Briefing
Residential sales

June 2018

SUMMARY

Local interest rates may finally rise given capital outflows and rising interbank rates.

- The first intervention by HKMA to defend the currency peg and stem capital outflows may serve as an early indicator of rate rises to come.

- Increasing upcoming supply may slow escalating home prices, but a closer look at building figures reveals that the increase in supply has come at the expense of decreasing unit sizes.

- Developers are still keen on replenishing land banks in urban areas, and their aggressive bids for prominent sites is a clear reflection of their upbeat outlook for the housing market.

- The luxury segment should prove more robust than the mass market with trophy assets in luxury enclaves still highly sought after by purchasers who are less dependent on bank financing.

- A chronic lack of short to medium term land supply, as confirmed by the Task Force on Land Supply, may help support house prices in the medium term.

"While luxury sentiment is likely to remain buoyant, the mass market may face more uncertainty this year, with capital flows and rate hikes the two most significant factors likely to slow the current price rally." Simon Smith, Savills Research

Interest rate hikes in Hong Kong seem inevitable

On April 12, the HKMA was forced to intervene in the money market to defend the currency peg and stem capital outflows by buying Hong Kong dollars for the first time since 2005. By the end of April, the Aggregate Balance had declined to HK$128 billion, the lowest level since the beginning of the first round of QE back in late 2008.

The Aggregate Balance, loosely regarded as an indicator of capital flows, shot up from HK$4.7 billion in mid-2008 (right before the first round of QE) to a historical high of HK$424.4 billion in Q4/2015 (right before the first interest rate increase in the US), indicating a vast amount of capital inflow over the period. The subsequent consecutive rate hikes in the US caused the Hong Kong dollar exchange rate to fall against the USD, and the Aggregate Balance also fell indicating consistent capital outflow from the territory, which finally triggered the April 12-event.

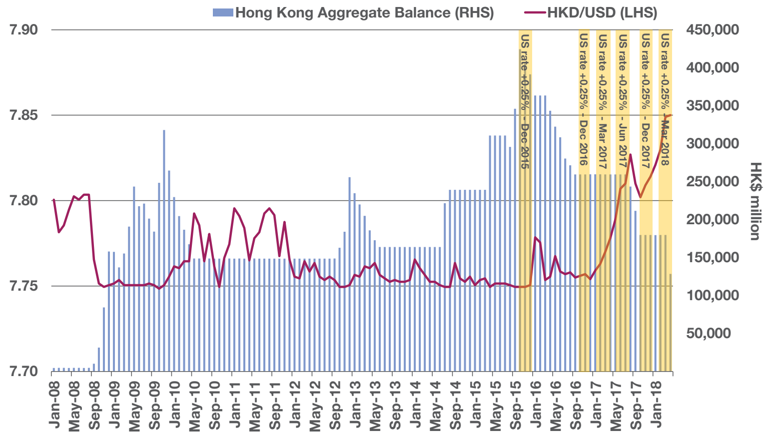
With the US looking set to further increase rates throughout the rest of the year, the Aggregate Balance is likely to fall further. Banking experts believe that an Aggregate Balance below HK$50 to HK$80 billion may start tightening local liquidity and force banks to rethink their interest rate policies.

3-month HIBOR, traditionally a measure of the interbank lending rate and more recently a main base of mortgage lending, has already increased steadily alongside the various rounds of US rate hikes, and is currently around 1.6%, four times higher than the 0.4% level before the first US interest rate increment in 2015. In spite of rising HIBOR, many banks have already raised their interest rates on three to twelve month fixed deposits to guarantee medium to long-term funding. With the cost of funding for banks gradually increasing, it is only a matter of time before they raise best lending rates as well as mortgage rates.

