Hong Kong - September 2022

SPOTLIGHT

*Savills Research*

# Mainland Demand for Hong Kong Property

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# Stronger economic bonds and greater connectivity with the Mainland

## OVERVIEW

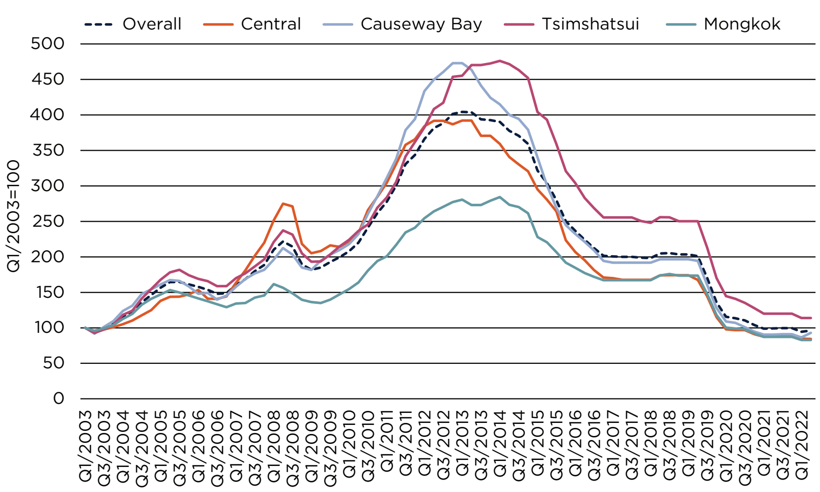
This year marks the 25th anniversary of the establishment of the Hong Kong Special Administrative Region, so it is worth looking at the increasing influence which mainland firms and individuals are having on the city's property markets. Mainland corporate activity in Hong Kong was rather limited in the early 1990s, but the city saw a quick pick-up after the handover as more state corporations started listing on the local stock exchange and private wealth also began to find its way into the city. In those days, in 1990, Hong Kong's GDP was 20% of China's while that figure today stands at around 2% reflecting the fundamental shift in economic dependency which has taken place over 30 years.

But it wasn't really until the Closer Economic Partnership Arrangement was signed in 2003 that trade and investment volumes began to take off in earnest and mainland corporate activity broadened to encompass a much wider range of business sectors from finance to energy, construction to tourism, real estate to insurance. Since then, a number of initiatives have sought to foster closer economic ties, the most significant of which involves the closer integration of the Pearl River Delta Greater Bay Area (a framework agreement between the National Development and Reform Commission and the Guangzhou, Macau and Hong Kong governments was signed in 2017). Part of the plan involves a 'one-hour living circle' between Hong Kong and neighbouring cities in Guangdong and Macau. Other major initiatives have included the Hong Kong Shanghai and Shenzhen Stock Connect Schemes of 2014 and 2016 as well as the launch of Wealth Management Connect in 2021.

Just as regulation has greyed the boundary between Hong Kong and the mainland, infrastructure initiatives have also driven integration with major new cross-border transport links and planned new development areas (NDAs). The Shenzhen Bay Bridge was opened to traffic in 2007 on the western side of Hong Kong, the Hong Kong-Zhuhai-Macau Bridge was completed in 2018, the Guangzhou-Shenzhen-Hong Kong Express Rail Link also in 2018 while the Heung Yuen Wai Highway which takes traffic to a new border control point east of Lo Wu was finished in 2019. Also under consideration are a Western Rail Link to Qianhai Co-operation Zone in Shenzhen and a Northern Link Spur Line running through the 87-hectare San Tin Technopole innovation and technology park currently under construction on the border with China and jointly administered by Shenzhen and Hong Kong.

The Northern Metropolis introduced in the 2021 Policy Address is the most significant initiative of recent years, and includes plans for Hung Shiu Kiu, a 'regional economic and civil hub' in the western New Territories positioned to take advantage of the Shenzhen Bay Bridge and the Tuen Mun-Chek Lap Kok Link to the airport where a third runway has recently been completed. The NDA is destined to house 20 million sq ft of commercial floor area and 43 million sq ft of industrial space when complete in 2037/38. The broader Northern Metropolis Strategic Spatial Framework envisages 'Twin Cities, Three Circles' to enhance inter-city cooperation.

