Colliers Quarterly

HONG KONG | OFFICE

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Accelerating success.

Company expansion fuelled rental growth amid low vacancy rates

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The leasing market stayed robust in Q2 2018, with overall net take-up increasing by 43.4% QOQ to 928,160 sq ft (86,230 sq m). The expansion of financial institutions from mainland China has driven leasing demand in the CBD. Relocation demand and an aggressive expansion of flexible workspace operators have benefited decentralised districts. Strong take-up drove vacancy down in Kowloon East despite scheduled new supply of 1.3 million sq ft (122,200 sq m) in 2018. The overall Grade A office rent increased 3.8% QOQ while the vacancy rate declined to 4.5% in Q2 from 5.1% in Q1. We expect overall rent to increase 7.9% in 2018 and increase by a total of 9.6% from the end of 2018 to the end of 2022. Companies should consider decentralised districts such as Wong Chuk Hang to save rent.

Forecast at a glance

Demand
We expect annual net take-up to increase to 2.0 million sq ft (185,805 sq m) on average from 2018 to 2022, up 130% compared to the average for 2013-2017.

Supply
The annual Grade A office supply from 2018 to 2022 should increase to 2.5 million sq ft (232,257 sq m) on average, up 76% from the average over the past five years.

Rent
RENT
Despite the increasing amount of new supply, we expect overall rent to increase 7.9% in 2018, and increase by a total of 9.6% from end-2018 to end-2022.

Highest net take-up since Q4 2015

The leasing market stayed robust in Q2 2018, with overall net take-up increasing by 43.4% QOQ to 928,160 sq ft (86,230 sq m). Kowloon East recorded 718,530 sq ft (66,755 sq m) of net take-up, driven by demand at new office buildings. The vacancy level of Kowloon East declined from 12.3% in Q1 to 10.3% in Q2 despite the completion of a new Grade A office building, Mapletree Bay Point, which already had more than 60% of space pre-committed. Vacancy levels in other Grade A buildings also declined given that the availability in new developments decreased.

Demand on Hong Kong Island stayed firm with a low vacancy rate. Central/Admiralty recorded 3,762 sq ft of net take-up with the vacancy rate staying low at 1.9%. Leasing demand in the CBD has been driven by the expansion of financial institutions from the PRC, including Guotai Junan leasing 11,000 sq ft (1,022 sq m) in Man Yee Building and Tian Fung Securities leasing about 10,000 sq ft (930 sq m) in Nexxus Building.

Wan Chai/Causeway Bay had the strongest net take-up on the Island at 42,614 sq ft (3,959 sq m), benefiting from relocation demand and the expansion of flexible workspace operators. A mainland flexible workspace operator, KR Space, leased 83,300 sq ft (7,740 sq m) in One Hennessy in Wan Chai and about 31,800 sq ft (2,954 sq m) at Times Squares in Causeway Bay.

The active investment market triggered more relocations due to changing building ownership and management. After the sale of The Center, Goldman Sachs decided to relocate certain operations to the new Grade A building, Lee Garden Three, in Causeway Bay.

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	1.9%	$136.2	4.5%	$139.0	9.0%
Wan Chai/Causeway Bay	2.1%	$77.1	5.1%	$77.2	10.0%
Island East	2.4%	$53.5	2.0%	$55.3	7.0%
Tsim Sha Tsui	1.6%	$62.1	3.0%	$63.1	9.0%
Kowloon East	10.3%	$35.7	2.0%	$37.2	7.0%
Overall	**4.5%**	**$77.6**	**3.8%**	**$79.5**	**7.9%**

Source: Colliers

Rents increased amid tight supply

Fast take-up in new developments and low vacancy rates have fuelled faster rental growth in the Grade A office market. Overall Grade A office rents increased by 3.8% QOQ, the fastest quarterly increase since Q4 2015. Wan Chai/ Causeway Bay saw the strongest growth among major submarkets due to strong demand, up 5.1% QOQ, and a YTD increase of 9.9%. Kowloon East rental growth accelerated to 2.0% QOQ, and landlords are more confident about increasing rents further given a lower vacancy rate despite strong supply. Compared to a 2.2% QOQ growth in Q1, rents in Central/Admiralty have also picked up by 4.5% QOQ amid very tight supply.

