Asia Pacific - March 2024

SPOTLIGHT
Savills Research

The Ups and Downs of Office Market Cycles

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The drivers of landlord and tenant marketplaces

Summary

- Positive economic growth has traditionally driven office demand.
- Demand translates into take-up except where space availability is constrained.
- Hybrid and work-from-home arrangements have weakened the relationship between economic growth and take-up.
- Employees are demanding greater amenity in and around the office.
- Investors and corporates are demanding ESG credentials from buildings.
- Two tier markets are likely to appear due to employee, corporate and investor demand.
- Outside China the majority of markets are seeing positive, if not healthy and sustainable growth.
- Where a mature market has limited supply, expect stable/ growing rents for ESG and prime offices.
- Tenant markets are expected in most major regional cities in 2024.
- Rental movements (positive or negative) in the cities we monitor will be modest this year.

FROM ECONOMIC GROWTH TO OFFICE DEMAND

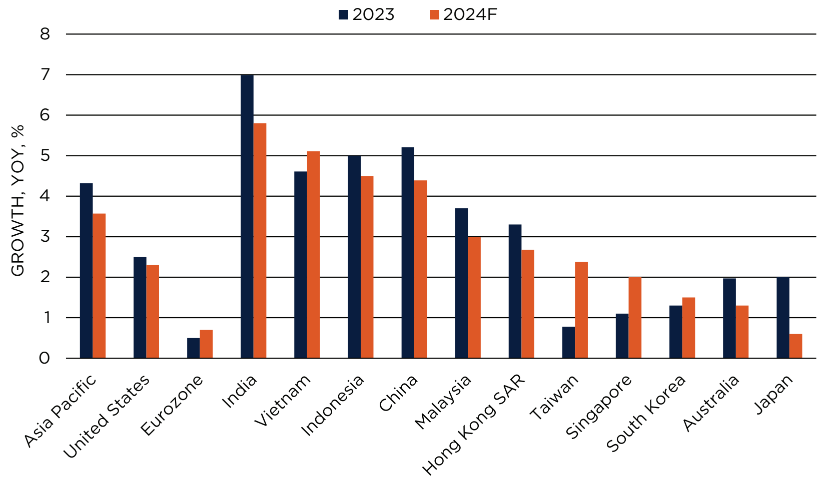
Strong GDP figures[1] broadly mean more commercial activity and greater demand for staff and therefore floorspace from businesses.

This has traditionally been a fairly straightforward and highly correlated relationship but the recent emergence of a variety of hybrid work arrangements including office, home or flex, mean that today's employers may not need as much office space as previously. The degree to which hybrid working takes hold depends on factors as varied as the quality and cost of transport, the size of homes, technology infrastructure, business culture or whether or not individual roles are client facing. Often a more flex design, when ten staff occupy six desks, requires the equivalent space of two desk's worth of space provided in social or alternative work areas. If there is a return to the office, then workers may still want social spaces and alternative work areas which may perversely increase demand.

Beyond economic growth, policy changes can also stimulate (or dampen) office demand. Examples include the opening up of new financial markets, sector subsidies, changes to taxation etc.

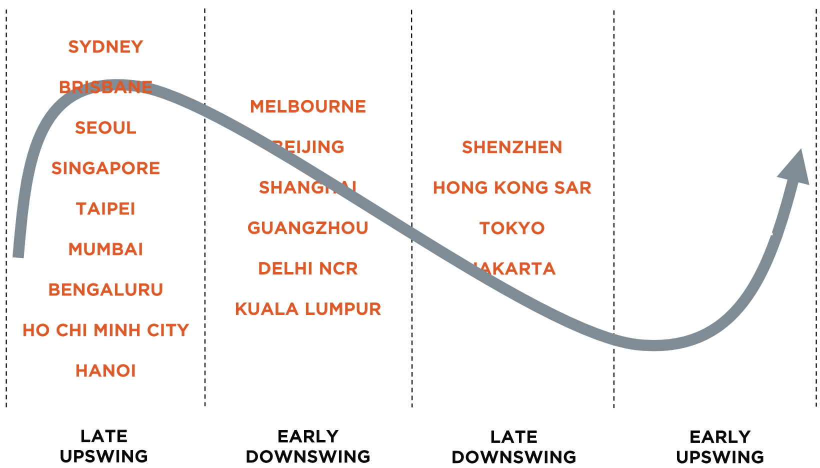
1 Particularly tertiary sector add-value figures.