**GRAPH 1: Savills Prime Street Shop Rental Index, Q1/2003 to Q2/2022**




**Source** Savills Research & Consultancy

## SOFT RETAIL MARKET CONDITIONS TO PERSIST UNTIL THE RETURN OF MAINLAND CHINESE SHOPPERS

So, what has all this meant for our local property markets? Retail has been most affected, and the early catalyst can be found in the Individual Visitor Scheme (IVS) of 2003 which opened the door to Mainland tourism on a huge scale. While the number of mainland Chinese tourist arrivals peaked in 2018 at 51 million visits, per capita shopping spending peaked in 2013 at HK$4,145. The surge in shopping spending led to most luxury retailers reporting world-beating sales turnover and street shop rents rose by 304.3% between 2003 and their peak in 2013. The impact on the trade and tenant mix on high streets and in shopping malls was profound as landlords weighted towards international brand names and discretionary spending. Pharmaceuticals, cosmetics, and the latest electronics also topped Mainland shopping lists. A pandemic-induced hiatus has inevitably brought the retail market back down to earth, and rents have fallen by 76.6% from the peak of Q1/2013 to Q2/2022, which are at or close to pre-IVS levels, while domestic demand now drives spending.

Will the giddy days of 2013 return? Most luxury retailers think probably not, but once the tourists return, we may see a slow climb back to 60% or even 70% of peak levels. We have seen a consistent decline in shopping spending among mainland Chinese visitors under the influence of a few factors, including the new emphasis on common prosperity which could discourage extravagant shopping sprees, the narrowing price gap as the Chinese government begins to develop its free-trade ports, as well as a growing emphasis on consumption reshoring. The border shutdown has also redirected a lot of overseas spending into new domestic destinations such as Hainan.

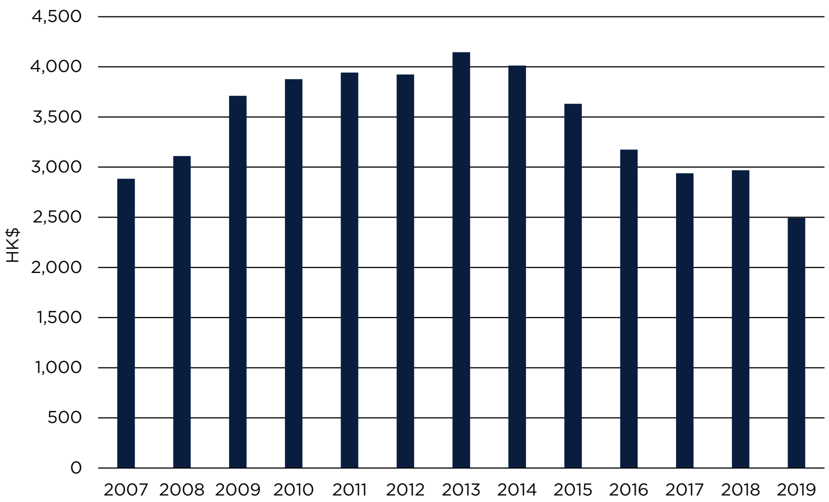
With prime retail rents largely supported by luxury sales, we expect another multi-year rally will only take place alongside the return of mainland shoppers. Until then, today's soft market conditions are likely to persist.

### GROWING DOMINANCE OF PRC DEMAND IN THE GRADE A OFFICE MARKET

In the office market, international financial services tenants have driven demand for Central space ever since Hong Kong emerged as a global financial centre in the 1980s, but Mainland firms now dominate with an 80% share by market cap of the Hong Kong Exchange and an 85% share of IPO funds raised over the past five years. Not surprisingly, this has translated into office take up and PRC businesses now occupy around 25% of Central Grade A space (21% in Admiralty and 36% in Sheung Wan) favouring landmark properties and sweeping harbour views. Private funds and asset managers dominate the tenant profile followed by securities, banking and (until recently) real estate. Demand is very core-focused , which include the Central, Wan Chai/Causeway Bay and Tsim Sha Tsui district, with little appetite currently to lease in more decentralized areas. While PRC takeup fell below 400,000 sq ft in 2019 amid the social unrest, by 2021 it had rebounded to nearer 500,000 sq ft, almost on par with the 2018 volume, showing remarkable resilience in the face of the pandemic.

