Briefing
Office sector

November 2017

Image: Collyer Quay

SUMMARY

Notwithstanding elevated vacancy levels, CBD Grade A office rents are rising in Q3/2017.

■ Backed by their strong holding power and healthy commitment from tenants, landlords of prime new office buildings are now confident enough to increase asking rents, with those owning older buildings, attempting to follow the trend.

■ The "flight-to-new-projects" theme which dominated the leasing market since the 2H/2015, has gradually morphed from observation to concrete rental increases. However, tenants will consider relocating to newer buildings only if there are strong push factors.

■ As at the end of September 2017, with net take-up at around 197,000 sq ft and no new supply, the vacancy rate of Grade A office space in the CBD fell 0.7 of a percentage point (ppt) to 5.8%.

■ Average rents of CBD Grade A offices increased slightly in Q3/2017 after recording no change in the previous quarter. Rents of such buildings tracked by Savills edged up 1.0% quarter-on-quarter (QoQ) to S$8.78 per sq ft in Q3/2017.

■ The office investment sales market also showed encouraging results in Q3/2017 with seven deals completed, resulting in total transaction values of S$2.48 billion. Capital values of CBD Grade A offices stayed firm at S$2,723 per sq ft.

"As the office market becomes more complex, understanding how the market structure evolves now is more important than traditional demand supply analysis."
Alan Cheong, Savills Research

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Market commentary

Based on the advance estimates from the Ministry of Trade and Industry (MTI), Singapore's economy expanded 4.6% year-on-year (YoY) in Q3/2017, the strongest growth in more than three years. The robust economy performance was supported mainly by the manufacturing sector which continued to power ahead with a 15.5% YoY growth. Service sector growth also accelerated, growing by 2.6% YoY in Q3/2017. The job market also showed further signs of recovery with the overall unemployment rate down slightly from 2.2% in June to 2.1% in September.

In tandem with the broad-based economic recovery, the office leasing market begun to come alive in the past few quarters. Sentiments amongst landlords and office marketing professionals have swung from pessimism to optimism as fears of oversupply began to evaporate. Backed by the strong holding power of landlords and accompanied by healthy commitment by tenants, landlords of prime new office buildings have turned bold and began to raise asking rents. For landlords of older buildings, they too have tried to follow suit. As a result of these factors, office rents turned the corner in Q3. At the same time, the number of leasing contracts continued to increase for three consecutive quarters starting from Q1/2017. Based on the statistics from the Urban Redevelopment Authority (URA), there were a total of 1,190[1] leases that commenced in the third quarter, a 2.1% increase from a quarter ago.

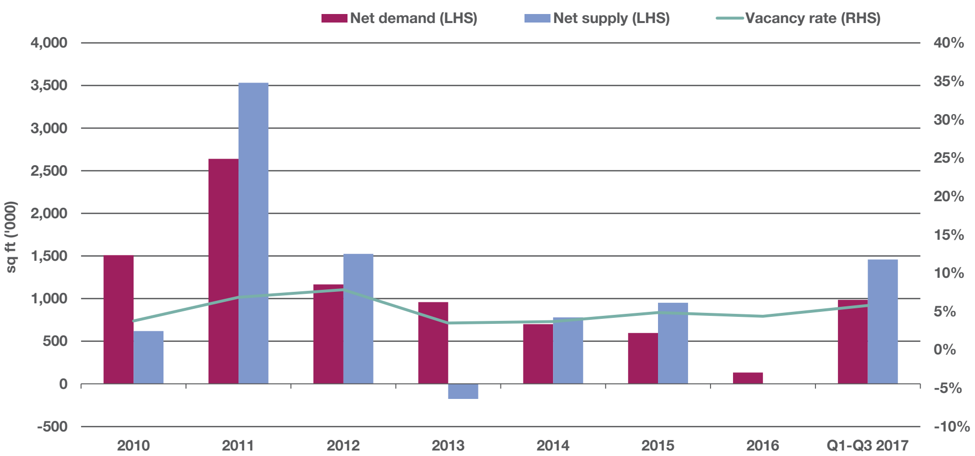
However, the "flight-to-new projects" theme which dominated the leasing market, since the second half of 2015, has gradually morphed from observation to concrete rental increases. Tenants will now consider relocating to newer buildings only if there are strong push factors, such as unreasonably high renewal rents by existing landlords, big changes to their real estate requirements arising from mergers & acquisition activity and aging premises at their current address. With rents beginning to trend up, coupled with limited supply in the medium term, the forward-thinking tenants have jettisoned their previous bearish outlook and begun early rental renewal negotiations, even if there is still one or two years left to run in their lease.

