Asian Cities - 2H 2020

SPOTLIGHT

Savills Research

Kuala Lumpur Offices

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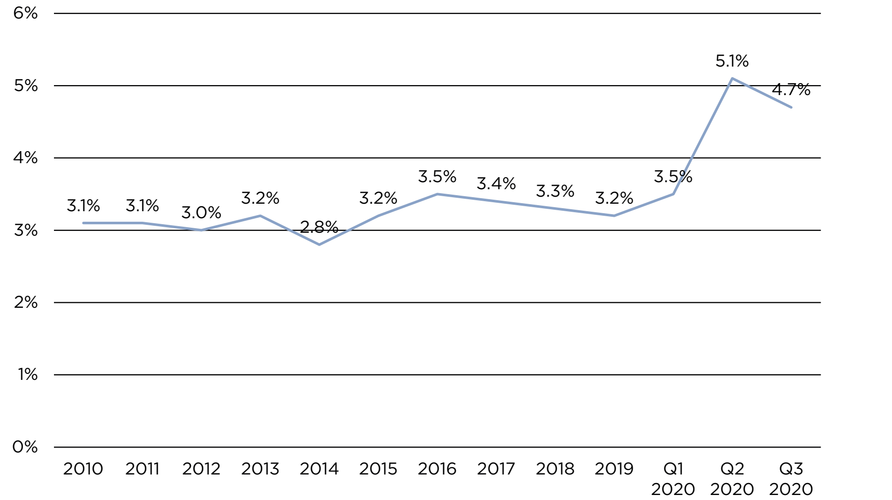
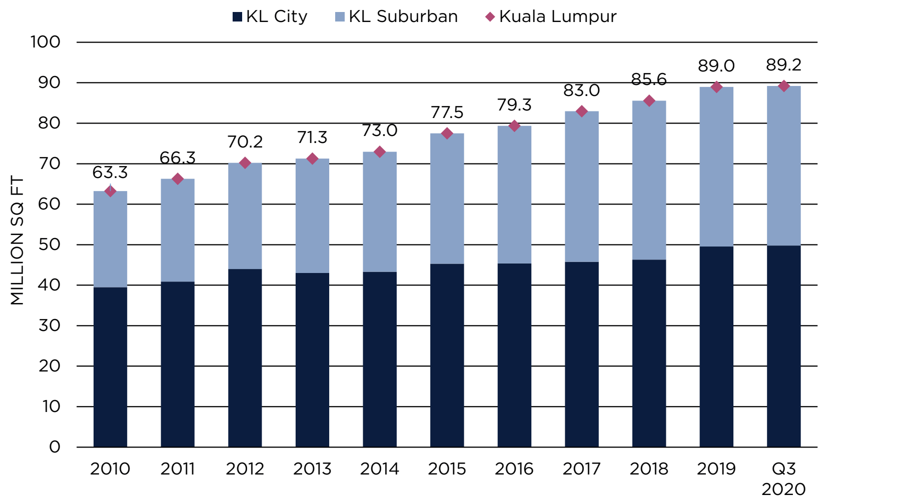
Greater KL's office market to expand by 10%

GRAPH 1: Unemployment Rates, 2010 to Q3/2020



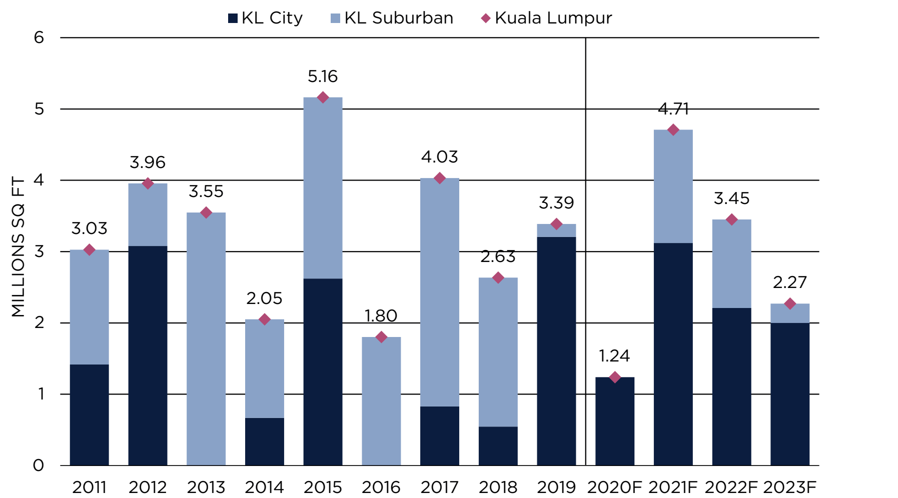
Source Department of Statistics Malaysia (DOSM)

