Asian Cities - 1H 2023

SPOTLIGHT

Savills Research

Singapore Offices

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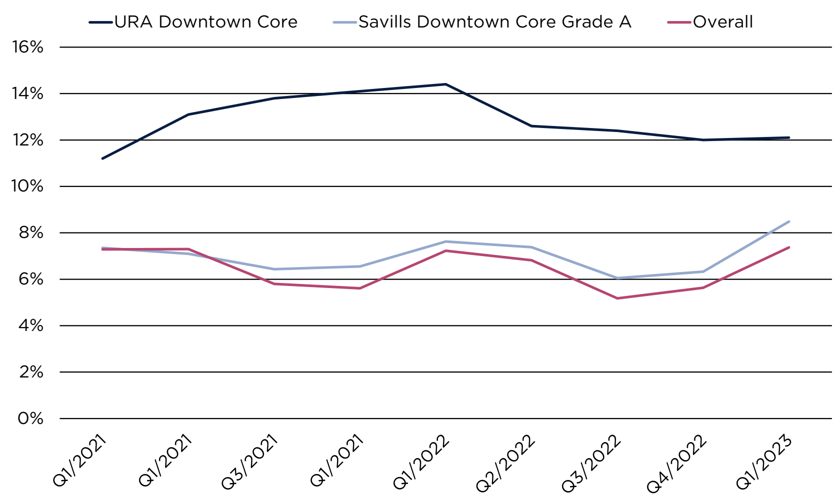
Should landlords fear their own shadows?

OVERVIEW

With increasing economic challenges and the shedding of workers in the tech industry, the Singapore office market is now at a crossroads. Although many tenants have been impacted by the troubles afflicting their respective industries, their office leases still have a reasonable runway left, courtesy of signing long term leases when times were good. However, today, more find themselves with space which they do not need and are actively trying to lease out. This is shadow space. So, while occupancies are still healthy, shadow space is emerging.

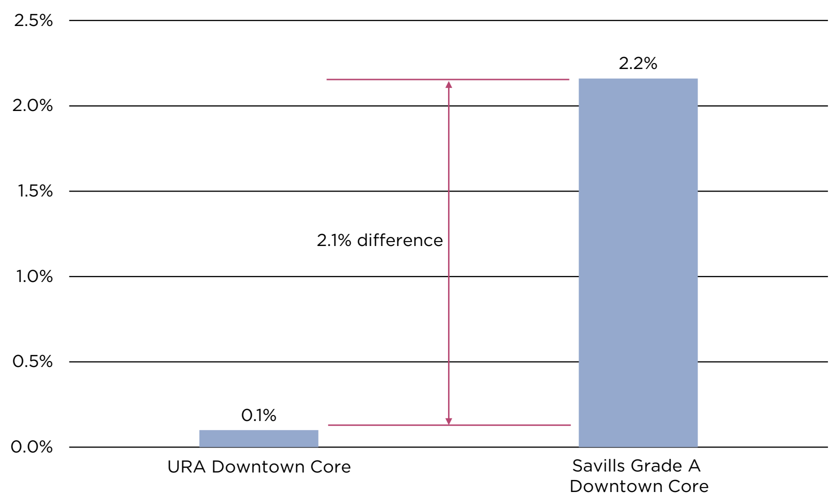
The big question is, how much shadow space is there in the Downtown Core Grade A CBD market? Other than doing a manual count of the available space which the leasing professionals are aware of, the other method is to compare the URA vacancy rate with our in-house rate. At Savills, we capture both actual vacancy as well as shadow space. The URA's numbers record vacant space mostly from surveys and better reflect the actual space available for letting from the landlord. By comparing Savills numbers with URA's we can tease out the amount of shadow space in the Downtown Core CBD Grade A market. We begin by looking at Graph 1 and it shows that there is a noticeable divergence between the URA's and Savills vacancy rates in Q1/2023.

