Colliers Quarterly

MANILA | OFFICE

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Accelerating success.

Moving up the value chain

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In the last five years, the office sector has been characterized by shifting industry drivers. In Q1 2018, we note the increasing importance of knowledge process outsourcers (KPOs). The breakdown of transaction volumes shows KPOs representing 28% of total volumes, up from merely 16% throughout 2017. This is a welcome development considering concerns of a potential reduction in fiscal incentives because of the impending passage of the Tax Reform for Acceleration and Inclusion - package two (TRAIN 2).

Meanwhile, due to strong demand, vacancy stayed below 6.0% in Q1 2018 despite the completion of 470,000 sq m (5.1 million sq ft) of new supply. We expect 900,000 sq m (9.7 million sq ft) annually over the next three years, or a 23% increase from current levels, pushing vacancy upward. Colliers believes that as vacancy increases, competition will intensify as developers look to attract more discerning tenants.

Colliers recommends that developers upgrade their buildings, creating a seamless and efficient overall experience for today's workforce. This can be done by incorporating technology and design enhancements in office space as we see the increasing importance of Leadership in Energy and Environmental Design (LEED) certified options to attract major tenants.

Vacancy Rates in Metro Manila Submarkets

LOCATION	Q4 2017	Q1 2018
Makati CBD	1.2%	1.2%
Fort Bonifacio	5.6%	4.4%
Ortigas Center	1.0%	4.5%
Manila Bay Area	3.4%	1.8%

Source: Colliers International Philippines

Forecast at a glance

Demand

Net take-up for the quarter reached 390,000 sqm (4.2 million sq ft), on track to outperform last year's numbers. We still expect net take-up to grow 6% per year in the next three years.

Supply

About 470,000 sq m (5.1 million sq ft) of office space was completed in the quarter. For 2018 to 2020, we expect an average of 900,000 sq m (9.7 million sq ft) more each year as developers upgrade their options and provide better quality buildings

Vacancy rate

Strong take-up has kept vacancy below 6% despite the sizeable supply that was completed during the quarter. Considering the heavy upcoming supply, we expect vacancy to reach 7.0% by end-2018, and increase to 9.0% by end-2020.

Rent

Despite the increasing vacancy, we estimate an average increase of 10% per annum in rents across submarkets over the next three years. This is due to the continued strong demand and tenants' preference for newer, higher quality buildings which can command premium rents. In Q1, rents in the primary submarkets range between PHP800 and PHP1,300 per per sqm (USD1.43 and USD2.32 per sq ft) per month. We expect Manila Bay Area to continue inching closer to these levels as demand from offshore gaming and KPOs puts upward pressure on rents.

Office Supply Forecast, GLA (sq m)

LOCATION	AS OF 2017	2018F	2019F	2020F	2021F	TOTAL
Alabang	572,600	60,700	91,000	-	77,800	802,100
Fort Bonifacio	1,916,800	166,500	265,400	38,900	32,900	2,420,400
Makati CBD	3,227,400	37,200	82,000	57,000	209,100	3,612,700
Makati Fringe	254,700	73,300	14,300	117,700	-	460,100
Mandaluyong	399,300	68,600	11,500	-	-	479,400
Manila Bay Area	400,900	273,000	52,800	81,000	128,000	935,800
Ortigas Center	1,645,000	98,000	25,000	421,600	41,400	2,230,800
QC*	1,048,500	159,400	230,500	142,400	43,400	1,624,000
Others**	312,600	59,200	64,100	69,100	36,000	541,000
Total	9,778,000	995,800	836,600	927,600	568,600	13,106,400

Source: Colliers International Philippines
*Includes Araneta Center, C-5 Corridor, Eastwood City, and North EDSA Triangle
**Manila and other fringe locations

KPOs drive demand despite risk of reduction in incentives

In the last five years, the office sector has been characterized by shifting industry drivers. Notably, since the early 2000s, voice-business process outsourcers (BPO) have been major sector drivers. By 2017, we saw the emergence of offshore gaming as a significant contributor of demand. Throughout this period, while traditional occupiers were a relatively consistent contributor, knowledge process outsourcers (KPO) were quietly growing. Consistent with our view back to 2017, we see a more diversified tenancy mix across the market. And in 1Q 2018, the breakdown of transactions reveals the increased importance of KPOs as a demand driver, representing 28% of total volumes, up from 16% in 2017.

