Colliers Bubble Watch H1 2018

PROPERTY MARKET INVESTMENT RISK

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Accelerating success.

No clear bubble yet

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Hong Kong property prices have been rising continuously in all market segments and investors have started to worry that a property bubble may soon burst. In this report, we have undertaken a reality check of current market conditions and examined the risk level for new investment. The result from our analysis indicates that the Hong Kong property market remains at a low-medium risk level in the residential, office and industrial sectors.

Actual Price vs Equilibrium Price

In classical economic theory, demand and supply are the fundamental concepts in determining price and quantity bought or sold for goods, securities and tradable assets in an efficient market, including properties. The market equilibrium price represents the price when demand is equal to supply, i.e. achieving market equilibrium. However, the actual price usually deviates from the market equilibrium price due to different factors, such as investment sentiment and imperfect information.

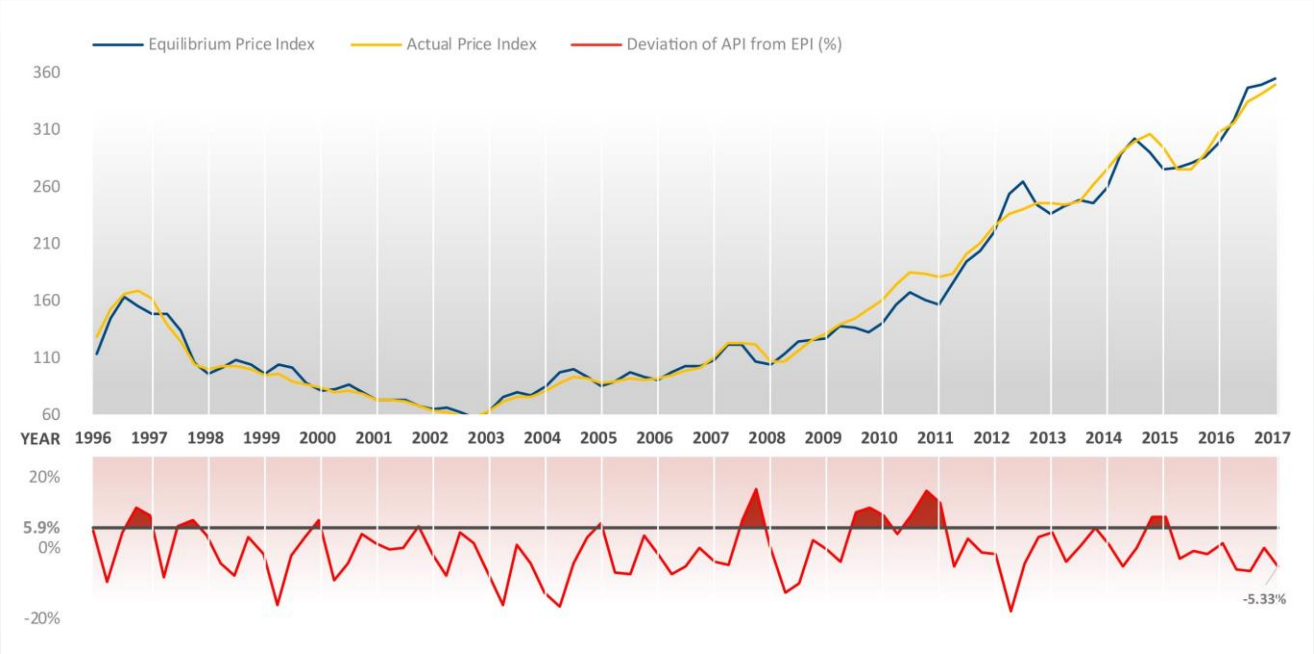
In our analysis, we have developed a time series model to estimate the market equilibrium price index (i.e. predicted price) and compared it with the price index published by the Rate and Valuation Department in determining whether the property market is overheating or not at different time periods. Our model considers both demand and supply-side factors of which address different aspects of the property market.

