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Strong employment outlook supports leasing demand

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The overall economy and labour market stayed strong in Q1 2018, supporting the leasing demand for office. The banking and finance sector is cautiously expanding, while leasing demand from PRC companies and flexible workspace operators has continued to grow. Relocation across Hong Kong Island has become more generally accepted due to high rents and low vacancies in Central. We expect more PRC companies to consider Tsim Sha Tsui due to the completion of the Express Rail Link. Kowloon East remains active as new buildings offer large floor plates for MNCs' consolidation.

Forecast at a glance

Demand
The banking and finance sector is cautiously expanding. Relocation demand has stayed strong on Hong Kong Island, while Kowloon East is becoming an option for consolidation.

Supply
2.5 million sq ft (233,080 sq m) of new Grade A office space should be completed in 2018, almost 50% above the 10-year annual average, and an average of 2 million sq ft (185,805 sq ft) in 2019-2021.

Rent
Despite the increasing amount of new supply, we expect overall rent to increase 8.7% over 2018 and 2019 due to firm business sentiment before turning down gradually in 2020 and 2021.

Strong demand in Q1 2018

The overall net absorption was positive at 651,343 sq ft (60,512 sq m), as companies continue to expand. In Central/Admiralty, a positive net take-up of 84,832 sq ft (7,881 sq m) was recorded, higher than last quarter's and the strongest since Q3 2015. In-house expansions have quickly backfilled space being surrendered, while stronger relocation demand has benefited Wan Chai/Causeway Bay and Island East, which reported positive net take-up of 167,273 sq ft (15,540 sq m) and 147,725 sq ft (13,724 sq m), respectively. Wong Chuk Hang remained relatively quiet, with net take-up up at 51,206 sq ft (4,757 sq m).

Tsim Sha Tsui's net take-up reported a mild decline of 23,678 sq ft (2,200 sq m) in Q1, while Kowloon East reported a positive net take-up of 117,998 sq ft (10,962 sq m). Large tenants have moved into new office buildings in Kowloon East to consolidate operations from multiple locations into one space, while flexible workspace operators continued to expand in the district.

Strong demand has maintained the overall vacancy rate low at 5.1%. Central/Admiralty stayed low at 2.0%, where PRC firms continued to expand, while the employment outlook for the banking and finance sector remained optimistic. In Wan Chai/Causeway Bay and Island East, vacancies stayed low by accommodating the tenants' relocation needs from Central. In Tsim Sha Tsui, vacancies remained tight as consecutive floors available for lease were rare. Kowloon East's vacancy increased slightly, back to double digits due to the completion of Two Harbour Square, which provides 400,000 sq ft (37,161 sq m) net floor area of new office space.

Grade A Office Submarkets	Vacancy Rate	Net Effective Rent (HKD / sq ft / month, NFA)	QOQ Rental Change	2018 Rental Forecast	2018 YOY Change
Central / Admiralty	2.0%	$130.4	2.2%	$134.8	5.0%
Wan Chai / Causeway Bay	2.7%	$73.3	4.5%	$74.1	6.0%
Island East	2.7%	$52.5	1.5%	$54.1	5.4%
Tsim Sha Tsui	2.6%	$60.3	4.1%	$60.8	6.0%
Kowloon East	12.1%	$35.0	0.7%	$35.8	3.0%
Overall	5.1%	$74.7	1.5%	$76.4	4.7%

Note: Building basket for Central/Admiralty was revised in Q1 2018

Rents increased amid tight supply

The positive business sentiment has driven overall Grade A office rents up by 1.5% QOQ. Rents for Central/Admiralty increased 2.2% amid a low vacancy rate. Rental growth in the CBD has spill over to lower tier Grade A buildings, as most popular buildings were fully occupied or too expensive, leaving tenants no choice in the CBD area. Some tenants had to search outside the CBD area, which has spread the rental growth to other submarkets on Hong Kong Island. International banks can easily afford the rents in other districts, relocation of their back offices supported rents in Wan Chai/Causeway Bay and Island East to increase 4.5% and 1.5% QOQ, respectively. The continuous decline of vacancies has driven rental growth in Wong Chuk Hang, up 3.9% QOQ.

