LOW VACANCY RATES SUPPORT RENTAL GROWTH DESPITE SLOWING EXPORTS

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Summary & Recommendations

In Q1 2019, total exports in January and February showed a notable decrease of 3.1% YOY due to US-China trade tensions and the slowdown of the global economy. Hong Kong's PMI figures stayed below 50 points for the twelfth consecutive month, indicating a contraction in private sector sentiment.

Despite the disappointing trade figures, the industrial leasing market held up well with tight vacancy and diverse demand coming from data centres, FMCG companies and logistics operators.

We expect that prices and rents of industrial spaces will continue to grow in 2019, thanks to the recent resumption of the revitalisation scheme. Large tenants should start the rent review process earlier to explore the renewal and relocation options amid a tight supply market.

		Q1 2019	Full Year 2019	2018–23 Annual Average
Demand	> We expect investment demand to pick up with more en-bloc transactions in 2019 amid higher investment returns for industrial properties redeveloped into office, retail or hotels due to the Revitalisation 2.0 scheme.	HKD5.7 bn	HKD25.0 bn	HKD30.0 bn
Supply	> New supply of industrial spaces remains tight, and the revitalisation scheme should further reduce existing available space for industrial usage.	182,360 sq ft*	856,000 sq ft	500,000 sq ft

		QOQ / End Q1	YOY / End 2019	Annual Average Growth 2018–23 / End 2023
Rent	> Industrial rents should continue on the uptrend in 2019 as the vacancy rate continues to be very low, despite expansion demand being slow on the back of trade war tension.	0.2% HKD13.1 psf	5.4% HKD13.8 psf	4.5% HKD16.3 psf
Capital Values	> The relaunch of the revitalisation scheme should drive investment activities and hence price growth of industrial buildings, although the investment market remained quiet in Q1.	0.7% HKD4,878 psf	8.4% HKD5,250 psf	6.6% HKD6,666 psf

*Data as of January 2019
Source: Colliers International.
Note: USD1 to HKD7.8 at the end of Q1 2019. 1 sq m = 10.76 sq ft

A FURTHER DECLINE IN EXPORTS

In February, US President Donald Trump said that he would delay the scheduled 1 March imposition of additional tariffs on Chinese goods. Although President Trump stated on Twitter that the US has made *substantial progress* in bilateral talks between the US and China, the conflict remains unresolved. Having declined since November 2018, the combined value of Hong Kong's total exports in January and February dropped further by 3.1% YOY.

Besides, according to IHS Markit, the Nikkei Hong Kong PMI in March remained at 48.0[1], staying below 50 points for the twelfth consecutive month, indicating a deterioration of private sector sentiment. The contraction was due to the declines in private sector's output, new orders and employment, on the back of weak Chinese demand with firms cutting purchases and trimming inventories.

INDUSTRIAL RENTS STAYED FLAT

In Q1 2019, although the external trade figures were disappointing, warehouse leasing demand remained firm, driving the already tight vacancy rates for ramp-access warehouses down further to 0.9%.

In view of the low vacancy rates, occupiers started early negotiations with landlords to explore the opportunities for new leases or renewals upon expiry. Notable leasing transactions included Land Crawford (Hong Kong) and JSI Logistics renewing their lease in Tsuen Wan International Centre for a gross floor area (GFA) of 69,700 sq feet (6,500 sq metres) and 23,200 sq feet (2,200 sq metres), respectively.

Rents for warehouses in Q1 2019 stayed largely stable, edging up only 0.2% QOQ. The impact of slower expansion due to the uncertainty of the US-China trade conflict has been balancing out by the tight supply across the market.

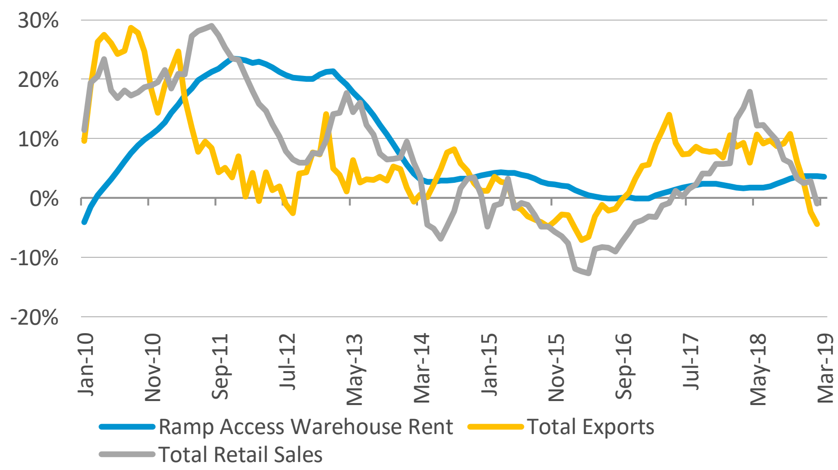
For the flatted factory subsector, the Development Bureau announced on 1 February to relax the usage of the arts and cultural sector in industrial buildings[2], needless to apply for a temporary waiver for the allowed specific use.

With the government increasing the flexibility of permitted uses in industrial buildings, flatted factory buildings will likely benefit from more diversified demand. We expect rental growth to be more backloaded in 2019 while Q1's rent stayed relatively flat by edging up only 0.3% QOQ.

