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AFTER COVID-19: NEW TRENDS IN THE HONG KONG OFFICE MARKET

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Insights & Recommendations

While Hong Kong SAR[1] has seen some success in managing the outbreak of COVID-19 situation in the city, companies with local footprints can take advantage of falling rents to upgrade and transform their workplace.

As Hong Kong Grade A office rents decline, the rental gap between the CBD and other submarkets is narrowing. We recommend occupiers located in non-core areas due to the previously high CBD rents now revisit recentralization or flight-for-quality options in Central and Admiralty.

We suggest companies review their operations and real estate strategies to include technology and agile workplace options to ensure business continuity while also supporting social distancing and staff wellness even after COVID-19.

Figure 1: Three key themes of the Hong Kong Grade A office market post-COVID-19

Recentralization opportunities in the CBD	Embrace of technology	Workspace flexibility
Narrowing rental gap between CBD and other submarkets	**Seamless business operations** while keeping social distances	Flexibility is important **for business continuity** and **corporate solutions**
More **new Grade A office supply in the CBD** over the next five years	**Raising awareness** of **wellness and hygiene** standards and requirements	The pandemic is a **Health-check** for firms' hardware, tech, workspace and productivity / culture
Increasing **flight-for-quality** Grade A office options for occupiers	**Improving workplace infrastructure** by office design and technology	Agile offices should be a **prominent feature** for tenants even **after COVID-19**

Source: Colliers International.

The spread of COVID-19 has triggered the largest ever *work-from-home* exercise around the globe. Although Hong Kong has seen some success in managing the outbreak of COVID-19 situation in the city, the pandemic continues to affect workplaces globally. While it may be too early to predict the lasting effects of COVID-19 on the flexible workspace sector, the pandemic alerts corporate occupiers to review their business continuity plans while keeping their staff and clients within a comfortable social distance. We believe that landlords and occupiers should work closely to make sure their office buildings and workplaces are safe for office workers to return to, especially in a densely populated city like Hong Kong.

In Hong Kong, the COVID-19 challenge is compounding a weak economy and leasing market and we forecast overall Grade A office rents to fall 14% YOY in 2020, with a bigger correction of 18% YOY in the CBD. Meanwhile, we also expect a return of demand from the PRC, with more mainland Chinese firms preferring to list in Hong Kong (instead of the US) due to current tightening of US regulations on listed companies. Against this backdrop, we recommend office occupiers move quickly to take advantage of falling rents in the CBD while planning their real estate strategies and workplace transformation after COVID-19. We believe the narrowing rental gap between core areas and other submarkets, as well as the upcoming new office supply around Central, should provide more *recentralization* options for companies to consider within the CBD area.

[1]This report covers the Hong Kong Special Administrative Region of the People's Republic of China.

RECENTRALIZATION

Flight-for-quality options in the CBD

The Hong Kong Grade A office market is very dynamic and displays a higher CBD/non-core area rental gap than other regional cities (see Figure 2). In general in Asia, we are recommending occupiers to look for decentralization options for purposes of cost-control and business continuity planning. However, we have observed that the rental gap in Hong Kong between the CBD and outer districts has been narrowing since 2019, mainly due to slower leasing momentum in core areas. This situation creates new opportunities in the centre for the financially well-established occupiers.

Historically, the CBD net effective rent (Central / Admiralty) has been as low as HKD19 (USD2.4) per sq foot during the September 2003 SARS market downcycle, displaying a rental gap of only HKD9 (USD1.2) compare to Island East at that time. When the office market recovered, the rental difference between the CBD and Island East gradually widened again, reaching HKD87 (USD11.2) during February 2008[2] (see Figure 3).

The COVID-19 pandemic is compounding a weak economy and leasing market, and we forecast the CBD rents to fall by 18% in 2020, after a 6% drop in 2019. With the office market entering a consolidation phase, CBD rents are declining at a faster pace than non-core areas, narrowing the rental gap to HKD63 (USD8.2) between CBD and Island East (as of May 2020), and we expect the rental gap to further narrow to HKD53 (USD6.8) by 2022.

We believe the narrowing rental gap and upcoming future supply around Central will provide more CBD leasing options for professional and PRC firms to explore the *recentralization* opportunities. Meanwhile, we expect a potential return of PRC demand, given more mainland Chinese firms may choose Hong Kong as their preferred listing location due to current tightening of US regulations on listed companies. Falling rents and closer integration of the Greater Bay Area shall help to boost Hong Kong's competitiveness, and should support overall leasing demand going forward.

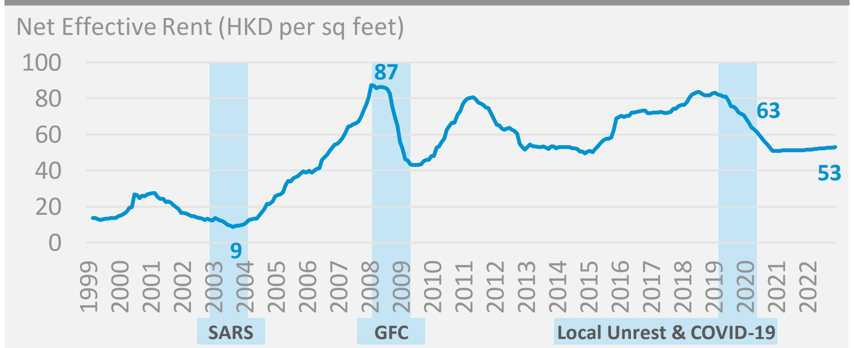
We also recommend companies with a long-term vision in Hong Kong pre-lease space in the upcoming new CBD supply (see Figure 4), while also taking advantage of the current tenant-favourable market to secure leases with more attractive terms.