While multiple factors have caused the 207% rebound in residential prices over the past decade, the negative real interest rate environment (interest rates net of the effects of inflation) has been a key driver of price growth with capital being pushed out from the banking

GRAPH 1

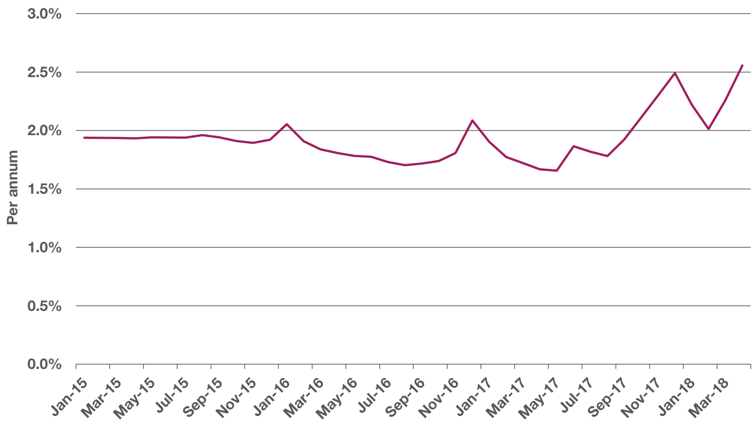
Hong Kong Aggregate Balance and Hong Kong Dollar exchange rate, Jan 2008 – Apr 2018



Source: HKMA, Savills Research & Consultancy

GRAPH 2

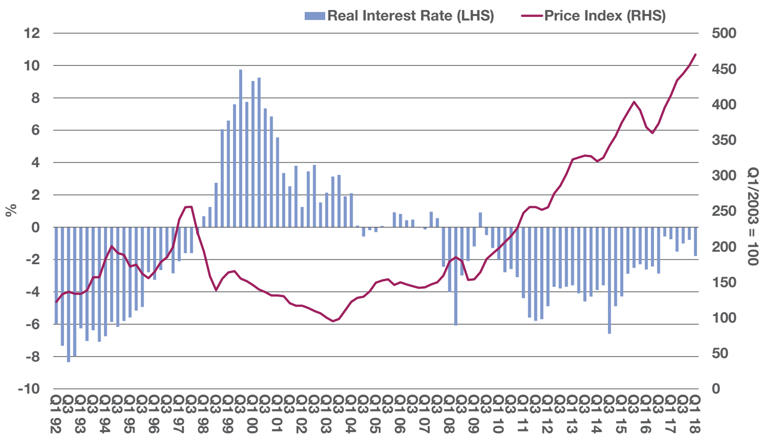
Movement of HIBOR-based mortgage rates, Jan 2015 – Apr 2018



Source: HKMA, Savills Research & Consultancy

GRAPH 3

Real interest rate vs residential prices, Q1/1992 – Q1/2018



Source: Census and Statistics Department, HKMA, Savills Research & Consultancy system into different asset classes, properties included, chasing higher returns.

With interest rates expected to rise and inflation likely to stabilize at around 2.5%, real interest rates are expected to turn positive over the next two to three years, which may lure some of the capital back to the banking system, tightening capital for investing / lending to the property sector, and ultimately slowing the current property price rally.

Rising volume of new supply comes at a cost

Another possible factor which could act to slow the current price rally is increasing future housing supply, with annual housing supply gradually rebounding from a historical low of 8,254 units in 2014 to 17,791 units in 2017. The government is forecasting further increases in home completions over 2018 and 2019, at 18,130 and 20,371 respectively, levels not seen since 2004.

Nevertheless, when we take a closer look at the average unit size of homes being completed, we find that the increasing supply comes at a cost: the average unit size (in terms of domestic GFA) fell sharply from 114 sq m in 2009 to 65 sq m in 2017, and is estimated to decline further to 56 and 58 sq m in 2018 and 2019 respectively, well below the 10-year historical average of 85 sq m. The proportion of Class A units (unit size below 40 sq m saleable) also increased sharply from 5% in 2009 to 39% in 2017, and is on course to increase to a historical high of 47% in 2019, much higher than the 10-year historical average of 16%.