Table 1: Equilibrium Price Index Factors

Factors	Effect on Price
3-month HIBOR (cost of borrowing)	–
Median income (affordability)	+
Number of domestic households (demand)	+
Yield for residential properties (investment return)	–
Hang Seng Index (wealth effect)	+
Number of units for residential buildings with consent to commence work (future supply)	–
Number of units for newly completed residential flats (current supply)	–

Source: Colliers; Rating and Valuation Department; Census and Statistics Department; Oxford Economics

Figure 1: Equilibrium and Actual Price Residential Index (1999 = 100)



Source: Colliers; Rating and Valuation Department; Census and Statistics Department; Civil Engineering and Development Department

Figure 1 illustrates the historical movement of both the Actual Price Index (API) and the Equilibrium Price Index (EPI) in the residential market between 1996 and 2017. The two indices have moved closely with each other most of the time, indicating Hong Kong's long-term housing price increase is supported by positive economic fundamentals.

According to Figure 1, when the API moves up faster than the EPI, for example in 1996-1997, 2007-2008, 2010-2011, and in 2015, prices become unsustainable and are followed by a period of price correction to absorb the rapid growth in the previous period. Further analysis shows that when the API is more than 5.9% (i.e. greater than One Standard Deviation of the historical average) higher than the EPI, a price correction becomes very likely.

Since 2015, the API has been falling slightly behind the EPI again. Based on the historical pattern, it therefore seems unlikely that Hong Kong's property market will head into overheating, unless the actual price begins to move faster and overtakes the equilibrium price more than 10% in 2018. However, we do expect the API to start moving faster again given positive economic prospects and improved business sentiment.

Assessing Investment Risk

While Figure 1 has demonstrated that the Hong Kong housing market remain relatively healthy, we want to assess investment risk in properties under current market circumstance.

In our investment risk assessment, we have looked at both actual price growth and price volatility as the major indicators for determining the investment risk levels. From the historical pattern, when the market overheats and reaches a very high-risk level, not only does price growth accelerate, but also price volatility increases significantly.

In the following sections, we examine the relationship between the monthly property price index and the six-month price growth rate (price volatility) for the individual segments of the Hong Kong property markets. We apply statistical analysis to detect whether price volatility is approaching a critical level heading for a market correction.

Our assessment shows that when the price volatility is below one standard deviation (+1 SD) of its average growth rate, the market is not at risk of a major price correction. Once the price volatility exceeds +1 SD while the price index continues to increase, the investment risk becomes high and a price correction may be imminent.

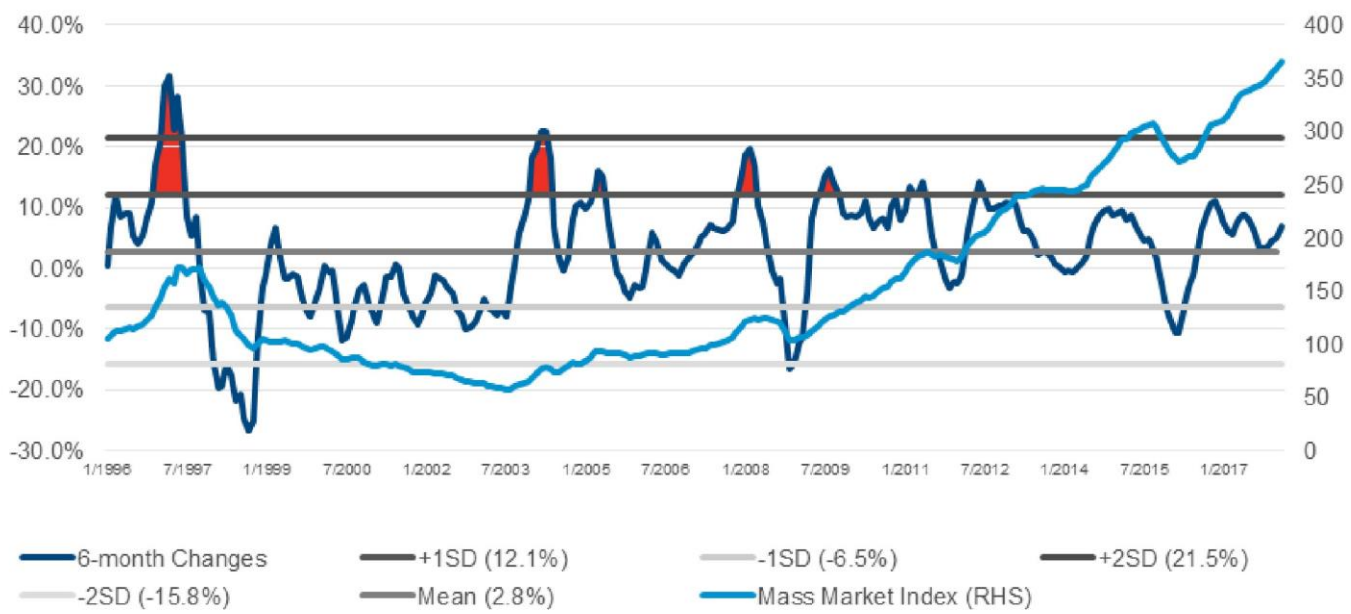
In other words, investors need to pay attention to both transaction price and price volatility when assessing the level of investment risk at different periods.

