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Demand on track but potential headwinds seen

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Net take-up for the first nine months of 2017 totalled 356,000 sq m (3.8 million sq ft), still on track to reach 550,000 sq m (5.9 million sq ft) of office space absorption for the full year 2017. Demand for the remainder of the year should be robust, driven by requirements from offshore gambling and traditional companies. Interestingly, Metro Manila vacancy is inching up. Vacancy has breached the 5% mark as of the end of 3Q 2017, and it appears that it will be the first time it will stay above 5% in the last seven years. The two-fold impact of historical highs in supply and notable demand headwinds have started moving the office sector from a landlord's market. The most pronounced outcome is the shift in the tenancy mix arising from the BPO slowdown. Furthermore, with supply from 2018 to 2020 projected to average 900,000 sq m (9.1 million sq ft) annually, we expect developers to make the necessary adjustments -- particularly if the demand headwinds persist. Developers will likely turn off the tap and pare down supply over 2019-2020, as they did in the aftermath of the Global Financial Crisis (GFC) of 2008-2009. Meanwhile, in the short term, we propose that they focus on demand from traditional companies, as well as maximise the potential of offshore gambling while demand still exists.

Forecast at a glance

Demand

Net take-up is still on track to reach 550,000 sq m (5.9 million sq ft) for 2017. However, demand headwinds await which may impact demand for 2018 onward, although the growing non-BPO segment will help keep demand flat in the coming years.

Supply

About 850,000 sq m (79,000 sq ft) of office will be completed for the entire 2017, a historical high for Metro Manila. There are at least 900,000 sq m (9.7 million sq ft) expected annually in the pipeline until 2020, twice the yearly supply in the past five years. As such, we foresee a paring of supply occurring in 2019 and 2020, particularly if issues on demand persist.

Vacancy

Overall vacancy in Metro Manila is at 5.6%, and the sector will likely see the market close above 6% by end 2017 before jumping to 8% the year after. Assuming developers cut their supply by 2019 and 2020, vacancy will normalise at the 7% range.

Rent

RENT

Rents continued to increase across Metro Manila, reflecting QoQ changes of under 1% to 3%. Interestingly, the rate of growth has slowed down compared to prior quarters, signalling some correction.

Comparative Office Vacancy Rates in Metro Manila

LOCATION	2Q 2017	3Q 2017
Makati CBD	1.3%	1.2%
Fort Bonifacio	3.2%	5.6%
Ortigas Center	1.0%	0.6%
Manila Bay Area	2.1%	3.4%

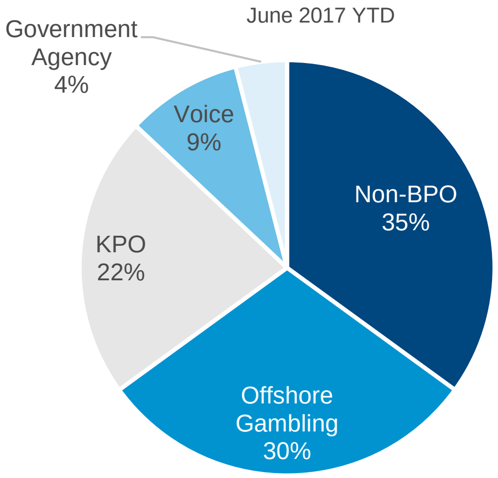
Source: Colliers International Philippines Research

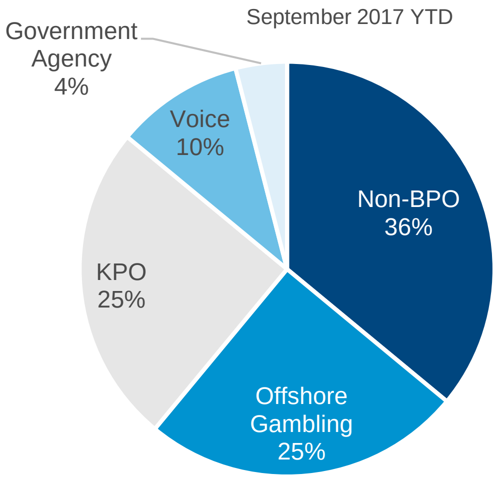
Office Supply Forecast, GLA (sq m)

