Briefing
Office sector

November 2016

Image: Guoco Tower, Wallich Street

SUMMARY

Notwithstanding weak demand and falling rents, prices are still biased on the upside.

- The main feature of the office leasing market in the third quarter was a continuation of the flight-to-new projects theme.

- According to Savills estimate, from Q4/2016 to 2018, around 926,000 sq ft of secondary stock is expected to be released back to the market.

- As of end-September, the vacancy rate of CBD Grade A offices in Savills basket still remained at a low of 4.4%.

- From data compiled by Savills, the fall in monthly rents of CBD Grade A office buildings has reaccelerated, falling 2.0% quarter-on-quarter (QoQ) and averaged S$8.91 per sq ft in Q3/2016, versus 1.3% previously.

- Sovereign wealth funds and high net worth individuals are drawn to the Singapore office market by the low-to-negative interest rates environment in developed economies and the need for portfolio reallocation.

- The capital value of CBD Grade A office space remained resilient at S$2,723 per sq ft in Q3/2016.

"The holding power of landlords and the opaqueness of information flow on effective rents may result in gross face rents falling less than expected in 2017."
Alan Cheong, Savills Research

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Market commentary

Owing to the twin effects of a global economic slowdown and the restructuring of Singapore's economy, business conditions within the state are mired in a protracted slowdown. From the advance estimates released by the Ministry of Trade and Industry (MTI), the gross domestic product (GDP) fell an annualized 4.1% in the July-September period, on a QoQ basis, reversing marginal positive growth in the two previous consecutive quarters. The manufacturing sector plunged 17.4% QoQ, while the services-producing industries contracted 1.9% from a quarter ago. Preliminary data also showed that total employment recorded the first contraction since Q1/2015, falling 3,300 in Q3. Although the unemployment rate remained flat at 2.1% in September, there is slack emerging in the labour market and should this persist, it could lead to a rise of unemployment numbers.

Based on the statistics from URA's REALIS, the whole island only saw 937 leasing transactions of office space in Q3/2016, the lowest since Q2/2011. Because of external headwinds and sluggish domestic business conditions, leasing activity continued to slow down as occupiers' demand shrank.

The main feature of the office leasing market in the third quarter was a continuation of the flight-to-new projects theme. Guoco Tower has found tenants for about 80% of its 890,000 sq ft of office space since its completion in September. The newly-announced tenants include Dentsu Aegis Network (the biggest tenant with 100,000 sq ft), ING, Itochu Singapore, Amadeus, Palo Alto Networks, The Straits Trading Company, Danone, Asics and Teva Pharmaceutical Industries. All of these tenants will relocate from their existing premises, most of which are located in Downtown Core, such as Republic Plaza, Robinson 77, Millennia Tower, Straits Trading Building, PWC Building and Parkview Square. Over in Shenton Way, the new development on the former UIC Building site has found two tenants, serviced office provider JustOffice and Japanese shipping group Mitsui OSK Lines, taking 40,000 sq ft and 68,000 sq ft respectively. The latter will consolidate its offices in several locations across the island to the office building at 5 Shenton Way.

Although some of these new office buildings have received healthy commitment levels, the market is expected to see a substantial amount of space being vacated by the flight-to-new project tenants once they have effectively moved over to their new premises. According to Savills estimate, from Q4/2016 to 2018, around 926,000 sq ft of secondary stock will be released back to the market. Together with the remaining available 305,000 sq ft carried over from the previous periods, there will be a total of approximately 1.23 million sq ft of secondary office space that needs to be absorbed. This stock will be on top of the office space from newly-completed and pipeline projects that have so far been unleased.

In the sales market, the activity also did not pick up significantly. However, because of low-to-negative interest rates in developed economies and the need for portfolio reallocation by sovereign wealth funds and high net worth individuals, office properties in Singapore continue to be attractive to these investors. For example, in the reviewed quarter, a Zhou Family from Shanghai, China purchased a 60% stake in the DB2Land Building located at 139 Cecil Street for S$84 million, while Indonesian tycoon Mr Tahir paid S$45.1 million for another freehold office building at 110 Robinson Road, following his purchase of the Straits Trade Building in June.

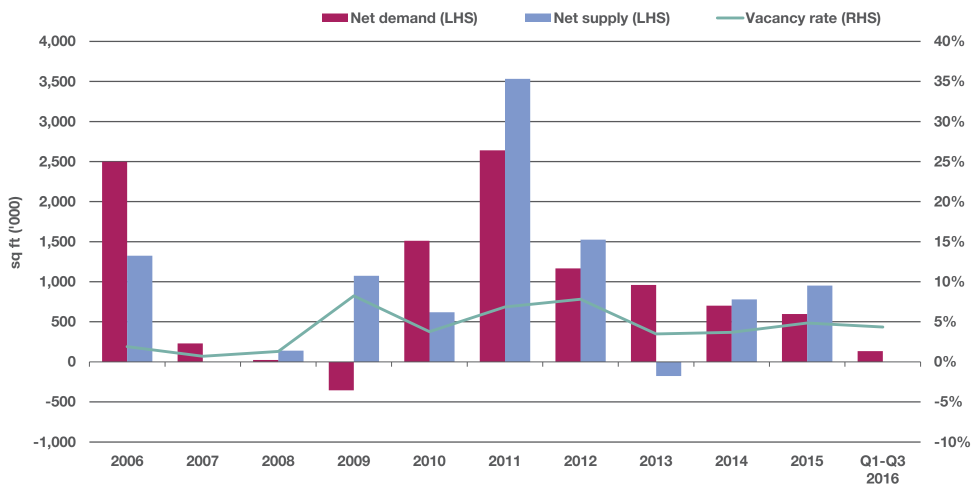
Demand, supply and vacancy

In Q3/2016, the stock of CBD Grade A offices in Savills basket remained unchanged from the previous quarter. As there was still a sliver of net demand, about 15,300 sq ft, although miniscule, but nevertheless a reversal of the negative absorption of 4,000 sq ft in Q2, the average vacancy rate of CBD Grade A offices inched down by 0.06%. As of end-September, the vacancy rate still remained at a low of 4.4%.

