Briefing
Office sector

August 2018

Image: Frasers Tower

SUMMARY

Tenants are in a hurry to secure space as depleting supply is accelerating rental growth.

- Underpinned by healthy economic growth, island-wide offices recorded a total of 1,342 leases in Q2/2018, 5.8% higher than a quarter ago. It's the highest quarterly number since 2013.

- On the co-working space front, demand remained robust.

- For Grade A office space in the CBD, the net absorption for Q2/2018 was approximately 304,000 sq ft, bringing half-year net take-up to 879,000 sq ft, the highest since 1H/2011.

- As of end-June, the overall vacancy rate in the CBD Grade A office market dropped by 1.0 percentage point (ppt) to 7.8% from a quarter ago.

- Going by the Savills basket of CBD Grade A office buildings, the quarterly rental growth accelerated to 2.5% in Q2 from Q1's 1.3%, bringing the average monthly gross rent to S$9.28 per sq ft.

- Although demand this year may be lower than last year, the declining new supply is giving landlords the confidence to raise asking rents. We hold firm to our previous forecast for CBD Grade A office rents to rise 10% year-on-year (YoY) this year.

"CBD rents remain on a firm upward trajectory where they are likely to remain over the second half." Alan Cheong, Savills Research

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Market commentary

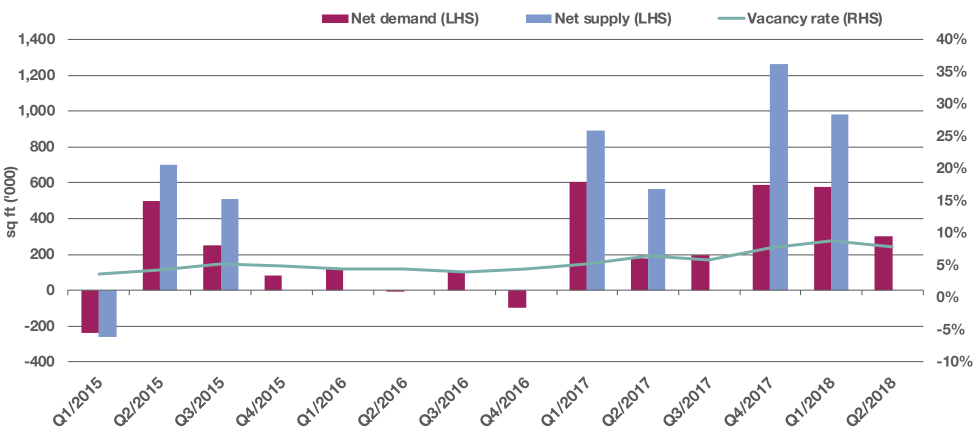
Singapore's economy performed well in the second quarter of 2018. Advance estimates from the Ministry of Trade and Industry (MTI) showed that Q2's GDP growth came in at 3.8% YoY, supported by a continuing surge in manufacturing—particularly the electronics and biomedical clusters—and strong showings in the finance and insurance, and wholesale and retail services sub-sectors. Fuelled by the healthy economy, the labour market posted encouraging results. In Q2/2018, total employment (excluding Foreign Domestic Workers) increased by 7,100, much larger than the 400 posted in Q1/2018 and reversing the contraction of 7,900 in the same period of 2017. The unemployment rate of 2.1% and retrenchment numbers of 2,500 remained lower compared to the same period a year ago.

Underpinned by the healthy economy and favourable job market, office leases commenced island-wide came in at 1,342[1] in Q2/2018, 5.8% higher than a quarter ago and the highest quarterly number since 2013. After a few months of stand-off between landlords and tenants, leasing activity picked up strongly, especially towards the latter part of the reviewed quarter, as tenants decided to secure some space quickly in view of accelerating rental growth and diminishing supply.

1 Based on data from the Urban Redevelopment Authority's (URA) Realis downloaded on 25 July 2018

GRAPH 1

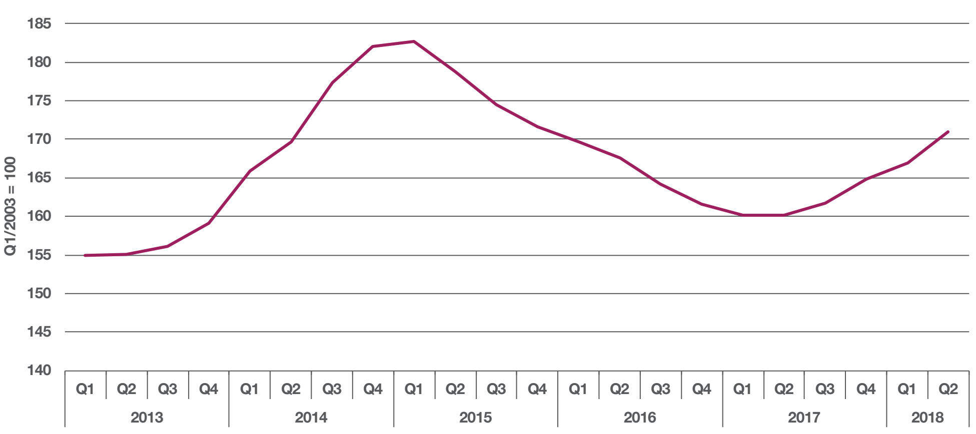
Net demand, net supply and vacancy rate of CBD Grade A offices, Q1/2015 – Q2/2018