LOCATION	AS OF 2016	2017F	2018F	2019F	2020F	TOTAL
Alabang	483,100	89,500	60,200	64,800	-	697,600
Fort Bonifacio	1,533,800	383,000	190,100	246,500	38,900	2,392,300
Makati CBD	3,199,000	28,400	37,600	79,500	54,100	3,398,600
Makati Fringe	229,400	25,300	72,300	14,300	120,800	462,100
Mandaluyong	304,900	80,600	68,500	103,600	-	557,600
Manila Bay Area	330,600	70,300	223,300	84,500	141,000	849,700
Ortigas Center	1,578,000	66,900	78,100	23,700	429,900	2,176,600
QC*	888,200	89,600	133,400	223,500	149,000	1,483,700
Others**	293,700	19,000	53,800	64,100	33,100	463,700
Total	8,840,700	852,600	917,300	904,500	966,800	12,481,900

Source: Colliers International Philippines Research
*Includes Araneta Center, C-5 Corridor, Eastwood City, and North EDSA Triangle
**Manila and other fringe locations

Office Leasing Transactions, FY 2016, June 2017 YTD, and September 2017 YTD





Source: Colliers International Philippines Research

Diversified tenancy mix continued

Net take-up for the first nine months of the year totalled 356,000 sq m (3.8 million sq ft), still on track to reach 550,000 sq m (5.9 million sq ft) for the full year of 2017. Demand for the year has been driven by requirements from offshore gambling and traditional companies. The Philippines' real GDP growth is likely to exceed 6% in both 2017 and 2018, thereby supporting strong demand from multinational companies (MNCs) and local traditional companies. Additionally, offshore gambling may carry a few perceived risks, but Colliers expects demand from this sector to persist for the rest of year.

The breakdown of transactions as of September year-to-date has offshore gambling contributing 25% of total transactions, while traditional companies are at 40%, including 4% from government agencies. The balance of 35% constitutes BPOs, primarily driven by knowledge process outsourcers (KPO). The biggest KPO transaction recorded this quarter came from Ernst and Young totalling 17,000 sq m (182,900 sq ft) GLA. Other notable tenants include Amdocs, ING, Uniqlo, Telkha, and ICTSI.

Nonetheless, while we recognize that demand for the year remains robust, we note a number of demand headwinds as we look ahead to 2018 onwards, namely: (a) BPO slowdown amid Philippine Economic Zone Authority (PEZA) delays, a US protection stance, and peace and order concerns locally; and (b) sustainability of offshore gambling.

We have reported the slowdown in demand from BPOs since the beginning of the year. Albeit showing a slight improvement to 35% from 21% of transactions in the first quarter, demand remains a far cry from the 60% to 70% that the market has been used to in previous years. Several factors may explain this slowdown including delays in PEZA proclamations, concerns about peace and order, as well as the US taking on a more protectionist stance on BPO expansions outside the country. In the medium to long term, concerns about labour and the potential impact of artificial intelligence keep the outlook less predictable.

Completed Buildings, 3Q 2017

BUILDING	LOCATION	GLA, sqm
Robinsons Cyber Sigma	Fort Bonifacio	48,200
Vertis BPO Phase 1	Quezon City	39,200
Menarco Tower	Fort Bonifacio	25,400
The Curve	Fort Bonifacio	24,200
Rockwell Sheridan Tower 1	Mandaluyong	22,000
South Park Corporate Center	Alabang	12,900
Inoza Tower	Fort Bonifacio	12,400
81 Newport Square	Pasay	10,300
Total		194,600

Source: Colliers International Philippines Research

Meanwhile, offshore gambling has substituted for the demand typically representated by BPOs. With the Philippine Amusement and Games Corporation (PAGCOR) issuing 42 Philippine Offshore Gaming Operators (POGO) licences since last late year, requirements from POGOs have sprung across the Metro, ranging between 5,000 sq m (53,800 sq ft) to 30,000 sq m (322,800 sq ft) per site. A total of 153,000 sq m (1.6 million sq ft) of newly leased space has been recorded from this sector so far, this year. However, given the wide range of space requirement from players in this sector, it has become difficult to predict the sustainability of this demand in the medium to long term. Assuming that the legality of their operations is recognised in the Philippines, notwithstanding cases which have been filed with the Supreme Court questioning PAGCOR's jurisdiction over POGOs, concerns about potential crackdowns in home countries such as China and Korea persist even over a year into the expanded mandate of PAGCOR to regulate these entities.