GRAPH 2: Kuala Lumpur Office Stock, 2010 to Q3/2020



Source Savills Research

GRAPH 3: New Office Supply In Kuala Lumpur, 2011 to 2023F



Source Savills Research

ECONOMY

On the back of a global pandemic, political uncertainty in Malaysia, oil price volatility and the US-China trade war, many business sectors have taken a heavy toll. The country's GDP fell by 2.7% in Q3/2020, after a double-digit contraction of 17.1% in Q2/2020, with unemployment hitting an all-time high of 5.7% in May 2020. Conditions have improved somewhat since, as employment declined to 4.7% in Q3/2020 when the government gradually relaxed movement restrictions, with most businesses resuming at least partial operations since early June 2020, guided by the standard operating procedures (SOPs) mandated by the government. At time of writing, most companies are still practicing flexible work arrangements, given that offices are only able to accommodate fewer employees due to physical distancing rules.

NEW SUPPLY

Office stock in Greater KL expanded to 132.9 million sq ft, while the cumulative supply in Kuala Lumpur (a subset of the Greater KL market) totaled 89.2 million sq ft in Q3/2020. This is marked by the completion of four medium-scale office buildings (of NLA <300,000 sq ft), totaling approximately 0.86 million sq ft, of which only one, Menara Hap Seng 3, is within Kuala Lumpur. The others, namely Sumurwang Tower, Menara Star 2 and Beta Office Suites at Pacific Star Commercial Hub in Petaling Jaya, are all in Selangor (another subset of the Greater KL market).

By 2023, the office market in Greater KL is projected to expand by another 10% (+14.1 million sq ft), with 80% of the new supply (11.4 million sq ft) located in Kuala Lumpur. The bulk of this supply in Greater KL is expected to be completed within the next 12 months (KL: 4.7 million sq ft, Outer KL: 1.9 million sq ft).

About 0.7 million sq ft (65%) of incoming space in Tun Razak Exchange have been pre-committed by owner-occupiers such as HSBC Bank and Affin Bank.

VACANCY RATE

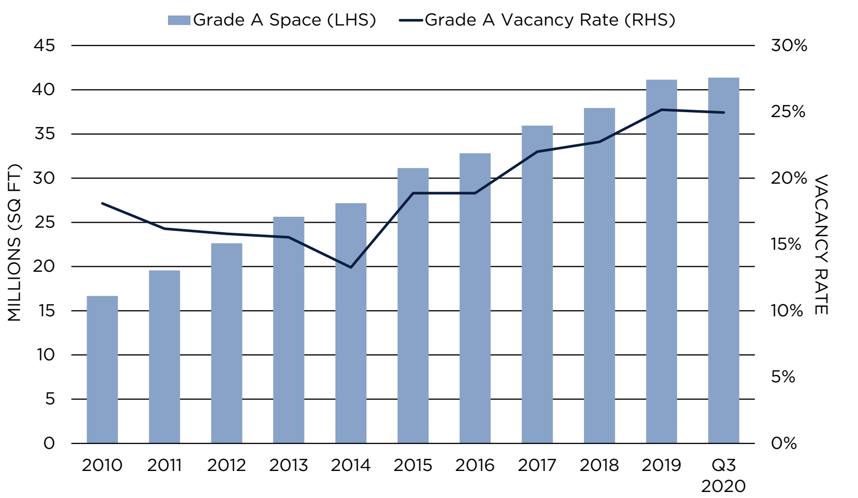
Leasing activity has been subdued not just due to uncertainty in economic conditions, but also what the future of the office may look like post-COVID. These factors have led to many companies putting their near-term expansion plans on hold. Companies are preserving cash flow, with the bulk of ongoing leasing activity being driven by absolute necessity or downsizing, i.e. the potential for savings.

The Q3/2020 Greater KL Grade A office vacancy stood at 25.9%, an increase from the 25.0% recorded in Q4/2019. Grade A office vacancy in Kuala Lumpur improved marginally, to 24.9% in Q3/2020 (2019: 25.2%), attributable to the newly-completed Menara Hap Seng 3 which is 40% occupied by Tokio Marine General Insurance, as well as the relocation of Accenture and expansion of Agoda at The Exchange 106.

Aside from the completion of new buildings, the overall increase in the vacancy rate in the Greater KL market is attributable to the difficulty in arranging viewings and fit-out works due to government-imposed movement restrictions for more than half the year. As flexible work arrangements gained traction this year, corporations have taken a step back to reassess their space requirements in the short to medium term.

