Briefing
Office sector

November 2018

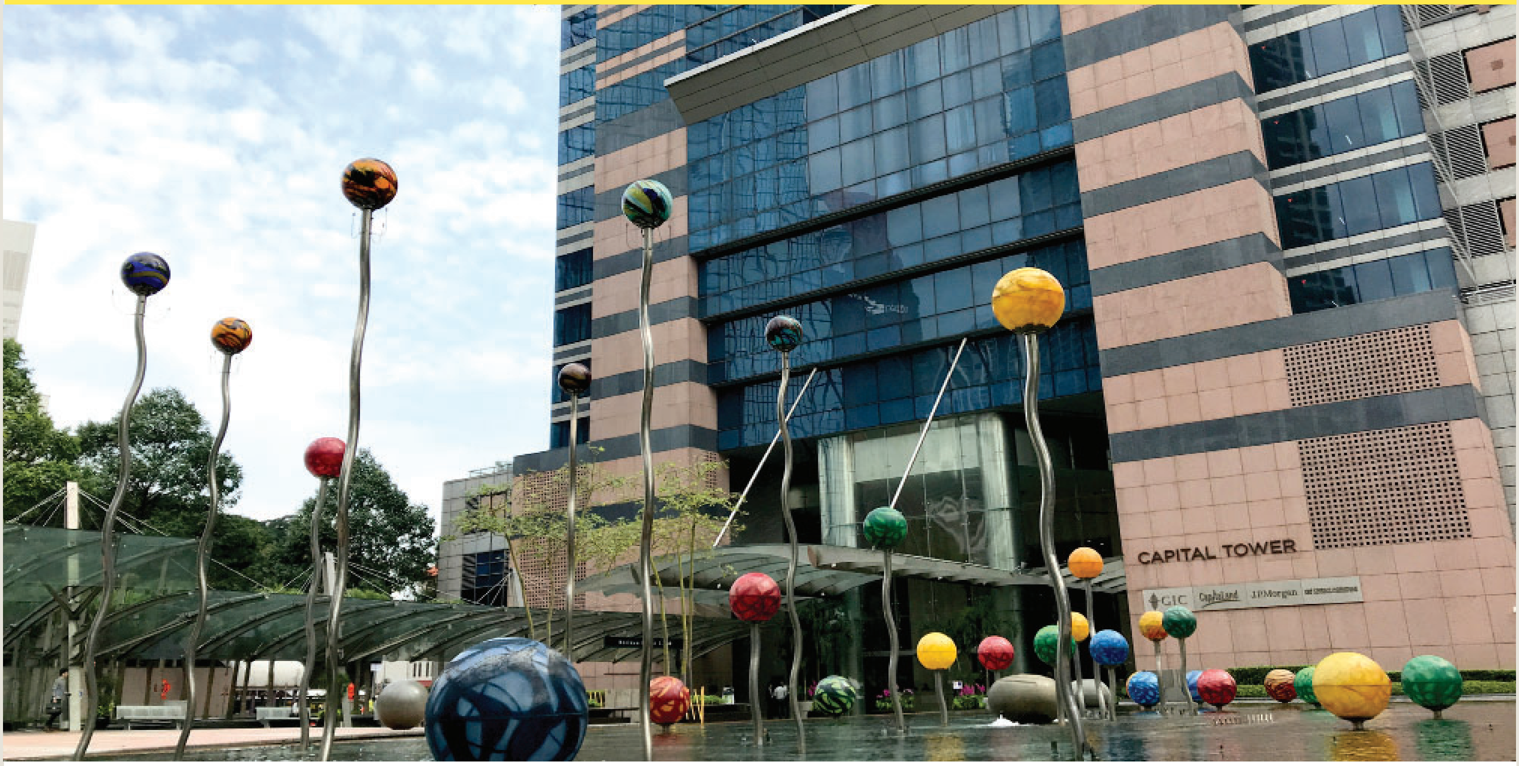

Image: Capital Tower on Robinson Road

SUMMARY

Landlords are raising asking rents and holding their ground during lease negotiations.

- In Q3/2018, leasing activity for office space, especially in the Central Business District (CBD), continued to build on the second quarter's momentum.

- The most notable deal in Q3/2018 was that of HSBC Bank relocating its head office from HSBC Building to Marina Bay Financial Centre Tower 2, with about 140,000 sq ft of space.

- In response to the modish trend of co-working spaces, an increasing number of major office landlords/developers in Singapore have jumped on the bandwagon and carved out such spaces within their properties.

- The overall vacancy rate for Grade A office buildings in the CBD inched down 0.2 of a percentage point (ppt) quarter-on-quarter (QoQ) to 7.6% as of end-September 2018.

