Colliers Quarterly

HONG KONG | RESIDENTIAL

Q4 2016

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Accelerating success.

Turning point in home prices yet to come

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Buying sentiment in Hong Kong residential property improved steadily over 2016 until the government proposed its new stamp duty policy in order to curb speculative activity. This action caused transaction volumes to slump in December. Chinese developers were active in bidding for residential sites in H2 2016; as a result several sites were sold above market expectations. With demand strong and supply limited, we expect overall home price growth in a range of 0-5% over 2017. However, if US interest rates rise faster than we expect, there is a risk that Hong Kong will return to positive real interest rates earlier than our present assumption of H2 2018. This could hit market sentiment hard.

Forecast at a glance

Demand
Demand for new developments should remain strong as developers and banks offering more aggressive financing schemes in response to the increased stamp duty while the secondary market should cooldown

Supply
The government's supply target of 94,000 private residential units for the coming three to four years looks too optimistic

Price
We expect home prices to rise 0-5% in 2017, reflecting firm consumer confidence but restrained volumes and rising interest rates

Rent
Rent should fall 3-5% since multinational and finance companies are not increasing staff housing allowances

Home prices hit record high

Despite declining visitor arrivals and retail sales, economic growth picked up steadily in Hong Kong over 2016, reflecting strong domestic demand. Consumer confidence was supported by persistent loose monetary conditions: real interest rates remain negative in Hong Kong, as they have been since 2009. Negative real interest rates have undoubtedly helped drive the residential property market in Hong Kong: between end-2008 and now, residential prices have risen by roughly 200%.

Against this favourable background, sentiment in the Hong Kong residential property market strengthened steadily over last year. In September, the number of double stamp duty (DSD) payments increased to a record high since the launch of the system in February 2013 of 2,600 cases, while in November, the residential price index surpassed the previous peak level of September 2015 by 0.2%.

In response to the strong volumes and ongoing price increases, the government implemented a new, tough ad valorem stamp duty. The new stamp duty had an immediate cooling effect on transaction volumes: in December, the number of private residential units sold fell to 3,550 units, compared to the monthly average of 4,675 units between February 2013 and December 2016. However, price growth persisted.

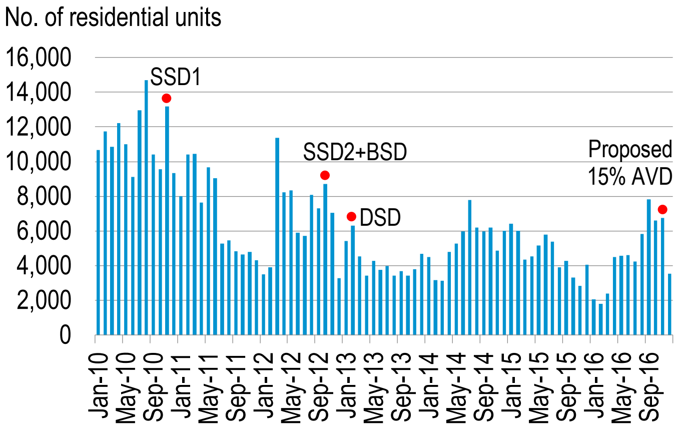
Whilst domestic demand has been strong, mainland Chinese buyers have been investing in Hong Kong residential properties as a hedge against possible further depreciation of the renminbi. The number of mainland buyers as a proportion of the total is harder to estimate than before due to the growing number of Hong Kong Identity Card holders among Chinese purchasers. Private residential units in the primary market have been generally popular, as developers have been offering more aggressive financing schemes in response to the increased stamp duty; banks have also been offering more attractive mortgage plans to prospective buyers to offset the impact of rising interest rates.

The government sold 23 residential sites by public tender over 2016. After the slowdown in Q1, 12 out of the 16 residential sites were sold above the market expectations in H2 2016 with only one site receiving a single-digit number of bids. Chinese developers largely contributed to driving up land prices. HNA Group was the most prominent, winning two sites in Kai Tak with accommodation values of HKD13,500-13,600 per sq ft (USD162-163 per sq metre). Local developers reacted quickly to secure new sites for their shrinking land banks. K. Wah International won the last residential site sold in the year in Kai Tak with an awarded price of HKD5.87 billion (USD756 million) or HKD10,220 per sq ft (USD122 per sq metre), at the upper-end of the market's expectations.

Impact of the new curbs

The number of residential transactions fell 12.2% y-o-y to 3,550 in December. We believe the new stamp duty policy in November was the primary reason why non-first-time home buyers stayed away from the market. The impact of introducing a flat rate of 15% on non-first-time home buyers appears to be weighing equally on both the mass and luxury markets.