Residential: Remains Healthy

As shown in the actual versus equilibrium price comparison, we do not see an imminent price correction for residential properties. When assessing the current investment risk, the six-month price volatility in February 2018 was 6.9%, staying well within +1 SD range (12.1%). This further confirms that the residential property market is still not in a critical stage yet.

Given that the Hong Kong economy is in sound condition and our assumption that strong demand in the residential market will persist, we believe that investment risk in the residential market remains at a low-medium level. In 2018, we predict that prices for the mass and luxury market will increase by 8-10% and 3-5% respectively. With the expectation of real interest rate to turn positive by late 2019 or early 2020, the residential prices should increase by 3-5% in 2019, and stay flat in 2020.

Figure 2: Investment Risk – Residential Market



Source: Colliers; Rating and Valuation Department

Table 2: Investment Risk Analysis- Residential

Residential Market Indicators	
Avg. 6-month growth rate	2.8%
Sept 17~ Feb 18 growth rate	6.9%
±1 Standard Deviation Range	-6.5%/ +12.1%
±2 Standard Deviation Range	-15.8%/ +21.5%
Current Investment Risk Level	Low-Medium

Source: Colliers; Rating and Valuation Department

Office: Still room for growth

Following a very hot office investment market in 2017, the office price index was at 483.9 in February 2018 according to the Ratings and Valuation Department. For 2017, the total number of strata title and en-bloc office investment deald surged by 89.8% YOY and 83.3% YOY, and the total value of office investment increased by 63% YOY, to HKD83.4 billion (USD10.7 billion).

In Q4 2017, the overall office investment volume reached a new record of HKD53.0 billion (USD6.8 billion), up by 408% QOQ, 5.6 times higher than the 10-year quarterly average of HKD7.8 billion. Record sales included the Center building in Central for HKD 40.2 billion (USD 5.2 billion). Based on the GFA of 1.22 million sq ft, the unit price was HKD33,000 (USD4,231) per sq ft. After this record breaking transaction, the strata title office market has become more active, potentially fuelling further growth in office prices over 2018.

With limited stock in Central, office buildings in the CBD fringe area (Admiralty and Wanchai) have attracted more interest, and price growth in this area has picked up since H2 2017.

Based on our risk assessment, the six-month price growth rate for Grade A offices was 4.7% in February 2018. This stayed below the +1SD of 16.7% implying the price volatility is still within an acceptable range. Hence, we see the Grade A office investment risk level also still as low-medium.