Developers keen on prominent urban sites

While capital outflows, interest rate rises and increases in short term supply all point to a possible slowdown of the current home price rally, developers remain keen on replenishing their landbanks, and are especially hungry for prominent sites in urban areas. Headlines were made when Sun Hung Kai won the tender for the residential / commercial site (Site 2, Kai Tak Area 1F) in the Kai Tak New Development Area for HK$25.2 billion (AV HK$17,777 per sq ft) in May, the largest consideration for a residential site in Kowloon. The second highest lump sum was paid for a Cheung Sha Wan coastal site (off Hing Wah Street West) sold to a Sino-led consortium in November for HK$17.3 billion (AV HK$17,501 per sq ft) while a site at the junction of Lung Cheung Road and Lion Rock Tunnel Road on Beacon Hill was sold to Wharf in January for HK$12.5 billion (AV HK$28,531 per sq ft).

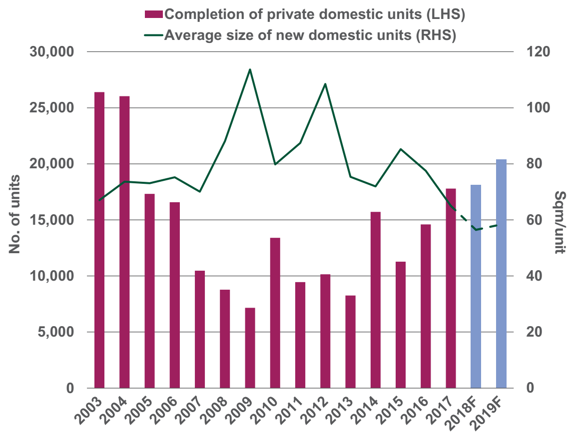
Luxury sentiment still strong

Sentiment in the luxury sector has remained robust with prices across all luxury segments continuing to register healthy growth over Q1/2018, in the range of 3% to 5%. Luxury transaction volumes also rebounded strongly over the quarter, with 199 and 293 luxury residences sold on Hong Kong Island and in Kowloon/New Territories respectively, a 42% and 54% y-o-y increase.

A few significant deals were closed over the quarter, including the sale of a site at 73 Repulse Bay Road for HK$1.6 billion (AV of around

GRAPH 4

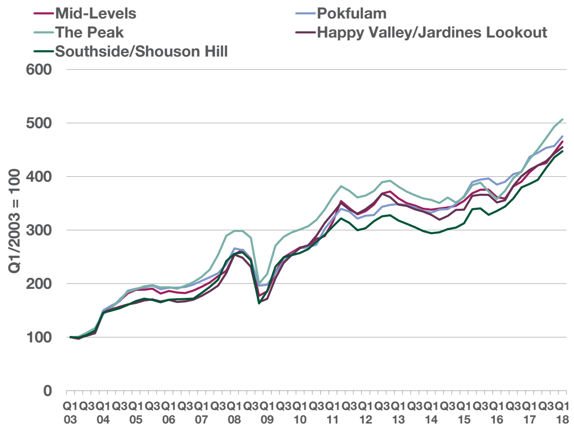
Residential completions and average unit sizes, 2003 – 2019E



Source: Rating and Valuation Department, Buildings Department, Savills Research & Consultancy

GRAPH 5

Luxury apartment price indices by district on Hong Kong Island, Q1/2003 – Q1/2018



