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Cost-conscious tenants put pressure on rental growth

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With rents stable on Hong Kong Island but softening in Kowloon, overall rental growth turned negative for the first time since Q4 2014. Vacancy rates edged up marginally in the CBD and Kowloon. Over the next two years, tenants seeking incentives from landlords and attractive rents may consider new office space in Kowloon East, Island East and Wong Chuk Hang.

Quarter at a glance

Demand

Overall leasing demand improved with increased net absorption compared to 2Q

Vacancy

Vacancy edged up in Central/Admiralty, Tsim Sha Tsui and Kowloon East

Rent

Island rents were stable, while Kowloon rents softened further. We expect this trend to continue over the rest of 2016

Investments

The investment market remained active with a number of major transactions totalling HKD21.5 billion.

Net absorption remained in the negative territory

Overall grade A net absorption reached -85,323 sq ft in 3Q. Despite being in negative territory, this is an improvement from 2Q, which recorded overall net absorption of -217,667 sq ft. Negative net absorption was recorded in Central / Admiralty (-75,372 sq ft), Island East (-3,994 sq ft), Tsim Sha Tsui (-10,634 sq ft), and Kowloon East (-28,253 sq ft).

Decreased take-up in Central/Admiralty reflects a marginal increase in vacancy rate from a number of small pocket spaces. Thus, this should not be considered as a sign of weakening demand in the CBD.

The overall vacancy rate stood at 3.3% in 3Q, a 14 basis point increase from 2Q. The Central/Admiralty vacancy rate experienced a marginal increase of 35 basis point reaching 2.4%. Vacancy in Wan Chai/Causeway Bay stood at 3.2%, a 29 basis point decrease. Island East vacancy remained stable at 1.4%.

In Kowloon market, Tsim Sha Tsui vacancy showed a marginal increase of 16 basis points compared to 2Q reaching 2.5%. Kowloon East vacancy was recorded at 7.7%, an increase of 25 basis points.

Overall rents edged down

Overall grade A rental growth turned negative with a QOQ decline of 10 basis points in Q3 reaching HKD74.16. This is the first time since Q4 2014 that the overall quarterly rental growth turned negative.

Central / Admiralty and Wan Chai / Causeway Bay rents

Submarkets	Grade A Vacancy	Grade A Net Effective Rents (HKD/ sq ft/ month)	QOQ Rental Change	2016 Rental Forecast
Central / Admiralty	2.4%	$117.1	0.1%	$118.2
Wan Chai / Causeway Bay	3.2%	$68.8	0.1%	$69.0
Island East	1.4%	$48.9	-1.1%	$50.6
Tsim Sha Tsui	2.5%	$55.1	-0.6%	$55.6
Kowloon East	7.7%	$35.0	-0.1%	$33.8
Overall	3.3%	$74.2	-0.1%	$74.9

Source: Colliers / Figures refer to grade A office buildings stayed steady with just a QOQ growth of 0.1%, reaching HKD117.13 and HKD68.78 respectively. Rents in Island East recorded a QOQ negative growth of -1.1% reaching HKD48.94. This is the first time since Q4 2014 that Island East recorded a negative quarterly growth. In Kowloon, Tsim Sha Tsui and Kowloon East rents continued to soften with QOQ growths of -0.6% and -0.1% reaching HKD55.12 and HKD34.95 respectively.

We attribute the stability of rents in Hong Kong Island to the fact that supply is very limited and that overall demand for space remains strong, with mainland Chinese companies and the insurance industry two important sources of overall demand for space. On the other hand, we see signs of increasing cost consciousness on the part of major tenants in the banking and finance sector and mainland Chinese tenants who have been the driving force behind strong rental growth in the past. There is also evidence that mainland Chinese tenants are more interested in buying office space rather than leasing.

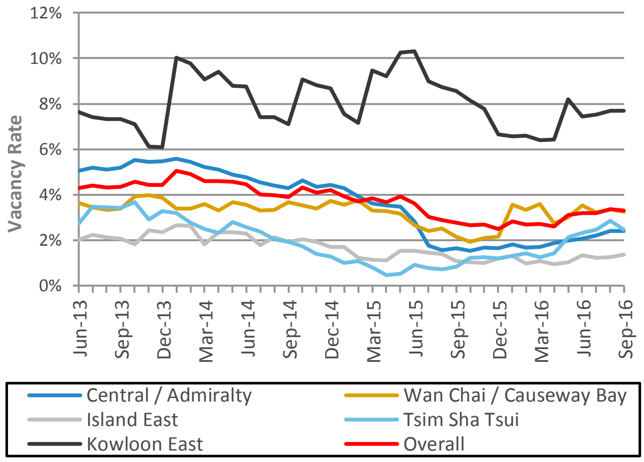
Decentralised areas are becoming more popular

New leasing activity in core areas slowed owing to cost sensitive tenants and low vacancy rates. Several sizable transactions include; Huarong International Financial Holdings Ltd renewed its 20,257 sq ft lease at One Pacific Place and Canada Pension Plan Investment Board renewed its lease of 16,600 sq ft at York House.

In fringe CBD areas, Aon Hong Kong Ltd and Neo Derm (HK) Ltd renewed their 55,284 sq ft and 51,666 sq ft respectively at Times Square - Tower One. Samsung Electronics HK Co Ltd renewed its 39,081 sq ft lease at Central Plaza.