For Q3/2016, four sub-markets tracked by Savills saw decreasing vacancy for Grade A offices. Tanjong Pagar recorded the biggest decline of 1.9 percentage points (ppts) QoQ, while vacancy rates in the other three areas, Marina Bay, Shenton Way and City Hall, were down marginally by 0.1 to 0.4 of a

GRAPH 1

Net demand, net supply and vacancy rate of CBD Grade A offices, 2006–Q3/2016



Source: Savills Research & Consultancy

TABLE 1

Micro-market Grade A office rents and vacancy rates, Q3/2016

Location	Monthly rent (S$ per sq ft per month)	Vacancy rate (%)
Marina Bay	10.87	4.9
Raffles Place	9.14	3.3
Shenton Way	8.01	4.7
Tanjong Pagar	7.78	7.6
City Hall	9.13	4.3
Orchard Road	9.15	4.1
Beach Road/Middle Road	7.39	4.6

Source: Savills Research & Consultancy

ppt from a quarter ago. In contrast, the vacancy rate in Beach Road increased by 0.7% QoQ, while those in both Raffles Place and Orchard Road went up 0.4% QoQ.

Rental and capital values

From data compiled by Savills, the monthly rents of CBD Grade A office buildings have fallen more steeply, by 2.0% QoQ, and averaged S$8.91 per sq ft in Q3/2016. In the second quarter, the comparable decline was 1.3%. After six consecutive quarters of decline, rents are now 10.1 per cent below the recent peak of Q1/2015. In the reviewed quarter, rents in the Marina Bay micro-market decreased the most, 3.8% QoQ, slightly slower than the 4.0% recorded in the previous quarter. Rents in Raffles Place and Tanjong Pagar slipped 2.8% QoQ and 2.7% QoQ respectively. All the other sub-markets registered rental declines, but as the fall ranged from 0.6% to 1.5% on a QoQ basis, it was relatively moderate compared with the former three areas.

GRAPH 2

Price and rental indices of CBD Grade A offices, Q1/2006–Q3/2016

Source: Savills Research & Consultancy

In contrast, the capital value of CBD Grade A office space continued to stay resilient, at S$2,723 per sq ft in Q3/2016, in spite of no transactions. Landlords are not willing to sell their office properties with discounted prices; owing to the low interest rate environment, some investors would rather pay higher prices and accept the accompanying yield compression.

OUTLOOK

The prospects for the market

The traditional large space users of CBD Grade A offices, namely financial institutions, have sailed right into a perfect storm. Heightened compliance measures, de-risking and capital adequacy measures are applying tremendous squeeze on margins. The current flight-to-new projects is therefore one where the space taken on is about the same as where they had vacated.

Our model for office space demand found best historical correlations with the performance of GDP. With a glacial pace of growth anticipated for 2016-2017, net new demand in the near term will be weak. From Q1-Q3/2016, the net take-up of Grade A office space in the CBD was just 135,000 sq ft. With just one quarter left in 2016, we will be fortunate if net demand for the entire year came to 150,000 sq ft. This is well below the five-year average of 1.2 million sq ft net take up pa. For the final quarter, we are quite confident that demand will be tepid as feedback from our leasing team revealed that the final quarter is likely to see subdued leasing activity. With less activity comes the greater probability that rents will remain rather firm for Q4/2016 on a QoQ basis.

While the above may make for sober reading, rents may not yet dance to that bearish tune. The holding power of the landlords, arising from their strong balance sheets and being aided by a low interest rate environment, means that there is likely to be resistance to any sharp decline in rents. With a rush of supply coming on stream in 2017, our model is forecasting a 20.6% year-on-year (YoY) decline in gross face rents next year. We would, however, interpret this as the worst-case scenario. However, if, and very likely, landlords put up resistance on the downside, gross face rents may not come off as much as anticipated. Blending our model forecast with the views of our office space leasing team, we believe that rents will fall less, by about 10% YoY in 2017.

Historically, although Singapore, due to the openness of her economy, has constantly performed above expectations, there are consternations building because many of the issues impacting the fortunes of large CBD Grade A office space users are structural in nature. The tech sector, while still growing rapidly, is unable to supplant the retraction of space left over by the beleaguered industries. Therefore, unless not one but several new growth drivers step in fast to fill that gap, net new annual demand forecast for CBD Grade A office space may downshift another notch from our already low 732,000 sq ft pa to sub-500,000 sq ft pa for the 2017-2021 period. At this juncture though, we still believe that with the swirl of interest in the background by foreign investors enquiring about investing in or developing CDB Grade A office buildings, demand still has a chance of falling into the 500,000 sq ft to 1 million sq ft pa range for the period 2017-2021.

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