Source: Savills Research & Consultancy

TABLE 1

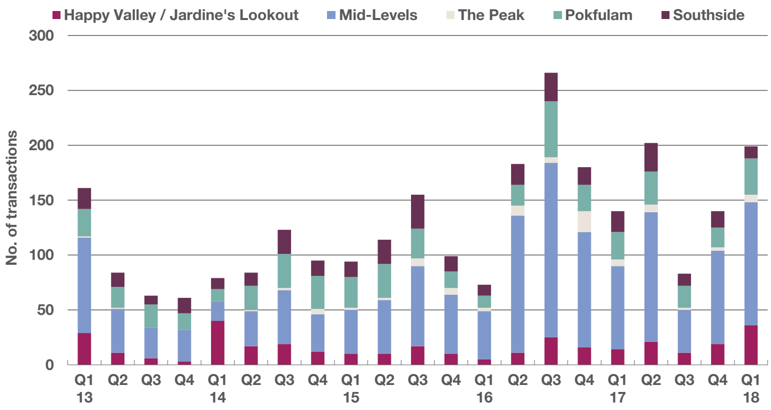
Luxury residential price changes

Sector	Q1/2018	2017	2016	2015
Townhouses	+3.8%	+12.3%	+5.5%	+8.3%
Hong Kong Island luxury apartments	+3.6%	+13.9%	+6.9%	+9.3%
Kowloon luxury apartments	+4.8%	+9.3%	+9.5%	+5.3%
New Territories luxury apartments	+2.7%	+13.5%	+6.6%	+6.2%

Source: Savills Research & Consultancy

GRAPH 6

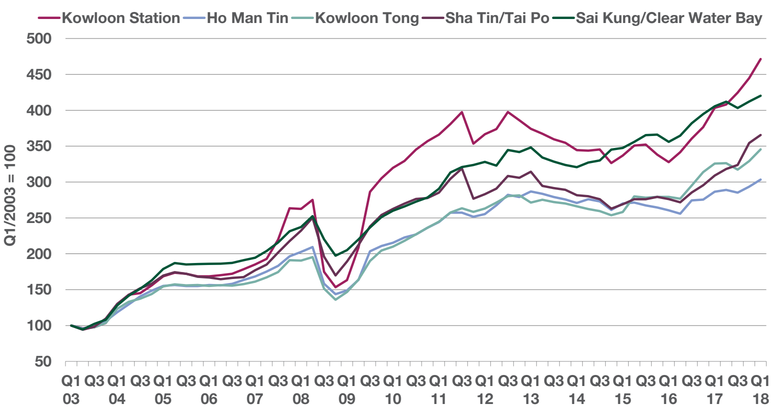
Luxury transaction volumes by district on Hong Kong Island, Q1/2013 – Q1/2018



Source: EPRC, Savills Research & Consultancy

GRAPH 7

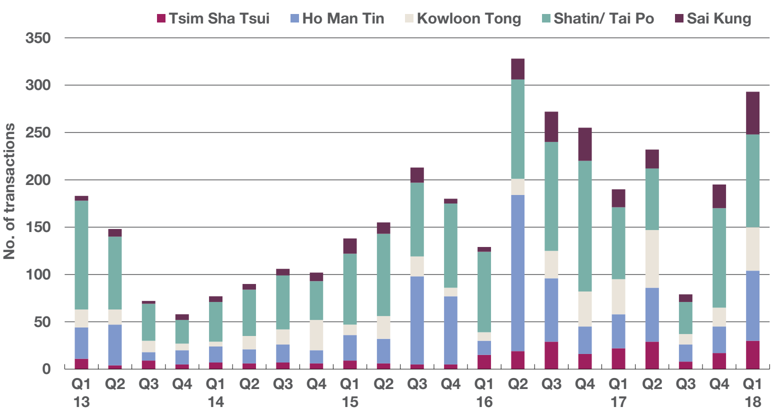
Kowloon and the New Territories luxury residential apartment price indices by district, Q1/2003–Q1/2018