- The growth of CBD Grade A office rents remained robust with another 2.5% QoQ gain recorded in Q3/2018.

"While an 8-10% yearly increase in rents is expected for 2019, the recent sharp correction in global equity markets, if not reversed, could become a major risk impacting office demand."
Alan Cheong, Savills Research

MCI (P) 017/10/2018
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Market commentary

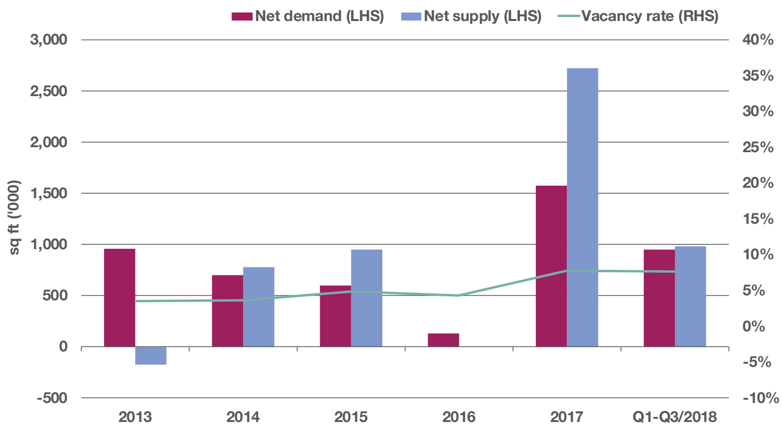
According to Ministry of Trade and Industry (MTI) preliminary estimates, Singapore's economic growth slowed in the three months to the end of September 2018. While the manufacturing sector's growth decelerated, the country's gross domestic product (GDP) expanded by 2.6% year-on-year (YoY) in the third quarter, down from Q2's 4.1%; however, the reading was still a notch higher than the economists' forecast. Compared with a quarter ago, the labour market showed further signs of improvement in Q3, with less retrenchments, better employment growth, and stable unemployment rates for both citizens and residents.

Leasing activity for office spaces, especially in the CBD, continued its momentum in to the third quarter of 2018. Data from the Urban Redevelopment Authority's (URA) Realis showed that a total of 1,260[1] leases commenced all over the island in Q3. Although this slipped 6.0% from the previous quarter, it was 5.5% higher than the 1,194 recorded in the same period of last year and the highest Q3 number since 2000. On the back of healthy demand from a wide spectrum of occupiers and limited available stock for lease, landlords have continued to raise their rents and hold firm in negotiations while tenants, who have less bargaining power now, have had to either accept the rental hikes or consider alternatives, such as non-core locations and flexible working spaces.

1 Based on data downloaded on 7 November 2018

GRAPH 1

Net demand, net supply and vacancy rate of CBD Grade A offices, Q1/2013 – Q3/2018



Source: Savills Research & Consultancy

For sizable deals concluded in the past few quarters, the theme of consolidation and flight-to-new projects continued to manifest itself. For example, the most notable deal in Q3/2018 came from HSBC Bank relocating its head office from HSBC Building at Collyer Quay, which was completed in 1985, to the newer Marina Bay Financial Centre Tower 2, where the bank took up about 140,000 sq ft of space. Another major deal in the reviewed quarter was Allianz leasing 50,000 sq ft at ASB Tower in Robinson Road, the redevelopment of the former CPF Building which is slated for completion in 2020.

In response to modish trends, an increasing number of major office landlords/developers in Singapore have jumped on the co-working bandwagon and carved out such spaces within their properties, through establishing their own brands as well as collaborating with or investing in existing operators. The most recent example is CapitaLand buying a 50% stake in co-working operator The Work Project, and forming a joint venture known as The Work Project Kingdom (TWPK). TWPK has leased 31,000 sq ft at Capital Tower and 41,000 sq ft at Asia Square Tower 2 from 1 Jan 2019, and has also acquired Collective Works' co-working business. Separately, Lendlease was also reported to be planning its own flexible workspace brand within its mixed-use development Paya Lebar Quarter.

Demand and vacancy

For the Savills basket of CBD Grade A offices, as at end-September 2018, the overall vacancy rate inched down 0.2 of a ppt QoQ to 7.6%. With no new supply completions, this improvement was supported by a net take-up of about 55,000 sq ft of office space in the quarter.

In the first three quarters of 2018, the net demand for CBD Grade A office space has already totalled 949,000 sq ft. The full year number could be in the range of 1.3-1.4 million sq ft, slightly less than the 1.57 million sq ft of 2017 but the second highest number since 2012.

