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CAUTIOUS BUSINESS OUTLOOK REDUCING LEASING DEMAND IN THE CBD

Average rent set to outgrow the CBD rents for the first time since 2014

Summary & Recommendations

Companies have put expansion plans on hold as the business environment has stayed gloomy. Although US-China trade tension did not intensify in Q4, market conditions remain uncertain and Hong Kong faces slower growth in 2019.

Given banking and financial companies and mainland Chinese companies are slowing their office expansion, we expect CBD rents to recalibrate, declining 3.8% in 2019. However, given low vacancy rates and the ongoing decentralisation trend, rents in other districts should stay firm.

With demand softening and rents adjusting, companies should find more space in the CBD by mid-2019. This should make it easier for financial occupiers to secure new office space.

		Q4 2018	Full Year 2019	2018–23 Annual Average
Demand	> Expansion should be less active given the uncertain economic outlook. However, consolidation in decentralised areas may support net take-up.	▼ -91,140 sq ft	▲ 2.9 mil sq ft	▼ 1.9 mil sq ft
Supply	> The annual Grade A office supply from 2019 to 2022 should increase to 2.3 million sq ft (223,000 sq m) on average, up 29% from the average of the past five years.	▼ 0 sq ft	▲ 3.6 mil sq ft	▲ 2.3 mil sq ft
		QOQ/ End Q4	**YOY / End 2019**	**Annual Average Growth 2018–23 / End 2023**
Rent	> We expect a slight rental adjustment in 2019 due to the downturn in the CBD. We expect most new supply to be absorbed quickly and to have only a small impact on rental growth.	-0.2% ▼ HKD78.1	-0.6% ▼ HKD77.6	1.2% ▲ HKD83.3
Vacancy	> In 2019, the vacancy rate should increase slightly due to ample new supply. However, limited new supply in 2020 and 2021 is likely to drive down the vacancy rate.	0.2pp ▲ 4.1%	0.8pp ▲ 4.9%	0.5pp ▼ 4.6%
Capital Values	> The strong growth in 2018 with weakening investment demand suggests CBD prices are peaking. Overall Grade A prices are likely to grow more slowly over the next five years.	-0.6% ▼ HKD26,000	-5.0% ▼ HKD24,700	2.0% ▲ HKD28,700

Source: Colliers International. 1 USD = 7.84 HKD. 1 sq m = 10.76 sq ft. Rents refer to net effective rent based on NFA. Prices are based on GFA.

SLOWDOWN IN EXPANSION

The US-China trade war, rising interest rates, slowing economic forecasts and a deteriorating business outlook have affected demand for Grade A office space and rental growth. After a robust Q3, the office market started to lose momentum in Q4 2018. Overall Grade A office rent was almost flat, down 0.2% qoq. Thanks to the strong growth in H1, it increased 6.1% yoy.

The drop was due to weakening demand with negative net take-up of 91,140 sq feet (8,470 sq metres), the first negative quarterly net take-up since Q2 2016. A negative net take-up was reflected in a slight increase in the vacancy rate to 4.1%, from a year-low of 3.9% in Q3 2018.

Landlords in Central/Admiralty have felt the pressure of softening demand from financial institutions and mainland Chinese companies. CBD Grade A office rents dropped 0.3% qoq, ending the consecutive quarterly growth since Q3 2017. Vacancy rates edged up by 0.7% to 2.1%, still very low, with -163,065 sq feet (-15,150 sq metres) of net take-up.

Thanks to the ongoing decentralisation trend, rents increased elsewhere on Hong Kong Island, supported by vacancy rates below 2%. One Taikoo Place, a new building in Quarry Bay, opened in Q3 and has quickly achieved full occupancy, indicating supply remained short in the area. With a supply shortage and quick absorption rate, newly completed quality office buildings did not push up the average vacancy rate in their district, but the average rent instead.

