Asian Cities - 1H 2023

SPOTLIGHT

Savills Research

Hong Kong Investment

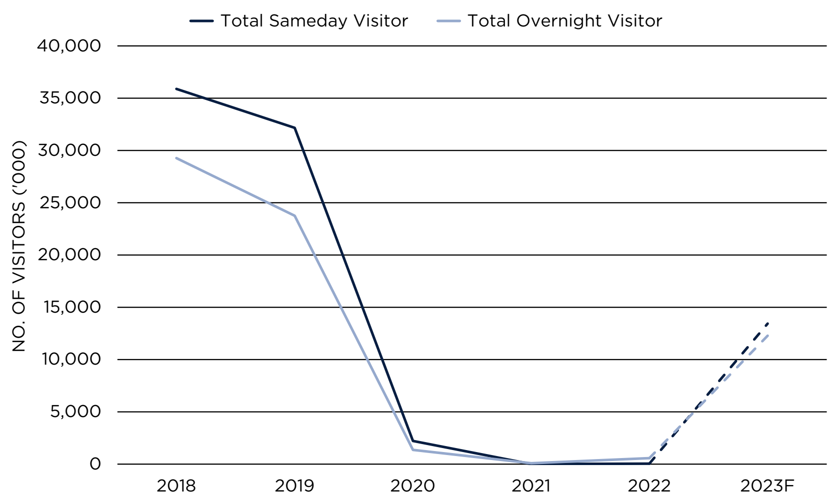
High cost of funds remains a major stumbling block

REBOUNDING TOURIST NUMBERS BOOSTING RETAIL AND HOSPITALITY DEMAND

It was four full months since border reopened, and Hong Kong has welcomed 7.3 million visitors (5.7 million from Mainland) over the period, representing around 30% of pre-COVID levels. After a 'disappointing' Easter Holidays when departing Hongkongers (1.58 million from April 4 to April 8) significantly outnumbered incoming Mainland tourists (270,000 over the same period), and many retail and F&B outlets reported declining sales over the period, the Labour Day Golden Week fared better, with 630,000 Mainland tourists coming to town over the 5-day festive period, around 50% of 2019 levels over the same period. Luxury retailers were the main beneficiaries with most reporting sales reaching 70% to 80% pre-COVID levels, while some even fully recovered 2019 Labour Day Golden Week sales. Some F&B operators also welcomed waves of Mainland tourists, given they were traceable on Xiaohongshu. Nevertheless, other retail sectors were mostly muted as Mainland tourists spent rest of their time touring around rather than shopping.

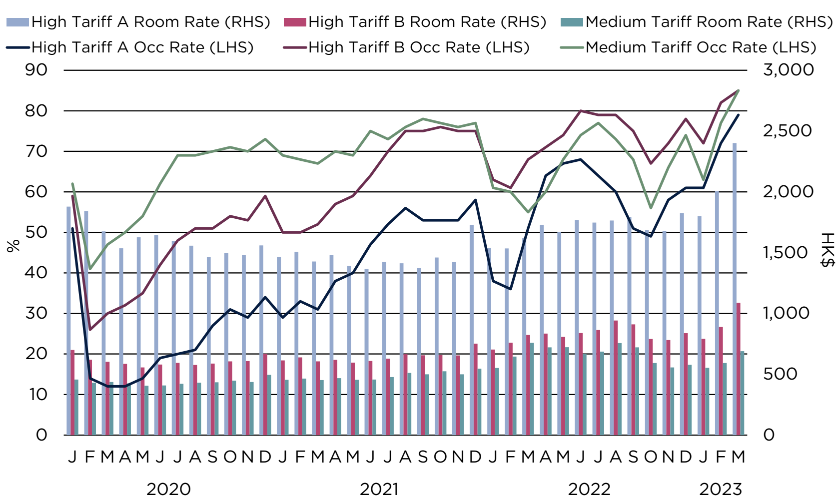
The hotel sector, which has already rebounded over the past two years due to strong staycation and quarantine demand, saw continuous growth in sales performances after border reopening: over Q1/2023, ADR reached HK$1,200 per room night, a 20% YoY increase, while occupancy rate improved dramatically from 57% a year ago to 76%, propelling RevPAR to register a staggering 63% YoY increase over the first three months of 2023, reaching around HK$920 per room night. The influx of overnight visitors, business travellers in particular, over the first four months of the year has more than compensated diminishing staycation and quarantine demand.

