Asian Cities - 2H 2022

SPOTLIGHT

Savills Research

Singapore Offices

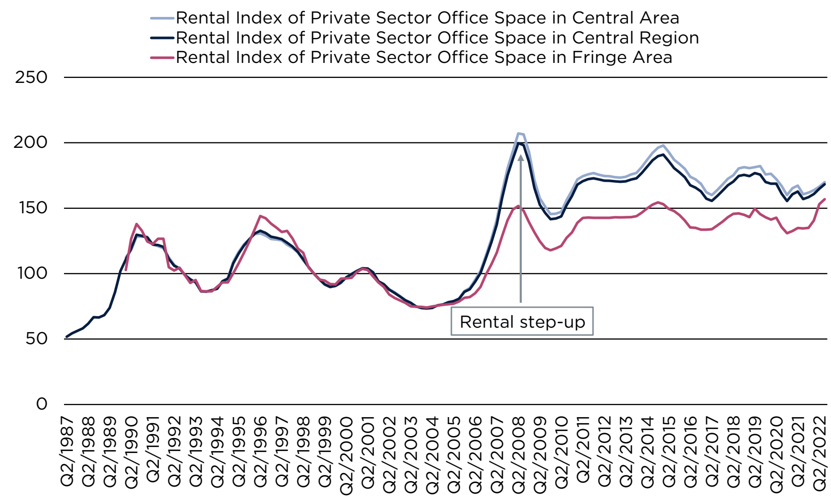
Prime Singapore office building rents ready for a reset

THE NEXT BIG THING – THE FLIGHT TO GREEN BUILDINGS

The Singapore office market is at the early stages of a global transformation where multinational tenants increasingly seek to be compliant with Economic Social and Governance standards set in their respective home countries. In the coming years, this pressure is going to weigh on the local real estate market, especially the office sector. This, and the re-ordering of centres of production caused by global political tensions is expected to remould the market from that which emerged after the global financial crisis in 2008 to what was shaped from Q1/2022 by the SARs-CoV-2 virus outbreak.

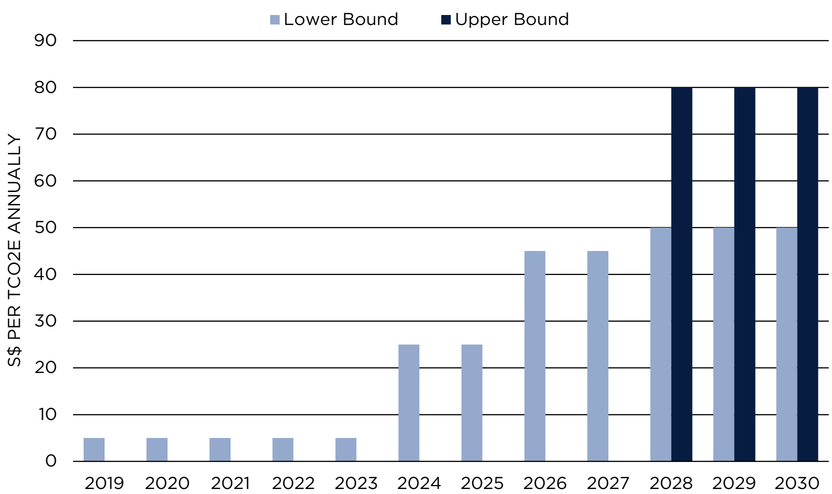
The previous decade has seen the emergence of what we term AAA-Grade offices which have surpassed the previous highwater AA-Grade building specifications. The latter were the crème-de-la-crème of offices from the 1980s to the mid-2000s. Rents were bumped up to a new baseline.

GRAPH 1: Office Rental Index by Area, Q2/1987 to Q3/2022



Source URA, Savills Research & Consultancy

GRAPH 2: Singapore Carbon Tax Rate - For those who emit at least 25,000 tCO2e annually, 2019 to 2030



Source National Climate Change Secretariat, Savills Research & Consultancy

(In 2007, rents spiked not because of the completion of Grade AAA buildings but a severe crunch in office space.) It was during this time that rents started to differentiate themselves by location. As more Grade A office buildings were developed in the Central Area, rents pulled ahead of those in the Fringe Area. (Please refer to Graph 1.)

