Briefing
Office sector

May 2017

Image: GSH Plaza on Cecil Street

SUMMARY

CBD Grade A office rental decline has slowed to a crawl.

■ During the first three months of this year, there was an increase in leasing enquiries for office space, especially for top-quality office space.

■ On the back of healthy take-up seen in these projects, as well as improved market sentiment, we observed that some landlords of prime offices have mustered greater confidence and started to test out the market with higher asking rents.

■ In the reviewed quarter, office properties in the CBD continued to be the top pick for investors, with a total of S$2.55 billion in investment sale transactions.

■ About 608,000 sq ft of Grade A office space in the CBD has been taken up in Q1/2017. However, the strong net demand still fell short of the 890,000 sq ft in net supply during the same period, resulting in the overall vacancy rate for CBD Grade A offices inching up by 0.9% quarter-on-quarter (QoQ) to 5.2%.

■ In Q1/2017, monthly gross rents from the Savills basket of CBD Grade A office buildings continued their downward trend, albeit at a slower rate, to S$8.70 per sq ft (psf), but capital values stayed unchanged at S$2,723 psf.

"Complex market dynamics centring on landlords' strong holding power will turn conventional supply/demand arguments on their head in the coming quarters, with rents likely to hold or even rise while vacancies increase substantially." Alan Cheong, Savills Research

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Market commentary

According to advance estimates from the Ministry of Trade and Industry (MTI), Singapore's economic growth in Q1/2017 was within expectations, expanding by 2.5% year-on-year (YoY). On a yearly basis, the manufacturing sector registered a growth of 6.6%, while the services-producing industries grew 1.5%. Construction continued to underperform by shrinking 1.1% YoY on the back of a slowdown in private sector construction activities.

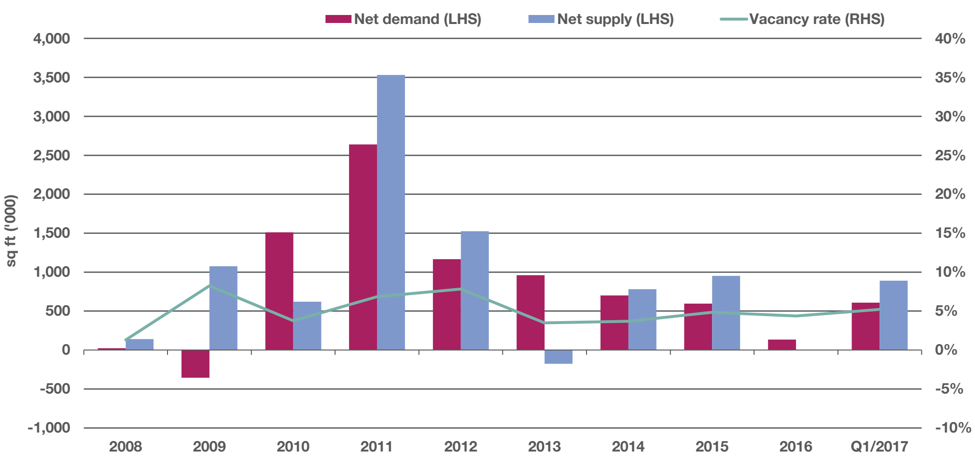
During the first three months of this year, there was an increase in leasing enquiries for office space, especially for top-quality space. The focus on the prime office segment was from tenants who, thinking that rents have fallen significantly, and are forecast to fall further, began testing the waters to seek newer accommodation when their existing leases run out in 2018 and beyond. However, leasing interest in the non-prime office market remained moderate in the first quarter. This was a reflection of the slow economy and also when tenants, after being surprised that landlords for new buildings are holding their rents firm or even upping them, decided to remain at their existing premises.

The focal point in the office leasing market has been Marina One. By the end of Q1/2017, fears of a rental meltdown have not only subsided but have now reversed and turned positive, largely because this mega-project, expected to complete in mid-2017 with 1.88 million sq ft of office space, registered a pre-commitment rate of more than 60%. New tenants for this development in Q1 took up large floor areas. For example, Facebook is taking some 250,000 sq ft. Meanwhile, Frasers Tower, a new commercial development at Cecil Street, expected to be completed by Q2/2018, has secured its first office tenant, The Executive Centre. This regional serviced office provider will take up an entire floor of about 20,000 sq ft. It was also reported that some 30% of the 663,000-sq ft office space at Frasers Tower has received leasing interest. As mentioned previously, the overly bearish view towards the office rental market did not square with the strong take-up seen in Marina One. Consequently, major landlords of Grade A CBD office buildings regained confidence and took a chance on asking for higher rents, which we believe may hold for the next two quarters.

In the reviewed quarter, office properties in the CBD continued to be the top pick for overseas companies and investors, resulting in S$2.55 billion worth of investment sales. Notable deals included: the sale of a 70% stake in TripleOne Somerset to Hong Kong's Shun Tak Holdings (S$880.6 million or S$2,200 psf of net lettable area (NLA)); Canadian insurer Manulife's acquisition of the PWC Building (S$746.8 million or S$2,100 psf of NLA); the divestment of Plaza Ventures Pte Ltd that holds GSH Plaza (S$663.5 million or S$2,900 psf of strata area); and the purchase of 17 strata office units at Prudential Tower by a fund managed by One Tree Partners (S$206.6 million or S$2,600 psf of strata area).

