The Evolution of Office Space in Hong Kong
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Introduction

The high occupancy costs and shortage of office space remain a major challenge for multinational companies looking for a prime location to set up their regional headquarters in Hong Kong. The acute shortage of land for development is the main factor driving prices higher and making rents expensive. To maintain its position as the most dynamic financial hub in Asia, Hong Kong needs to expand its commercial landscape, while infrastructure spending can provide immediate economic stimulus.

In this report, we address the new infrastructure links and their impact on how office locations will evolve over the next decade. We will review the development of new office locations. We will also examine new infrastructure projects and how they affect rental performance in decentralised locations. By comparing demand from office occupiers by district – core versus decentralised neighbourhoods – we can identify the specific types of industry demand and the likely demand drivers for office space in the future.
Infrastructure and diversification

Hong Kong is the financial hub of Asia and competes with the major financial capitals around the world such as London and New York. The development of Hong Kong’s new central business district (CBD2), including Kwun Tong, Kowloon Bay and Kai Tak, is part of an all-encompassing plan for the city that will expand its commercial landscape and provide a long-term solution to its current lack of space. The plan will free up a vast amount of space for expansion by both local and international businesses. CBD2 should also facilitate business by providing a wide variety of quality hotels, residential property, offices, conference venues, retail outlets and transportation nodes.

The government is also spending a vast amount on infrastructure projects to boost the city’s economic growth in the years to come. Infrastructure spending provides immediate economic stimulus, but the city also needs to ponder how it can upgrade and diversify its economy.

Regional focus: Pearl River Delta represents a driver for growth

Hong Kong’s economic future is tied to the Pearl River Delta (PRD) in neighbouring Guangdong province. Hong Kong remains the nexus between the most dynamic economic region in China and the rest of the world. The territory also remains a high-end service provider, management centre and financier for much of the economic activity in the PRD.

Hong Kong continues its integration with the PRD through improved infrastructure, including the Hong Kong-Zhuhai-Macao Bridge (originally scheduled for completion by late 2016 but it is now under review due to delays), the Guangzhou-Shenzhen-Hong Kong Express Rail Link (2017) as well as the Tuen Mun Western Bypass and Tuen Mun-Chek Lap Kok link (2018). These infrastructure upgrades are very positive for the domestic economy, paving the way for an upgrade and greater economic diversification. The strong infrastructure network within Hong Kong itself also promotes growth in trades and services.
Major infrastructure projects under construction

The evolution of front offices to locations that are outside Central is likely to take place first in Island East.
Improved local transportation network

Factors that drive tenants to relocate outside Central

The evolution of front offices to locations that are outside Central is likely to take place first in Island East, which is attractive to corporate occupiers due to its strong portfolio of offices, retail outlets, hotels and serviced apartments. This will be supported by the completion of the Central-Wan Chai Bypass and Island Eastern Corridor Link, due in 2017.

Central-Wan Chai Bypass and Island Eastern Corridor Link

Wong Chuk Hang

The scheduled completion of the MTR South Island Line (East) at the end of 2016 will attract tenants to the neighbourhood of Wong Chuk Hang. It will therefore facilitate the redevelopment and revitalisation of the large number of industrial buildings in the area for office use.

That change will get added impetus from the 7 km South Island Line (East). That line will extend MTR services from Admiralty to the Southern District of Hong Kong Island and will have a train station in Wong Chuk Hang, just two stops from Admiralty. Admiralty will be the interlink station for four lines: Island Line, the Tsuen Wan Line, the South Island Line (East) and the Shatin to Central Link.

There are several industrial-revitalization and redevelopment projects already under way in Wong Chuk Hang, but the area currently lacks a dominant developer capable of creating a coordinated and integrated array of business amenities. Wong Chuk Hang will be an interesting area for office development in Hong Kong driven by improving transport connectivity – it will be just seven minutes of travel time by MTR from Wong Chuk Hang to Admiralty station. The neighbourhood will become more attractive to corporate occupiers as the portfolio of offices, retail, hotels and serviced apartments improves.