Some of the major KPOs that closed deals during the quarter were Amazon, Google, Accenture, and ING, among others. These transactions were closed across submarkets with deals ranging between 3,700 sq m to as high as 49,000 sq m (39,800 sq ft - 527,400 sq ft).

The strong demand from KPOs is a welcome development amid concerns of a potential cut in fiscal incentives for outsourcing firms. If TRAIN 2 is passed, it will limit the income tax holiday to four years, and implement a sunset provision on the prevailing favourable tax rate of 5% on gross income instead of applying it perpetually.

Summary of potential changes due to TRAIN 2

Incentive	Current Law	Proposed Law
Income Tax Holiday	5 years, possible extension to 6 years	4 years, with no extension
Tax rate in lieu of regular corporate tax rate	5% on gross income earned (GIE)	15% on net taxable income
Period of applicability of GIE	Perpetual	Receiving for more than 10 years: 2 years Receiving between 5 and 10 years: 3 years; Receiving below 5 years: 5 years

Source: Department of Finance, Colliers International Philippines

Data from the Department of Finance points to various changes in tax incentives. The biggest concern however, comes from the application of the Income Tax Holiday (ITH), and the 5% tax rate on gross income earned in lieu of the regular income tax rate.

Although the legislation is still under deliberation with the House of Representatives, some outsourcing firms are already lobbying to keep existing incentives intact as they claim it would make the country less competitive relative to other countries like India, Vietnam, China, and Malaysia.

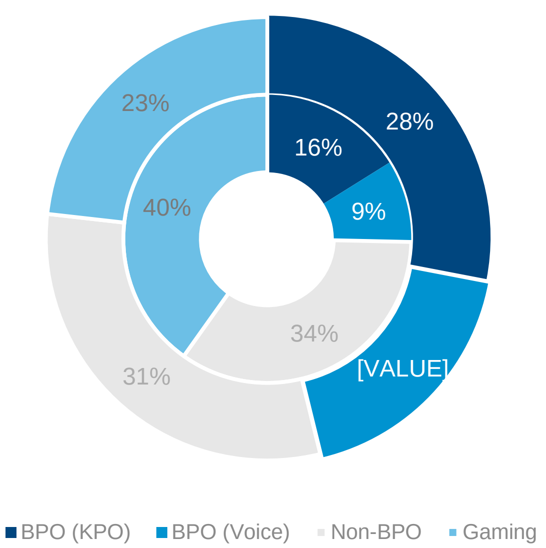
At present, the IT and Business Process Association of the Philippines (IBPAP) is studying the financial impact of TRAIN 2 to KPOs and voice-BPOs alike, possibly to make stronger case before legislators and policy-makers.

Based on discussions with existing occupiers, while many view TRAIN 2 negatively, we understand they are more likely to stay considering other factors such as size of operations, cultural affinity with the local workforce, and other qualitative factors. Assuming the bill is indeed passed into law, Colliers believes it will have a bigger impact on new entrants more than existing players which are well-established in the local market.

We still foresee a stronger contribution from KPOs, as the BPO market shifts to higher value services including an upskill or re-skilling of the workforce, consistent with the forecast of the IBPAP. In fact, it is interesting to note that since 2014 KPOs have had improved share relative to voice-BPOs.

Colliers forecasts a 6% growth in net take-up over the next three years, driven by a more diversified tenancy mix. Notably, employment in finance, insurance, real estate activities and other related services is tracking at least a 6% growth based on government numbers. This is also in line with GDP growth numbers which should spur demand from KPOs and traditional occupiers. Interest from offshore gaming remains strong with more than 86,000 sq m (925,700 sq ft) of transactions closed this quarter.