GRAPH 1

Net demand, net supply and vacancy rate of CBD Grade A offices, 2008–Q1/2017



Source: Savills Research & Consultancy

Demand, supply and vacancy

Savills estimates that there was a net increase of 608,000 sq ft of Grade A CBD office space taken up in Q1/2017, reversing the contraction in the previous quarter. The substantial increase of net absorption was mainly driven by the high commitment level in the newly-completed Guoco Tower. However, the growing secondary stock returning to the market, together with slow take-up in some older Grade A office buildings, has made the net take-up still fall short of the 890,000 sq ft net supply during the same period. This resulted in the overall vacancy rate of CBD Grade A offices inching up by 0.9% QoQ to 5.2% by the end of March 2017.

By location, the vacancy rate in the Tanjong Pagar submarket showed the highest quarterly increase of 9.5 percentage points (ppts). This was due to the fact that some tenants have not yet moved into Guoco Tower. On the other hand, vacancies in other micro-markets tracked by Savills remained fairly stable, varying only marginally from three months ago.

Rental and capital values

In Q1/2017, monthly gross rents for CBD Grade A offices continued the downward trend and averaged at S$8.70 psf.

Although the decline was still broad-based, the rate of decline for Grade A office rents decelerated to -0.9% QoQ in Q1/2017, down from -2.0% in Q3/2016 and -1.6% in Q4/2016. This trend is more evident in the AAA Grade offices located in the Marina Bay/Raffles Place area. The flight-to-quality factor played a key role in

TABLE 1

Micro-market Grade A office rents and vacancy rates, Q1/2017

Location	Monthly rent (S$ per sq ft)	Vacancy rate (%)
Marina Bay	10.14	4.6
Raffles Place	8.86	3.1
Shenton Way	7.88	4.0
Tanjong Pagar	7.65	15.6
City Hall	9.01	5.2
Orchard Road	9.15	3.3
Beach Road/Middle Road	7.13	6.8

Source: Savills Research & Consultancy

the healthy pre-commitment levels in Marina One and also the quick take-up of secondary stock in some Grade A buildings, for example Asia Square Tower 1. Coupled with limited immediate available space in these prime office developments, and a better economic outlook, a bedrock is being formed for the rental market.

An active investment sales market and high prices achieved in recent deals have supported the capital values of CBD Grade A offices, which stayed unchanged at S$2,723 psf in Q1/2017.

GRAPH 2

Price and rental indices of CBD Grade A offices, Q1/2008–Q1/2017

Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

According to the latest quarterly survey by the Monetary Authority of Singapore (MAS) in March 2017, economists are expecting a healthier growth rate of 2.3% for this year's economy. The job market, however, is expected to be subdued in the near-term, as net employment growth is expected to stay modest and uneven across sectors. Therefore, a majority of office occupiers will remain conservative with their expansion plans and adopt a "wait-and-see" attitude.

Meanwhile, in spite of recent pick-up in leasing enquires, the office market is expected to face challenges again in the second half of this year when Marina One at Marina Bay and the new UIC Building on Shenton Way receive their Temporary Occupation Permits (TOP). Tenants moving to these new buildings will start to release back to the market a substantial amount of secondary stock from older buildings. Looking at the market based on traditional supply demand dynamics, you could not be faulted for expecting further downsides for rents, especially in older Grade A office developments.

However, that may well not turn out to be the case, at least for the next couple of quarters. Although the rental market may still appear uneasy at this point, feedback from the ground is that these jitters are likely to relax because of several, inter-linked reasons. Firstly, there are only a handful of Grade A office landlords, and all have deep-rooted liquidity, especially Marina One and Duo Tower, both of which are owned by

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the same sovereign wealth funds of Singapore and Malaysia. As these two projects have a total of 2.45 million sq ft, or about 30% of the known supply of Grade A CBD office in the pipeline, they are right on top of the leader-board from which all other developers and landlords, who themselves also have strong holding power, make reference to when setting rents. With 60% of Marina One being pre-committed, the pressure to lease out the remaining 40% is reduced. Equally important in explaining the state of the rental market is that cash flow to fund these two projects is not an issue – the land component being the result of an offsetting swap with the Malayan railway land and the total construction cost was substantially covered by the sale of the residential component. The landlords could have the option of setting asking rents for the unleased space either at low levels or, theoretically, at whatever they wanted. But the fact is that when it comes to commercial undertakings, sovereign wealth funds are still profit-driven, and thus their ability to maintain or even up asking rents is the greater likelihood. With this, the market has thus stabilised, easing the anxieties of owners of the other Grade A offices under construction. Signed-on rents for the next two quarters are thus likely to veer more towards the latter end in the bid-ask spread.

On the tenants' side, because they were inundated with reports that Grade A office rents are likely to remain soft for 2017, they, in Q1/2017, made more enquires about leasing space in the new buildings for delivery in 2018 and beyond. However, on finding out that landlords are now holding asking rents firm, with some even upping them, they are in a conundrum. This then plays back into the hands of their existing landlords, reducing the pressure on them to lower rents.

To conclude, the rental market is finding a floor at this juncture. Whether this support holds depends a lot on the ability of the supply side to maintain their stoic composure. Although net take-up in 2017 for Grade A CBD office space is expected at 1.24 million sq ft, up more than nine times from 2016's 134,000 sq ft, it still falls far short of the 4.27 million sq ft of new space that is in moving-in condition this year. Also, there will be this backdraft of about 630,000 sq ft of secondary stock, coming back into the market when tenants move out to the newly-completed buildings this year. Nevertheless, in this staring game, landlords may still win because of the abovementioned complex dynamics; the kernel of all these complexities being their strong holding power.

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