SPOTLIGHT
Savills Research

Asian Cities - 1H 2023

Metro Manila Offices

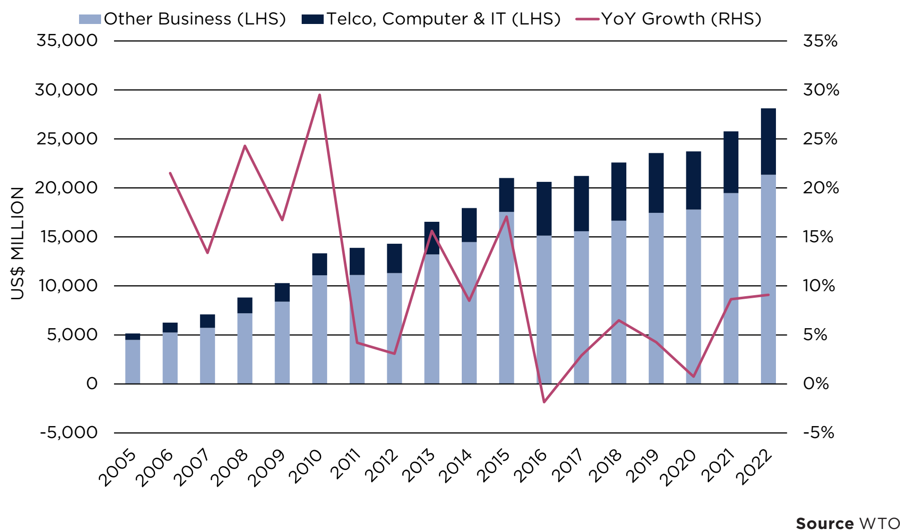
The divergence between office demand and supply has widened in recent quarters

MACROECONOMY

The Philippine Gross Domestic Product (GDP) grew by 6.4% in Q1/2023 – its slowest since the economy rebounded in Q2/2021. Domestic consumption took a massive hit from rising interest rates as it started to decelerate to 6.3% YoY from 8.3% in 2022. Merchandise exports also took a hit when semiconductor exports dropped as a consequence of the chips trade conflict between the United States and China. On the other hand, service exports continued to grow in double digits, recording 19.9% YoY growth during the quarter. Service exports in travel and transport returned to their pre-pandemic levels, reflecting economic activity moving back to normalcy. Information technology and business process management (IT-BPM) services continued to drive more than two-thirds of service exports in Q1/2023.

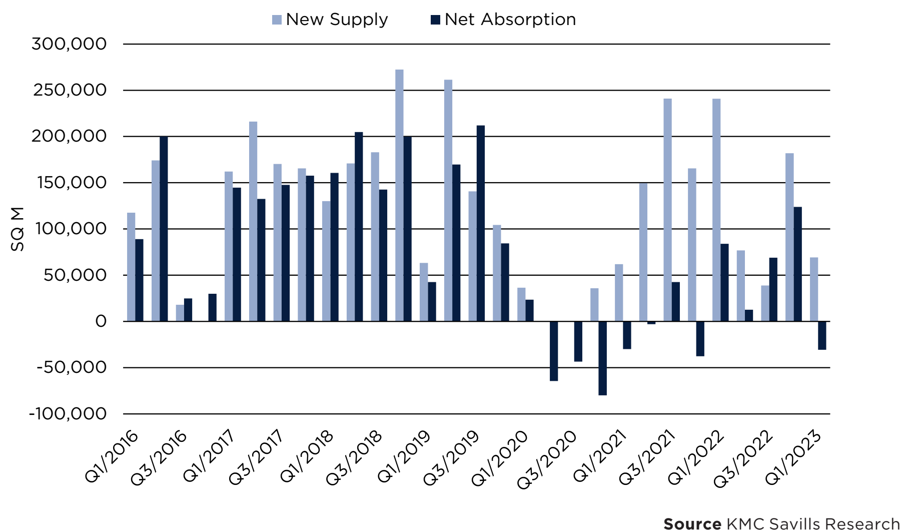
The IT-BPM service exports accelerated by 9.1% YoY in 2022 after recovering by 8.6% YoY in 2021. Its resiliency was also on display during the COVID-19 lockdowns as it grew by 0.7% in 2020. Industry leaders remain bullish on their growth prospects amidst threats of a global recession and trade disputes. It has remained the bedrock of Philippine exports as the semiconductor industry adjusts to new global trade policies.

GRAPH 1: Philippine IT-BPM Services Exports, 2005 to 2022



Source WTO

GRAPH 2: Grade A Office New Supply and Net Absoprtion, Q1/2016 to Q1/2023



Source KMC Savills Research

SUPPLY

In the real estate sector, the IT-BPM industry has shaped the Metro Manila skyline as business outsourcing firms constitute the largest occupiers of the capital's Grade A office stock. Landlords have catered to the industry by constructing according to their preferred specifications (e.g. larger floor layouts, 24/7 operations) and accrediting these buildings with the Philippine Economic Zone Authority (PEZA). IT-oriented economic zones account for more than two-thirds of all PEZA-accredited ecozones in the country. The metro also hosts more than 6 million sq m of PEZA-registered office buildings.