Source: Savills Research & Consultancy

GRAPH 2

Rental index of CBD Grade A offices, Q1/2013 – Q2/2018



Source: Savills Research & Consultancy

In the reviewed quarter, the largest deal came from JP Morgan, taking up 155,000 sq ft of office space in CapitaSpring, the former Golden Shoe Car Park at Market Street. Other notable transactions include Great Eastern leasing about 125,000 sq ft of space or four floors in Paya Lebar Quarter (PLQ), and NTUC Income occupying 55,000 sq ft across two levels in the same development. It was reported that the pre-commitment level for PLQ has increased to about 80% ahead of its completion in the third quarter of this year.

On the co-working space front, demand remained robust. IWG, the world's leading provider of flexible workspaces, has aggressively rolled out new co-working facilities under its lifestyle co-working concept, Spaces. By 2019, Spaces will open five new locations in Singapore: Crown At Robinson, One Raffles Place Shopping Mall (35,000 sq ft), TripleOne Somerset (35,000 sq ft), PLQ (50,000 sq ft) and Clarke Quay. In addition, Chinese co-working space operator Kr Space will be leasing more than 40,000 sq ft of space or four floors at Prudential Tower, while Hong Kong-based Campfire will take the whole building at 139 Cecil Street to open its first co-working facility in Singapore.

Demand and vacancy

For Grade A office space in the CBD, the quarterly net absorption for Q2/2018 was approximately 304,000 sq ft, bringing the first-half year net take-up to 879,000 sq ft. This is the highest level since 1H/2011 and about 75.0% higher than the five-year average (2013-2017). The strength of the take up came partly from tenants' moves into buildings completed in 2017 and also the strong take-up of secondary stock. Using the Marina Bay micro-market as a macrocosm explaining demand, this area alone saw a net take-up of 125,000 sq ft - 41.2% of the total net absorption in the reviewed quarter.

As of end-June, the overall vacancy rate in the CBD Grade A office market dropped by 1.0 ppt quarter-on-quarter (QoQ) to 7.8%. Except for the Orchard Road precinct where the vacancy rate inched up 80 basis points, vacancy levels of Grade 'A' offices generally declined across all the remaining geographical submarkets, including Marina Bay, Raffles Place, Shenton Way, Tanjong Pagar, City Hall and Beach Road/ Middle Road, falling by 0.2% to 4.0% from a quarter ago.

Rents

While leasing activity remained strong, the availability of Grade A office space in the CBD continued to decline due to limited new supply. The tight supply situation has not been overlooked by landlords and they sought to adjust their asking rents upwards at a faster pace compared with the last few quarters. As a result, going by the Savills basket of CBD Grade A office buildings, the quarterly rental growth accelerated to 2.5% in Q2 from Q1's 1.3%, bringing the average monthly gross rent to S$9.28 per sq ft. For the first half of 2018, rents have increased by 3.8%, with rents for the top prime grade offices rising the fastest at 6.4%.

Location wise, the rise in rents was broad-based. The top three locations where rents for the second quarter of 2018 rose the most were: Marina Bay (5.1%), Shenton Way (3.9%) and Tanjong Pagar (2.6%).

TABLE 1

Micro-market Grade A office rents and vacancy rates, Q2/2018

Location	Monthly rent (S$ per sq ft)	Vacancy rate (%)
Marina Bay	11.47	14.8
Raffles Place	9.38	5.5
Shenton Way	8.61	4.8
Tanjong Pagar	8.26	4.4
City Hall	9.57	3.1
Orchard Road	9.25	3.6
Beach Road/Middle Road	7.71	13.6