Table 3: Investment Risk Analysis - Office

Office Market Indicators	
Avg. 6-month growth rate	2.9%
Aug 17~ Feb 18 growth rate	4.7%
±1 Standard Deviation Range	-11.0%/ +16.7%
±2 Standard Deviation Range	-24.8%/ +30.6%
Investment Risk Level	Low-Medium

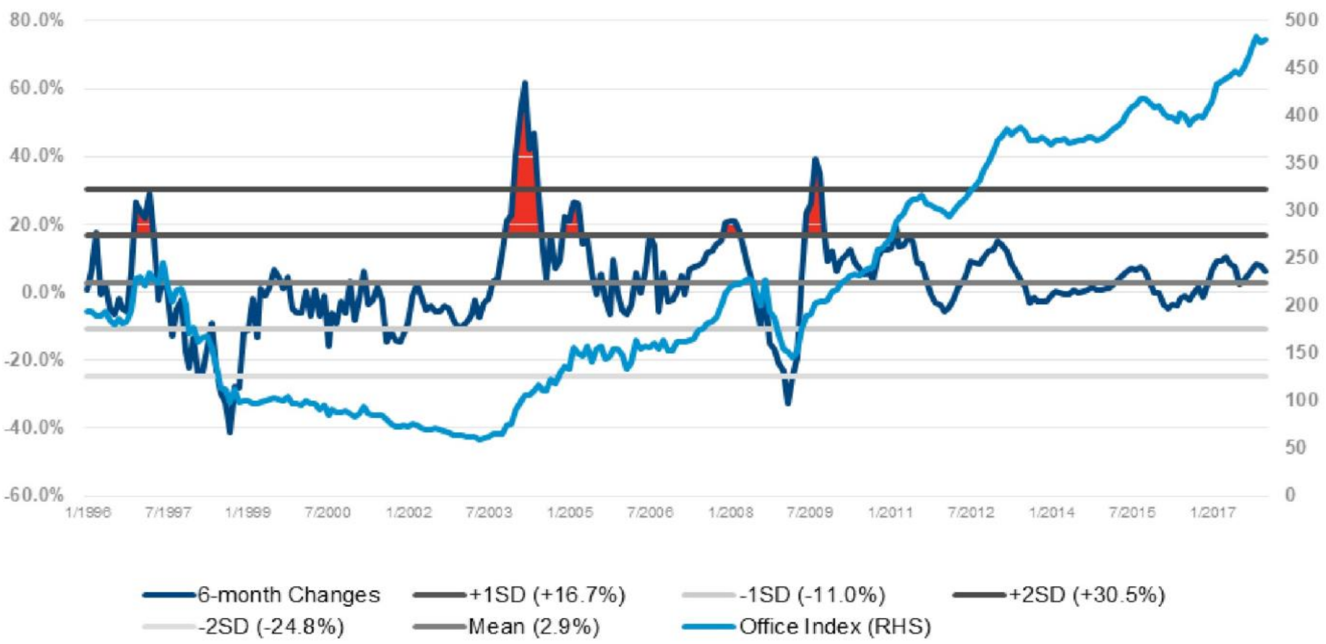
Source: Colliers; Rating and Valuation Department

We expect investors to remain cautiously optimistic about office investment in 2018. Hunting for potential value-add opportunities in Grade B buildings in the CBD fringe area should continue. We estimate that prices for Grade A offices will increase by about 10% in 2018. With average office rent set to pick up further due to strong economic prospects, we think that office yields in Hong Kong will stay stable. In the next five years, the office price should increase by 3-5% per annum.

Industrial: More gains ahead

The industrial property price index stood at 843.9 in February 2018 according to the Rating and Valuation Department. The Government's forthcoming Industrial Revitalisation Scheme 2.0, scheduled to be announced by mid-2018, has renewed investors' interest in industrial properties and has driven up industrial prices.

Figure 3: Investment Risk – Office Market



Source: Colliers; Rating and Valuation Department

Between Q4 2017 and Q1 2018, there have been 12 en bloc industrial transactions worth HKD11.2 billion (USD1.4 billion) across different districts with a total GFA of 3.0 million sq ft (278,709 sq metres). We believe that developers are interested in the redevelopment potential of these properties.

