

IMPACT OF CORONAVIRUS ON HONG KONG PROPERTY MARKETS

Rosanna Tang
Head of Research |
Hong Kong SAR and Southern China
+852 2822 0514
rosanna.tang@colliers.com

Zac Tang
Manager | Research | Hong Kong SAR
+852 2822 0578
zac.tang@colliers.com

Hebe Lau
Manager | Research | Hong Kong SAR
+852 2822 0602
hebe.lau@colliers.com

Summary & Recommendations

The outbreak of the Novel Coronavirus (COVID-19) that began in December 2019 poses downside risks to China, as well as Hong Kong SAR¹ which faced a tough year in 2019.

Market players in Hong Kong generally expect the history of SARS in 2003 to be repeated. If capital values initially decline due to coronavirus, this may well create a chance for investors to enter the market.

We recommend landlords focus on office occupier sectors likely to remain active despite the virus, while offering retailers short-term rental relief.

Occupiers desiring Central offices should look now given recent increases in the vacancy rate and falling rents. Meanwhile, this is a good chance for growth sectors to expand at lower rental costs.

2020 HK GDP Growth: -2.8%



Oxford Economics has recently lowered its forecast for 2020 real GDP growth in Hong Kong from -1.4% to -2.8% given the negative impact of coronavirus. Meanwhile, it has cut its estimate of real GDP growth for China in 2020 from 6.0% to 5.4%.

Office: Rents to fall sooner, not more



We reaffirm our forecast that average Hong Kong and Central rents will fall by 8% and 13% respectively in 2020. Landlords should target occupier sectors whose businesses are likely to remain stable despite the virus, e.g. insurance, biotech, pharmaceuticals.

Hang Seng Index: -4%



Since the outbreak of coronavirus in December 2019 and its spread to Hong Kong in early January, the Hang Seng Index has dropped by 4% from its recent high on 17 January 2020, indicating a decline but certainly not a collapse in market sentiment.

Investment: time to treasure hunt



It is time for investors to offload long-held assets to secure strong capital gains. Office prices should rebound quickly once demand returns amid limited supply, with strata-titled space and en-bloc assets in fringe areas the key targets. Investors should also focus on hotels, whose prices have fallen sharply.

The coronavirus compounds Hong Kong's recent problems, notably large-scale demonstrations, the lagging effects of US-China trade tension and pressures on the important financial sector. Assuming that Hong Kong's steep downturn persists over H1 2020, but that coronavirus peaks within the same period, we expect:

- > Office leasing activity to stay slow, with rents likely to fall sooner than we had assumed until now (but at a similar rate over 2020 as a whole), and with vacancy likely to rise
- > Weak investment sales over H1 as a whole, but with the possibility of a steep and rapid recovery in sentiment from Q2. We think investors should start looking at distressed property assets now
- > Travel and tourism, which makes up 18% of GDP² in Hong Kong, to weaken again in 2020, further reducing hotel occupancy. However, we think this pressure has been fully reflected in the drop in hotel prices of about 30% from their peak
- > Further pressure on retail sales, especially luxury retail, and hence declining demand for luxury retail space

¹ This report covers the Hong Kong Special Administrative Region of the People's Republic of China. ² Source: Oxford Economics

A BLACK SWAN AT START OF 2020

A “quadruple whammy” to the real estate market

The outbreak of the coronavirus compounds Hong Kong’s recent problems, notably large-scale demonstrations, the lagging effects of US-China trade tension, and long-term pressures on the important financial sector. Given the negative impact of the coronavirus, Oxford Economics has recently lowered its estimate of real GDP growth in 2020 from –1.4% to –2.8% YOY¹. Following the –1.2% real GDP growth in 2019, this would be the first time in recent history that Hong Kong has been in recession for two years in a row.

Hong Kong’s steep downturn thus looks set to persist at least over H1 2020. For occupiers, we expect a challenging business situation to persist, although opportunities to sign new leases at attractive rents should arise. We think that landlords may need to be flexible in providing leasing incentives and discounts in order to attract tenants.

We note that monetary conditions remain very loose in Hong Kong. Real (i.e. inflation-adjusted) interest rates have been negative ever since the Global Financial Crisis of 2008-2009. Assuming that coronavirus peaks within H1 2020, there could be a sharp recovery in investment sentiment in H2, making this a good time to investigate distressed investment assets.

WILL HISTORY REPEAT ITSELF?

A comparison with SARS in 2003

We believe it is reasonable to expect the historical cycle of the property market during the outbreak of SARS in 2003 to repeat itself. In similar fashion to now, Hong Kong’s property market was already declining prior to the outbreak of SARS, having been hit by the end of internet bubble in 1999-2000, high and positive real interest rates, and a supply boom since 2001. SARS was the “black swan” event of 2003.

As Hong Kong was named among “Affected Areas” by the World Health Organization, retail sales value and high-street shop rents in H1 2003 dropped 6.7% and 18% YOY², respectively. In 2003, Grade A office rents recorded a decline of 17.2% with CBD dropping 22.5% YOY. With investment sentiment and activity frozen during the SARS period, investment volume contracted significantly while office prices dropped about 15% in 2003.