Increasingly, as more real estate is drawn into an ESR regime, office rents for the top-grade buildings may be given a boost by the need of multinationals to comply with their home country regulations. Also, with the Building & Construction Authority's (BCA) Green Mark 2021 certification scheme, embedded carbon is now a consideration which commercial property developers have to bear in mind for new builds and landlords of existing buildings have to think through before embarking on addition and alteration works. Although adherence is not yet compulsory, it may over time be either made so or incentives could be introduced for parties to commit to it.

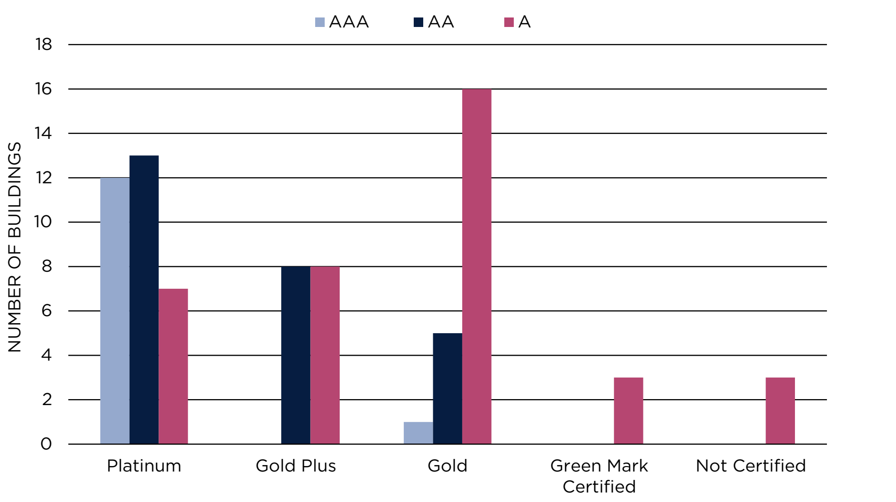
Given that parts of the CBD have ageing buildings, but their micro-locations are secondary, these buildings may either be redeveloped or repurposed for other uses with a lesser office content. The sharp rise in construction costs caused by the pandemic plus the fact that for now, green building and mechanical & electrical technology comes at a cost, may not tilt the cost benefit analysis in favour of office use in these secondary locations in our Downtown CBD. With the dilutive impact planned regional centres have on office demand, and the adoption of hybrid working, town planners may need to rein in the future supply of land for Grade A office developments.

All this works in favour of existing A graded green rated buildings which may be able to leverage on this epochal change and in the process be able to reset their rents to a higher base. We believe that there are grounds for such a view. For one, multinationals currently housed in non-green rated buildings here may find rents sticky on the downside because our carbon tax rate will be increasing throughout the course of this decade. (Please refer to Graph 2.) These older buildings may have lower floor efficiencies and because their rents are low, the cost benefit trade off to upgrade their M&E services may be tilted in favour of doing nothing. Over time, these buildings will either be redeveloped or repurposed to other uses. In the process of redeveloping or repurposing, the office supply will be reduced.

Graph 3 shows the number of green rated Grade A buildings in Savills basket of office buildings. By descending order of green rating standards, with Platinum being the highest, the number of buildings falling under each rating basket is correlated with our sub-grading status of CBD offices. So, we see that in our basket, Grade AAA and AA has the highest number of buildings which is conferred the Platinum rating while some Grade A buildings are not even certified. Over time, as an increasing number of tenants need to comply with ESG standards, their decisions will compress them into Grade A buildings with at least some form of green rating.

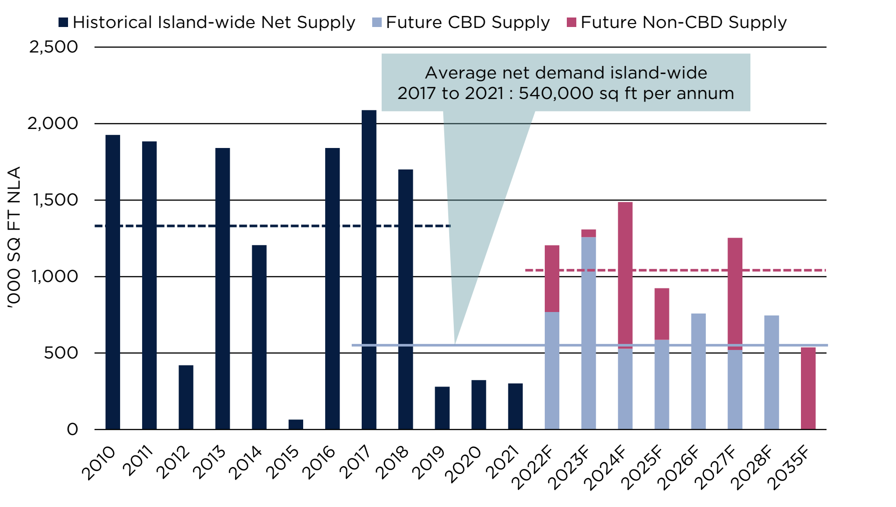
Compliance with increasingly stricter ESG standards is likely to redefine the office demand market. With ESG dominating all aspects of commercial discussions, office demand is following in tandem, increasingly favouring environmentally friendly buildings.