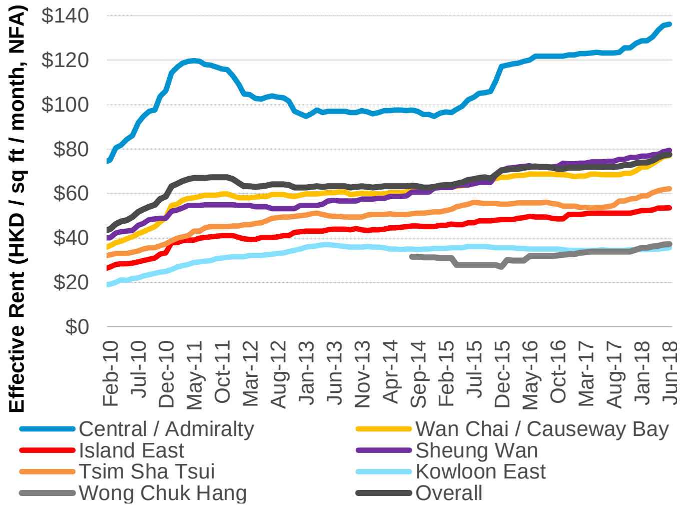
New supply at Island South to drive rents up in H2

With vacancy rates falling to 2.1% in Wan Chai/Causeway Bay and 2.4% in Island East, available space has become scarce on Hong Kong Island. Wong Chuk Hang, emerging as a commercial district since 2011, should become the next focus in H2 2018 with the completion of South Island Place, a new Grade A office building with a total GFA of 382,500 sq ft (35,535 sq m) and an average floorplate of 14,800 sq ft (1,375 sq m). With a total 1.6 million sq ft (148,645 sq m) of Grade A office space, Wong Chuk Hang is still recognised as a decentralised location even though it is only two MTR stations from Admiralty. With the district's vacancy rate dropping significantly since its peak in 2016, we expect rental growth to pick up further in H2, achieving a 10% YOY growth by the end of 2018.

A lack of amenities, including F&B venues, retail and service stores and ATMs, are a major concern of potential tenants. However, we do not expect the level of services and amenities to improve rapidly given the currently small residential population in the area. Previously a major industrial district on Hong Kong Island, the transformation of Wong Chuk Hang into a new office submarket will likely take more time as landlords are slowly converting industrial buildings to office use.

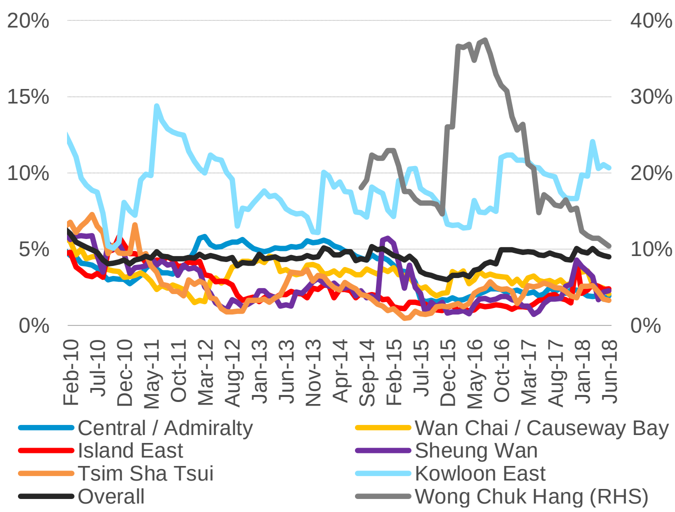
The upcoming residential/retail mix-used development atop the Wong Chuk Hang MTR station should improve its attractiveness. The 3.8 million sq ft (350,000 sq m) mixed-use development is intended to add a range of retail, F&B and other amenities in the district. More new office supply, including the project jointly developed by Sino Land and Empire Group with a scheduled GFA of 284,940 sq ft (26,470 sq m), should encourage more landlords to convert their industrial buildings to office use through revitalisation or redevelopment.