Source: Savills Research & Consultancy

GRAPH 8

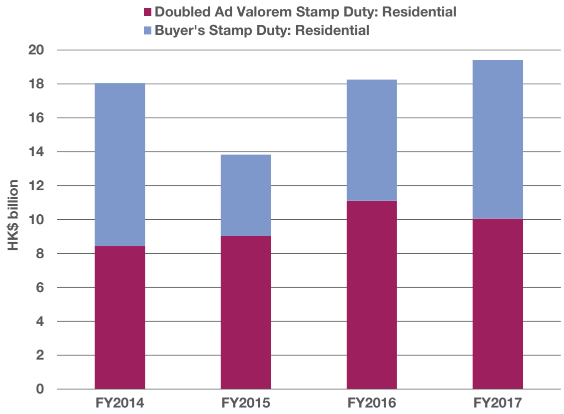
Luxury transaction volumes by district in Kowloon and the New Territories, Q1/2013–Q1/2018



Source: EPRC, Savills Research & Consultancy

GRAPH 9

Amount of Doubled Ad Valorem and Buyer's Stamp Duties, FY2014 – FY2017



Source: Inland Revenue Department, Savills Research & Consultancy
* Financial Year (FY) starts in April each year.
** Buyer's Stamp Duty and Doubled Ad Valorem Stamp Duty have been collecting since March 2014 and July 2014 respectively.

HK$163,000 per sq ft), as well as the sale of House 2 in Mount Nicholson for HK$1.399 billion (HK$151,785 per sq ft). A property at 37 Barker Road (with a site area of 20,400 sq ft and a plot ratio of 0.5) was reported to have been sold for HK$3 billion, representing an AV of HK$294,118 per sq ft if the premises is redeveloped.

As luxury units located in niche luxury enclaves are scarce in nature, someone is always willing to acquire a trophy asset at all costs: two apartment units in Mount Nicholson were sold to the same person in December last year for HK$1.16 billion, which amounted to a staggering HK$109 million in stamp duty. Another company purchaser bought a high floor unit at The Morgan for HK$83.4 million, paying the full 30% Ad Valorem and Buyer's Stamp Duties, amounting to HK$25 million.

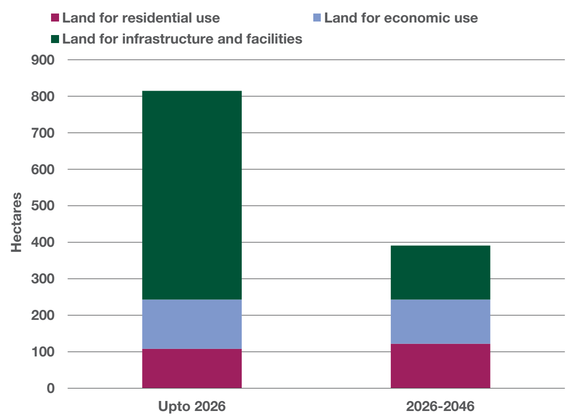
In fact, the amount raised from both Doubled Ad Valorem Stamp Duty (now 15%) and Buyer's Stamp Duty (15%) has risen over the past few years, with total additional stamp duties paid by second-home purchasers / non-local buyers rising from HK$18.1 billion in FY2014 to HK$19.4 billion in FY2017. Interestingly, the number of units paying these extra stamp duties declined (from 18,406 in FY2014 to 13,106 in FY2017), suggesting that buyers who were willing to pay extra to acquire their homes are more concentrated in the luxury segment paying higher lump sums.

Land supply shortage in the medium term may help support prices

The recently assembled Task Force on Land Supply revealed that there will be a shortfall in land supply of over 1,200 hectares from now to 2046, with over two-thirds (around 815 hectares) of the shortage occuring in the short to medium term between now and 2026. While the Task Force has put forward 18 possible land supply options (from short to long-term and some conceptual) to tackle the problem, there seems to be no quick fix in the near term. It follows that, after the increase in new development over the next three to five years, which will consume most of the available land supply from the Government and MTRC, we may expect residential supply to trend down in the medium term due to a shortage of land, thereby supporting residential price development until more viable options to increase land supply are put in place.

GRAPH 10

Estimate of land shortage, 2018 – 2046



Source: Planning Department, Task Force on Land Supply

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