The office investment sales market also registered good results in Q3/2017 with seven deals contributing a total transaction value of S$2.48 billion. This number was more than double the S$1.18 billion in a quarter ago. Among these, the most notable deal was CapitaLand Commercial Trust's (CCT) acquisition of Asia Square Tower 2 (excluding the hotel component) from BlackRock Asia Property Fund III, which is also the biggest office investment sales deal in Singapore so far this year. The transaction total of S$2.094 billion translates to S$2,689 per sq ft based on 778,719 sq ft net lettable space. Separately, CCT divested the commercial component at its Wilkie Edge to a joint venture of Lian Beng Group and Apricot Capital for S$280.0 million. In addition, there were five strata-sale transactions, each worth at least S$10 million, in Q3/2017, involving strata units at Springleaf Tower, Suntec Towers and Prudential Tower in the CBD.

1 Based on data downloaded on 27 October 2017

GRAPH 1

Net demand, net supply and vacancy rate of CBD Grade A offices, 2010–Q3/2017



Source: Savills Research & Consultancy

Demand, supply and vacancy

Based on Savills estimates, with tenants moving in newly-completed projects and gradual take-up of secondary stock, the third quarter saw a net take-up of around 197,000 sq ft Grade A CBD office space. With no new supply entering the market, the occupancy level of CBD Grade A office space improved with the vacancy rate dropping 0.7 of a ppt QoQ to 5.8%.

Rental and capital values

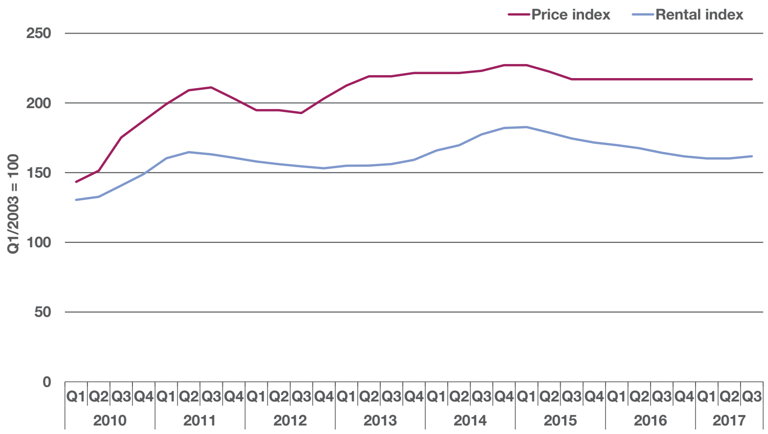
After the second quarter, where rents did not change on a QoQ basis, average rents of overall CBD Grade A offices increased in Q3/2017. Rents of such buildings tracked by Savills edged up 1.0% QoQ from S$8.70 per sq ft in Q2/2017 to S$8.78 per sq ft in Q3/2017. Grade AAA office rents recorded the biggest quarterly growth of 2.1%, followed by those of Grade AA and Grade A offices, which increased marginally by 1.0% and 0.6% respectively.

On a location basis, rents were unchanged in the City Hall and Orchard Road submarkets, while those in other areas rose slightly from last quarter, with the Beach Road/ Middle Road and Marina Bay micro-markets topping ranks at 2.7% QoQ and 2.5% QoQ increase respectively.

Underpinned by low interest rates and ample liquidity, activity in the office sales market remained healthy in Q3/2017. Capital values of CBD Grade A offices stayed firm and hovered around S$2,723 per sq ft in the quarter under review.

GRAPH 2

Price and rental indices of CBD Grade A offices, Q1/2010–Q3/2017



Source: Savills Research & Consultancy

TABLE 1

Micro-market Grade A office rents and vacancy rates, Q3/2017

Location	Monthly rent (S$ per sq ft)	Vacancy rate (%)
Marina Bay	10.32	3.9
Raffles Place	8.90	3.6
Shenton Way	8.04	4.5
Tanjong Pagar	7.78	8.9
City Hall	9.08	4.3
Orchard Road	9.15	4.1
Beach Road/Middle Road	7.32	23.7

Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

Going by URA's latest statistics, after nine consecutive quarters' decline, the median rent of Category 1[2] office space recovered in Q3/2017. It rose by 2.9% QoQ despite vacancy levels rising even more sharply from 14.2% in Q2/2017 to 17.7% in Q3/2017. This unusual situation is amplified further when the island-wide net demand for office space was just 53,800 sq ft for the first nine months of this year. This is a significant difference from the 279,900 sq ft for the similar period in 2016 and just a faction of the 10-year average of 917,100 sq ft for the Q1-Q3 period. The situation is further complicated when Savills estimates for the net take-up for just Grade A CBD offices for the first nine months of 2017 was 984,700 sq ft, much higher than the island-wide demand of 53,800 sq ft.

2 Refers to office space in buildings located in core business areas in Downtown Core and Orchard Planning Area which are relatively modern or recently refurbished, command relatively high rentals and have large floor plate size and gross floor area.