The occupancy of Grade A offices was tight in most of the geographical submarkets tracked by Savills, including Raffles Place, Shenton Way, Tanjong Pagar, City Hall and Orchard Road. In these areas, vacancy rates were all below 5.0%. For the Marina Bay and Beach Road/ Middle Road micro-markets, the high vacancy rates will gradually decline in the next few months as several pre-committed tenants move in.

Rents

Based on Savills statistics, the growth of CBD Grade A office rents remained robust with another 2.5%

TABLE 1

Micro-market Grade A office rents and vacancy rates, Q3/2018

Location	Monthly rent (S$ per sq ft)	Vacancy rate (%)
Marina Bay	11.98	15.1
Raffles Place	9.65	4.8
Shenton Way	8.83	3.8
Tanjong Pagar	8.41	4.1
City Hall	9.85	3.2
Orchard Road	9.37	3.4
Beach Road/Middle Road	7.88	13.4

Source: Savills Research & Consultancy

QoQ gain recorded in Q3/2018. The monthly gross rents of such good-quality office space averaged at S$9.53 per sq ft per month as of end-September, representing an accumulative growth of 9.6% for five successive quarters since Q3/2017. Same as the last quarter, rents for the top-tier prime grade offices (AAA Grade) continued to lead with the fastest increase of 4.3% QoQ in Q3, while those of AA and A Grade have been catching up with a quarterly growth of 3.0% and 1.6% respectively.

Location wise, the rise in rents was seen across all the micro-markets and ranged from 1.3% to 4.5% QoQ in the reviewed quarter.

GRAPH 2

Rental index of CBD Grade A offices, Q1/2013 – Q3/2018

Source: Savills Research & Consultancy

OUTLOOK

The prospects for the market

In the last six months, the market has seen the sudden emergence of greater downside risks to global growth. Escalating trade tensions and the weaker-than-expected performance of some key economies in 1H/2018 have given rise to this spike in the global economic risk profile. According to the latest polls conducted by the Economic Development Board (EDB) in October, firms in Singapore have also become gloomier in their business outlook for the six months from October to next March. Despite a less than sanguine macroeconomic environment, lopped on top of the market's current favorite risk theme—trade war—Savills expects the office leasing market to remain healthy in the immediate to medium-term. Tightening new supply by end-2019 and office landlords' composure and confidence levels will be key to overcoming these potential risks. Therefore, we maintain our rental growth forecast of 10% in 2018 and 8-10% in 2019 for the CBD Grade A offices. We shall further analyse the market by looking separately at the tenant and landlord sides of the coin.

Tenants

Although we expect rents to rise 8-10% YoY in 2019, it does not imply that demand is free of headwinds. Next year, we believe that demand based on tenants' expansion will be muted because of the year-to-date (YTD) performance of the major equity sectors in the US stock market. By the end of the third quarter, the S&P 500 was up 7.71% YTD but by 8 November, this had dropped to 4.98% with all the major sectors witnessing major reductions in YTD positive or increased negative growth rates. If not reversed, this proxy to firms' profitability should begin to cascade down to multinationals' corporate real estate plans. In this briefing note, we will analyse a few major users of office space: technology and financial services companies, and co-working space operators and business disruptors.

In the period 2015 - 2017, while office market observers noted the proliferation of relocations, forward leases and more importantly, significant office space expansions by firms in the technology sector, not much thought was given as to why this sector expanded their real estate acreage here.

Looking at reasons why some sectors were aggressive in their office space requirements, we have traced it to the performance of the technology sector on Wall Street. During this period, the S&P Depository Receipts (SPDR) returns for tech companies was sterling, rising 15.63%, 14.8% and 34.3% respectively (please refer to Table 2). Their performance on the SPDR front was mapped to our office leasing market, which showed companies in this sector expanded in both CBD Grade A offices as well as in business parks. However, a pullback in the SPDR to 19.07% by 30 September 2018 and then to 9.5% as of 8 November 2018 is likely to have further deleterious effects next year on office space usage from technology companies in general.

The same can be said of banks and other financial institutions. In the 2016 – 2018 period, we saw banks either move to new buildings or we made prognostications that they would do so by 2020. However, in their relocations, they either took up the same amount of square footage or reduced their real estate footprint. Looking at Graph 3, we may understand why this was the case. For the financial sector, and for energy as well, the SPDR performance