Historically, the Makati CBD has been the country's premier home of office buildings, with Ortigas Center as its closest rival. Today, the capital has six distinct submarkets that account for 79.5% of Grade A office stock. Makati CBD is still the premier financial district and is home to several local conglomerates and multinational companies, but Bonifacio Global City (BGC) has now become the leader with 2.1 million sq m of office space. Additionally, more than half of BGC's stock are green buildings certified by the LEED Rating System. With newer and greener buildings, BGC has become the most sought-after submarket by either traditional or outsourcing tenants – overtaking both the Makati CBD and Ortigas Center in less than a decade.

DEMAND

Despite the resiliency and continued growth of the IT-BPM sector, office demand has been tepid. Net absorption in 1H/2023 is expected to hit 73,900 sq m compared to the 106,800 sq m recorded a year earlier. The lack of demand has been a key concern because of the incoming supply. Since the economy re-opened, 1.5 million sq m has been completed and close to a million more is expected to come online by 2025. Vacancy rates have remained elevated with the average still in double digits at 20.1% in Q1/2023.

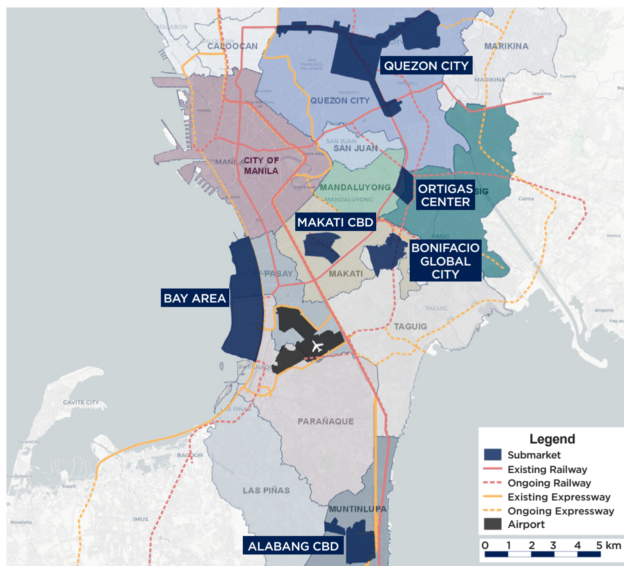
The pandemic has structurally changed office demand as work-from-home and other hybrid policies have taken root across the world. Additional headcount no longer means an increase in office space. Office floor plans of today have ditched the cubicle office design for open floor layouts. In Metro Manila, that is also the case as the business outsourcing sector consolidates their office

portfolio to incorporate a flexible workforce. Qualified leads since the economy reopened have skewed towards smaller requirements with whole-floor inquiries close to non-existent. Current tenants have started downsizing their premises or cancelled any expansion plans.

Demand has not only weakened but will start to migrate outside of Metro Manila. The IT-BPM sector is forecasted to employ an additional million full-time employees (FTE) from 2022 to 2028, but half of these will be in provincial cities, such as Cebu, Iloilo, and Bacolod. Together with flexible work arrangements and a massive construction pipeline, the Metro Manila Grade A office market is set to have a challenging road ahead.

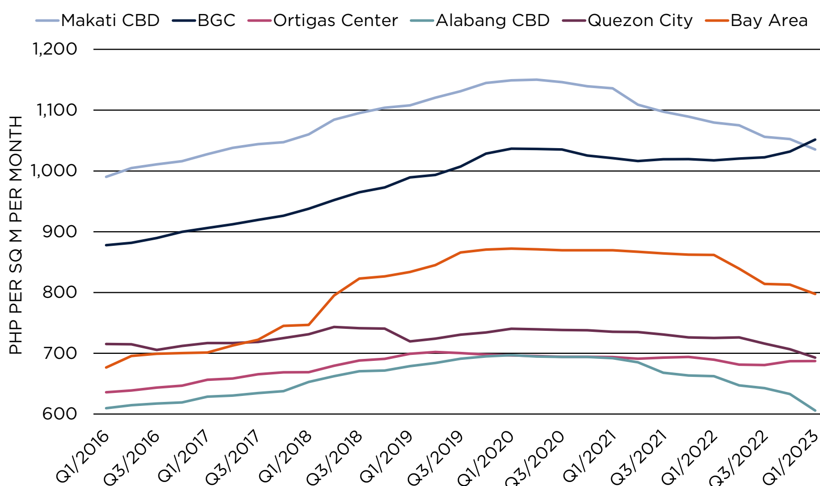
Despite the resilience and continued growth of the IT-BPM sector, office demand has been tepid. Net absorption in 1H/2023 is expected to hit 73,900 sq m compared to the 106,800 sq m recorded a year earlier.