GRAPH 1: Number of Sameday and Overnight Visitors, 2018 to 2023F



Source HKTB, Savills Research & Consultancy

GRAPH 2: Hotel Performances by Category, January 2020 to March 2023



Source HKTB, Savills Research & Consultancy

HIGH COST OF FUNDS DAMPENING INVESTMENT SENTIMENT

US Fed as expected raised interest rates by 0.25 percentage point in early May, and all banks in Hong Kong followed suit with a 0.125 percentage point increment, raising prime rate to 5.75% to 6%. This was also the first time US Fed signaled a potential end, or at least a pause, to the current rate hike. Nevertheless, even if this signal becomes reality, according to previous rate hike cycles, interest rates may still remain at current high levels for at least another year, and the high cost of funds (around 5.5% to 6.5% for most commercial loans) would remain a major stumbling block to commercial real estate investments for the rest of the year.

En-bloc / major investment transactions therefore declined heavily in Q1/2023, with only HK$7 billion worth of transactions over the period. PERE funds, which were active in such market over the past five years with market share ranging from 30% to 60%, were hardly seen in the market as even 4% to 5% on offer with some current asset sales were difficult for them to underwrite given high cost of funds. Under such circumstances, the investment market was vastly muted over the past two months, with Uni-China Group purchasing the retail podiums of One Kai Tak (I) (II) (29,732 sq ft) for HK$650 million being the only significant investment deal, and the 5.2% passing yield on offer reflected the cautious attitude of professional investors in this new high interest rate era, even with retail prospects the most promising among all sectors.

Another rumoured deal was the disposal of Mapletree Logistics Centre Fanling for HK$590 million to another investor /

operator. The 6-storey logistics facility has a total GFA of around 137,000 sq ft, and the new buyer could enjoy around 4% yield if the premises is fully let. If confirmed, this will be the largest industrial transaction for 2023, after the sales of Novel Industrial Building in Cheung Sha Wan to Blackstone / Storefriendly for HK$850 million late last year.

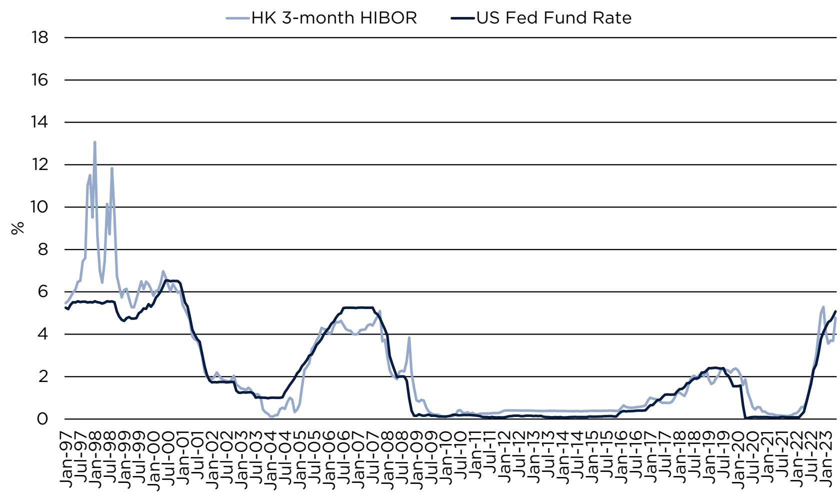
While the retail and hospitality segments are rebounding strongly after border reopening, the office and residential sectors are facing much more uncertainties due mainly to oversupply in the short-term.

OFFICE SECTOR DOMINATED BY END USERS AS OVERSUPPLY LOOMS

The office sector, which was clouded by escalating vacancy (13.5% or 9.3 million sq ft net in April 2023) and thus declining rents (down 33% from 2019 peak), registered no major investment transactions, and most larger deals recorded in April and May were concluded by end users, such as the purchase of several units on 27/F of Convention Plaza Office Tower (8,206 sq ft) for HK$255 million (HK$31,000 per sq ft) by an SOE end user, as well as the purchase of 7/F of Fairmont House (8,824 sq ft) for HK$168.3 million (HK$19,073 per sq ft) to an end user who already owns an upper floor. The only deal with an investment element was the sale of 22/F of Euro Trade Centre (5,267 sq ft) for HK$142 million (HK$26,960 per sq ft) to a local investor with a passing yield of around 2.4%.

