MARKET IN MINUTES
Savills Research

Office

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CBD Grade A office vacancy falls further

There were no new completions of CBD Grade A office space in Q2, while net demand for such space was about 376,000 sq ft during the same period.

- In view of rising rents and a sluggish economic performance, leasing demand from most office occupiers has fallen, with the exception of co-working operators and tech companies.
- Slowing demand for traditional offices, coupled with tenants' increasing resistance to rent hikes upon lease renewal, has begun to shift the balance of negotiating power away from landlords. Consequently, they have lowered their asking rents in recent months.
- The most notable deal inked in Q2 was UBS Singapore's lease of the entire office block (383,000 sq ft) at 9 Penang Road, the redevelopment of Park Mall building just opposite Dhoby Ghaut MRT.
- After a relatively quiet first quarter, the investment sales market for office properties revived in Q2 with a few big-ticket block transactions concluded.
- Albeit at a slower tick, the average monthly rent of CBD Grade A offices in Savills basket continued its upward trend, edging up 1.0% quarter-on-quarter (QoQ) to S$10.08 per sq ft (psf) in Q2/2019.

"While storms batter the sea of commerce, co-working space users, tech companies and landlords' stoicism is keeping rents afloat."

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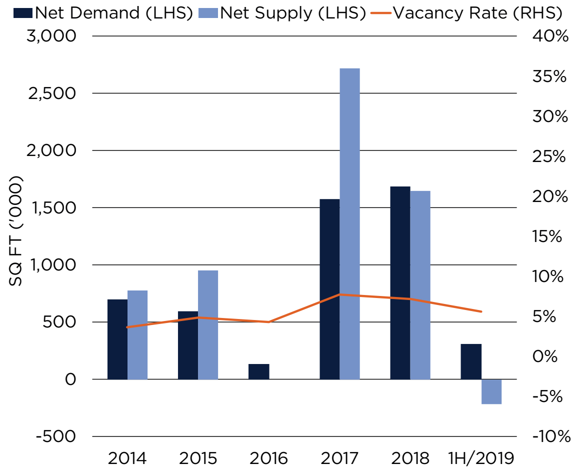
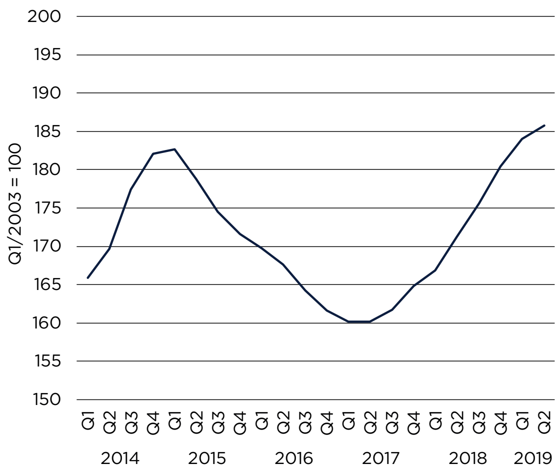
GRAPH 1: Net Demand, Net Supply And Vacancy Rate Of CBD Grade A Offices, 2014 to 1H/2019



Source Savills Research & Consultancy

GRAPH 2: Rental Indices Of CBD Grade A Offices, Q1/2014 to Q2/2019



Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q2/2019

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	13.12	7.8
Raffles Place	10.28	3.0
Shenton Way	9.32	11.2
Tanjong Pagar	9.04	6.9
City Hall	10.31	2.1
Orchard Road	9.58	3.6
Beach Road/Middle Road	8.16	7.1

Source Savills Research & Consultancy

MARKET COMMENTARY

Against a backdrop of increasing trade tensions and softening global growth, Singapore's trade-reliant economy recorded an anemic 0.1% year-on-year (YoY) growth in Q2/2019, according to the flash estimate by the Ministry of Trade and Industry. This marked the worst YoY performance since the second quarter of 2009. In the April-June quarter, the manufacturing sector remained the main drag on the economy, contracting by 3.8% YoY, much higher than Q1's 0.4% decline. The construction sector expanded at a slower rate of 2.2% YoY compared with the previous quarter while service-producing industries posted a yearly growth of 1.2% in Q2, unchanged from a quarter ago.

In view of rising rents and a sluggish economic performance, leasing demand from most office occupiers has fallen, except for co-working operators and tech companies, who have continued to expand after successful rounds of fundraising. The relationship between co-working spaces and smaller tech companies setting foot in Singapore is symbiotic, as the latter prefers flexible workspaces. In the meantime, declining demand for traditional offices, coupled with tenants' increasing resistance to rent hikes, is starting to turn the negotiating tables around. From agents' feedback, the word is some landlords have lowered their asking rents in recent months to levels reflective of tenants' business conditions.