We witnessed a strong rental growth in Tsim Sha Tsui, up by 4.1% QOQ, given the Express Railway Line is close to completion. Despite the strong supply market, the expanding rental gap between Kowloon East and Hong Kong Island has left little room for rents in Kowloon East to fall further, even though high vacancy rates at some buildings remained. The district's rent has increased 0.7% QOQ, thanks to the consolidation demand.

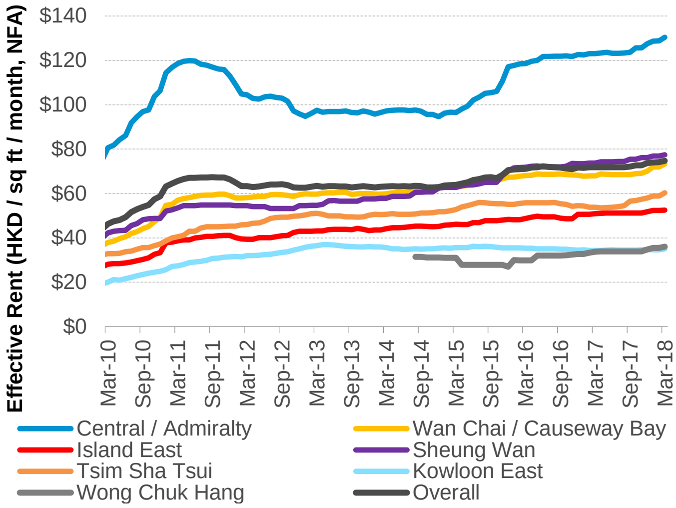
Strong demand for new buildings

The employment outlook for Q2 2018 for Finance, Insurance, and Real estate will be the strongest since Q1 2011, according to a survey conducted by Manpower[1]. The intake by PRC companies and flexible workspace operators also remained as key demand drivers. Large corporates continued their office consolidation strategy, but availability of consecutive floors remained very rare in core areas.

Amid the growing demand and low vacancy on Hong Kong Island, new Grade A buildings have become the only option for most office consolidations. Relocating across Hong Kong Island has become more widely accepted for MNCs as office rents in Central were too high. New developments on the Island such as Lee Garden Three in Causeway, which was completed in December 2017, has already leased over 90%. Goldman Sachs, the latest tenant to move in, has taken five floors in the building, relocating from The Center in Central. One Taikoo Place in Quarry Bay which should be completed in Q3 2018 has around 80% space being pre-committed. The improving retail/F&B amenities and infrastructures have also been stimulating relocations.

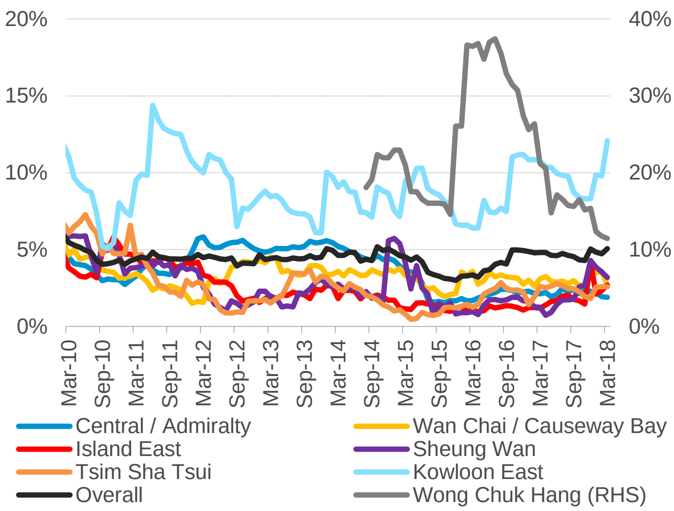
New office buildings in Kowloon are popular for a wide range of tenants. Manufacturing companies, insurance companies, and flexible workspaces have been the demand drivers, while relocation and consolidation within the same district have also become a major source of demand for new Grade A buildings in Kowloon East.