The office sector has become extremely complex. However, it is still possible to identify a trend between the supply and demand to provide an explanation to this seemingly bizarre rental-vacancy relationship and the paradoxical behaviour for demand where the set of island-wide demand does not appear to contain the subset of CBD Grade A demand.

Year-to-date, the high net take-up for Grade A CBD office space has been due to three kinds of tenant movements. One is by those expanding within their existing Grade A CBD building and also by those expanding by moving to other Grade A buildings (new builds or otherwise). The second is by an inflow of tenants moving from non-Grade A CBD or non-CBD buildings to Grade A CBD premises. Thus, over a measured period in time, although the set CBD Grade A office space is closed, the tenants can move in (and out) of the various sets of office by type and location. We see evidence of such infiltration to Grade A CBD office space when tenants have consolidated their operations into a single address and in the process moved parts of their offices from ungraded buildings to UIC Building and Guoco Tower. Similarly for Duo Tower, we have a pharmaceutical company that consolidated from three locations, two of which are not in our Grade A basket. Partial evidence of this second action by tenants is

TABLE 3

Net take-up and net supply of office space by location, Q1/2017–Q3/2017

Location	New supply ('000 sq ft)				Net take-up ('000 sq ft)			
	Q1	Q2	Q3	Total	Q1	Q2	Q3	Total
Downtown Core Planning Area	-43	990	1,001	1,948	86	323	140	549
Orchard Planning Area	-11	0	32	22	-43	0	-32	-75
Rest of Central Area	-65	-22	-11	-97	0	-258	11	-248
Fringe Area	-54	-161	-65	-280	-108	-108	-75	-291
Outside Central Region	506	11	22	538	0	54	65	118
Island-wide	334	818	980	2,131	-65	11	108	54

Source: URA

OUTLOOK

The prospects for the market

shown when we refer to the net take up from URA's statistics that showed a negative take up of 613,500 sq ft for the Rest of Central Area, Fringe Area and Orchard Planning Area in the first nine months of 2017.

Tenants could not all have leaked out to Outside Central Region because the net demand here was just 118,400 sq ft for nine months of this year. Offset, this negative net take-up of 613,500 sq ft, still results in a net deficit take up of 495,100 sq ft.

This means that demand was either extinguished and/or moved to the Downtown Core. That demand completely vanished is a distinct possibility as there was a net withdrawal of 376,700 sq ft for the Rest of Central Area and Fringe Area where tenants displaced in general didn't come back to the market to seek replacement premises, as seen in negative take up outside the Downtown Core.

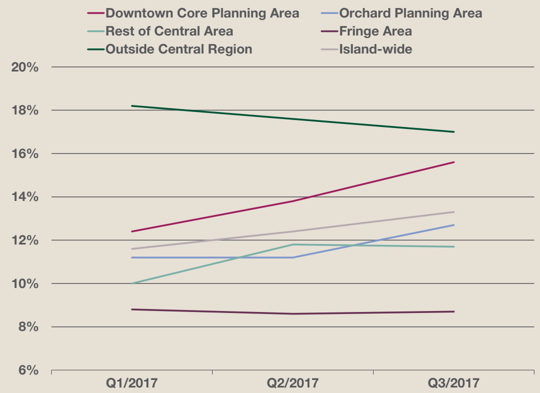
Therefore, the new Grade A office buildings in the CBD are vacuuming tenants out of buildings located outside the Downtown Core area. In simple parlance, this is the "flight-to-new-builds" effect that we have monitored for the past few quarters.

Aside from the spatial shift in demand towards the core new CBD offices, on the supply side, landlords are starting to behave differently from past cycles. Landlords of Grade A CBD offices now have much stronger holding power than they had prior to the Global Financial Crisis and they can hold out longer for higher rents for the remaining unlet space. The entrance of companies in the disruptive business space who have a war chest of cash to burn is adding another slice of demand over and above fundamental space drivers. This adds much greater complexity to the office market because a significant amount of demand is now and moving forward driven by cash burn business models rather than by demand from traditional for profit companies' spatial requirements. These, together with co-working space operators are throwing a spanner into the models developed to predict office space demand and rents.

All said, if we limit our analysis only to CBD Grade A offices, although vacancies may trend up until Q4/2017 and thereafter improve throughout

GRAPH 3

Vacancy rate of office space by location, Q1/2017–Q3/2017



Source: URA

2018, they will remain elevated. However, rents are expected to continue rising next year because not only is there a limited stock of new buildings, they are mostly held by strong landlords. Multinational companies that need to be in Singapore for various reasons will continue to gravitate towards the new Grade A CBD office buildings. For all these reasons, we are projecting a 10% YoY increase in rents for CBD Grade A offices for 2018.

Please contact us for further information

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