For leases that commenced in Q2/2019, a total of 1,519[1] transactions were recorded in the Urban Redevelopment Authority's (URA) Realis. This is nearly 13.0% higher than the 1,345 recorded a quarter ago. The strong growth came mostly from leases for spaces of no more than 2,000 sq ft. These deals could have been signed at least a few months ago when macro-economic conditions and business confidence were still largely positive.

The most notable deal inked in the reviewed quarter was UBS Singapore's lease of the entire office space at 9 Penang Road, the redevelopment of Park Mall building just opposite Dhoby Ghaut MRT, which will be completed in the last quarter of this year. UBS will take up a total of 383,000 sq ft net lettable area, which spans eight levels across two towers. The move will consolidate UBS's offices, currently in One Raffles Quay and Suntec City, in the second half of 2020. Over in the City Hall area, the revamped Funan had almost fully rented out its 214,000 sq ft of office space, ahead of its completion in June 2019. Following WeWork's expansion from 40,000 sq ft to 70,000 sq ft, a number of statutory boards—including the Department of Statistics, Attorney-General's Chambers, the Smart Nation and Digital Government Office, the Ministry of Culture, Community and Youth and the Government Technology Agency—took up close to 100,000 sq ft in total in the development.

After a relatively quiet first quarter, the investment sales market for office properties revived in Q2 with the conclusion of a few big-ticket block transactions. They are: AEW's S$1.025 billion acquisition of Chevron House at Raffles Place; the S$982.5 million sale of a 50% interest in Frasers Tower at Cecil Street to South Korea's National Pension Services; the S$395.0 million acquisition of 7 & 9 Tampines Grande by a consortium consisting of Metro Holdings and Evia Real Estate; and the S$148.0 million collective sale of Realty Centre in Tanjong Pagar to Singapore-listed The Place Holdings.

DEMAND, SUPPLY AND VACANCY

In the three months from April to June, there were no new completions of CBD Grade A office buildings, while the net demand for CBD Grade A office space in Savills basket was about 376,000 sq ft during the same period, reversing the negative take-up in Q1. As a result, at the end of June, the overall vacancy rate of such office space fell by 1.2 percentage points (ppts) QoQ to 5.6%, with vacant stock of about 1.8 million sq ft.

The improvement in vacancy rates was seen in most of the sub-markets tracked by Savills. Shenton Way and Marina Bay, where vacancy dropped by 3.7 ppts and 2.5 ppts respectively, led the market as tenants moved into newer buildings, such as Frasers Tower and Marina One West Tower, and boosted occupancy rates.

Vacancy rates in the other micro-markets, including Tanjong Pagar, City Hall and Beach Road, recorded marginal declines between 0.1 and 0.9 of a ppt from the previous quarter, while Raffles Place's vacancy rate stayed at 3.0% for the second consecutive quarter. In contrast, the Orchard Road micro-market's vacancy rate experienced a modest QoQ increase of 0.5 of a ppt.

RENTS

The average monthly rent of CBD Grade A offices in Savills basket continued its upward trend, edging up 1.0% QoQ to S$10.08 psf in Q2/2019. For the sub-markets tracked by Savills, rental growth ranged from 0.6% to 1.9% on a quarterly basis.

After an accumulated 12.7% growth over the six consecutive quarters from Q3/2017 to Q4/2018, rental growth has started to taper off in the first two quarters of this year, due to the gloomy global and local economic outlook and tenants' resistance to rent hikes. However, we don't expect rents to fall in the near term. This is supported mostly by limited new supply in the pipeline for the second half of 2019 to 2022. In addition, the continuous expansion of flexible workspaces has, to some extent, mitigated risks arising from the substantial amount of secondary stock vacated by tenants' relocations, such as HSBC's current space at 21 Collyer Quay.

1 Based on the statistics downloaded on 02 August 2019.

TABLE 2: URA Median Rentals Of Category 1 Office Space By Date Of Contracts Signed, Q1/2016 to Q2/2019

PERIOD	URA CATEGORY 1 BUILDING RENTS QOQ CHANGE	SAVILLS GRADE A CBD RENT QOQ CHANGE
Q1/2016	-3.6%	-1.1%
Q2/2016	-3.2%	-1.3%
Q3/2016	-2.2%	-2.0%
Q4/2016	-2.2%	-1.6%
Q1/2017	-1.7%	-0.9%
Q2/2017	-1.7%	0.0%
Q3/2017	3.0%	0.9%
Q4/2017	2.9%	1.9%
Q1/2018	2.4%	1.3%
Q2/2018	2.4%	2.6%
Q3/2018	3.9%	2.5%
Q4/2018	0.9%	2.8%
Q1/2019	4.3%	2.0%
Q2/2019	1.1%	1.0%