Hong Kong Grade A Rental Trend



Source: Colliers

Hong Kong Grade A Vacancy Trend



Source: Colliers

[1] ManpowerGroup Employment Outlook Survey Hong Kong Q2 2018

Tenant	Building	District	Floor Area (sq ft)	Transaction Type
WeWork	Cityplaza Three	Quarry Bay	54,000 (L)	New Letting
FTLife	Hong Kong Pacific Tower	Kowloon Bay	98,800 (G)	New Letting
Star TV	The Harbourfront Tower 1	Hung Hom	70,150 (G)	Renewal
Arcadis	Two Harbour Square	Kwun Tong	77,900 (G)	Consolidation
Goldman Sachs	Lee Garden Three	Causeway Bay	72,114 (L)	Relocation

Source: Colliers

Positive rental outlook encourages office conversions

The rental outlook remains positive for the coming three years given the positive economic and business cycles which are expected to stay. Despite the increasing new supply, space shortage remains amid growing demand.

More landlords have considered to convert hotels or serviced apartments into office buildings, especially the ones outside Central as they expect a stronger potential rental growth due to the widening rental gap between CBD and non-CBD areas.

Following the conversion of the upper floors in The Gateway - Sun Life Tower from serviced apartments to offices, Cheung Kong has applied to convert its serviced apartment and hotel in Hung Hom, Harbourview Horizon and Harbourfront Horizon, into office buildings, which could provide a potential 2.2 million sq ft of commercial/office space.

Some landlords have applied for office conversions to give the property higher flexibility and to increase the property's value. Occupancies for hotels and serviced apartments have become stable due to the rebounds of tourism and housing budgets for expat staff. However, investors and landlords are more confident on the rental growth and price growth of office buildings.

Enhancement of amenities to lure office relocations

As large corporates consider office environments and business communities as important factors to attract millennials and young talents, landlords have started to enhance their portfolios by offering additional amenities and facilities, as well as enhancing the pedestrian linkages to stay competitive.

While the CBD has been enjoying the most advanced connectivity between Grade A office buildings, a landlord in Central has introduced new mobile application, enhance the tenants' experience around enjoying the retail and conference facilities.

As relocation needs are accelerating, landlords outside the CBD have been actively expanding and upgrading their portfolios to capture the demand. The development Hopewell Centre II in Wan Chai South will provide a new retail podium and a green park. Its landlord has refined the development plan which proposes to build new walkways and bridges to connect buildings within the portfolio, to the Wan Chai station exit at Lee Tung Avenue and apartments adjoining the office towers.

In Causeway Bay, the new Grade A development Lee Garden Three will not only provide new quality office space but also a five-level retail podium of shops on the lower floors. The landlord plans to improve the connectivity within its portfolio in Causeway Bay through new bridges and tunnels.

In Quarry Bay, the two new gardens developed within the landlord's portfolio will provide nearly 70,000 sq ft of open green space. The Refinery, unveiled at Taikoo Place, will offer new amenities to tenants including restaurants, bar and lounges as well as a fitness centre to encourage tenants to socialize and strengthen their business potentials.

Tsim Sha Tsui to regain its glitter

The 632,917 sq ft (58,800 sq m) site above the Express Rail Link (XRL) terminus in West Kowloon will be the largest commercial site to be sold in two decades. The site will provide a GFA of 3.16 million sq ft (294,000 sq m), comprising 2.85 million sq ft (264,600 sq m) of office space and 316,460 sq ft (29,400 sq m) of retail space. With a height restriction of 125 metres above Principle Datum, we expect the development to provide large floor plates which will be suitable for expansion and consolidation. Tsim Sha Tsui will again attract influx of MNCs amid the very low vacancy in the CBD area and the huge rental gap compared to Central.