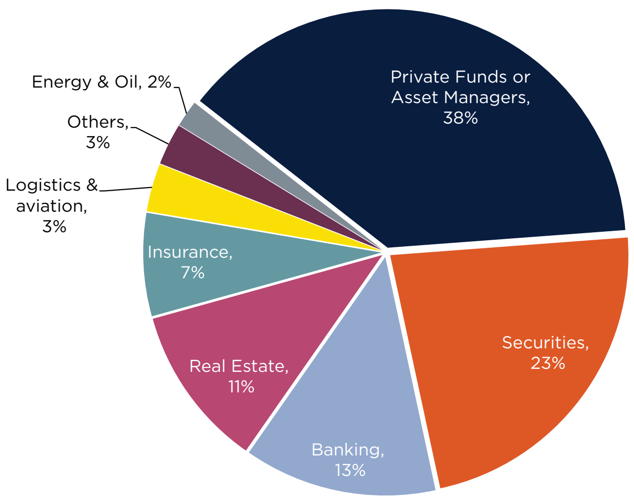
## Despite the near-term headwinds, Hong Kong remains an attractive investment hotspot in Asia Pacific and a broad-based market recovery is expected once PRC demand returns.

**GRAPH 2: Mainland Chinese Tourist per Capita Spending on Shopping, 2007 to 2019**




**Source** Hong Kong Tourism Board

**GRAPH 3: New PRC Grade A Office Lettings by Industry, 2021**

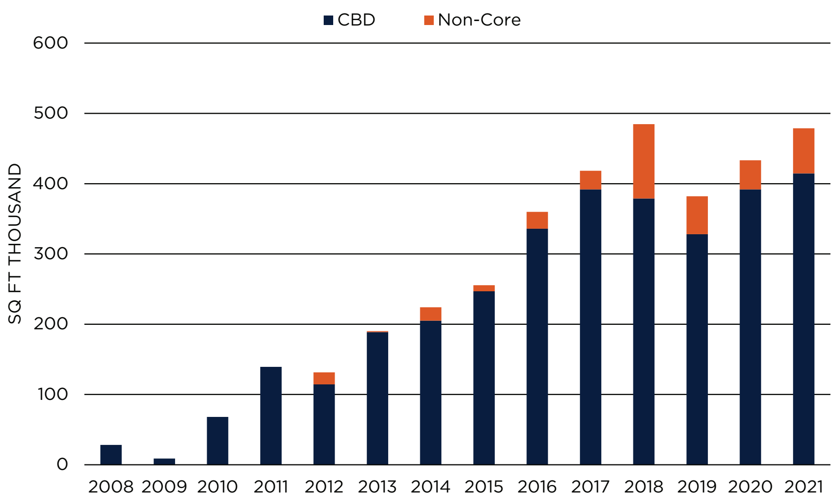



**Source** Savills Research & Consultancy

On the investment side, PRC buyers were more active between 2016 and 2018 when the Hong Kong Grade A office market was on the rise. Though en-bloc transactions were relatively limited, these deals usually involved high-profile Grade A office buildings in prime locations. As an example, Ping An Life Insurance acquired a 30% interest in the office portion of the West Kowloon Station project from SHKP for HK$11.27 billion in 2020. PRC buyers were also a key driver of strata-title Grade A office prices, particularly with a series of strata sales taking place at the Center in Central. However, in light of the recent debt woes, the market has seen some divestment taking place since 2021. China Evergrande, reportedly, is marketing its Hong Kong headquarters for HK$9 billion to raise cash, about 28% less than the acquisition price the group paid in 2015.