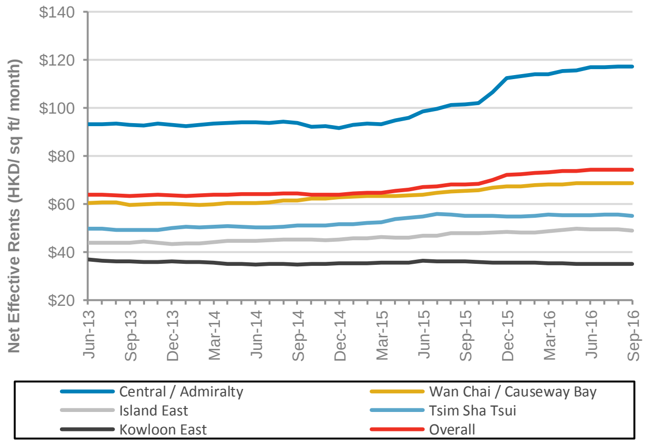
In decentralized areas, Esprit De Corp (FE) Ltd leased 40,824 sq ft at Enterprise Square Three. Bureau Veritas renewed their lease of 28,400 sq ft at Octa Tower. In West Kowloon, Fossil (Far East) Ltd leased 28,140 sq ft at CDW Building while LeTV leased 21,351 sq ft at the Octagon.

Hong Kong Grade A Vacancy Trend



Source: Colliers

Hong Kong Grade A Rental Trend



Source: Colliers

Tenant	Building	District	NFA (sq ft)	Transaction Type
Aon HK Ltd	Times Square - Tower One	Causeway Bay	55,284	Renewal
Neo Derm (HK) Ltd	Times Square - Tower One	Causeway Bay	51,666	Renewal
Esprit De Corp (FE) Ltd	Enterprise Square Three	Kowloon Bay	40,824	New Letting
Samsung Electronics HK Co Ltd	Central Plaza	Wan Chai	39,081	Renewal
Bureau Veritas	Octa Tower	Kowloon Bay	28,400	Renew
Fossil (Far East) Ltd	CDW Building	Tsuen Wan	28,140	New Letting
C&A Sourcing	Millennium City 6	Kwun Tong	25,676	Renew
Sun Life Hong Kong Ltd	The Harbourfront Tower 2	Hung Hom	25,129	New Letting
LeTV	The Octagon	Tsuen Wan	21,351	New Letting

Source: Colliers

A number of sizable transactions were observed in decentralized locations such as Tsuen Wan, Cheung Sha Wan and Lai Chi Kok. West Kowloon, that includes Kwai Chung, Cheung Sha Wan, Lai Chi Kok and Tsuen Wan has attracted the attention of tenants as an alternative office node in Kowloon due to its new supply of quality office spaces and strategic location.

Investment market remained active

The third quarter was an active quarter with a number of major transactions totalling HKD21.5 billion. In fringe CBD, headline transactions include; Golden Centre that was bought by an undisclosed buyer for HKD4,368 million, 21-23 floors of Convention Plaza office tower bought by China Energy Fund Committee for HKD1,388 million and Continental Place bought by AEW for HKD1,134 million.

Major transactions in decentralized markets include; One Harbour Gate (East Tower) by Cheung Kei Group for HKD4,500 million and levels 18-22 of KCC Building Tower B by Hong Kong Police Credit Union for HKD1,409 million.

Infrastructure developments and upcoming supply offer new opportunities

Amid global economic headwinds we are seeing signs of weakening demand for office spaces, particularly from tenants in banking & finance, logistics and sourcing industries. Recent news reports (in many cases not yet confirmed) of job cuts and rationalisation measures affecting the Asian operations of large banks and investment banks such as Bank of America, Barclays, BNP Paribas, Deutsche Bank, Goldman Sachs, ING and Standard Chartered provide evidence of the continuing pressure on large financial institutions to strengthen their capital bases and streamline their cost structures. Looking forward, the challenges that large financial groups face could have direct impacts on their demand for office space. Consequences in the market could include decisions to downsize or to opt for more cost-effective solutions such as decentralized locations

With the completion of South Island Line in the end of this year, we have noticed an increase in inquiries for office space in Wong Chuk Hang. The area is attractive to tenants due to two major reasons. First, with monthly net effective rent of HKD31.95 per sq ft, Wong Chuk Hang is cheaper than other major decentralized submarkets such as Island East and Kowloon East. Second, it is conveniently located within 15 minutes of travelling distance from the CBD, which is closer than other decentralized submarkets.

We expect that around 4.5 million sq ft of office space will be added to the market in 2017 including revitalized and redeveloped buildings. 53% of this will be concentrated in Kowloon East. This large upcoming supply has forced the landlords to become more aggressive in order to retain the existing tenants and to attract new occupants to fill up their buildings. Tenants can benefit from these incentives by considering upcoming office spaces in Kowloon East, Island East and Wong Chuk Hang in next two years.

Going forward, we believe the overall grade A rents to stabilize in the remainder of this year with Hong Kong Island experiencing marginal growth while Kowloon submarkets experiencing further rent softening. Vacancies in prime office spaces in the CBD will remain low, while decentralized markets will experience slight increases in their vacancies owing to changing supply conditions.

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