Source: Hong Kong government, Colliers
Kowloon East

Several government initiatives in Kowloon East, including the development of CBD2, industrial revitalization, and an improved transportation network connecting the neighbourhood to the rest of the city, have encouraged both investors and occupiers to look into the opportunities in the district.

The construction of the Shatin to Central Link should help overcome the perception that CBD2 is a remote location. The railway link will connect Tai Wai to Admiralty via Kai Tak and is due for completion in 2020.

The proposed monorail route to connect Kwun Tong, Kowloon Bay and Kai Tak will also improve connectivity for the CBD2 area. The 9 km elevated monorail system with 12 stations is expected to be completed by 2023.

The construction of the Shatin to Central Link should help overcome the perception that CBD2 is a remote location.
In September 2014, the government announced it is planning to build six new railway lines and one new station with a total investment of about HK$110 billion. The East Kowloon Line will take the biggest share at HK$27.5 billion.

Construction is due to start in 2018 and end in 2026. The new services will shorten travel times and commutes within the territory. The focus of the new railway schemes is to support existing neighbourhoods and open up other areas for potential development. The investment in the expanded railway network will bring direct economic benefits, leading to a modern, efficient railway network.

Source: HKSAR Government
Offices with easy access to public transport fetch higher rents

The attraction of being located close to railway stations is every bit as applicable to offices as it is to residential real estate. Offices near stations fetch higher rents than offices outside main business districts or farther away from public transport.

Before the completion of the MTR Island Line, the premium for Grade A office rents in Central when compared with the neighbourhoods of Wan Chai and Causeway Bay averaged 56% in 1983 and 1984. The MTR Island Line opened in May 1985, with the section linking Admiralty to Chai Wan, and the section linking Sheung Wan to Admiralty opened in May 1986. Following those developments, the premium for annual rents for Grade A offices in Central narrowed to 45% in 1987 and 1988. The improved infrastructure connections directly led to a closing in the rental gap between core and non-core areas. Decentralised areas saw quicker rental growth around that time as a result.

Grade A Office Rental Trend
Central vs. Wan Chai / Causeway Bay

Source: Rating and Valuation Department
Assumptions of rental-premium change for the next 10 years

Based on the above data, we conclude that the improved infrastructure connections to come linking the central business district and non-CBD locations will lead to a narrowing rental gap between core and non-core areas. Based on precedent, we can project a potential narrowing of 23 percentage points.

During 1983 and 1984, two years before the opening of MTR Island Line, the average rental premium for Central stood at 56%. After the opening in 1986, the average rental premium contracted to 33% for the eight-year period between 1987 and 1994, representing a decline of 23 percentage points. The narrowing gap implies a quicker pace of rental growth in non-core locations, in percentage terms.
Rental growth of non-core locations to outperform core district

Between 2006 and 2014, the rental premium of core over non-core locations contracted significantly thanks to the onset of the global financial crisis in 2008, its fallout, and the trend of increased decentralisation by cost-sensitive tenants. For example, the rental premium of Central over Wan Chai and Causeway Bay declined from 101% in 2006 to 46% in 2014. The premium between Central and Island East fell from 178% to 103%. Central’s premium over Kowloon East also declined substantially from 249% to 159%.

For the next 10 years, we conclude that the rental premium of Central over Wan Chai and Causeway Bay will narrow from 46% in 2014 to 23% in 2025, fundamentally driven by the improved infrastructure development of the Central-Wan Chai Bypass and Island Eastern Corridor Link.

The Island East area will also benefit from the improved transportation network. As a result, we project that the premium for Central over Island East will contract from 103% in 2014 to 80% in 2025. The premium between Central and Kowloon East will fall from 159% to 136% over the same period.