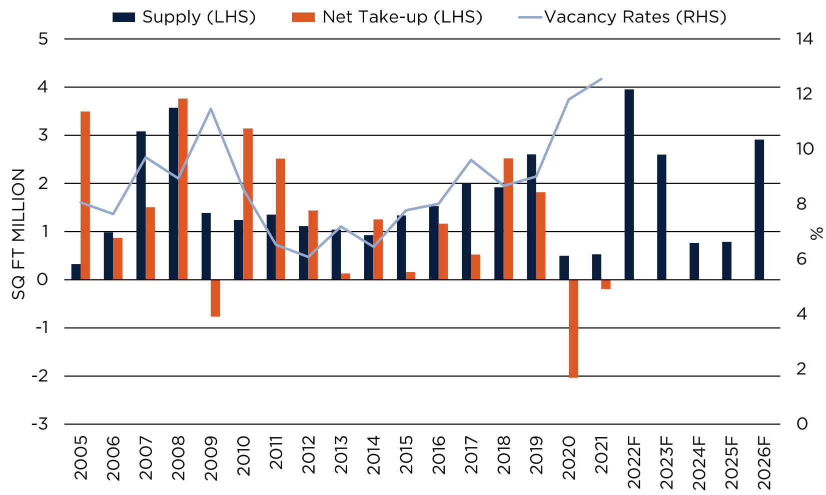
Looking ahead, the estimated supply pipeline of Grade A offices from 2022 to 2024 shows that a total of 11 million sq ft will come online while annual take-up over the period could only average around 1.3 million sq ft net under normal circumstances. Supply pressures will undoubtedly reinforce the downward trend in both rents and capital values until 2024, dampening investment sentiment. As the market shifts

**GRAPH 4: New PRC Grade A Office Lettings by District, 2008 to 2021**



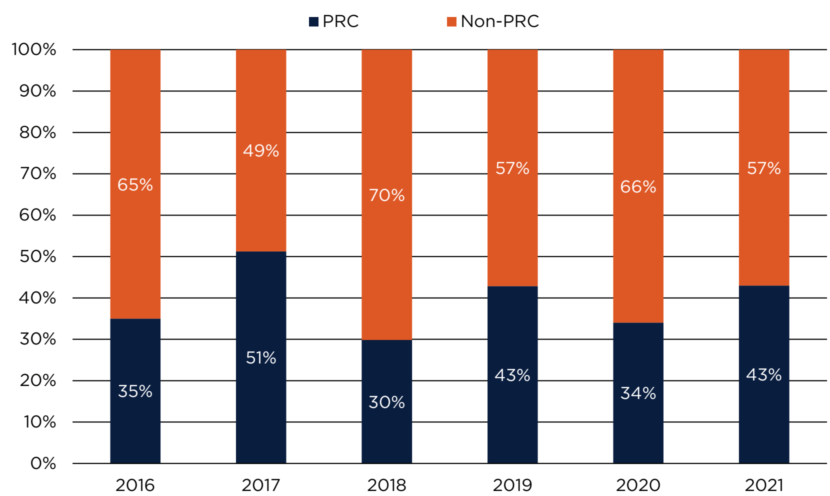

**Source** Savills Research & Consultancy

**GRAPH 5: Grade A Office Supply, Net Take-up and Vacancy Rates, 2005 to 2026F**




**Source** Rating and Valuation Department, Savills Research & Consultancy

**GRAPH 6: Super Luxury Residential Property Transaction Volume by Buyer Profile, 2016 to 2021**




**Source** EPRC, Savills Research & Consultancy
**Note** Only includes transaction valued above HK$100 million

more in favour of tenants, we expect to see a wider range of mainland businesses represented outside the typical banking and finance trades, as well as a wider dispersion in terms of geography and building grade. Despite their growing importance in other global first-tier cities, demand from tech tenants is likely to remain firmly focused on Shenzhen for now.

## HONG KONG REMAINS ATTRACTIVE TO MAINLAND LUXURY HOMEBUYERS

Residential markets have not been unaffected. Typically, people who have made their money in finance and technology in the GBA seek out the best 'super-luxury' homes on the Peak, in Mid-Levels and Southside while mega yachts have recently begun to appear in local marinas. For houses valued above HK$100 million, Mainlanders have typically represented around 40% of buyers over the past five years.