GRAPH 1: Real GDP Growth by Market, 2023 to 2024F



Source Oxford Economics

GRAPH 2: Prime Office Market Cycles, 2H/2023



Source Savills Research & Consultancy

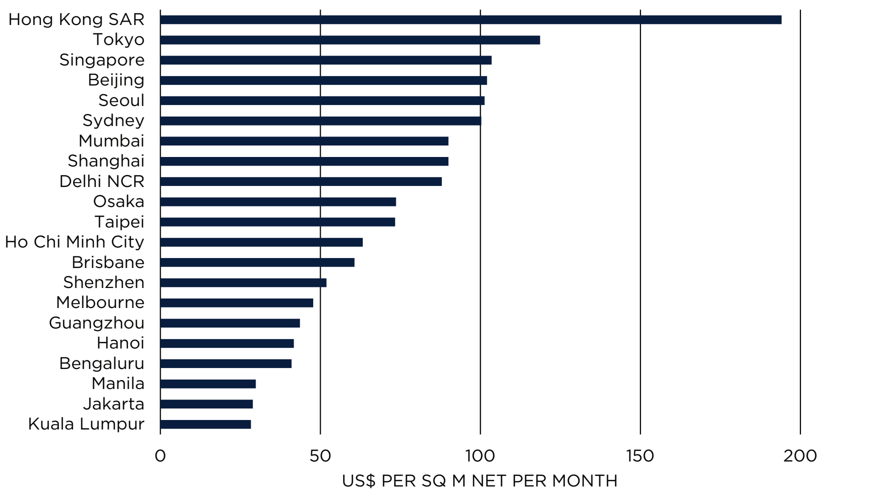
FROM OFFICE DEMAND TO TAKE UP

Greater demand for offices should translate into a higher take-up of floorspace but this is not always the case. Under some circumstances, take-up is constrained by a lack of existing space (vacancy) and/or a lack of supply of new offices. If availability is limited, landlords are able to raise rents and tenants will be required to either accept a higher cost base or be forced to decentralize or downgrade to poorer quality buildings. Given the strength of their bargaining power, a 'landlord's market' materializes.

In the case of abundant space availability, landlords must compete for tenants, ensuring that the potential for rental growth is limited and tenants enjoy greater bargaining power: a 'tenant's market'. Recently, with hybrid work options, a focus on greater amenity and pressure to occupy green certified buildings, businesses have demonstrated a greater bias towards prime offices (or new-build ESG qualified buildings) over lower grade stock than was the case before.

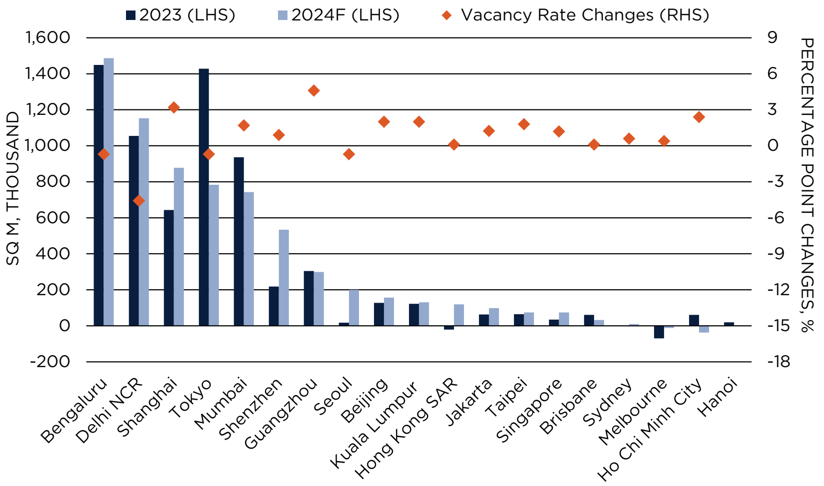
Despite the bleak outlook for office markets elsewhere in the world, many of Asia-Pacific's office markets will see positive rental growth this year.

GRAPH 3: Total Office Occupancy Cost (Top 5 Average), 2H/2023



Source Savills Research & Consultancy

GRAPH 4: Grade A Office Net Take-up and Vacancy Rate Changes by Market, 2023 to 2024F



Source Savills Research & Consultancy
Note Bengaluru, Delhi NCR and Mumbai are gross take-up. Hanoi has no forecasted net take-up and vacancy rate.

