Colliers Quarterly

HONG KONG | RETAIL
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Accelerating success.

International brands cash in on falling retail rents

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Challenges in the Hong Kong retail sector remain significant with slowing visitor arrivals, falling tourist expenditure and the strong Hong Kong dollar further squeezing sales across the board. However, demand from international brands for the right physical space in prime locations remains strong. Retailers should take advantage of softening rents to expand their presence in the city. Colliers Research predicts rents of prime street shops will decline by a further 10% for the whole year of 2016.

Quarter at a glance

Demand

The spending power of the rising middle class remains firm given a healthy employment market and steady wage growth despite changes in the retail landscape. Consumer essentials is the sector that will continue to show strength.

Rent

RENT

We expect rents of prime high-street shops to fall by 10% in 2016, following a 24% decline in 2015. Rents should rebound from H2 2017 as tourist spending stops declining and local consumption expands.

Price

The effective real interest rate in Hong Kong is currently about -2.1%. Retail market yields increased marginally in Q3 and investors are more interested in shopping malls and retail podium offering opportunities to remix or reposition

Year	Current	2016 F
Overall Rental Index*	75	-12%
Central	83	-8%
Causeway Bay	71	-8%
Tsim Sha Tsui	77	-10%
Mong Kok	72	-17%
Yield	2.6%	50 bps

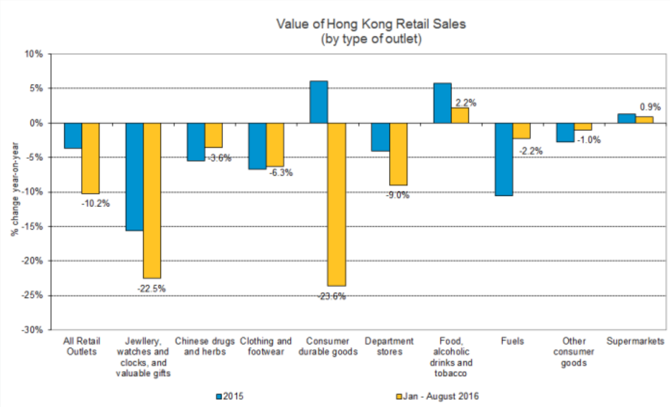
Index: Nov 2011 = 100
*Street level shops on key street segments

Falling tourist expenditure amid declines of visitor arrivals

A further slowdown in visitor arrivals and structural changes in mainland consumer behaviour continued to squeeze retail sales across the board. Overall retail sales fell for the eighteenth straight month in August 2016, with total sales value down 10.2% year-on-year (YOY) between January and August 2016, according to the Census and Statistics Department.

Meanwhile, the volume of inbound visitors decreased 6.4% YOY during January and August 2016, in which mainland tourists saw a sharper decline, down 9.2% YOY, according to the latest statistics from the Hong Kong Tourism Board. Tourists are spending less in Hong Kong, with the overall tourist expenditure dropping 14.6%in 1H 2016, from HKD7,598 to HKD6,492 per person (USD974 - USD832). Similarly, mainland tourist expenditure fell 15.8% from HKD8,445 to HKD7,105 per person.

Value of HK retail sales (by type of outlet)



Source: Census and Statistics Department

We expect the impact of declining tourist spending on the local retail industry will start to diminish after 18 months of consecutive decreases. The retail industry is adjusting to the changing market conditions, exploring new business models, and tailoring its services more to the local population.

Oxford Economics predicts that Hong Kong retail sales will contract 9.4% in 2016 before rebounding to positive growth in 2017 (2.0%) 2018 (2.8%), 2019 (2.9%) and 2020 (2.8%). Given a soft tourism market, we expect that local consumption's share of total retail sales value will expand further as the revenue from tourists continues to decrease. The spending power of the middle class should remain firm given a healthy employment market and steady wage growth. Accordingly, we believe consumer essentials is the sector that will continue to show strength.

Luxury's pain as others gain

Despite current challenges in the retail market, a new opportunity has presented itself in the form of fast fashion, activewear, affordable luxury fashion, cosmetics and beauty brands, as well as overseas food and beverage operators. Retailers in these sectors have become more active in looking for prime retail spaces. With shop rents having already dropped an average of 30%, these brands are taking advantage of the new, lower cost of entering or expanding their operations in Hong Kong.

International brands taking up prime retail spaces

Godiva, a Belgian chocolate company, opened a store on D'Aguilar Street, Central, during Q3 2016 with a rent reduction of almost 40% compared to the previous lease in 2014. It is Godiva's first standalone shop in Hong Kong as the company normally runs stores in shopping malls. This is a tactic that was previously prohibitive on cost grounds.