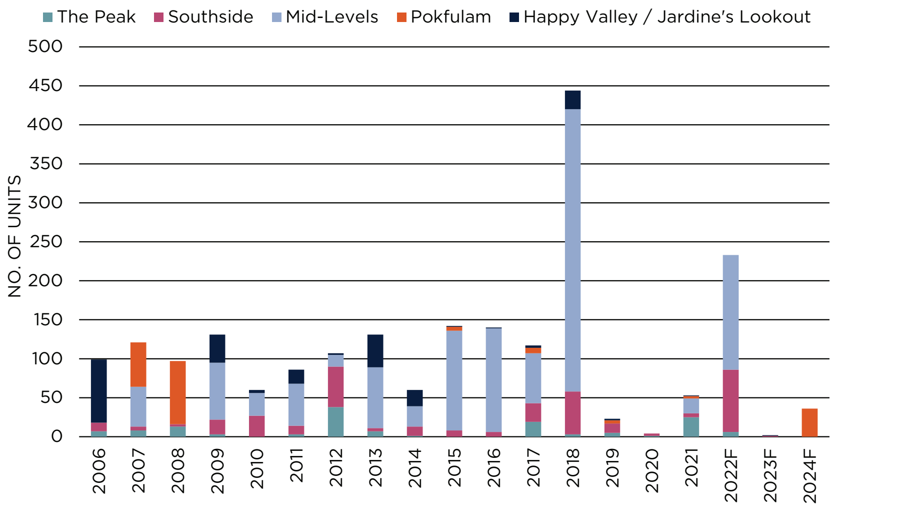
Looking ahead, we remain cautious about the recovery of the local luxury residential market, as near-term headwinds still bring a lot of uncertainty to the market. Apart from the limited visibility of the border reopening timeline, a lacklustre economy both at home and abroad, as well as the pace of interest rate hikes could also negatively impact Mainland HNWIs' willingness to invest in Hong Kong.

Even though these buyers are still finding it difficult to cross the border, their interest in Hong Kong's residential market should remain intact as the city is still an extremely attractive domicile in the GBA with its international lifestyle and extensive air links. Meanwhile, the tight supply pipeline over the next two to three years, with around 90 luxury units scheduled for completion per annum, will also limit the potential for a price correction.

## MAINLANDERS AND NEW HONGKONGERS DRIVE LEASING MOMENTUM FOR LUXURY HOMES

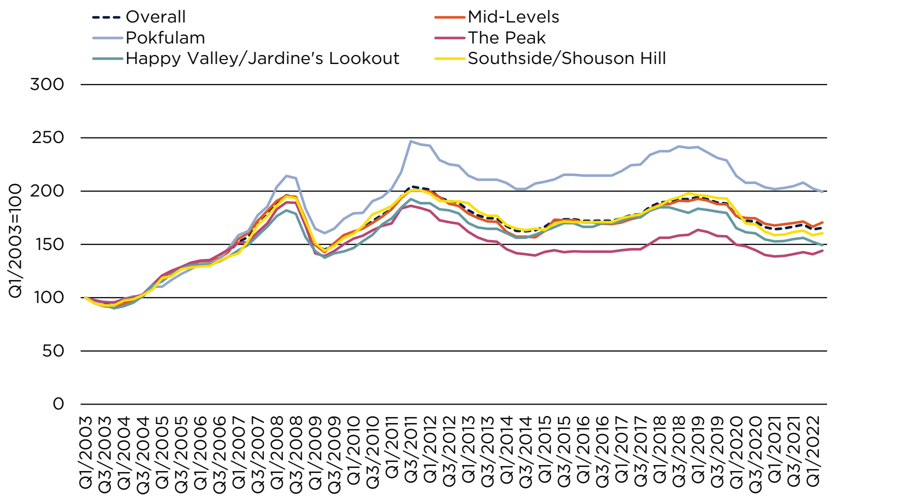
In the luxury leasing market, mainland professionals are more visible. The Admission Scheme for Mainland Talents and Professionals (ASMTP) was introduced in 2003 and allows Mainland Chinese residents who possess special skills, knowledge or experience not readily available in Hong Kong to apply for a visa. The initial visa is for 24 months which can be extended on a 3-3 yearly basis. Other schemes include the General Employment Policy which allows local employers to recruit professionals not readily available in Hong Kong and the Immigration Arrangements for Non-local Graduates (IANG) which is applicable for those who have obtained an undergraduate