In conclusion, the pace of rental growth in non-core locations of Wan Chai and Causeway Bay, Island East and Kowloon East will outperform the rate of growth in the core district of Central over the next decade. It is likely that Kowloon East will witness stronger take-up than Hong Kong Island, due to the sizable volume of new supply in the district, where it can offer major cost savings for occupiers.
Fastest rental growth rate in Wan Chai and Causeway Bay

For projection purposes, we assume rents in Central will follow the local economic performance. The Economist Intelligence Unit (EIU) predicts that Hong Kong’s real GDP growth will range from 2.0% to 3.3% per year between 2015 and 2025, while annual inflation will rise between 2.5% and 4.4%. We project Central rents will increase 83.5% over the next 10 years to HK$168.1 per sq ft per month, or a compound annual growth rate (CAGR) of 5.7%. Based on the aforementioned rental premium predictions, rents in decentralised locations – Wan Chai/Causeway Bay, Island East and Kowloon East – will record a CAGR of 7.3%, 6.8% and 6.6%, respectively. Simply speaking, the pace of rental growth in Wan Chai and Causeway Bay as well as in Island East will outperform Kowloon East in the next decade. But all those districts will outperform Central.

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<th>GRADE A OFFICE RENTS BY DISTRICTS IN 2025</th>
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<tr>
<td>AVERAGE RENT (HK$ / SQ FT / MONTH ON NET FLOOR AREA BASIS)</td>
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<tr>
<td>CENTRAL</td>
</tr>
<tr>
<td>2006</td>
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<tr>
<td>2014</td>
</tr>
<tr>
<td>2025 F</td>
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<tr>
<td>RENTAL CHANGE</td>
</tr>
<tr>
<td>2006 to 2014</td>
</tr>
<tr>
<td>*CAGR</td>
</tr>
<tr>
<td>2014 to 2025</td>
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<td>*CAGR</td>
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Remarks: *Compound Annual Growth Rate
Hong Kong will remain a leading financial centre in the next decade, which in turn will continue to support demand for business and professional services.
How will office locations and occupier demand evolve over the next decade?

Despite the threat of high rents and lack of space in Central, we expect that Hong Kong will remain a leading financial centre in the next decade, which in turn will continue to support demand for business and professional services. The corporate expansion in the accounting and legal sectors in recent years was to a significant extent caused by the surge in initial price offering (IPO) activity in Hong Kong. Chinese corporations are also increasing their presence in Hong Kong to improve their access to capital and financing. The development of RMB businesses and the Shanghai-Hong Kong stock connect scheme, establishing new fund-flow connections with the mainland, will broaden Hong Kong’s financial market and will create more business opportunities in the banking and finance industries.

Central

The well-established submarket of Central has developed into a concentrated cluster of banking, legal and financial services, as well as the Asia or global headquarters of many multinationals, including law and accounting firms. Central will continue to serve as the centre of trade and financial services.

The growth of Chinese corporates plays a major part in redefining the market, and remains the key driver of demand for office space. We expect there will be further demand from Chinese firms over the next decade, especially second-tier mainland financial institutions, when the Shanghai-Hong Kong Stock Connect and trading volume gathers momentum. Planning for a Shenzhen-Hong Kong stock link is also under way.

On the other hand, it is doubtful that Western financial services companies will expand aggressively, particularly when compared with past growth. The strategies of such banks and other financial institutions have changed and they have adopted more-efficient business models that require fewer staff to operate. It is likely that multinational tenants that require large floor plates will continue to move out of Central and Hong Kong’s traditional core into more fiscally responsible districts.

Wong Chuk Hang

Wong Chuk Hang will be an interesting area for office development in Hong Kong. Over time, it may well develop into an office market for international retailers as well as the back offices of global companies and professional firms. However, the current office stock size in the area is yet to reach its critical mass as an office node. Taking multi-ownership development in Wong Chuk Hang into account, there is with an existing office stock of 1.3 million sq ft (gross), which is yet to reach the critical mass for a minor office node, which requires a minimum stock of about 2 million sq ft. However, the sites currently identified in Wong Chuk Hang for office use will bring an additional 1.57 million sq ft to the market, resulting in a total of 2.9 million sq ft and passing that node threshold.

Some of the buildings in Wong Chuk Hang have a structure of multiple ownership, since projects such as One Island South, W50 and Global Trade Square were offered for strata-title sale. There are several single-ownership developments in the area too, such as 38 Southside, Genesis, Vertical Square and a project at 41 Heung Yip Road. Still, Wong Chuk Hang has quite a few buildings with smaller floor plates – usually below 10,000 sq ft – which means it can capture demand from small-and-medium sized enterprises.
Island East

Taikoo Place became the first successful decentralised office hub when Swire Properties completed seven office towers in the early 1990s, converting mostly industrial land. The area has attracted tenants such as information/technology and trading firms, insurance and telecom corporations, as well as advertising companies. Since the construction of One Island East, the area has developed into a more diverse business hub, encompassing the back-office functions of banking and finance companies. Swire Properties is now further redeveloping Taikoo Place in a project that will bring about 2 million sq ft of office space to the market by phases between 2017 and 2025.