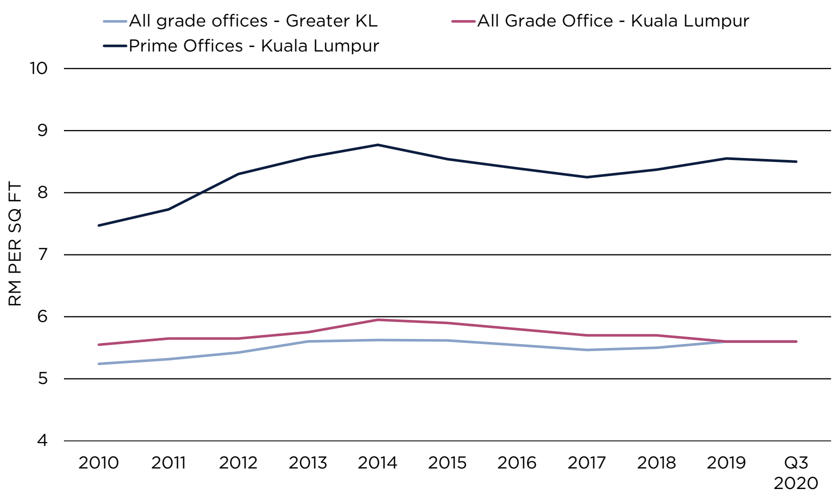
Impending new supply with better M&E coupled with the flight-to-quality phenomenon suggest that older buildings might suffer from greater obsolescence in the coming years, leading to a potentially higher vacancy risk.

GRAPH 4: Kuala Lumpur Grade A Office Supply And Vacancy, 2010 to Q3/2020



Source Savills Research

GRAPH 5: Average Office Asking Rents In Greater KL, 2010 to Q3/2020



Source Savills Research

RENTAL RATE

While sentiment is weak, the lack of concluded transactions across the market makes it difficult to quantify rental movements. Most landlords have left asking rents at their previous level, however many are willing to discuss higher incentives once they are sure a potential tenant is serious. We have observed that there are requests from occupiers / prospects for a more flexible lease term (less than three years) and have seen landlords considering exploring amortization of fit-out costs over a reasonably long lease term.

As such, average gross asking rents in Greater KL remain at RM5.60 per sq ft per month while offices in Kuala Lumpur stand at RM5.80 per sq ft. In the Grade A office market, average gross asking rents for selected prime buildings in Kuala Lumpur experienced only a marginal decline of 1%, from RM7.60 to RM7.50 per sq ft per month in Q3/2020.

CAPITAL VALUE & INVESTMENT

To date, there are three major office transactions recorded in the first nine months of 2020, amounting to RM1.4 billion. This represents a three-fold increase in investment value compared to 2019. All of these are related party transactions between the Sponsors to the REITs. The buildings all report over 90% occupancy, with initial net yields ranging from 5.5% to 6.2%.

In June 2020, IGB Bhd announced the proposed establishment of a pure-play office asset REIT which is targeted to be completed by the end of 2020 / early 2021. The proposed IGB Commercial REIT is reported to involve the sale of ten properties, seven of which

TABLE 1: Major Office Transactions, Q1/2020 to Q3/2020

PROPERTY	LOCATION	AREA (SQ FT)	PRICE (RM MILLION)	BUYER
UOA Corporate Tower	KL Suburban	732,871	700	UOA REIT
The Pinnacle Sunway	Selangor	577,000	450	Sunway REIT
Menara Guoco	KL Suburban	232,000	242	Tower REIT

Source Savills Research

are in Mid Valley City and three in the Golden Triangle. This is the second REIT by IGB Bhd since the establishment of IGB REIT in 2012, comprising two prime retail assets; Mid Valley and The Gardens.

Impending new supply with better M&E coupled with the flight-to-quality phenomenon suggest that older buildings might suffer from greater obsolescence in the coming years, leading to a potentially higher vacancy risk. This is evident from a handful of aged office buildings 20 years or older, which are in the market for buyers. Over the past 36 months, we have observed this in buildings such as Menara MIDF, Menara JCorp, Menara Affin, Menara AA and Wisma KFC.

OUTLOOK

The obvious impact derived from the pandemic is perhaps the acceleration of remote working trends and fast-tracked digital adoption in workspaces. As most companies have been forced to adapt their workforce's remote working ability and juggle with physical distancing rules, it is anticipated that the office footprint is unlikely to change in the short to medium term.

Back in the pre-pandemic period, the fundamentals of the Greater KL office market were already in a fairly weak and challenging state, with supply outstripping demand. This is not anticipated to change before 2023, in light of the impending supply between now and then.

The country's economy was brought to a standstill during the 47 days of MCO, with an estimated RM2.4 billion of losses every business day according to the Prime Minister of Malaysia. Services (especially tourism, retail and F&B) were the hardest hit, while the information technology sector may have turned the crisis into an opportunity. At the time of writing, most of the key states in the country have re-entered into CMCO, as part of efforts to flatten a third wave. Unlike the earlier MCO, the government has permitted most business and economic activities to operate as usual by adhering to the stipulated operating procedures (SOPs), while schools and social spaces remain closed. This CMCO is expected to last until December 2020.

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