GRAPH 3: Savills CBD Grade A Office Green Mark Ratings, Q3/2022



Source BCA, Savills Research & Consultancy

GRAPH 4: Historical Islandwide and Future Supply (CBD & Non-CBD), 2010 to 2035F



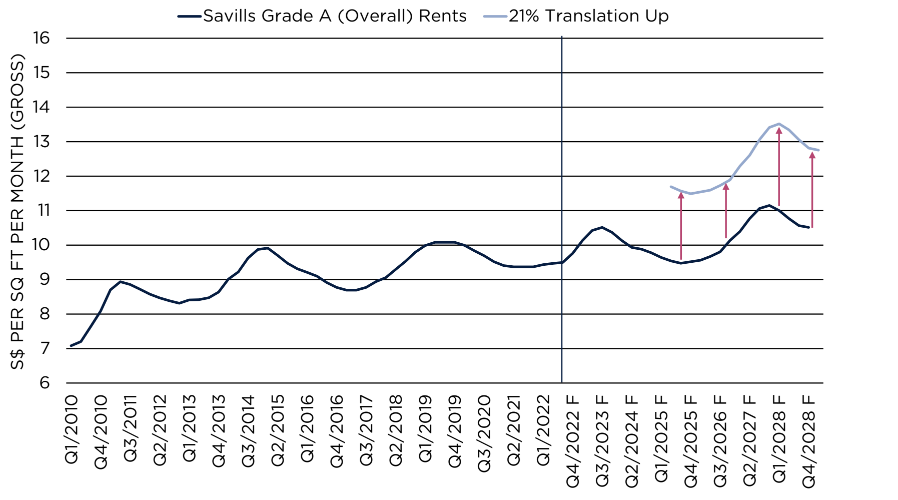
Source Savills Research & Consultancy

Although there are opposing forces, such as hybrid working arrangements and the reduction of commuting frequencies to reduce workers carbon footprint acting to reduce the office footprint, the balancing force is that future expected supply of office space is likely to be significantly lower than the historical 10-year period average from 2010 to 2019 (excluding the disruptive years of 2020 and 2021). We believe that the islandwide future supply of offices from 2022 to 2035 is slightly over 1 million sq ft net lettable area (NLA). For the period 2010 to 2019, the 10-year historical average was about 1.3 million sq ft. Not only is future new supply expected to come off by 23%, one has to bear in mind the potential removal of older stock which is no longer economically viable nor ecologically friendly. Therefore, whilst tenants may contract their office requirements, lower supply numbers will be the counterbalancing force.

For the remainder of 2022 and 2023, near term concerns ranging from global political risks, economic slowdown and a deflating tech economy may weigh on the office market. All this may mask the need for tenants who have to migrate to green buildings, however, most of which are in CBD Grade A stock. However, once the uncertainty begins to lift, we may see another upward shift in rents for buildings which are environmentally friendly.

How much this uplift may be is moot but from the Q1/2010 to Q4/2011 period, with the completion of modern Grade AAA offices in the Marina Bay area, rents in the Central Area rose by 21% (Please refer to Graph 1). Using a machine learning forecasting technique which relies on what transpired in the past 12 years (2010 to 2021), a forecast can be made. This forms a baseline where the market operated in a period of high liquidity, low interest rates,

GRAPH 5: New Baseline Forecast for Overall Grade A CBD Rents, Q1/2010 to Q4/2028F



Source Savills Research & Consultancy

global political stability and where ESG regulations, though increasing in tone, were not overbearing. Graph 5 shows where the old machine-learned baseline forecast would be in 2025 (assuming the global political economy stabilises by then) and beyond. With a translation of 21%, means the office market will enter a new era where ESG consideration will be another key factor influencing tenants locational requirements. (Please note that the 21% uplift is applied to our overall Grade A office rent. This is the average of our AAA, AA and A sub-grades. The baseline forecast for AAA rents show a greater increase than for the overall Grade A average.)

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