Source: Savills Research & Consultancy

OUTLOOK

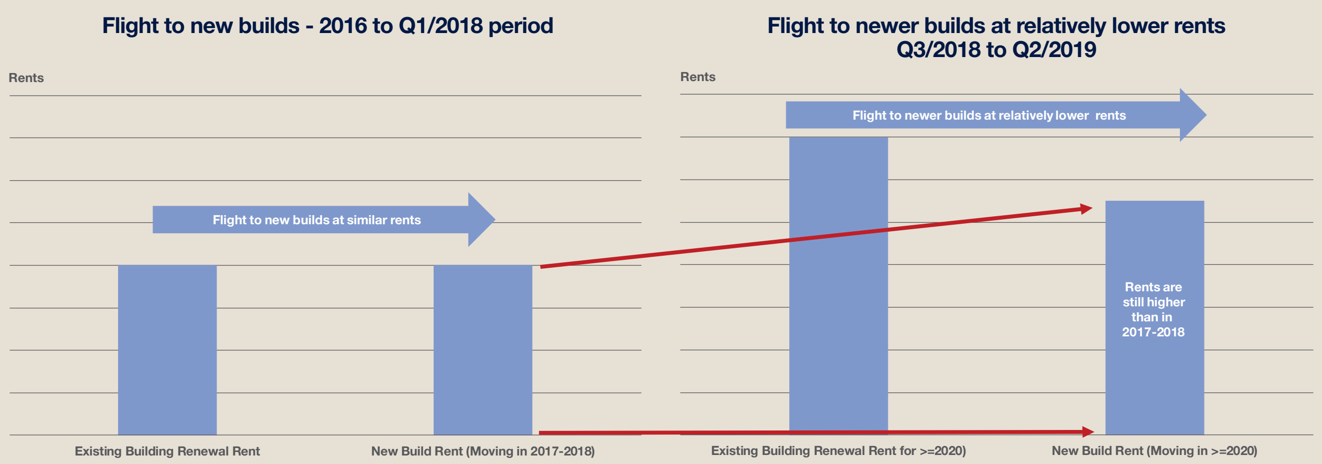
The prospects for the market

Savills forecasts a completion of nearly 800,000 sq ft of Grade A CBD office space in 2018, coming mainly from Frasers Tower at Cecil Street. The supply of Grade A office space this year is a drastic climbdown from the 2.25 million sq ft recorded for 2017. Therefore, although demand this year may be lower than last year, the deceleration rate in new supply plus the unexpected savior in the secondary market that came in the form of co-working space operators gave landlords the confidence to raise asking rents. Recall that during the 2016 to early-2018 period, tenants were committing to new buildings that were completing either in 2017 or 2018. Their move was driven by the early bird sign on rents in these new builds as well as the incentive to move because their existing space and fit out had already become well depreciated. Then, the move was what we call a flight to new builds.

Today, the storyline has taken a short detour. It is that of the flight from new to newer builds. Tenants who are already occupying Grade AAA space feel that their landlords are not budging from significantly higher renewal rental rates. Some are voting with their feet by agreeing to move to new office completions in 2020. Although the forward rental rates for these future buildings are not low, nevertheless, it is still at a steep discount to the renewal rents in tenants' existing Grade AAA buildings.

GRAPH 3

Relative rents evoke different responses from tenants



Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

Landlords of their existing premises are not perturbed by this because their tenants' departures are still some way off. The pressure on landlords of existing buildings to lower rents will begin to build in late-2019 when the new buildings completing in 2020 begin an aggressive campaign to sign on tenants. However, even if rents were lowered, it could be from a much higher base than today's rates. This is the expected outcome because the relative lull in new supply between now and 2020 plays into the hands of landlords of both existing buildings and those in the pipeline.

So, as landlords of existing Grade AAA space consistently push the envelope for higher renewal rents, the push factor on their tenants increases and this gives landlords of buildings completing in 2020 and beyond greater confidence to stick to their asking rents.

These asking rents of buildings in the pipeline were punched into their Excel spreadsheets a few years ago and are by no means low. However, if landlords of existing stock use this supply lull to reset renewal rents to a level that is very much higher than the desktop-processed rents for new builds completing in 2020 and beyond, it will end up as a win-win situation for both.

Nevertheless, it does not mean that tenants' spatial requirements are inelastic to rents. For the period 2017 to H2/2018, quite a few renters either did not increase their footprint when they moved to new premises or shrunk it slightly. Therefore, while rents remain elevated and landlords' optimism continues to grow, one has to be mindful of the roadmap that led market rents to where they are today. That is, in the secondary market, demand was high - for co-working space and then for the newly completed buildings in the 2016-Q1/2018 period - from tenants who had already fully depreciated their office fit-outs and fixtures and thus were unfettered to move, and from those in the growing Telecommunication-Multimedia-Technology (TMT) sectors. For the next two years, however, demand from co-working space operators is expected to be more subdued, and only demand from tenants who are thinking of moving to new buildings will remain. One scenario that could provide an upside surprise would be if a multinational(s), most likely from the TMT sector, decides to take up a large space in an office building. However, these events are binary in nature and hard to pin down with a high degree of accuracy.

Given the current dynamics, we hold to our previous forecast for CBD Grade A office rents to rise 10% YoY this year and another 10% for 2019.

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