HONG KONG | 2018 MARKET OUTLOOK

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Accelerating success.

2018: Rising Confidence in Growth

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We expect Hong Kong's property market will remain buoyant in 2018, supported by rising confidence in economic growth, persistent negative real interest rates, and continuous inflow of Chinese capital, although external factors may result in a tightening of local market liquidity. We expect property prices and rents to rise further, with decentralisation and flexible working the key trends in the office leasing market and the retail property market emerging from its long slump. However, due to expected interest rate hikes, price increase is likely to be more moderate than in 2017.

Hong Kong's economy and property sector continued to gain strength during 2017. The Government revised its forecast for Hong Kong's real GDP growth from 2-3% at the beginning of 2017 to 3.7% in December 2017. Hong Kong's PMI picked up momentum towards year end and stayed above 50 in H2, 2017, indicating that the private sector economy continues to expand. With current global economic conditions remaining robust, Oxford Economics now predicts real GDP growth of 2.8% for Hong Kong in 2018 - a forecast which looks conservative to us.

The retail sector has finally come out of its slump with total retail sales growing by a modest 1% over the first 10 months of 2017. The rate of increase accelerated in H2 and we expect that retail sales during the holiday season had generated more positive returns for retailers and shopping malls.

Undermining external factors

We believe the growth momentum will persist in 2018. However, there are factors that can have negative impacts for the local property market, especially concerning with the tightening of local market liquidity:

> Faster than expected interest rate increases

The US Federal Reserve has indicated three interest rates hikes in 2018. Hong Kong interest rates are effectively tied to US rates by the territory's currency peg, so Hong Kong will have to raise rates too. Nevertheless, we do not expect real (i.e. inflation-adjusted) interest rates to turn positive again in Hong Kong before late 2019 or early 2020. Still, if US interest rates rise faster than the Fed's current indications, the pace of increase in Hong Kong will also accelerate.

> Tightening liquidity

More central banks could start cutting back on their balance sheets in 2018 after the Federal Reserve had started a scheme to gradually reduce its balance sheet in 2017. Balance sheets of major central banks have increased from roughly USD 7 trillion to USD 18 trillion in the last decade. While the balance sheet normalisation will probably be very gradual, it does signal the end of easy money which could dampen the investment sentiment.

Figure 1: Aggregate Balance Sheet of Large Central Banks (USD Tn)

Source: Citi Research

> US tax reform

The US Congress has passed a new tax reform to lower the corporate tax rate from 37% to 21%. US corporates which repatriate overseas profits to the US will be subject to a lower 14.5% tax rate for cash and a 7.5% tax rate for reinvested earnings. The reform is expected to support faster GDP growth, but could also result in more interest rate hikes and capital outflow from emerging economies back to the US. Neither outcome would bode well for the property investment market.

2018 property investment: cautiously optimistic

In 2017, Hong Kong saw total real estate transaction value in excess of USD54 billion making Hong Kong the second largest urban property market in the world, following New York metro, according to data from RCA.

Figure 2: Most Active Urban Investment Markets 2017

Source: Real Capital Analytics

The Colliers Investor Survey Report, released in November 2017, reveals that Hong Kong's investors still have more appetite for property. Half of the investors surveyed told Colliers that they would be net buyers in 2018, and more than 68% would increase their exposure in real estate. Investors will search for value-added opportunities because persistent high prices and low yields have made underwriting core or core-plus properties challenging. In the APAC context, Hong Kong based investors are still focusing on Tier One cities in China and Singapore.

Looking ahead, we expect the investment market in Hong Kong to stay strong provided that real interest rates do not rise too quickly. Interest in retail property should strengthen after the rebound in the local sales.

Evolving Chinese interest

Although China's capital outflow controls are still in place, we expect Chinese investors to continue being major players in the local property market. Both PRC developers and investors continued to invest in Hong Kong's land and property market over 2017.

During H1 2017, the greater part of the Chinese capital invested in Hong Kong went into undeveloped land because PRC-based developers won many large government residential land tenders via a more aggressive bidding strategy. PRC developers also showed strong interest in urban regeneration projects. In 2018, we expect that competitions among local and PRC developers will probably drive land prices further up to build up a sustainable landbank.

PRC companies have not ignored investment in en-bloc and strata-title investment in office properties. On the contrary, they became more active in this field in H2 2017. Within the months of October and November, PRC investors acquired two en-bloc office properties: 8 Bay East in Kowloon Bay and the Centre in CBD from local developers for a total of USD6.35 billion.

There are still a few large trophy buildings on the market and Chinese investors should have the resources to outbid most other investors if these properties match their investment strategies. We remain confident that more en-bloc transactions will be completed in 2018.

Office leasing: Spotlight on Quarry Bay and flexible workspace

Decentralisation and flexible workspace have been the two leading trends in Hong Kong's office leasing market in the past couple of years. We believe these two trends will continue especially because Central remains the world's most expensive office market. The growing presence of Chinese companies in Central has contributed to the relocation of many MNCs and professional companies to emerging office districts, notably Quarry Bay and Wong Chuk Hang on Hong Kong Island and the CBD2 in East Kowloon.

However, based on Colliers' Occupier Survey, the banking and finance sector prefers a good business cluster to lower rental cost. Hence, with its world-class business amenities, Central should continue to be the preferred choice for banks and financial institutes.