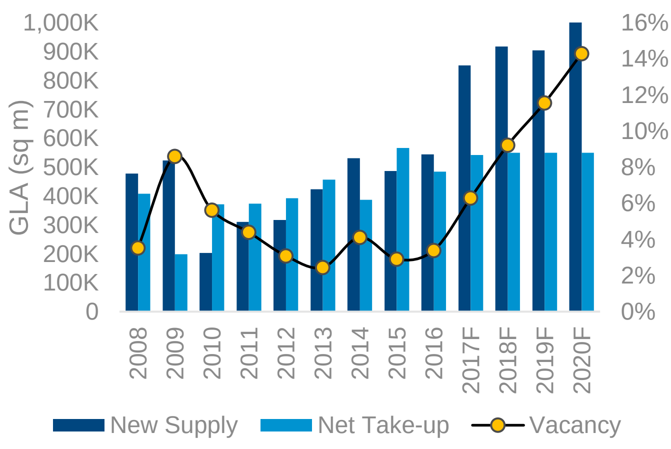
Potential paring down of supply in the medium-term

We expect to reach over 850,000 sq m (9.1 million sq ft) of office GLA for this year, the highest historically for Metro Manila. In 3Q 2017, eight buildings were completed, representing 194,000 sq m (2.1 million sq ft) of office space. The biggest contributor is Robinsons Cyber Sigma in Taguig City on about 48,000 sq m. Other contributors include Vertis BPO Phase 1, The Menarco Tower, Rockwell Sheridan Tower 1 (North), and The Curve, among others. All these bring the total stock in Metro Manila to 9.4 million sq m (101.1 million sq ft). The majority of the stock still comes from Makati with 3.2 million sq m (34.4 million sq ft), although Fort Bonifacio still moved closer to Makati with 1.8 million sq m (19.4 million sq ft).

Between 2018 and 2020, we project supply to average 900,000 sq m (9.7 million sq ft) annually. This is twice the yearly level of the supply in the past five years. Should the potential issues facing demand continue, it is unlikely for the massive supply to be taken up since this would require historical highs in take-up as well. In this event, we expect developers to make the necessary adjustments.

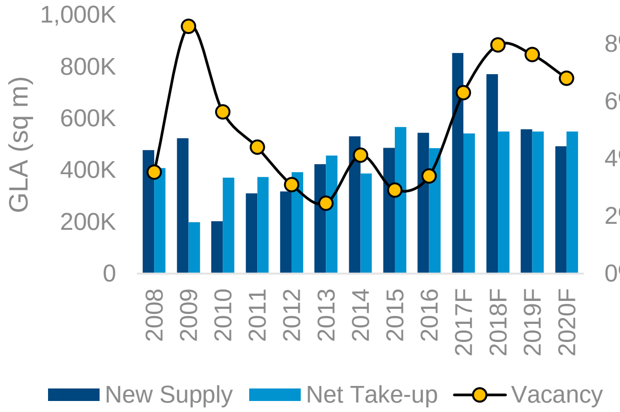
From the bitter experience of 1997 to 2002, in the years after the Asian Financial Crisis (AFC), developers learned the necessity of turning off the supply tap – and quickly. That was adequately demonstrated in 2010 in the aftermath of the Global Financial Crisis (GFC) when after ramping up supply to 480,000 sq m (5.1 million sq ft) in 2008 and 523,000 sq m (5.6 million sq ft) in 2009, completions fell sharply to 203,000 sq m (2.2 million sq ft) in 2010 as projects were deferred or outright cancelled.

Demand, and Vacancy Forecast (with unchanged Supply)



Source: Colliers International Philippines Research

Vacancy and Demand Forecast (with Pared-down Supply)



Source: Colliers International Philippines Research

Understandably, not much can be done about 2017's completions and most of 2018's supply has already broken ground, but Colliers expects 2019 and 2020 completions to be pared back by as much as 50%, perhaps even more if the current take-up of 550,000 sq m (5.9 million sq ft) annually is not maintained.