The limited supply of quality office space on Hong Kong Island has always been a challenge for large occupiers. Many cost-sensitive tenants find office rents in the submarket of Central hard to afford. They are searching for opportunities in decentralised areas. Supported by the completion of the Central-Wan Chai bypass and Island Eastern Corridor Link by 2017, the Taikoo Place overhaul is providing buildings with large floor plates and will continue to capture demand from cost-sensitive tenants, such as insurance companies, trading and I/T firms. Most importantly, the district can potentially capture front office operations of those companies or even entire banking operations relocating to Island East. The district is attractive to corporate occupiers due to its existing portfolio of offices, retail outlets, hotels and serviced apartments. Since the area is essentially owned and managed by Swire Properties, it also fits the criteria of sizable occupiers who prefer single-landlord ownership for the ease of building management and lease negotiation.

Insurance companies, trading and I/T firms or even entire banking operations

Architectural and design firms, international fashion retailers, the back offices of multinational companies, professional firms as well as artists and the creative industries in general
Kowloon East

Kowloon East, traditionally a residential and industrial area, has undergone a major facelift in recent years. The transformation of Kowloon East into Hong Kong’s CBD2 is under way. The back office of banks, insurance companies, sourcing firms and quasi-governmental organisations account for the largest amount of office space in the area. Some I/T companies and retail companies have followed that move into the neighbourhood.

The future node will continue to develop and thrive, driven by improving transport connectivity with the rest of Hong Kong, and most importantly, the sizable volume of new office supply. Kowloon East is the location accounting for the lion’s share of new supply in the city. A total of over 12 million sq ft of commercial space is expected to be completed in Kowloon East in the next 10 years through 2025.

The improved accessibility of Kowloon East will make relocation outside of Central more feasible. The high rents and high fit-out costs in the Hong Kong Island CBD now pose a major challenge for companies seeking large office spaces. Kowloon East, as a new decentralised office hub, will offer significant cost savings for occupiers. The district is not dominated by a single landlord, so it is likely to grow with a diverse ownership structure, potentially to the benefit of occupiers.

Kowloon East will be a mid-office location for operational staff, as well as for the front offices of non-finance companies. Leasing demand will continue to be underpinned by a group of tenants on Hong Kong Island seeking possible options to rationalise their rental outgoings by relocating across the harbour. The area is likely to be the primary choice for professional-service providers.

Given the limited supply of new and low-cost options on Hong Kong Island suitable for companies looking to split front-office operations from middle- and back-office functions, Kowloon East will continue to evolve into an attractive and feasible location for split-office operations, particularly from the banking and finance industries.

Central will continue to serve as the centre of trade and financial services.

The growth of Chinese corporates plays a major part in redefining the market, and remains the key driver of demand for office space.

The transformation of Kowloon East into Hong Kong’s CBD2 is under way.

The back office of banks, insurance companies, sourcing firms and quasi-governmental organisations account for the largest amount of office space in the area.
Conclusion

Hong Kong’s Central district continues to be the most expensive place in Asia to rent office space. However, the high occupancy cost could ultimately weaken the overall competitiveness of the city as a business location. In this regard, a new wave of office development will accommodate future economic growth.

There are a number of new business locations evolving in Hong Kong over the next 10 years. We have highlighted several districts, including Island East and Kowloon East, believing there is potential for them to emerge as core office locations for most industry segments, including professional services and banking and finance. Although Kowloon East has been earmarked by the government as a key office location for the future, the market will first develop along Hong Kong Island before making an eventual jump across the harbour.