GRAPH 1: URA vs Savills Vacancy Rate for Downtown Core, Q1/2021 to Q1/2023



Source URA Realis, Savills Research & Consultancy

GRAPH 2: Vacancy Rate for Downtown Core, URA vs Savills, Q1/2023



Source URA Realis, Savills Research & Consultancy

ESTIMATING SHADOW SPACE

For the Downtown Core, in Q1/2023, the URA vacancy rate rose 0.1 percentage points to 12.1%. For Savills Grade A space in the Downtown Core, it increased 2.2 percentage points to 8.5%. If we assume that the underlying relationship between URA's office stock (both Category 1 and Category 2) and Savills basket of Grade A buildings in the Downtown Core was maintained, the net percentage point change of 2.1% (calculated as the 2.2% increase in vacancy from Savills minus the 0.1% increase from URA's figures), could be a proxy for shadow space. Graph 2 shows the different vacancy rates for Q1/2023 and the gap proxying shadow space.

We have in our basket about 31.4 million sq ft of Grade A office space in the Downtown Core area, and at 2.1%, the estimated shadow space is about 660,000 sq ft. At first glance, if we compare it to the average net take-up of 747,000 sq ft of CBD Grade A for the period 2013 to 2022. this looks like a large number (Please refer to Graph 3.)

MANAGEABLE SHADOW SPACE

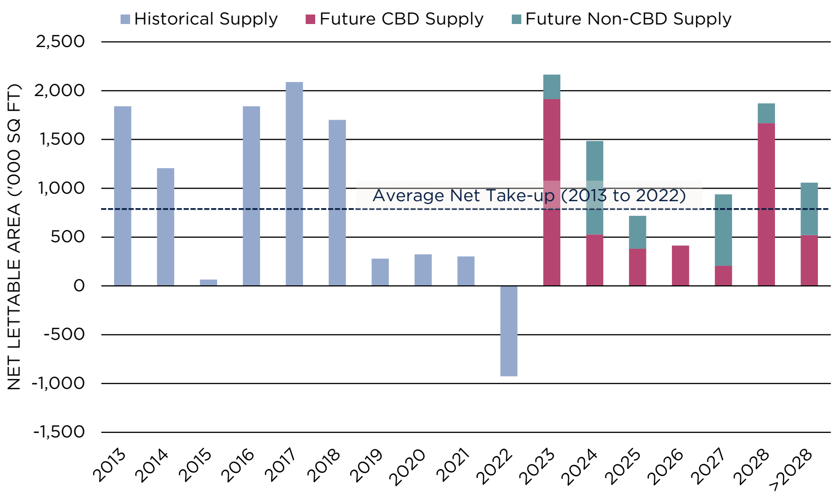
If we spread the shadow space amongst the multitude of Grade A office buildings in our Downtown Core basket, it is still manageable. We do not believe that the underlying actual vacancy rate has changed that much in Q1/2023. In Q4/2022, the vacancy rate for Savills Downtown Core was 6.3% (vs 8.5% in Q1/2023). To landlords, that means the market is still relatively tight for space which tenants want to lease direct and fit-out themselves. We see some evidence of this in Graph 4 where despite the rise in vacancy rates in our basket of CBD Grade A office space, Category 1 office rents rose almost across the board. (From the URA: Category 1 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 plates and gross floor areas.)

From our market knowledge, typically for large tenants, the shadow space available is often over 10,000 sq ft (ie. the >1,000 sq m range) per tenant. However, we find that demand is still concentrated in the <7,000 sq ft range. With the underlying lease still running, landlords appear at this juncture to be unperturbed and this mismatch in size demanded vs size available could be the reason why rents in Q1/2023 still rose.

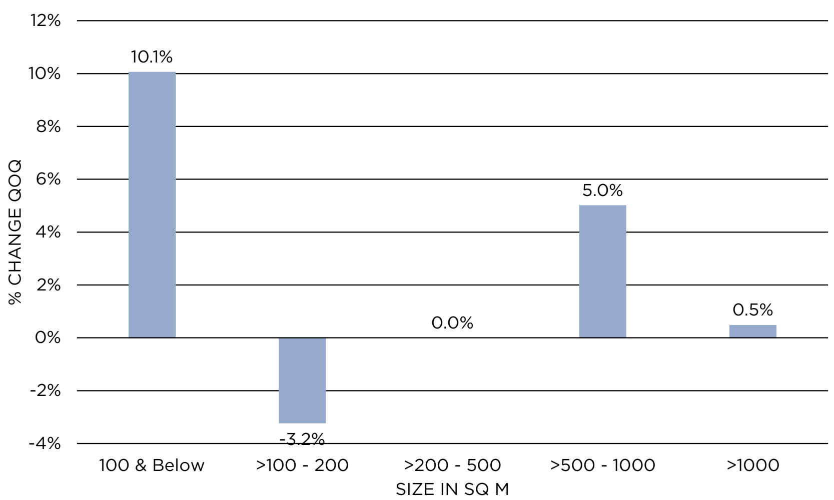
Although 2023 is a year when shadow space is emerging rapidly, rents may still hold as supply is concentrated towards the end of this year and could slip into the next.