Vacancy rising to healthier levels

Given record completions in supply, it appears that this is the first time in the last seven years that the market will close the year with vacancy above the 5% mark. Currently, overall vacancy in Metro Manila stands at 5.6%, up from 4.5% last quarter. And with more completions to follow in the last quarter of the year, we expect vacancy to inch up further above the 6% level.

Over much of the time since 2012, the market was stuck in the 3% vacancy range. A persistently low vacancy is symptomatic of a market that is not functioning adequately and where the supply and demand balance is severely skewed in favour of landlords. At 3% vacancy, businesses are constrained in expansion as they are provided with limited options. Consequently, relocation decisions are postponed or compromised in terms of location, size, or building quality. We therefore see the jump in vacancy as a welcome development.

Looking ahead to 2018, we expect vacancy to move up to the 8% range as supply will be largely unchanged from the current 900,000 sq m (8.6 million sq ft) projection, regardless of whether developers attempt to postpone project completions or not. For 2019 to 2020, should developers plans push through and demand stays flat, we expect vacancy to reach the mid-teens level – not exactly ideal for them.

As such, Colliers believes it is more likely that developers will make the necessary adjustments, allowing vacancy to dip back to the 7% level.

Rents reaching a plateau

A relatively healthy level of vacancy effectively pushes rents to become more competitive across submarkets. While we note that headline rents have continued to increase, the difference between transacted and asking rates has similarly increased. Historically, negotiated rates have been limited to PHP50 to PHP100 per sq m (0.09 USD to 0.18 USD per sq ft) discounts. Today, we noted instances when discounts of P150 to P200 per sq m (0.27 USD to 0.36 USD per sq ft). Combined with increased incentives and more rent-free periods on occasion, net effective rents may be reaching a plateau.

In fact, even the velocity of rental growth slowed down in the major CBDs in 3Q 2017. Makati CBD average rents increased by 1.8% compared with 2.5% last quarter. For Fort Bonifacio, average rents grew by a mere 2.4% versus 4.4% the prior quarter. Ortigas Center rents grew by 0.9% in Q3 after growing by 2.1% previously. The same trend was observed in emerging business district Manila Bay Area which saw rents grow by 3.2%, slower than last quarter's 5.1%

We recognise that the slowdown may not be occurring in all buildings given that a respectable number of them are performing better than others, but the few noted instances are indicative of a market moving from a landlord-driven one. Following the rapid rise in rents since 2009, and the sizeable upcoming supply, rents appear to be showing signs of correction. Consequently, tenants now have some leeway in their process of selection and enough room to negotiate rents.

Comparative Office Rental Rates in Metro Manila (PHP / sq m / month)

LOCATION	3Q 2017	%CHANGE (QoQ)
Makati CBD	800 - 1,750	1.8%
Fort Bonifacio	800 - 1,500	2.4%
Ortigas Center	500 - 900	0.9%
Manila Bay Area	675 - 875	3.2%

Source: Colliers International Philippines Research

Developer and tenant opportunities

As mentioned, demand is still strong for 2017. We expect that no significant adjustments in supply will be made until 2019, maybe late 2018 at best. A drastic correction in rents is unlikely given that developers should be able to turn off the supply tap just in time to keep vacancy at a healthy 7%. Against this background, apart from preparing for a possible paring down of supply, there are opportunities that developers and tenants may take advantage of.

Colliers recommends that developers ride on the demand from expansions and relocations of traditional companies. Many local and multinational companies expanded or moved to newer office spaces recently, and with the country's business and economic fundamentals still in place, it will not be surprising to see similar activities from this tenant segment continue. Offshore gambling continues to be a major driver in the short-term, as we expect more take-up from POGOs at least until the end of the year through to early next year. Developers with significant PEZA-proclaimed supply may still target BPOs, particularly KPOs.

For tenants, we advise them to be more carefully selective about their office space. Companies looking for space, especially non-PEZA entities may look to Fort Bonifacio and Manila Bay Area as we expect abundant upcoming supply in these locations. The consequent faster rise in vacancy in these submarkets should provide reasonable choices for premises for both new entrants and expanding entities. It also presents an opportunity for companies to relocate or consolidate existing sites to better facilities. PEZA-accredited tenants meanwhile should still be quick to close deals given the limitations in PEZA-proclaimed supply.

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