Residential Sales and Purchase Agreements

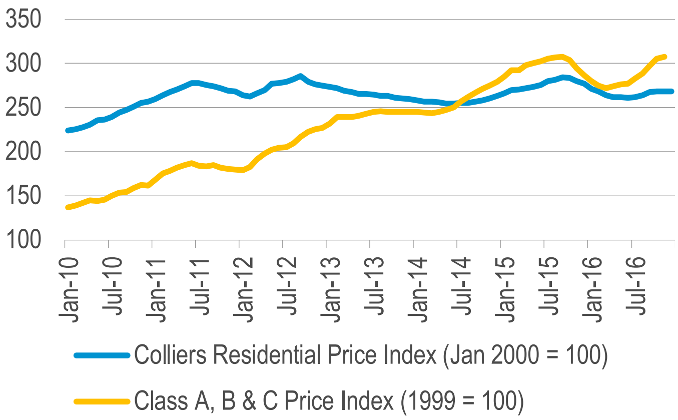


Source: Land Registry

Demand in the primary market should remain unaffected by the implementation of the new curbs in the near term, since developers have adopted sales strategies such as offering mortgage financing, discounts on stamp duty and reducing unit sizes to secure buying interest.

Residential prices have not responded as quickly as transaction volume to the new curbs as owners have greater holding power. Luxury residential prices were unchanged in Q4, with demand in the Peak, Mid-levels and Happy Valley remaining stable, while the new South Island MTR line boosted the attractiveness of Southside.

Mass vs. Luxury Residential Price Index



Source: Colliers; Rating and Valuation Department

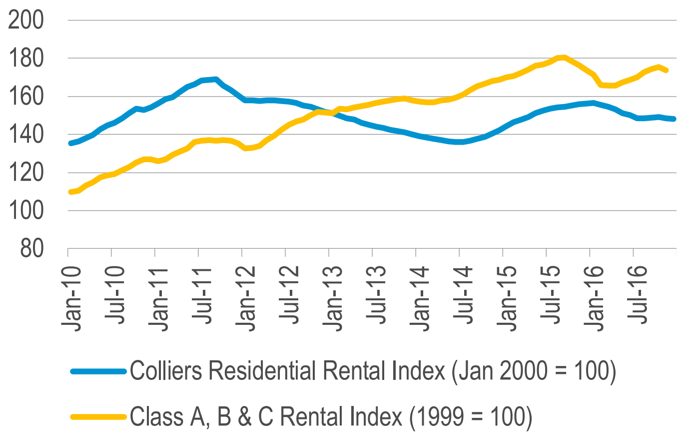
Stagnant leasing market for ultra-luxury units

Multinational and finance companies in Hong Kong have become increasingly cost-conscious and continue to reduce housing allowances for their staff. Relocation demand was also low in Q4 due to seasonal factors. As a result luxury flats costing more than HKD100,000 per month (USD12,900) to rent experienced a stagnant quarter in Q4.

Leasing demand for flats with monthly rents of between HKD70,000 and HKD100,000 (USD9,000-12,900) weakened appreciably, because owners showed greater willingness to negotiate over rent and lease terms, partly reflecting competition to attract tenants from new developments in the luxury districts. Mainland Chinese tenants were the major source of demand in the leasing market amid softer demand from multinational companies. Flats with monthly rents of between HKD20,000 and HKD35,000 (roughly USD2,600-4,500) per month, along MTR lines, proved quite popular in Southside, Kennedy Town and West Kowloon.

Rent for luxury private residential units slid 0.5% q-o-q in Q4, depressed by lower demand for ultra-luxury units in traditional up-market districts. We expect the trend in 2017 to be similar to that of 2016, and predict luxury residential rent will edge down 3-5% by the year-end.

Mass vs. Luxury Residential Rental Index



Source: Colliers; Rating and Valuation Department

Economic risks hiding behind the scene

This year should be a more challenging year for the residential market, with increasing supply and the potential for demand to deteriorate. The government has reaffirmed its target of supplying 94,000 private residential units in the coming three to four years during its 2017 policy address; this target could translate into annual supply of 23,000-31,330 units. We consider that a more realistic figure for supply in the coming four years would be the 74,000 units which are under construction, which could translate into a maximum amount of completion of 18,500 units per year. Despite the increase from the completion of about 12,000 units per year during 2013-2016, the amount of new supply should be still limited in 2017.

We believe factors affecting the demand are potentially more significant. One of the key factors determining demand for property in Hong Kong over 2017 and 2018 is likely to be interest rates. Based on our calculation, the real (i.e. inflation-adjusted) interest rate in Hong Kong currently stands at about -1.1%. Nominal interest rates in Hong Kong are effectively tied to US interest rates by the territory's currency peg. Assuming three ¼ percentage point hikes in the US Fed Funds rate over 2017 (which is the Federal Reserve's present indication), we assume that Hong Kong will not return to positive real interest rates till H2 2018. If our projection is correct, and if the pace of interest rate increases is gradual, Hong Kong's residential property market can probably absorb the downward pressure. Hence our prediction that home prices will increase by 0-5% over 2017.

However, if US economic growth exceeds forecasts (perhaps in response to the stimulus package that the new administration of President Trump is widely expected to deliver), US interest rates may rise more rapidly than expected. In this case, it is possible that Hong Kong will see an earlier and sharper return to positive real rates than we currently assume. This outcome would probably hit confidence in the residential property market hard, pushing down prices.

At present, a downturn in Hong Kong residential property prices seems more probable in 2018 than 2017, and it may not happen even then. However, we shall watch developments in the US economy carefully this year. In simple terms, we see faster than expected US economic growth as perhaps the biggest risk to Hong Kong property markets in general, and especially the residential market.

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