GRAPH 3: Historical Average Net Take-Up vs Supply, 2013 to 2028F



Source Savills Research & Consultancy

GRAPH 4: QoQ Change for Category 1 Office Rents, Q1/2023 vs Q4/2022



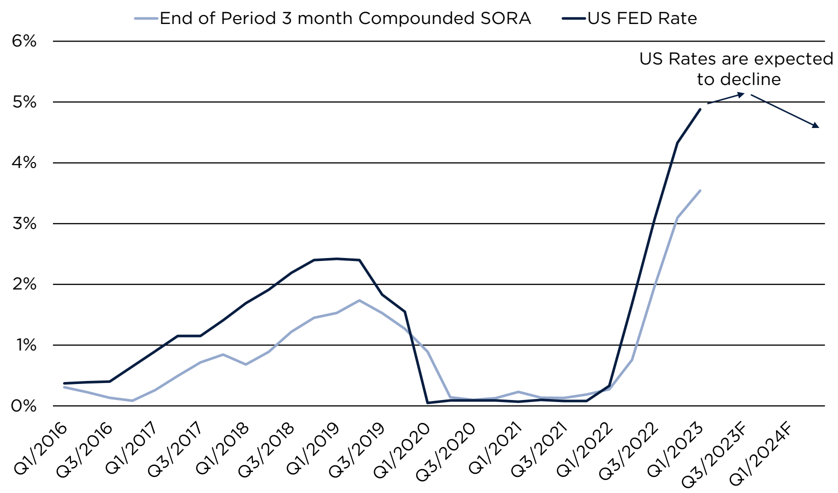
Source URA Realis, Savills Research & Consultancy

OUTLOOK

Moving forward, the market may face turbulence when leases from some big tech companies expire. However, there is a probability that the market could react mildly in 2023. There are a couple of reasons for this. One is landlords remain confident about their finances. Two is that they may have the ability to draw tenants over from non-Green buildings. Demand from tenants seeking environmentally friendly buildings should increase for Grade A buildings in the CBD, all of which carry at least the Gold Plus BCA Green Mark certification. But as these tenants are moving from more economical Grade B or ungraded buildings, they may face budgetary constraints and thus their spatial requirements in Grade A buildings may be small and it will take a while to backfill the increasing vacancy left by the larger tenants.

Besides the exodus to green mark buildings, and notwithstanding mounting economic challenges, the market is also seeing mild space expansion demand from several industries. Whether financial prices head up or down, some hedge funds will still thrive as they are able to take bi-directional bets. Chinese investment firms have also been looking to set up in Singapore albeit the space they are looking for is individually small (2,000 to 3,000 sq ft). Serviced offices are now on the prowl for more space in buildings where the landlord is willing to strike a management deal (in short this means profit sharing). The austere fund raising market for start ups is resulting in these companies either giving up direct leases and heading back to serviced offices or co-working spaces. Over time, we believe that the rapidly growing Artificial Intelligence sub-space within the tech sector is likely to lead to more demand for office (and business park) space.

GRAPH 5: US Fed Rate and 3-month SORA, Q1/2016 to Q2/2024F



Source US Federal Reserve, MAS, Savills Research & Consultancy

Nevertheless, with expectations of interest rates peaking and even reversing in direction, the pressure on landlords to lease out space at all costs could reduce. (Please refer to Graph 5.) Ultimately, if the market behaves as expected, CBD Grade A office rents may be able to ride through this combination of economic uncertainty and tech retrenchment with minimal injuries this year. With inflation still running high, we may still get to see Grade CBD rents rise 2% YoY in 2023 with the rise concentrated in the first half of the year.

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