The beginning of XRL service in Q3 2018 will turn Tsim Sha Tsui into the major gateway for cross-border business within the Greater Bay Area. Tsim Sha Tsui will only be 14 minutes from Futian in Shenzhen, 23 minutes from Shenzhen North, and 48 minutes from Guangzhou South via the XRL. PRC companies' presence in Tsim Sha Tsui is much lower than in Central. With the completion of the XRL, we expect a much stronger interest from mainland companies in the premium Grade A offices in Tsim Sha Tsui, which will accelerate rental growth and narrow the rental gap with Central.

Given the optimistic outlook of the developments in Tsim Sha Tsui, we forecast Grade A office rents for Tsim Sha Tsui to increase 5% per annum from 2019 to 2022. The enhancement of amenities and accessibility will surely drive new demand, while the strategic location of Tsim Sha Tsui will always retain its competitiveness against the rising CBD2 in Kowloon East.

The buying spree has no stopping

Investors have not stopped their buying spree for office properties in 2018 despite compressing yield. Q1 2018 has recorded a total transaction value of HKD30.9 billion (USD4 billion). It declined 41.7% QOQ due to the record sale of The Centre in Q4 2017, but it was the second strongest quarter over the decade.

PRC buyers were once again behind the high transaction values. 18 King Wah Road, a 22-storey office development in North Point developed by Henderson Land was sold to a consortium of China Taiping and China Create Capital for HKD9.95 billion (USD1.3 billion), the third largest en bloc office transaction in Hong Kong. The price tag equated to about HKD30,170 (USD3,900) per sq ft based on a gross floor area of 329,800 sq ft, a record high for an office building in North Point.

As the supply of Grade A offices remained limited in the sales market, buyers continued to look for opportunities in the lower tier market. Some other notable en bloc transactions of Grade B offices include the acquisitions of Bonham Circus in Sheung Wan and W Square in Wan Chai, which were sold for HKD1.7 billion (USD218.5 million) and HKD2.85 billion (USD366.3 million) respectively.

The strata title market remained active with private equity and local buyers chasing limited stock. The active market has pushed strata-titled office prices further up by 8.6% QOQ. This strong growth was mainly driven by record transactions in Central and Admiralty, which were around HKD40,000 (USD5,141) per sq ft or above, compared to HKD30,000-35,000 for most transactions in 2017. Notable transactions include two units on the 19/F in Bank of America Tower in Admiralty, sold to local investors for HKD105 million (USD13.5 million), or HKD39,900 (USD5,128) per sq ft, the highest record of the building in terms of unit price. The whole 18/F in 9 Queen's Road Central was sold for HKD660 million (USD84.8 million), the unit price was the building's highest record at HKD48,000 (USD6,170) per sq ft.

Purchasing demand to persist amid and low interest rates

The Chinese Central government has reinforced capital controls which might impact Hong Kong's investment market. It is undeniable that Chinese investors have become inactive in investing trophy assets, or investing for speculations. However, we expect the organic demand from PRC buyers to stay, where they should continue to purchase properties for their own use, or to purchase at reasonable prices for long-term investment purpose.

With PRC buyers being less aggressive than before, we expect fewer Grade A office buildings to be offered for sale in 2018, while investment activities for Grade B or ginza-style buildings should stay strong.

With more PRC companies setting up their operations in Hong Kong, the strata title market has benefited from the owner-occupation demand due to expensive office rents. Meanwhile, Hong Kong's office properties should remain the most popular asset type as offices are easy to manage compared to shopping malls and industrial buildings.

The US Federal Reserve has indicated three 25-basis point interest rate increases in the Federal Funds rate over 2018. We expect Hong Kong's interest rates to track these increases. The Hong Kong Monetary Authority has been encouraging local banks to increase lending rates as the Hong Kong dollar has been deteriorating against the US dollar, hitting close to the lower end of the trading band at 7.85.

However, the low interest environment should be sustained in 2018 and Hong Kong's real (i.e. inflation adjusted) interest rate should remain negative in 2018. The investment market should stay active and office prices should increase until late 2019 when real interest rates turn positive again. We expect office prices to increase 8-10% in 2018. Office yields should stay low but may be supported by the increase of office rents.

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