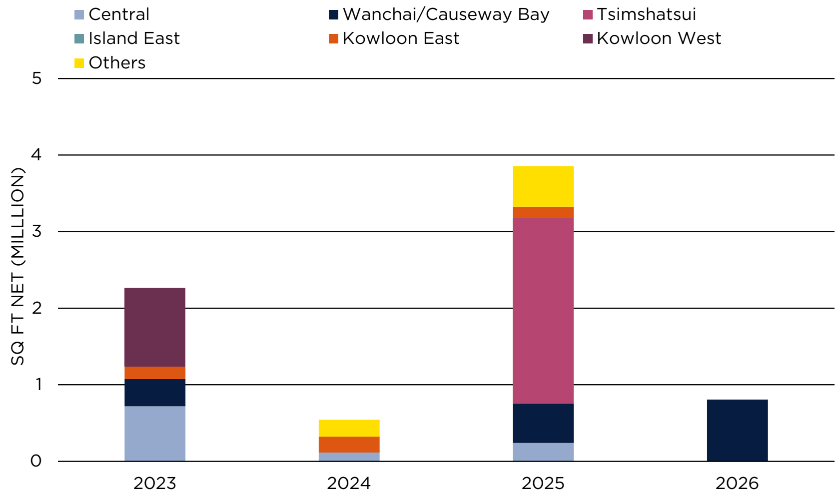
With another 7.5 million sq ft net of office supply coming on stream over the next four years, office vacancy rates are expected to increase to around 16% by 2025, assuming take-up over the period to resume to pre-COVID level of around 1.3 million sq ft net per annum. As such, office rents would likely to decline by another 10% to 20% from 2023 to 2025, rendering office investment unattractive with yields likely to hover below 3%, way below the current cost of funds of around 5.5% to 6.5%.

GRAPH 3: Hong Kong 3-month HIBOR vs US Fed Fund Rate, January 1997 to April 2023



Source HKMA, US Federal Reserve

GRAPH 4: Grade A Office Supply Forecast by District, 2023 to 2026

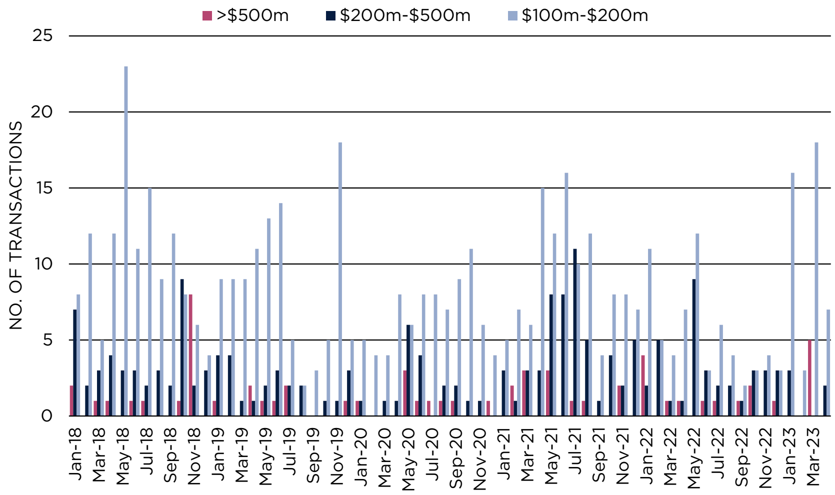


Source Savills Research & Consultancy

RESIDENTIAL SECTOR MAY ENDURE A BUMPY RIDE

The residential sector was more mixed, with the mass segment buoyant by border reopening in Q1, and developers were keen to launch primary projects over the first four months of 2023 with more than 4,300 first-hand units sold, a 120% increment compared to the same period last year. Despite the strong primary sales, secondary market was more muted with 14,251 transactions, a mere 19% increase compared to the first four months last year. Developers were keen to offload their new residential units given improved sentiment and high holding costs, some offering price discounts of 15% to 20% of new launches in Apr / May 2023 as compared to earlier phases of the same projects launched last year.

GRAPH 5: Luxury Transaction Volume by Price Range, January 2018 to April 2023



Source Land Registry, Savills Research & Consultancy

The luxury segment, after being dominated by distressed sales with general 20% to 30% discount to market in 2022, saw a couple of significant deals in the first few months of 2023. The most eye-catching deal being the sales of 30-38 Magazine Gap Road on the Peak for around HK$4.5 to HK$4.7 billion (share transfer, no official record of transaction price), with a maximum GFA of around 48,000 sq ft and AV of over HK$100,000 per sq ft. In fact the HK$100 million to HK$200 million price bracket saw the strongest recovery with 44 transactions being recorded from Jan-Apr 2023, the highest four-month sales from 2018. Elsewhere, the luxury market was more muted with the anticipated return of Mainland HNWIs yet to materialize.

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