MAP 1: Metro Manila Grade A Office by Submarket



Source KMC Savills Research

GRAPH 3: Metro Manila Grade A Office Rents by Submarket, Q1/2016 to Q1/2023



Source KMC Savills Research

RENTAL PERFORMANCE

Even with the unfavorable supply-demand conditions in the market, the average rent in Metro Manila has eroded less than anticipated. The capital's Grade A average rent has dropped by only 2.8% since the start of the lockdowns late in Q1/2020. However, this does not mean that the rental trajectories for all six submarkets have been relatively unchanged. During the same period, rents in the Bay Area and Alabang have dropped by 8.6% and 13.1% respectively while a 1.4% growth was recorded in BGC. Quezon City suffered similar rental declines, but rents in Ortigas Center roughly budged. Despite high absorption rates for its newer stock, rates in Makati CBD are weighed down by its aging buildings.

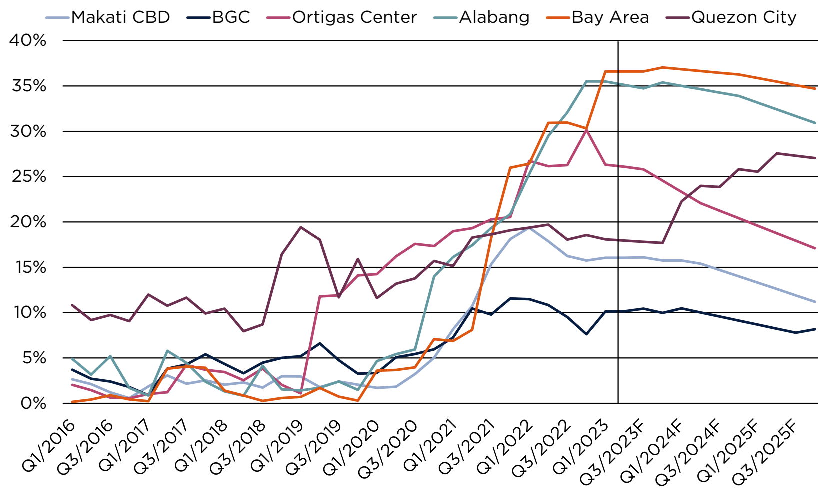
Although the rental declines have been significant in the worst-hit submarkets, these movements are not as severe as the 22.8% drop Metro Manila experienced from Q4/2007 to Q4/2009. The quick adjustment from landlords and the resurging IT-BPM industry demand in the post-Global Financial Crisis kept vacancy rates within 10% until dropping to single digits in 2010. Landlords today are preserving their headline rates in exchange for generous incentives (i.e. significantly longer rent-free periods). This has deterred any traction for a quicker recovery in the office market.

Some landlords' reluctance to adapt may be because of the lucrative rents paid by the Philippine Offshore Gaming Operators (POGO) sector prior to the pandemic. Though the sector's exodus created a gaping hole in Alabang and the Bay Area, landlords have already adjusted headline rates accordingly but are still heavily anchored on pre-pandemic rates. The bias has been hard to shake off, but given current market conditions, a further reduction is warranted.

OUTLOOK

The divergence between demand and supply has increased in recent quarters, and we do not expect vacancy conditions to return to pre-pandemic levels soon. The average

GRAPH 4: Grade A Office Vacancy Rates and Forecast, Q1/2016 to Q4/2025F



Source KMC Savills Research

occupancy rate is expected to remain within 85% until 2025 unless workforce policies change or a new sector fills the gap. On the other hand, we still believe the office still has a meaningful place in business, and teams will still demand space to collaborate and remain productive despite the myriad of online and virtual platforms.

In addition, the disagreement between PEZA and the IT-BPM sector on flexible and hybrid policies has resulted in outsourcing firms foregoing their incentives and transferring to the Board of Investments (BOI). PEZA retains its position that 90% of the IT-BPM workforce should return to the IT ecozones. This essentially has broken the monopoly of PEZA-certified buildings on the outsourcing sector during a time when companies implement successful hybrid and work-from-home policies. As such, regulatory changes may have increased landlord competition as newer non-PEZA buildings have become acceptable locations for outsourcing operations.

Lastly, leasing activity continues to drift toward the top markets of Makati CBD, BGC, and Ortigas Center. However, the success of Ortigas Center in attracting large occupiers due to its affordability and quality stock has endangered BGC's chances of further improving its footing in the market. The added competition may cap any rental growth which could be exacerbated if landlords in Makati CBD further drop rents to remain competitive.

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