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TABLE 2

SPDR# YoY performance

2015	2016	2017	2018*
Consumer Discretionary 9.94	Energy 28.01	Technology 34.28	Consumer Discretionary 19.87
Healthcare 6.86	Financials 22.69	Materials 23.94	Technology 19.07
Consumer Staples 6.83	Industrials 19.95	Industrials 23.84	Healthcare 16.45
Technology 15.63	Materials 16.66	Consumer Discretionary 22.77	S&P 500 7.71
S&P 500 1.38	Utilities 16.00	Financials 22.04	Energy 7.16
Financials -1.60	Technology 14.82	S&P 500 21.83	Industrials 5.05
Industrials -4.25	S&P 500 11.96	Healthcare 21.70	Utilities 2.66
Utilities -4.86	Consumer Discretionary 5.88	Consumer Staples 12.92	Real Estate 1.62
Materials -8.58	Consumer Staples 5.00	Utilities 12.02	Financials 0.01
Energy -21.46	Real Estate 3.19	Real Estate 10.70	Materials -2.93
	Healthcare -2.83	Energy -1.06	Consumer Staples -3.20

Source: Bloomberg
SPDR: S&P Depository Receipts
* YTD 1 Jan - 30 Sep 2018

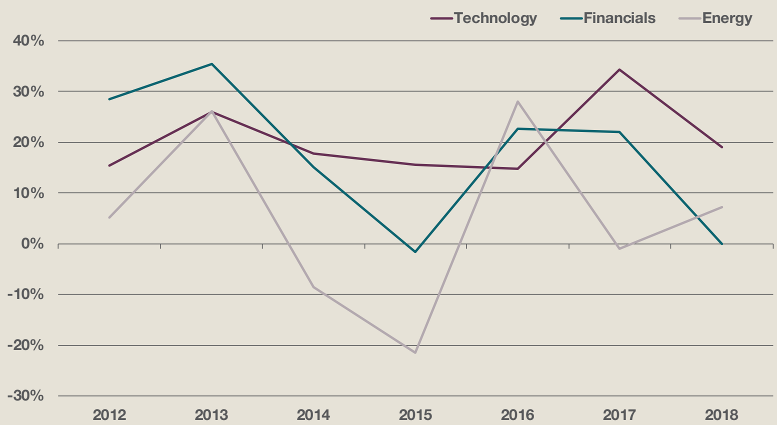
exhibited a larger magnitude of volatility during the period 2012 to 2015.

Although this approach to forecasting near-term demand relies on the lag effect, it is however not regression-based. Rather, because we see the colours on the ground, we approach forecasts by conjugating the up-to-date goings-on in the equity/derivative marketplace and how that implicitly affects the actions of major office space users pertaining to their corporate real estate plans for the coming year or two.

For co-working spaces and those in disruptive industries (we collectively call them disruptors),

GRAPH 3

SPDR# YoY performance of three equity sectors



Source: Bloomberg, Savills Research & Consultancy
SPDR: S&P Depository Receipts

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forecasting demand requires a different approach. The burn-rate approach to financing a disruptor's business model together with the trend for major landlords to take equity stakes in such operators and in doing so, soak up space in their office buildings, makes it almost impossible to rely on any traditional or advance forecasting methods. However, it appears that because disruptors are operating on a cash-burn model, the ability to continually raise funding becomes key to maintaining or expanding their real estate footprint. The ability of disruptors (and tech companies) to raise money in 2018 was not in doubt for much of this year. In fact, with one quarter remaining in 2018, global investment by venture capitalists had already surpassed the whole of 2017's US$171 billion (source: KPMG Venture Pulse Q3/2018). However, the decline in the NASDAQ only happened in October and, should it be sustained, may have delayed knock-on effects on tenants using our office space in the 2019-2020 period.

Landlords

Landlords and asset managers have hitherto been focused on achieving key performance indicators, and we believe they have generally ignored the increasing complexity of the tenancy landscape. The jury is still out as to whether the NASDAQ's recent fall represents a mid-term decline or is merely a correction. If it is the latter, then demand from disruptors (and tech companies as well) may be sustained. However, a multi-quarter decline may result in greater cost management in 2019. However, landlords' behavior at present does not appear to show any concerns over tenants' ability to raise copious levels of funding or whether tenants' senior management may call for belt-tightening measures. In fact, the feeling is that landlords and asset managers are quite presumptuous about tenants' willingness to close at the asking sign-on rents, and that overconfidence, in our opinion, is a major potential risk.

In conclusion, we are still holding on to our forecast of 10% and 8-10% YoY rental increases for Grade A CBD Offices. The 10% growth forecast for 2018 seems almost in the bag with Q3/2018 rents having grown by 6.6% YTD. For 2019, the saving grace will come in the form of a dearth of supply in the CBD. Landlords and asset managers realize this and will attempt to use the 2019 supply landscape to eke out higher rents from tenants whose leases are due for renewal or negotiations in the period 2020 - 2021. All of this may still work out in landlords and asset managers' favor if the recent declines in the major equity markets are transient and tenants continue to believe that they should lock in their future rents before rates go even higher. However, if that scenario turns out otherwise, then the case of the tail wagging the dog may come to the fore.

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