Major industrial market indicators

Major Industrial Market Indicators	Q1 2019
Total Exports (Jan – Feb)	-3.1% YOY
Port Container Throughput (Jan – Feb)	-15.3% YOY
Air Cargo Throughput	-5.4% YOY
Warehouse Rents	0.2% QOQ
Factory Rents	0.3% QOQ

Hong Kong warehouse rents



Source: Census and Statistics Department, Colliers International. Note: data is a three month moving average.

[1] IHS Markit, 3 April 2019
[2] Development Bureau, 1 February 2019

INVESTMENT YET TO PICK UP

The industrial investment market remained relatively slow following a quiet quarter in Q4 2018. The total value of strata-title transactions (with deal size HKD30 million or larger) decreased by 3.2% QOQ, while that of en bloc transactions increased by 4.4% QOQ. Meanwhile, factory prices remained stable compared to Q4 2018, and that of warehouses edged up by 0.7% QOQ.

A notable investment transaction was Hanison Construction acquiring Hay Nien Building in Kwun Tong for HKD489 million (USD62.7 million). Based on a gross floor area of 62,889 sq feet (5,843 sq metres), the unit price was HKD7,776 (USD997) per sq foot[3].

We expect the investment market to regain momentum gradually given the supportive government policies, including the industrial revitalisation scheme and the relaxation of plot ratios for redevelopment. The Lands Department has started to receive applications for increasing the non-domestic plot ratio up to 20% for aged industrial buildings built outside "Residential" (R) zones on or before 1 March 1987. The policy is effective for the three-year period from 10 October 2018[4].

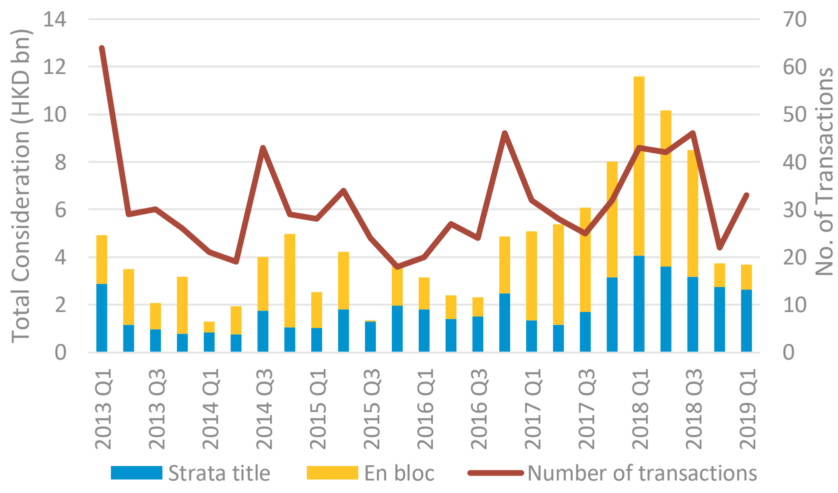
THRIVING AGAINST HEADWINDS

We expect that the trade war would be clearer in H2 2019 as uncertainty diminishes. On a positive note, the lack of new industrial supply as well as low vacancy rates should continue to provide support for prices and rents.

We believe the industrial revitalisation scheme, which should be launched progressively over the course of the year, will drive leasing and investment demand. According to Colliers Radar report *Industrial 2.0: More than a Face Lift*, the estimated internal rate of return (IRR) of purchasing industrial buildings and revitalising them for office use are in general the highest (13.6%), compared to developing new office buildings (10.7%) or industrial buildings (11.4%) via land acquisition. With reference to the successful cases under the previous revitalisation scheme, we expect more landlords to explore the investment potential in the industrial revitalisation 2.0. This should provide support to rent and price levels in the rest of 2019.

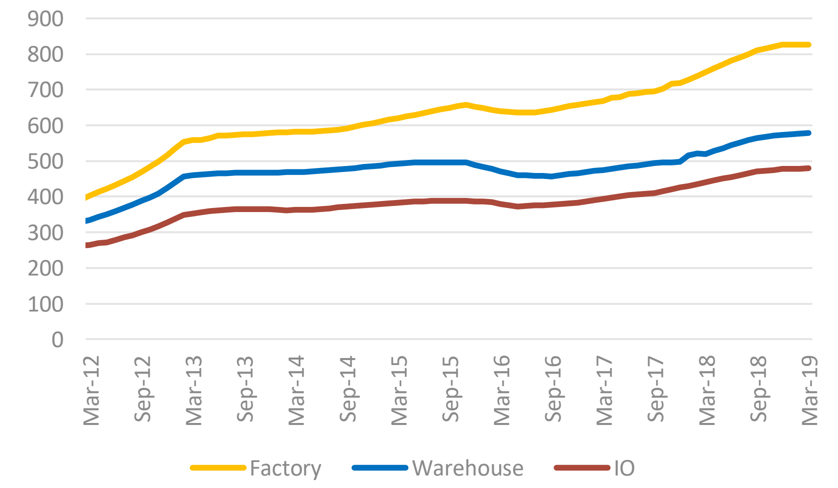
[3] hkexnews, 27 March 2019
[4] Lands Department, 18 February 2019

Value of industrial property transactions (deal size ≥HKD30 million)



Source: EPRC, Market News, Colliers International

Hong Kong industrial price index (Jan-2000 = 100)



Source: Colliers International

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