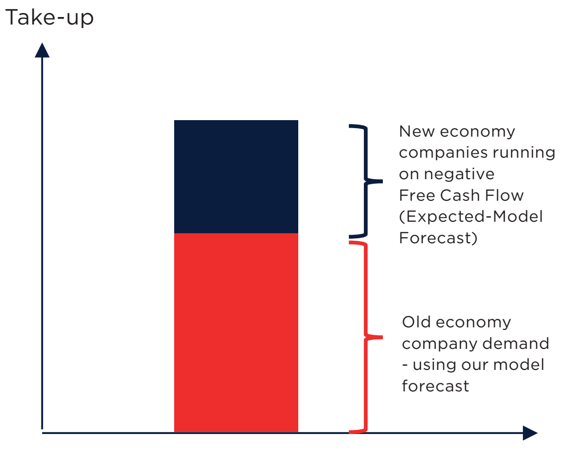
Source URA

TABLE 3: Expected vs Model Forecast Of CBD Grade A Office Take-up

PERIOD	EXPECTED ACTUAL	MODEL FORECAST	EXPECTED-MODEL FORECAST (NEW ECONOMY USER TAKE-UP)
2018	1,690,000 sq ft	1,078,000 sq ft	612,000 sq ft
2019F	626,000 sq ft^	362,000 sq ft*	264,000 sq ft

Source Savills Research & Consultancy
^ Half-year take-up of 313,000 sq ft x 2
* Preliminary forecast, using GDP growth at 1.5%

GRAPH 3: Tracking CBD Grade A Office Demand From Various Users



Source URA, Savills Research & Consultancy

OUTLOOK

With the Singapore and regional economies facing significant slowdowns, one would expect office rents and prices to decline, as has happened in previous economic downturns. However, this does not appear to be the case, at least not for the rest of the year. Change will depend greatly on the behaviour of landlords towards the continuing plight faced by tenants in the financial industry.

Although the URA data for both Category 1 (somewhat like our Grade A classification and Category 2 buildings saw QoQ increases for both Contracted and Commencement rents, we would like to point out that rental growth has come off quite sharply. This is particularly so for Contracted rents for Category 1 buildings. To highlight this point, the median rental of Category 1 office space, by date of contracts signed, recorded a QoQ increase of 1.1% in the second quarter. Although this seems high, it was a dramatic climbdown from the 4.3% in Q1/2019. Please refer to Table 2.

This decrease in Contracted rental growth rate is at first impression homomorphous to Savills rental growth for CBD Grade A buildings in Q2/2019. For the quarter in review, rents from our basket of CBD Grade A buildings rose 1.0% QoQ, halving from the 2.0% increase in Q1/2019. Moving into the third and final quarter of this year, there is greater likelihood of rental growth losing momentum. Many old-economy companies are experiencing rapidly souring business conditions and the plight of these tenants may finally get mapped onto demand for office space in the subsequent quarters. But can the lackadaisical demand from old-economy companies be offset by new-economy ones e.g. co-working space operators and tech companies?

As it was in 2017, when CBD Grade A office rents turned the corner, so it is now; the determinant shoring up office demand comes from co-working space operators and tech-related companies. The relationship between these two office space users is symbiotic as foreign tech and unicorn entrants to Singapore prefer co-working spaces due to the flexibility of lease terms and space arrangements. For without these two user categories, we believe that office demand would be lower than the 313,000 sq ft recorded for 1H/2019. Any significant shortfall in demand from the disruptors and tech companies would be a counterweight to the 3% rental increase that we saw in the corresponding period. Table 3 shows our net take-up of CBD Grade A office space in 2019 for "old economy" companies (traditional office users).

Graph 3 provides a graphical explanation of what Table 3 seeks to achieve. Our in-house model forecasts CBD Grade A office demand from old-economy (traditional) office users. This is the red bar in the figure. The blue bar refers to demand from new economy companies.

The expected take-up, which includes both old and new economy users, is taken from the half year's net take-up of 313,000 sq ft multiplied by two while the model forecast is derived from a GDP-based model. Our model has been tracking old-economy demand well. However, given that the expected demand is 626,000 sq ft for 2019 (computed from taking 1H/2019 net take-up and multiplied by two) and the model forecast is 362,000 sq ft, the variance of 264,000 sq ft is likely to be from co-working space operators, disruptors and tech companies that adopt business models that are running on negative free cash flow for the moment (hopefully). For 2018, our forecast from old-economy companies was about 1.1 million sq ft with 612,000 sq ft coming from new-economy companies. This means that for 2019, the forecast demand from co-working and tech companies is about 43% of last year's level.

That appears low but nonetheless, as 2019 draws to a close, given the 3% rental increase achieved till end-June 2019, it will not be easy to unwind from those market gains to record a negative full-YoY growth. We believe that shadow space will begin to expand significantly in the coming quarters. But, as landlord's ability and determination to keep rents at current or slightly higher levels is strong and there is no new supply forecast for this year, the supply side should be able to counter the headwinds that the demand side faces. Therefore, we should see an overall YoY rental increase for CBD Grade A office space. As for the outlook for 2020, the complexity rises to a level where, due to constraints of space, we shall touch on this in our third quarter brief.