Among all new offices, the spotlight in 2018 will be on One Taikoo Place (OTP) at Quarry Bay. Out of a total GFA of 1 million sq ft (92,900 sq metres), over 50% is already committed. It would not be surprising to see OTP attain a 100% commitment rate before its completion. We expect Quarry Bay to reinvent itself as a new premium business district for finance and professional services with improved connectivity via the Central-Wanchai Bypass, better business amenities, and new quality offices. We believe office rents in Quarry Bay will rise the fastest of all sub-markets in Hong Kong.

Flexible workspace/coworking operators took up more than 250,000 sq ft (23,250 sq metres) in 2017 and landlords are making use of coworking operators to revamp their tenant profile or reposition their properties. We expect new players with different backgrounds to enter the market, for example Tencent will open its first "Makerspace" in 2018 to accommodate 200 start-ups. The government has also thrown its weight behind coworking spaces to recharge Hong Kong's economic future. With a growing start-up community, demand for incubation and coworking spaces should increase. However, operators will have to differentiate themselves from competitors in an increasingly crowded landscape.

Retail: new shopping experience

Hong Kong is finally out of its retail slump. For the first 11 months of 2017, total retail sales rose by 1.8%. The rate of increase picked up towards the year-end and we expect the trend will continue into 2018 with total retail sales growing by 3-4%. The successful sale of 17 malls owned by LINK REIT for HKD 23 billion (USD 2.94 billion) demonstrates investors' optimism about Hong Kong's retail sector.

Driven by a strong local consumption and millennial shoppers, market sub-sectors focusing on lifestyle, F&B, and so-called athleisure have remained active. We expect that skincare and cosmetics, home living, and F&B and desserts will enjoy a solid expansion in 2018.

New technologies have penetrated the retail property market more rapidly than any other real estate sector. New retail concepts anchored by the integration of online-to-offline strategies offer unique shopping experiences, e.g. facial recognition, personalised promotion, VR/AR/Magic Mirror, mobile payment and smart checkout. Behind the scenes, big data analytics have been applied to develop new brand loyalty programmes and better customer experience.

Rents in popular shopping districts have become more stratified. First-tier spots remaining popular for new entrants and for brands continuing to expand in Hong Kong. However, second and third-tier streets have a higher vacancy rate and rents are likely to see more downward adjustments. We expect that the average street-front retail rent will rebound by 3% in 2018, but that the rental gap between first-tier and lower-tier streets within the same district will widen until the retail market has fully recovered.

Industrial: eyeing the revitalisation scheme 2.0

The market is waiting for more details from the government regarding the next round of the industrial revitalisation scheme to be announced in mid-2018. Under a similar scheme which ended in 2016, more than 90 buildings submitted applications for a total of 10.7 million sq ft (994,000 sq metres) of GFA. Many of the approved applications are in planning or development stages. When completed, the scheme will have reduced about 6% of industrial stocks from the existing supply.

The net yield of industrial property has also dropped from roughly 5% to 3% since 2010 when the industrial revitalisation scheme started. The volume of industrial property transactions worth over HKD30 million has also increased from HKD8.0 billion to HKD21.3 billion (USD10.0 to USD2.7 billion) since 2010.

The revitalisation scheme will also have strong implications for the industrial rental market. With more industrial space being pulled from the market, competition for the limited remaining space should drive rents further up.

Figure 3: Application of Technology in Retail

Source: Nielsen, Worldpay

2018 Property Market Forecasts

Rental Market Outlook

Office (HKI)	+4~7%
Office (Kln)	+1%
Retail	+1~3%
Industrial	+5%
Residential (Mass)	5~8%
Residential (Luxury)	+3%

Source: Colliers International

Given strong economic momentum, we believe the property leasing market will rise further in 2018:

> Hong Kong Island office rent will benefit from very little new supply and a stronger demand. Rents in Central will remain firm while Quarry Bay and Wong Chuk Hang will see faster growth than 2017.

> The Kowloon office market will be active due to a large new supply and rents will increase within 1-3%. Given a strong demand, Kowloon East rents will start to gather momentum again.

> High street retail rent will start to rebound with lower vacancy, following further growth in total retail sales.

> Industrial rent will continue to rise due to increasing trade volume and strong e-commerce demand.

> Residential rents will see a 5-8% growth in the mass market and 3% in the luxury market.

Capital Value Outlook

Office (HKI)	+5%
Office (Kln)	+5%
Retail	Flat
Industrial	+5~10%
Residential (Mass)	+8~10%
Residential (Luxury)	+3~5%

Source: Colliers International

As the negative real interest rate environment ought to persist in 2018, the outlook for property prices remains positive. However, with interest rate increases, price growth will be modest when compared to 2017:

> Office prices in both Hong Kong Island and Kowloon will grow moderately, but investors will stay focused on value-added opportunities.

> Since retail sales and rent will only rise modestly, prices for high street shops will remain flat.

> Industrial property prices will increase by 5-10% subject to the details of the new revitalisation scheme of industrial buildings.

> Residential property prices will continue to rise at 8-10% for the mass market because of strong demand and smaller lump sum prices. The luxury market should grow at a slower rate of 3-5%.

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