According to our risk assessment, the six-month growth rate for industrial properties was 5.4% in February 2018, staying well below +1 SD of 12.1%, implying that that industrial prices have the potential to rise further in coming months.

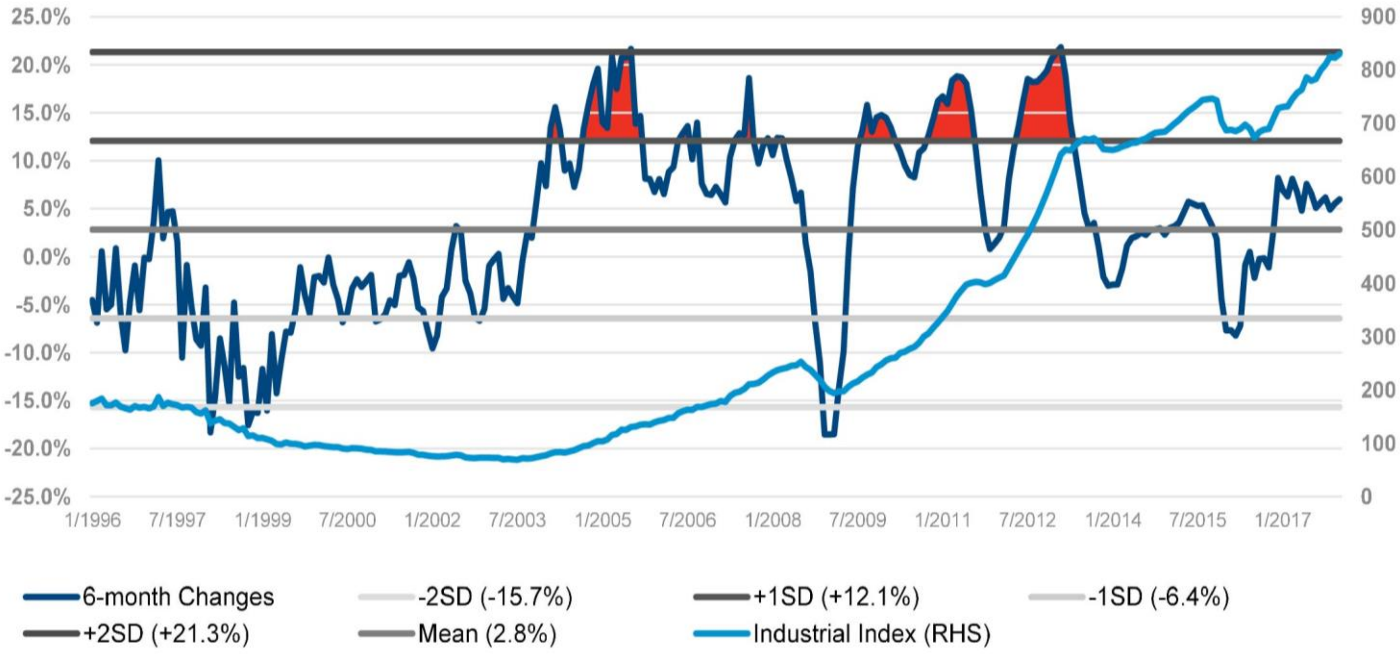
Table 4: Investment Risk Analysis – Industrial

Industrial Market Indicators	
Avg. 6-month growth rate	2.8%
Aug 17~Feb 18 growth rate	5.4%
±1 Standard Deviation Range	-6.4%/ +12.1%
±2 Standard Deviation Range	-15.7%/ +21.3%
Investment Risk Level	Low-Medium

Source: Colliers; Rating and Valuation Department

Looking ahead, industrial property should receive strong support from rent growth as external merchandise trade and e-commerce expand further. We foresee that prices for warehouses and flatted factories will go up by 8-10% per annum on average between 2018 and 2022. At the same time, the warehouse vacancy rate should remain low and continue to decrease over 2018 due to high demand for industrial space and a lack of new supply.

Figure 4: Investment Risk - Industrial Market



Source: Colliers; Rating and Valuation Department

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