Hong Kong Grade A Rental Trend



Source: Colliers

Hong Kong Grade A Vacancy Trend



Source: Colliers

Notable Leasing Transactions in Q2 2018

Tenant	Building	District	Floor Area (sq ft)	Transaction Type
KR Space	One Hennessy	Wan Chai	83,300 (L)	New Letting
Shanghai Pudong Bank	One Hennessy	Wan Chai	98,400 (L)	New Letting
HSBC	Mapletree Bay Point	Kwun Tong	71,867 (G)	New Letting
AIA	Hopewell Centre	Wan Chai	76,727 (L)	Relocation
Goldman Sachs	Lee Garden Three	Causeway Bay	125,646 (L)	Relocation

Source: Colliers

The non-stop office buying spree

The office investment market has been the most active among all sectors in Q2 with total transaction value (based on Colliers figures which include deal sizes over HKD30 million) up 19.7% QOQ to HKD36.9 billion (USD4.7 billion), which makes it the second strongest quarter over the last 10 years. For H1 2018, according to Real Capital Analytics (RCA), total investment transactions in Hong Kong amounted to USD18.7 billion, up 77% YOY and ahead of both Japan and mainland China (although the RCA figures were boosted by the conclusion of The Center building which we included in our Q4 2017 figures).

The high total transaction value in Q2 was led by major en bloc sales. The Hong Kong developer Swire Properties announced the sale of two Grade A office buildings, Cityplaza Three and Cityplaza Four in Quarry Bay, to Henglilong Investments Limited, for a total of HKD15 billion (USD1.9 billion). These projects comprise a total GFA of about 777,000 sq ft (72,185 sq m), the unit price is about HKD19,300 (USD2,481) per sq ft. Another notable transaction was the acquisition of the Octa Tower in Kowloon Bay by a consortium of C Land, CSI Properties and Asia Standard, for HKD8.0 billion (USD1.0 billion), representing strong investment interest from both local and PRC investors.

Despite a robust en bloc investment market, strata-titled office transactions (deal sizes over HKD100 million) made up 43% of total office investments in H1 2018, compared to 33% in H1 2017. New record prices were set at Grade A strata-titled offices in CBD. For example, both Far East Financial Centre and Nine Queen's Road Central saw transactions over HKD50,000 (USD6,427) per sq ft, which further widened the price gap with non-CBD areas. Prices in Kowloon East also increased. Three high zone units in Montery Plaza in Kwun Tong were reportedly sold for HKD19,000 (USD2,442) per sq ft, the highest for the district. Overall Grade A office prices have increased 5.4% QOQ or 12.5% YTD. With price growth outpacing rental growth, office initial yields further declined to 2.3% for Hong Kong as a whole.

Price growth should moderate as rent growth lags behind

The active investment market and attractive sales prices have encouraged more owners to consider considering selling despite enjoying a sustainable rental growth. While office prices in Central have been growing the fastest, the price gap between Central and decentralised districts such as Wong Chuk Hang, Island East and Kowloon East has been increasing. The ongoing development of the CBD2 in Kowloon East, with a more affordable rent and price level, would make Kowloon East a more attractive option for investors.

In June, the US Federal Reserve raised interest rates for the second time this year, and upgraded its forecast to four total increases in 2018. Most forecasters expect three more increases in 2019 of 25 basis points each. In July, the Hong Kong three-month HIBOR increased to 2.0% for the first time since 2008, which should also suggest a smaller room for office yields to decline and price growth to moderate.

We expect Grade A office prices to achieve 15% growth in 2018. However, the growth pace in H2 should moderate amid rising financing costs and further tightening of liquidity.

We expect Grade A office rents to increase 7.9% in 2018, compared to price growth of 15%. There may therefore be room for modest further yield compression over the rest of 2018.

However, in view of upward pressure on Hong Kong's interest rates and the low spread of property yields over ten-year government bond yields, we expect office yields to stabilise and perhaps start rising over 2019. While a possible US-China trade war could dampen investment sentiment and trigger capital outflows from Hong Kong, we expect office prices to see modest growth of 3-5% 2019.

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