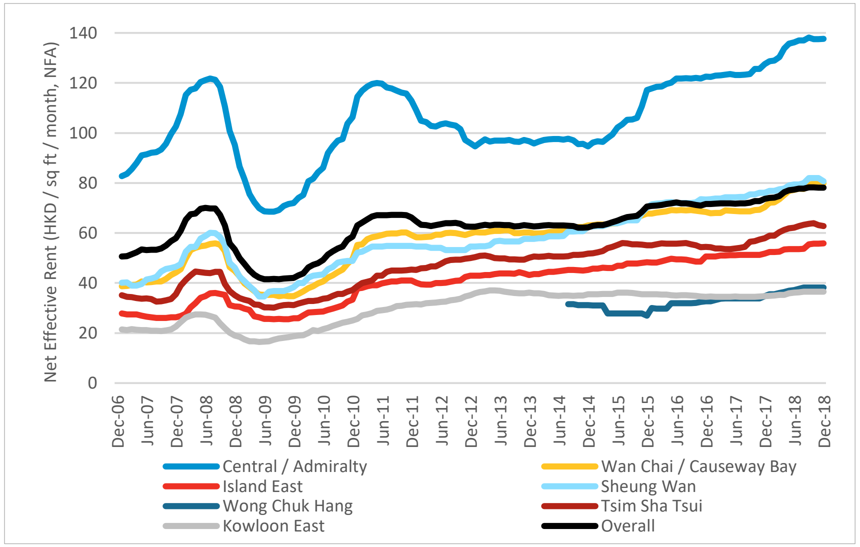
Similarly, South Island Place, in Wong Chuk Hang, was over 90% leased one quarter after completion. As such, the district's vacancy rates declined to single digit percentages for the first time ever.

Hong Kong Grade A office market performance in Q4 2018

Tenant	Vacancy Rate	Net Effective Rent	Quarter-on-quarter
Central/Admiralty	2.1%	$137.7	-0.3%
Wan Chai/Causeway Bay	1.7%	$79.9	0.5%
Island East	1.9%	$55.9	0.6%
Tsim Sha Tsui	1.9%	$62.7	-1.5%
Kowloon East	9.8%	$36.5	-0.1%
Overall	4.1%	$78.1	-0.2%

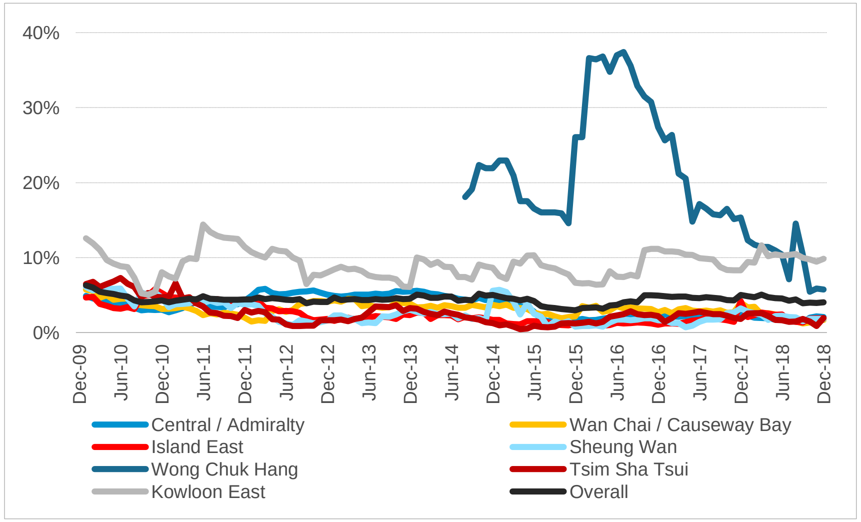
Source: Colliers International. Note: Net effective rents are monthly rents psf per month on net floor area basis.