Impact of SARS on Hong Kong property prices and rents

| | Jan-Jun 2003 | The whole of 2003 (YOY) |
|--------------------------|--------------|-------------------------|
| Grade A office rents | -13.0% | -17.2% |
| High-street shop rents | -17.8% | -5.7% |
| Residential prices | -8.5% | +0.9% |
| Luxury residential rents | -9.0% | -8.1% |
| Industrial prices | -10.3% | -3.4% |
| Warehousing rents | -11.8% | -2.8% |
| Hotel room rate | -20% | -4.7% |

Source: Colliers International, HKTB, Rating and Valuation Department

Nevertheless, 2003 real GDP growth in Hong Kong increased 3.1% (as expressed in constant 2017 dollars) despite the SARS epidemic³. This time, we expect office price and rental growth to stay negative for the whole of 2020, with office rents and prices falling steeply over H1 2020 (especially in Q1). However, we think both rents and prices will rally in H2 assuming that coronavirus peaks in H1. For the whole year, we forecast office rental growth remaining negative, declining 8.3% (rounded to 8% on page 1).

Hong Kong was able to recover quickly from 2003 since its status as an international financial centre was assured. As a result of the Individual Visit Scheme (IVS) and CEPA⁴, Hong Kong’s real GDP growth bounced 8.7% in 2004. As such, the property market demonstrated strong resilience after SARS. For instance, Grade A office rents rebounded 45% YOY in 2004.

We expect the office and investment markets to recover modestly after 2020, as the prolonged lack of supply should support a rebound in prices and rents. The impact of the new virus outbreak on the retail and hotel sectors should be similar to the impact during SARS, with no obvious quick relief in the form of a new version of the IVS. However, the problems of the hotels sector seem to be fully reflected in a decline in prices of roughly 30% from their peak. Investors should target hotels rather than retail for recovery.

It is critical for Hong Kong to find new tools to repeat the history of a speedy recovery. As the Chinese economy accounts for a much larger proportion of the global economy than in 2003, we think Hong Kong needs to integrate further with China including strengthening collaboration with the other cities in the Greater Bay Area. After 2020, we believe Hong Kong’s property market should return to a trajectory of steady growth.

¹ “Novel coronavirus outbreak raises downside growth risks in the short term”, Oxford Econ. (3 Feb 2020)

² <https://www.statistics.gov.hk/pub/B10800032003MM12B0100.pdf>

³ https://www.yearbook.gov.hk/2003/english/chapter03/03_00.html

⁴ Mainland and Hong Kong Closer Economic Partnership Arrangement

| Sector | Impact on real estate market | Recommendations |
|--|--|---|
|  <p>OFFICE</p> | <ul style="list-style-type: none"> > Inspection activity should decline and hence leasing momentum will probably remain slow > A challenging business situation will hinder expansion > Likely postponement of IPOs or companies' plans to open offices in Hong Kong > Business travel between Hong Kong and the mainland will probably stay temporarily on hold | <ul style="list-style-type: none"> > Occupiers – look at Central now considering recent increases in vacancy rates and falling rents, together with Tsim Sha Tsui where we expect rents to fall by 8% over 2020 > Landlords – target occupier sectors whose business is likely to remain stable despite the virus, e.g. insurance, biotech and pharmaceuticals; provide flexible and alternative lease terms in addition to rental reduction |
|  <p>RETAIL</p> | <ul style="list-style-type: none"> > Retail and hospitality set to feel the immediate heat > Inbound tourism will likely see a significant drop due to the closure of border crossings and travel bans > Domestic consumption should also weaken in the short term as citizens minimize their outdoor exposure > Online retailers and supermarkets should benefit during this period | <ul style="list-style-type: none"> > Retailers – implement online-to-offline strategy; diversify revenue streams; explore core areas as there are greater opportunities to negotiate for a significant adjusted rental > Landlords – provide short-term rental relief measures to support retailers; ensure hygiene standards in the shopping malls through good ventilation and sterilization |
|  <p>RESIDENTIAL</p> | <ul style="list-style-type: none"> > Transaction volumes likely to freeze in the short term > Owners' holding power should remain strong thanks to the growth in capital values over the past two decades, although the market may see some discounting > Unless the virus outbreak keeps worsening and boosts unemployment, a collapse in prices is unlikely given the strong pent-up demand and low interest rates | <ul style="list-style-type: none"> > Developers – offer more flexible packages/terms and reasonable asking prices to attract buyers; focus on property management as it is crucial to the health and safety of the building > Buyers – exploit increased chances to negotiate better pricing. In the secondary market, Mid-Levels and the South Side remain attractive districts with units available |
|  <p>INVESTMENT</p> | <ul style="list-style-type: none"> > Similar to the leasing market, inspection activity will likely be slow with investors testing the bottom of the market > Buyers should find more prime properties around the CBD available on the market > Price corrections will likely be significant in the retail and hospitality sector | <ul style="list-style-type: none"> > A rapid recovery in Q2 2020 and beyond is possible, giving investors the opportunity to investigate distressed investment assets > Best targets for treasure hunting are strata-titled space and en-bloc assets in fringe areas, including Kowloon East which benefits from the Shatin to Central Link > Hotels should provide strong rebound opportunities; industrial assets for conversion remain stable and safe |

Primary Authors:

Rosanna Tang

Head of Research | Hong Kong SAR and Southern China

+852 2822 0514

rosanna.tang@colliers.com

Zac Tang

Manager | Research | Hong Kong SAR

+852 2822 0578

zac.tang@colliers.com

Hebe Lau

Manager | Research | Hong Kong SAR

+852 2822 0602

hebe.lau@colliers.com

For further information, please contact:

Nigel Smith

Managing Director | Hong Kong SAR

+852 2822 0508

nigel.smith@colliers.com

Andrew Haskins

Executive Director | Research | Asia

+852 2822 0511

andrew.haskins@colliers.com

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