Breakdown of Office Transactions 2017 (Inner Circle) vs 1Q 2018 (Outer Circle)



Source: Colliers International Philippines Research
*Government entities are included in Non-BPOs

Upcoming supply augmented by offices for sale

A total of 470,000 sq m (5.1 million sq ft) of new office space were completed in 1Q 2018, the highest in any quarter in Metro Manila's history. This has pushed total office stock in Metro Manila to 10.2 million sq m (110 million sq ft). This was driven, among others, by the Quantum Building by Greenfield Properties, Circuit Makati Corporate Center One and Vertis BPO Phase Two both by Ayala Land, and Meridian Park Towers Two and Three by Double Dragon Properties. All these buildings have a gross leasable area of at least 30,000 sq m (322,900 sq ft).

Completed Buildings, 4Q 2017

BUILDING	LOCATION	GLA (sqm)
Alphaland Corporate T3	Makati Fringe	26,600
Aseana Three	Manila Bay	29,600
Eastfield Center	Manila Bay	23,400
Hexagon Corporate Center	Quezon City	13,700
Meridian Park 2, 3 and 4	Manila Bay	90,000
One Park Drive	Fort Bonifacio	19,700
Quantum Building	Mandaluyong	55,800
Silver City Annex	Ortigas Center	3,600
Circuit Makati Corporate Center One	Makati Fringe	46,700
M1 Tower	Makati CBD	7,600
Nexgen Tower	Manila Bay	18,500
Ortigas Technopoint Two	Ortigas Center	22,100
Ri Rance 1	Manila Bay	6,600
Total		470,500

Source: Colliers International Philippines Research; Total includes buildings outside major submarkets

For the rest of 2018, Colliers expects over 525,000 sq m (5.6 million sq ft) of new office space to be completed, pushing 2018 full year supply to 996,000 sq m (1.1 million sq ft). Interestingly, sizeable developments due within the year are significantly leased out. SM Prime's 60,000 sq m (645,800 sq ft) building, The Three E-Com Center, and Daiichi Properties' 56,000 sq m (602,800 sq ft) property, The Finance Center, are at least 90% leased out, primarily to KPOs. Examples of major occupiers in these buildings are Amazon and Shell.

Between 2018 and 2020, an average of 900,000 sq m (9.7 million sq ft) annually will be added before normalizing in 2021 with approximately 560,000 sq m of supply. Most of the supply in 2019 will be in Fort Bonifacio, accounting for 32% of upcoming supply.

The biggest buildings due for completion that year are Ayala Land's High Street South Corporate Plaza and Megaworld's World Commerce Plaza. Meanwhile, for 2020, Ortigas Center will account for 45% of the year's supply coming in prime submarkets.

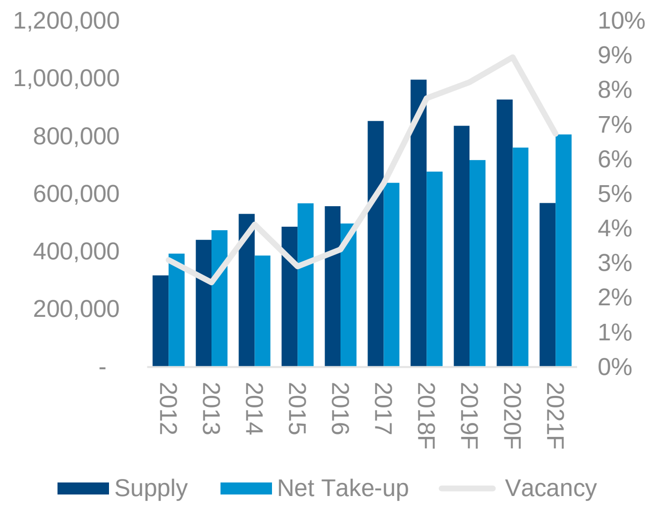
Approximately 10% or 330,000 sq m (3.6 million sq ft) of upcoming supply through 2021 are office buildings for sale. Some of the notable buildings that will be completed are High Street South Corporate Plaza Tower 2, Park Triangle Corporate Plaza (North Tower), Parkway Corporate Center, and Century Spire. With non-BPOs being the primary occupiers of offices for sale, it is not surprising to see this emerging trend, consistent with shifting profile of tenants in the market.