In addition, the American fashion retail brand Forever 21 opened its second store, a new three level store of 19,000 sq ft, in Mong Kok; Minki (street-style-meets-Scandi-chic design brand under H&M) opened its fourth standalone store at Windsor House in Causeway Bay; and the French sportswear brand Lacoste took over the space at The One in Tsim Sha Tsui which was previously occupied by a luxury watch brand.

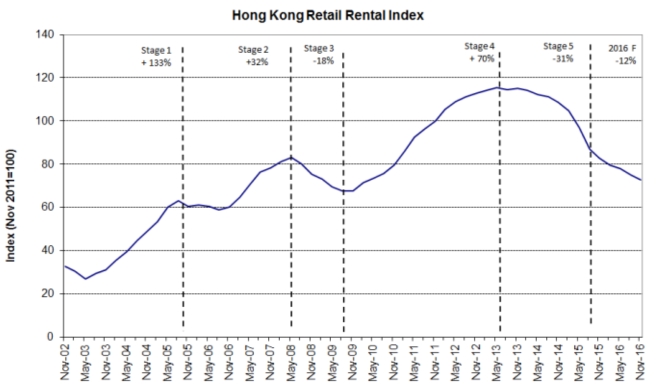
Furthermore, Da-Jiang Innovations Science & Technology Company (DJI), the world's biggest maker of drones, said it would open its 10,000 sq ft store (over three floors) at Tower 535 in Causeway Bay, according to the SCMP on 29 August 2016. Hong Kong would mark the third flagship retail location for DJI, following the company's first store in Shenzhen and the second outlet in Seoul that opened in March. Earlier in May, DJI expanded its "Experience Zone" inside Terminal 1 of the Hong Kong International Airport to show travellers the latest aerial photographs and videos taken by drones.

Retail industry moving on to digital platforms

The Hong Kong retail landscape is rapidly changing. Technology and e-commerce platforms are becoming more sophisticated; the middle class is rising in importance; and millennial shoppers are shifting towards an emphasis on creative shopping experiences. Since international luxury retail brands are no longer dominating the market, other players are emerging and innovating. The retail industry is moving on to digital platforms to improve shopping experiences and deliver greater personalisation with the intention of attracting, connecting and engaging with the most valuable consumers. Looking ahead, Augmented Reality/Virtual Reality should be increasingly popular and should facilitate personalised shopping.

Prime street rents set to continue sliding before rebounding in H2 2017

Reflecting falling retail sales and lower tourism spending, Hong Kong retail rents in the traditional top four shopping locations decreased by another 3.1% quarter-on-quarter (QOQ) in Q3 2016, bringing the year-to-date decline to 8.9%, based on Colliers statistics. We project that average rent for prime street shops in core areas will decrease by 10% for the whole year of 2016. In line with the retail sales forecasts from Oxford Economics, Colliers Research estimates that rent will rebound starting in the second half of 2017 as tourist spending stops declining and local consumption expands.



Source: Colliers

Yield-hungry investors have strong incentive to diversify their retail properties

The sales market became more active during the quarter due to investors' stronger demand for retail podiums. Chance Advance, a wholly owned subsidiary of Pioneer Global Group Limited (i.e. Gaw Capital), acquired the whole of the lower ground floor, 1/F and 2/F at Kiu Fat Building, located at 115-119 Queen's Road West in Sai Ying Pun, for a total of HKD648 (USD83) million, according to the public announcement by Hong Kong Stock Exchange. The purchase price represents approximately HKD11,420 (USD1,464) per sq ft with a rental yield of 2.5% based on passing rents. We expect the new investor to look to remix or reposition the asset, and to diversify by exploring new retail concepts and seeking to attract a broader mix of retail tenants including more food and beverages outlets, art galleries and co-working space operators, in order to achieve a higher yield of around 5%.

Retail market yields increased marginally to 2.6% in Q3 2016, compared with 2.4% in Q1 2016. With capital values falling faster than rents, yields should continue to expand going forward. We do not expect a drastic decline in capital values as the delay in US interest rate hikes should prolong the period of negative real interest rates in Hong Kong, implying a soft landing in property prices. The effective real interest rate in Hong Kong is currently about -2.1%. We expect investors seeking yield to continue to show interest in shopping malls or retail podiums that present opportunities to remix or reposition assets. Investors can achieve a higher yield by exploring new retail concepts, for example, creative food and beverages concepts, themed events and the addition of pop-up stores that provide excitement to shoppers in general, and in particular technologically aware and experience-seeking millennial consumers.

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