[2] Net effective rents for CBD and Island East were HKD 115 and HK28, respectively during February 2008.

Figure 2: CBD rental discount vs. decentralized area (%)

Source: Colliers Asia Research

Figure 3: Hong Kong CBD - Island East Rental Gap



Source: Colliers International

Figure 4: Key Grade A office new supply in CBD, 2020 - 2024

Year	Future Supply	Area	GFA (sq feet)	Developer
2021	Peel Street / Graham Street	Sheung Wan	333,600	Wing Tai / CSI
2023	Hutchison House redevelopment	Central	493,500	CK Asset
2023	Murray Road Carpark Site	Central	465,000	Henderson Land

Source: Colliers International

EMBRACE OF TECHNOLOGY

The global outbreak of COVID-19 has forced corporates to maintain seamless business operations while maintaining social distancing in the office or having employees work-from-home. This has again pushed technology to the forefront of the agenda, with the pandemic demonstrating the fundamental role of technology in connecting people and business, especially during unforeseen circumstances that prohibit physical contact.

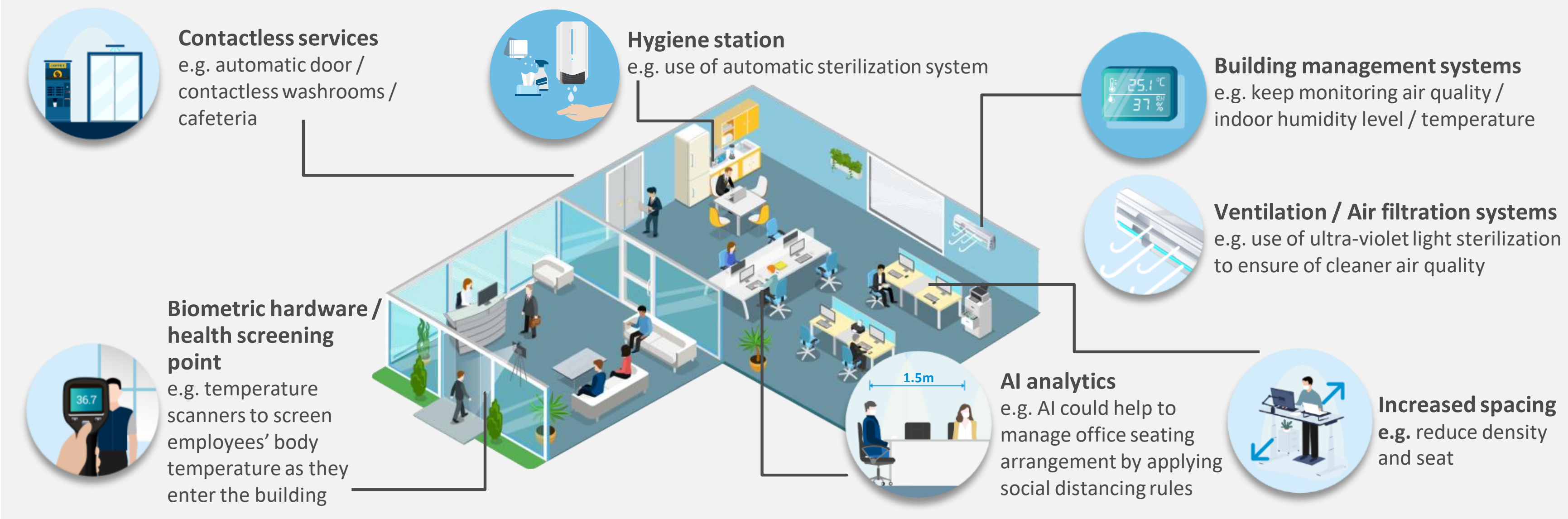
We believe one of COVID-19's lasting impacts will be raising people's awareness of wellness and hygiene requirements for their workplace. Some workplace infrastructure will likely need to be rearranged to take better advantage of the underlying technology to meet the requirements of the *new normal* as illustrated in Figure 5. For example, thermal cameras at office lobby or reception areas would help detect people with high temperatures. Landlords and tenants alike should be transitioning to contactless offices with doors, gates and equipment like photocopiers operated by infrared or voice-controlled technology.

FLEXIBILITY COMES TO THE FORE

This is an opportune time for companies to reevaluate their real estate portfolios to ensure they have the most flexibility from both a near-term business continuity and longer-term corporate solutions perspective. Indeed, the pandemic has served as a check of both companies' hardware and software. Firms already implementing flexible working arrangements are better positioned to maintain a continuity of business considering any situation requiring people to work remotely, and we believe this should continue even with the COVID-19 situation calming down.

In our previous report Hong Kong Annual Occupier Survey Report 2019, 51% of occupiers said they plan to implement a *Flex-and-Core* or *Activity-Based Working* environment, demonstrating that occupiers are already making their operations more flexible. We believe this trend should continue after the COVID-19 pandemic as flexible workstations seem to become a more prominent feature to provide greater flexibility from an operational perspective.

Figure 5: Examples of technologies applications in the office environment



Source: Colliers International.

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