Vacancy stays below 6%

Despite the completion of 470,500 sq m (5.1 million sq ft) GLA, due to the strong take-up recorded in the quarter vacancy increased by a mere half a percentage point QOQ to 5.8%. Compared with the prior year however, this reflected an increase from 3.4% in 1Q 2017, primarily due to the over one million sq m that were completed in the past four quarters.

Looking ahead, given the approximately 900,000 sq m (9.7 million sq ft) of supply each year until 2020, we expect vacancy to rise from 6% to as high as 9% in the next two to three years, before possibly correcting back to 6% by 2021 when supply drops to 560,000 sq m.

Vacancy, Supply, and Demand Forecast



Source: Colliers International Philippines Research

Understandably, at this level of vacancy, there is still a healthy level of negotiation between landlords and tenants. Landlords are forced to compete based on building quality rather than mere availability. Tenants, on the other hand, may still find new options in the market where the primary submarkets virtually have no vacancy.

Rents continue to increase

The strong demand since 2017, which carried into this quarter, has pushed average rents upward despite the huge supply added to the market. Prime and Grade A rents in primary submarkets of Makati and Fort Bonifacio are still the most expensive in the market, reaching north of PHP1,300 per sq m (USD 2.32 per sq ft) per month. Meanwhile, Manila Bay area rents are seeing a few buildings already offering more than PHP1,000 per sq m (USD1.79 per sq ft) per month. Lastly, alternative locations are between PHP550 and PHP900 per sq m (USD0.98 and USD1.61 per sq ft) per month.

Despite the large volume of new supply coming online, rents are still expected to increase as the changing occupier profile increasingly prefers higher quality buildings. As this new supply comes online, demand will shift to these buildings, which can command higher rents.

Colliers expects rents to increase by 10% on average across major CBDs given the strong demand, and the improving options in the market. We project faster growths in Manila Bay Area and Fort Bonifacio in 2018 and 2019. We expect rents in Ortigas to pick up in 2020.

Comparative Office Rental Rates in Metro Manila (PHP / sq m / month)

LOCATION	Q1 2018	% CHANGE (QoQ)
Makati CBD	800 - 1,800	3.2%
Fort Bonifacio	850 - 1,500	2.0%
Ortigas Center	650 - 900	1.5%
Manila Bay Area	675 - 1,200	8.0%
QC*	650 - 950	1.1%
Alabang	650 - 750	1.20%

Source: Colliers International Philippines Research
*Eastwood

Due for an upgrade

Overall, Colliers foresees a market that is due for an upgrade driven by shifting tenant profiles that cater to the more discerning KPOs, MNCs and traditional occupiers. Given this, naturally, the market moves from basic structures to more spacious, LEED certified buildings, with more energy efficient systems, consequently improving the overall experience of employees and visitors alike.

Firstly, as vacancy increases, product differentiation becomes key to ensure that buildings are selected by tenants given the increasing options in the market. The building construction, finishing, materials, and efficiency also allow developers to leverage on these upgrades to keep rents competitive. Secondly, as the market shifts to a more diversified tenancy mix, it forces developers to focus on MNCs, KPOs, and traditional occupiers looking for different quality requirements such as an increased floor to ceiling height, glass ratio, and more premium construction. All these lead to improved options for tenants and increased research and development for developers.

Already, we see more developers constructing LEED-certified buildings to offer an increasingly broad and more discerning clientele. Some of the LEED-certified buildings due from 2018 onwards are SM Prime's Three E-Com Center, BDO-Keppel Land's SM Keppel Land Office Tower, Robinsons Land's Exxa and Zeta Towers, Filinvest Land's Filinvest Axis Tower One, Century Properties' Asian Century Center, and Alveo Land's Park Triangle Corporate Plaza, among others.

Colliers recommends that developers continuously upgrade the offerings in the market to remain competitive considering the shifting tenant profile. On the other hand, we suggest that tenants be more discerning in selecting office spaces as vacancy increases and options in the market widens alongside. Today's labor force is also more discerning in selecting companies to work in and the type of workspaces would also be key in attracting the right talent.

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