Hong Kong Grade A office rental trend



Source: Colliers International

Hong Kong Grade A office vacancy trend



Source: Colliers International

TUG OF WAR BETWEEN KOWLOON EAST AND WEST

In Q4, the already low average vacancy rate in Tsim Sha Tsui was almost unchanged at 1.9% amid an inactive market. The weakening demand from mainland Chinese companies was a disappointment to Tsim Sha Tsui's landlords, who expected increasing office demand driven by the completion of the Express Rail Link Terminus in West Kowloon. Major tenant groups such as banking & finance companies and trading & sourcing companies were affected by the trade war and challenging business environment.

With low vacancy in Tsim Sha Tsui and Kowloon East offering new Grade A office space with cheaper rents as an alternative for relocation or consolidation, we witnessed more multinational companies willing to expand their footprints in Kowloon East. MNCs, such as JP Morgan, helped to fill multiple floors in new buildings. However, large floor plates might not be favourable to local small-and-medium sized corporations, while buildings which are relatively remote from MTR stations found it even harder to attract tenants.

CBD RENTS TO FALL IN 2019

According to Colliers Radar report *Top Locations in Asia – Financial Sector*, Hong Kong's office market, especially the CBD, is facing downside risks given that the Hang Seng index has declined by 18% (as of 18 January) from its recent high point in early 2018, and that mainland companies are losing their shine entering 2019. As such, we reaffirm our forecast of -3.8% growth for Central/Admiralty Grade A offices in 2019. However, other submarkets, which are less affected by the movements of financial institutions, should continue to enjoy modest rental growth amid very low vacancy rates.

Following a strong expansion in 2018, flexible workspace operators may face challenges to occupancy amid the soft business outlook, implying their expansion in 2019 may not be as aggressive as before. Meanwhile, the stagnant trading sector reduced overall demand in Kowloon. The weaker renminbi may also pressure the retail market's performance and affect demand for offices in Kowloon which hosts a larger proportion of retailers and servicing companies. However, the economy has not shown an obvious slowdown amid these uncertainties, and we believe that rents will not fall sharply in Kowloon given the current low vacancy rates.

Selected Grade A office leasing transactions in Q4 2018

Tenant	Building	District	Floor area (sq ft)	Transaction Type
China Merchants Bank	Three Exchange Square	Central	55,000 (N)	New Letting
Royal Bank of Canada	One Taikoo Place	Quarry Bay	43,700 (L)	New Letting
T. Rowe Price	Chater House	Central	37,250 (N)	New Letting
JP Morgan	The Quayside	Kwun Tong	50,500 (G)	New Letting
Lee and Wrangler	C-Bons International Center	Kwun Tong	44,400 (G)	New Letting

Source: Colliers International
Note: (N), (G) and (L) stand for net floor area, gross floor area and lettable floor area respectively.

INVESTMENT: WAITING FOR CLARITY

Following a stagnant quarter in Q3 2018, office investment demand further softened. The total office investment transaction volume declined further, by 26.8% qoq to HKD6.0 billion (USD7.7 million). Despite a strong market in H1, the subdued market in H2 pulled down the annual volume. The total transaction volume declined 1.7% yoy in 2018.

There was only one en bloc office investment transaction in Q4. SOCAM Development acquired FC Group Building at 93 Wai Yip Street in Kwun Tong for HKD303.5 million (USD38.9 million).[1] The unit price was about average for the district at HKD10,917 (USD1,400) per sq foot with a gross floor area of 27,800 sq foot (2,583 sq metres).

The transaction volume in the strata-title market slid further, by 23% qoq, while the number of transactions declined 38%, the lowest level since Q3 2017. Institutional investors were affected by the slower economic outlook. They are likely to stay conservative and not enter the market again until they have a clearer picture of the economy and outlook for property.