FROM TAKE UP TO RENTAL CYCLES

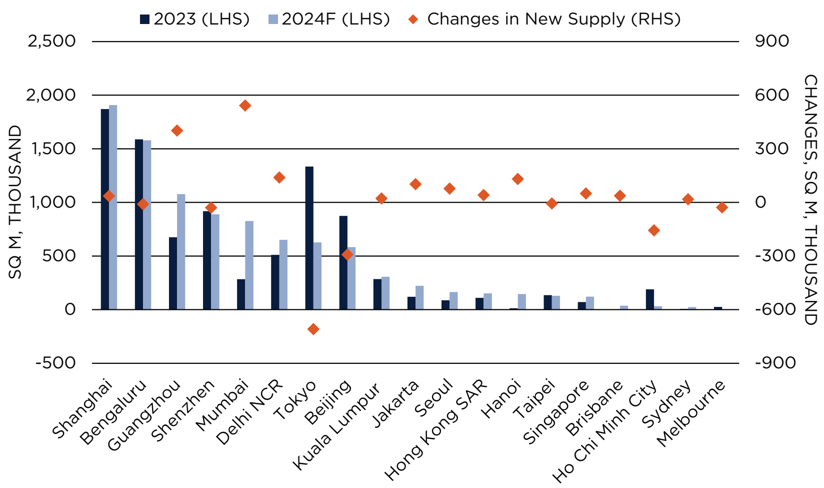
As offices are taken up, a pattern of rental growth emerges as vacancy thresholds are crossed. In developed markets, if vacancy rates fall below 5%, limited availability should trigger rental growth as landlords adopt a firmer stance in lease negotiations. In less developed markets where prime stock is more limited, this figure can be as high as 10% or more[2]. In a positive business environment, profitable businesses will tend to chase prime or ESG qualified stock, and the rental premium of this class of building will rise over other buildings. In a falling market this premium diminishes as tenants are drawn to more cost competitive options in decentralized locations or a lower grade of accommodation. In a downcycle, landlords tend to offer more incentives to tenants and agents before lowering face rents (with implications for portfolio valuations). Incentives typically include longer rent-free periods, fit-out allowances and higher agency fees.

THE ASIA PACIFIC OFFICE MARKETS IN 2024

So where in the cycle are Asia's major office markets? Chart 2 above tracks prime offices only (the overall market will be slightly lagged). Most are in a late upswing where rental growth is slowing, or in an early

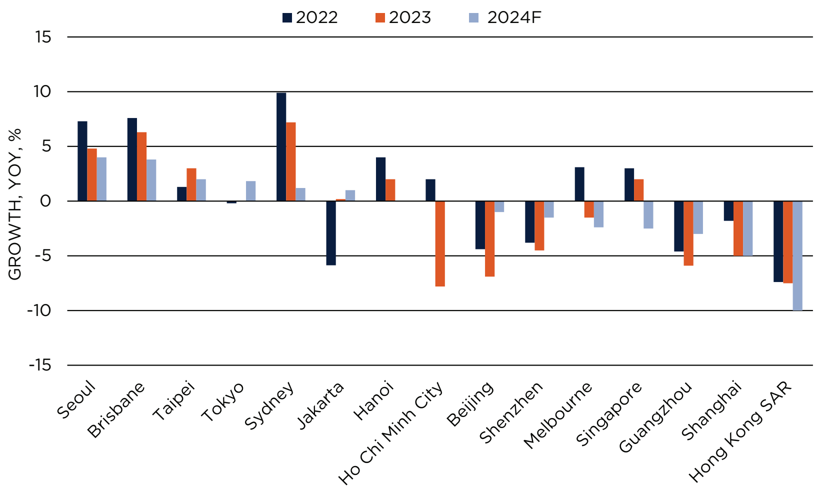
2 A feature of less developed markets is that new supply (often speculatively built) continues to inject new space at a rapid pace which takes time to absorb, meaning vacancy rates can remain low in established stock while high in recently completed stock. The blended average is often higher than more mature markets.

GRAPH 5: Grade A Office New Supply by Market, 2023 to 2024F



Source Savills Research & Consultancy

GRAPH 6: Grade A Office Rental Forecast by Market, 2022 to 2024F



Source Savills Research & Consultancy

downswing where rents are falling. None of the markets we track have yet turned the corner into an early upswing.

The relative sizes of regional office markets tend to be governed by the size of the services sector in each country, and the highest rents tend to be driven by financial services and technology tenants. This helps to explain why, for example, Tokyo, Hong Kong SAR and Singapore consistently offer the most expensive office accommodation in the region. It should be noted that over recent years, the technology sector has seen robust growth and increased demand for office space whereas the finance sector has experienced a contraction.

SO WHAT CAN WE LOOK FORWARD TO IN 2024?

Fortunately, GDP growth is positive across all markets, and will vary from 0.6% (Japan) to 5.8% (India) suggesting strong demand for offices. Our estimates are that take up levels will rise year-on-year in all the city markets we monitor except for Brisbane, Guangzhou Tokyo, Mumbai and Ho Chi Minh where numbers are coming off a high peak in 2023. Disruption from hybrid working appears to be manageable.

Vacancies meanwhile will show modest increases in all markets driven largely by higher new supply levels, except for Tokyo, Seoul, Bengaluru and Delhi NCR.

Almost all markets will favour tenants in 2024 while office markets in Seoul, Delhi NCR, Mumbai and Ho Chi Minh will see landlord strength. In rental terms, Asia Pacific's markets will prove relatively stable, registering only modest rises and declines. Hong Kong SAR is an outlier in this respect and falls of 5% to 10% are expected in an overbuilt market facing weak demand.

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