The improved transport connectivity between decentralised areas and the rest of Hong Kong will surely lead to higher rents in those areas, resulting in a narrowing rental gap between core and non-core districts. In other words, the pace of rental growth in the non-core locations of Wan Chai and Causeway Bay, Island East and Kowloon East will outperform the core district of Central over the next decade. Supported by the completion of the Central-Wan Chai bypass and Island Eastern Corridor Link, due in 2017, the rental growth of key business districts on Hong Kong Island, including Wan Chai, Causeway Bay and Island East, will outpace Kowloon East. However, Kowloon East is likely to witness stronger take-up than Hong Kong Island, due to the sizable volume of new supply in the district, where it can offer major cost savings for occupiers.

In this study, we have also identified the likelihood of specific types of industry demand for office space in these areas. In Central, the growth of Chinese corporates will play a major part in redefining the market, and remains the key driver of demand for office space. We expect there will be further demand from Chinese firms over the next decade, especially second-tier mainland financial institutions, when trading volumes for the Shanghai-Hong Kong Stock Connect gather momentum.

In Island East, the redevelopment of Taikoo Place is providing buildings with large floor plates. That will continue to capture demand from cost-sensitive tenants, such as insurance companies, trading and information/technology companies. Most importantly, the district could potentially capture front-office operations for those companies or even see entire banking operations relocate to Island East.

Meanwhile, Wong Chuk Hang could be a niche office market for international retailers, as well as the back office of global companies and professional firms. However, the current amount of office property in the area (an existing stock of 1.3 million sq ft) is yet to reach critical mass and make it a minor office node, which requires a minimum of about 2 million sq ft. Still, Wong Chuk Hang will offer cost savings for occupiers, and will also soon have much-improved transportation connectivity. As a result, the area can capture demand from tenants such as architectural and design firms, international fashion retailers, the back offices of multinational companies, professional-services companies, artists and creative industries in general.

Kowloon East will ultimately thrive as a major source of office space, emerging as a “second CBD,” where it will be a mid-office location for operational staff and front offices for non-finance companies. Leasing demand will continue to be driven by a group of tenants on Hong Kong Island seeking possible options to rationalise their rental outgoings by relocating across the harbour. Kowloon East will be the primary choice for professional-service providers and it will continue to evolve into an attractive and feasible location for split-office operations, particularly for the banking and finance industries.

### Grade A Office Rents by Districts in 2025

<table>
<thead>
<tr>
<th></th>
<th>Central</th>
<th>Wan Chai / Causeway Bay</th>
<th>Island East</th>
<th>Kowloon East</th>
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<tbody>
<tr>
<td>2006</td>
<td>$77.1</td>
<td>$38.5</td>
<td>$27.8</td>
<td>$22.1</td>
</tr>
<tr>
<td>2014</td>
<td>$91.6</td>
<td>$62.9</td>
<td>$45.2</td>
<td>$35.4</td>
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<tr>
<td>2025 F</td>
<td>$168.1</td>
<td>$136.9</td>
<td>$93.5</td>
<td>$71.3</td>
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<table>
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<tr>
<th>Rental Change</th>
<th>Central</th>
<th>Wan Chai / Causeway Bay</th>
<th>Island East</th>
<th>Kowloon East</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 to 2014</td>
<td>18.8%</td>
<td>63.4%</td>
<td>62.7%</td>
<td>60.3%</td>
</tr>
<tr>
<td>*CAGR</td>
<td>2.2%</td>
<td>6.3%</td>
<td>6.3%</td>
<td>6.1%</td>
</tr>
<tr>
<td>2014 to 2025</td>
<td>83.5%</td>
<td>117.8%</td>
<td>106.9%</td>
<td>101.4%</td>
</tr>
<tr>
<td>*CAGR</td>
<td>5.7%</td>
<td>7.3%</td>
<td>6.8%</td>
<td>6.6%</td>
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Remarks: * Compound Annual Growth Rate
Office Services Specialists in Hong Kong and Kowloon

Wendy Lau
Executive Director | Office Services | Hong Kong
+852 2822 0550
wendy.lau@colliers.com
Individual License: E-144423

Fiona Ngan
General Manager | Office Services | Kowloon
+852 2822 0751
fiona.ngan@colliers.com
Individual License: E-197789
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$2.3 billion in annual revenue

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16,300 professionals and staff

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