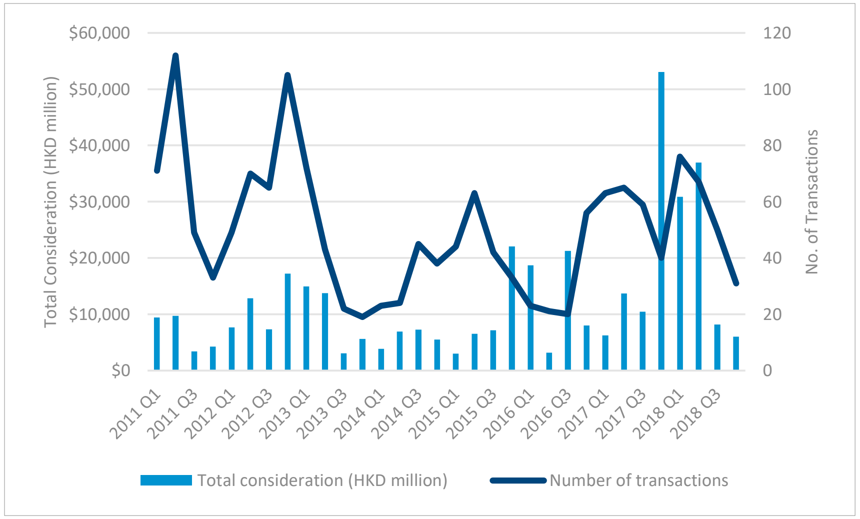
Given the inactive market, the overall price of strata-titled Grade A offices edged down by 0.6% qoq, the first quarterly decline since Q2 2016. Grade A office prices in Central peaked after the strong growth in H1. With reference to the softening price growth in the CBD, prices in other Hong Kong Island districts and Tsim Sha Tsui remained mostly flat. Prices for Grade A offices in Kowloon East were also affected by a flat rental outlook, and high vacancy rates have remained a challenge to increasing prices.

According to *Colliers Annual Investor Survey 2018*, regarding transaction volumes, investors were expecting a slower market for Hong Kong and Chinese cities in 2019.

While the US Federal Reserve has trimmed the expected number of rate hikes in 2019, to two from three, liquidity tightening has so far not been a major constraint in institutional fund raising. Given liquidity is still readily available, we think that investors are waiting for the opportunity to return once the price adjustment period is over. However, given the low yield of Grade A office properties in Hong Kong (about 2.3%), some investors are priced out of the Grade A office market, and we see value-add opportunities as offering the best return in 2019.

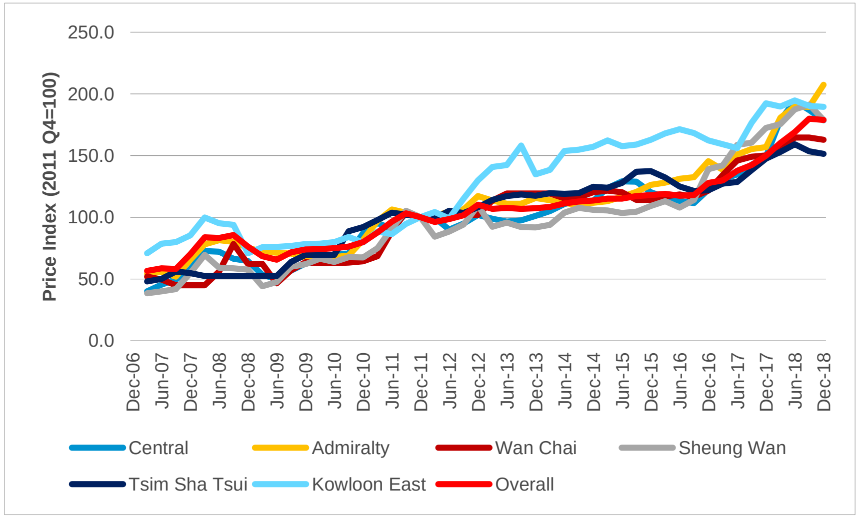
[1] HKEXnews, 27 December 2018

Hong Kong Office investment volume (transactions >HKD 30 million)



Source: Colliers International

Hong Kong Grade A office price trend



Source: Colliers International

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