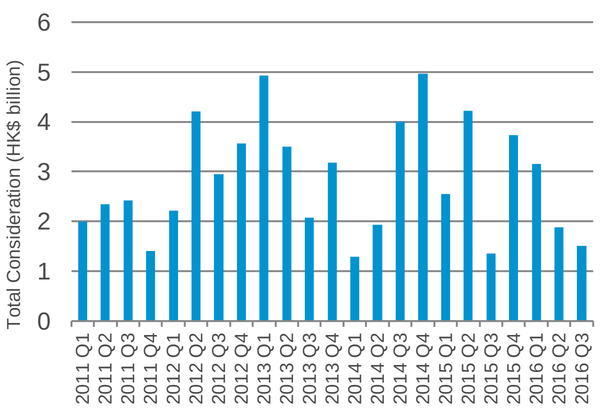


3-MMA = 3-month Moving Average
Source: Colliers; Hong Kong Census and Statistics Department; Hong Kong Trade Development Council; Oxford Economics

Investment activities further decreased

Investment volume fell further with ground floor workshops represented the majority of sale transactions by local buyers. Sales volume was down a further 20% QOQ following a 40% QOQ slump in Q2 2016. Chinese buyers marked two significant strata-titled transactions. China Mobile acquired a whole floor on 9/F in Mita Centre, Kwai Chung for HKD75.8 million or HKD2,770 per sq ft. Meanwhile in Cheung Sha Wan, China Fund for Peace and Development Ltd. acquired the whole floor on 8/F in Ford Glory Plaza for HKD60 million.

Industrial Property Transaction Volume



Source: Colliers
Note: sale transactions over HKD30 million

Lower transaction volume was due to weak demand with increasing supply. We witnessed that several industrial buildings in Kowloon East, Yau Tong, Kwai Chung and Tsuen Wan have been put up for sale with more negotiable price terms given sellers more than buyers.

Curtain-walled industrial buildings[(1)] remained relatively popular amid the quiet market. New curtain-walled industrial buildings have been quickly taken up with some of them being fully occupied in few months after the launches. The primary sales of The Agora in Cheung Sha Wan developed by Kai Long and Rykadan Capital have completed around 80% so far at an average price of around HKD7,460 per sq ft. The development will be completed by December 2018 according to its official website.

[(1)]curtain-walled industrial buildings usually refer to modern flatted industrial buildings with aluminium alloy, aluminium grille and glazing facing the exterior

More industrial space to maintain long-term growth

The government announced the revised plan for the Hung Shui Kiu New Development Area in September 2016 after the three-stage community engagement was completed in August 2015. Despite the designated land area for industrial and special industrial uses remained unchanged; the floor area has increased to 46.4 million sq ft through the achievement of a higher efficiency by the merging of land parcels with similar uses. We expect industrial and logistics uses to cluster in the western part of the development area benefiting from better connectivity with China through Kong Sham Western Highway.

For new supply, Billion Development won the government tender for the industrial site in Kwai Chung for HKD834 million. The 39,902 sq ft site is the only site for industrial use in the latest government land sale programme. The development is designated for industrial use and at least 30% of total floor area will be built for storage use.

Factory owners desperate for wholesale conversion

Falling buying interest for old flatted factories could be partly explained by the fact that the government started reviewing the use of industrial buildings in July 2016. Under the new rules, District Land Offices of the Lands Department will re-enter premises if the owners fail to rectify the unauthorised uses in 14 days after they receive warning letters regarding the breaches. The government announced a list of six industrial buildings in various districts to be reviewed in July. As of 28 September, 92 premises in 15 industrial buildings were inspected by District Land Offices. The department has given out warning letters to 27 cases.

As the government is set to continue its review of unauthorised uses of industrial buildings, existing demand from unauthorised uses will temporarily disappear from the market. With the expectation of a further shrinking in market demand, factory owners and investors have been actively seeking to redevelop or convert the use of existing industrial buildings. The Town Planning Board approved an industrial site in Kwai Chung to build a 12-storey private columbarium (i.e. place to house cremated remains) after the applicant slashed the development scale by 45% from the original proposal. Kerry Logistics has also proposed to convert its warehouse in Chai Wan to a private columbarium, but was just rejected by the Board as the majority of residents expressed objections. In view of Wong Chuk Hang transforming into a commercial district, a local investor plans to unify the ownership in Reliance Manufactory Building by acquiring units on 2/F and 3/F for HKD240 million and HKD235 million, respectively, as a value-added investment with the opportunity to convert the existing premises into a commercial building.

However, plenty of industrial buildings have fragmented ownership and it will be costly and time consuming to proceed from acquisition to conversion, especially for those in traditional industrial areas such as Kowloon East. We expect rental growth to slow down in the short term to attract new tenants. With healthy demand, self-storage use has the best potential to backfill the vacant space left by unauthorised uses.

Uncertainties to persist with further decline in rents and prices

A rebound in total exports remains unlikely due to uncertain economic prospects for China. Growth in private investment and imports has been constrained in China, which has affected Hong Kong via re-export trade and trade-related services. While Hong Kong's economy was largely unscathed by Brexit in Q2, the result of the US Presidential Election in November 2016 could create another disruption to global economy in the long term with both candidates advocating the tightening of trading policies. Hong Kong Trade Development Council's forecast of a 4% decline for the whole year in total export has become more likely with a decline of 3.4% YOY for the YTD volume between January 2016 and August 2016. We expect logistics demand to stay soft in general amid a sluggish export sector with only a few operators expanded their footprints.

Against this backdrop, demand for warehouses should stay subdued for 2016. Although e-commerce and 3PLs took up some space in the first half of this year, activities have not been strong enough against the slowing export market. The weak market sentiment and negative growth forecast of total exports prevent us from adjusting our forecast of a 4% decline in warehouse rents.

The transaction information originates from the Land Registry and market news and is for reference only.
The information contained in this report is a summarised version of our observations on the market in the past quarter. A more in-depth overview on specific sectors is available upon request.

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