**GRAPH 7: Luxury Residential Supply by District, 2021 to 2024F**



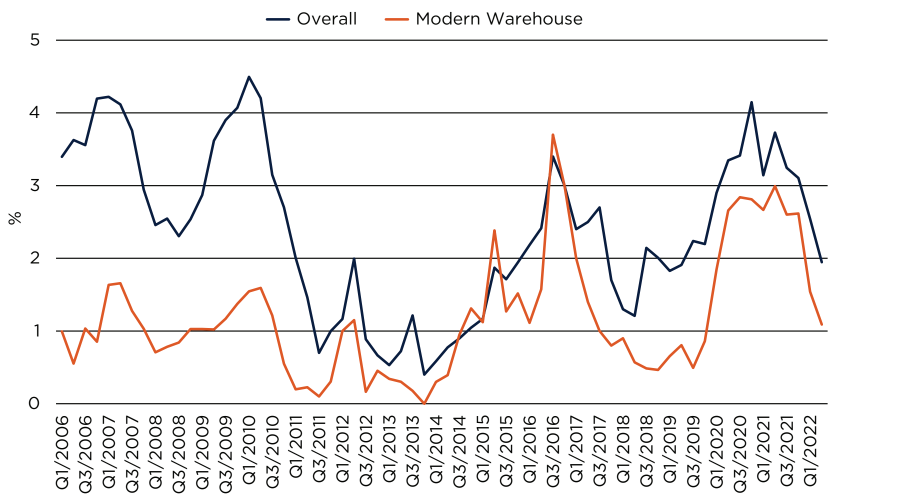

**Source** Rating and Valuation Department, Buildings Department, Savills Research & Consultancy

**GRAPH 8: Savills Luxury Residential Rental Index by District, Q1/2003 to Q2/2022**




**Source** Savills Research & Consultancy

**GRAPH 9: Warehouse Vacancy Rate by Property Type, Q1/2006 to Q2/2022**




**Source** Savills Research & Consultancy

or higher qualification in a full-time, locally accredited programme in Hong Kong. From all three schemes, an average of around 60,000 people per annum were granted visas over the five pre-pandemic years.

Meanwhile, the citywide lockdowns across multiple cities in China this year have also led to more people moving to Hong Kong or overseas to avoid possible confinement. While many have relocated to Singapore given its more relaxed travel restrictions, Hong Kong remains a popular choice among Mainlanders and has a certain appeal in comparison. In the Lion City, a lack of availability of suitable accommodation, the limited availability of openings for certain grades in the better-known international schools and the inconvenience of having to open the same job position to locals for at least a month before foreigners can apply, are creating barriers to entry.

Overall, we have seen that Hong Kong's leasing market is increasingly being driven by Mainland expats and 'New Hongkongers', those who have been living in Hong Kong for seven consecutive years and have become permanent residents. This group of renters typically prefer new builds and high-end renovations owned by the larger 'corporate' landlords with attractive city or harbour views. Popular residential locations for this target market include Mid-Levels, The Peak, Shouson Hill, Deepwater Bay, and Kowloon Station. Looking forward, this group of renters should continue to support luxury residential rental growth.

## CASH-RICH LOGISTICS OPERATORS LOOK FOR PREMISES TO BUY

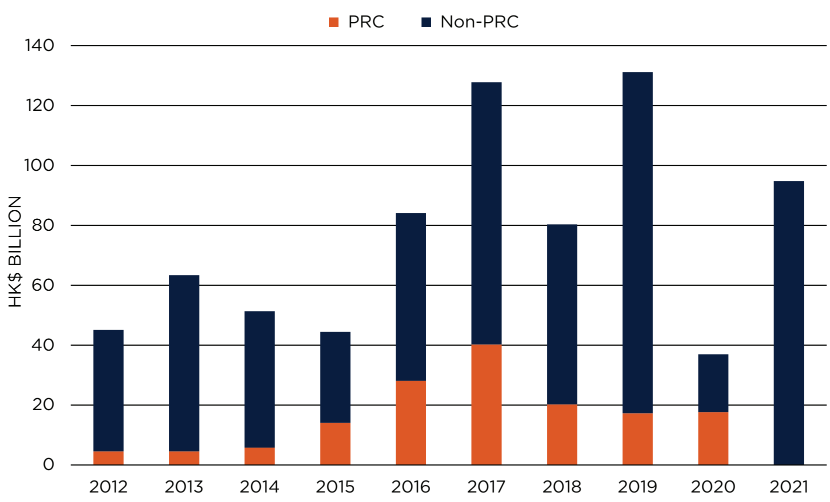
Albeit a bit late to the game, we have also seen more mainland logistics operators entering the local industrial and logistics market in recent years. Boosted by the growing demand from e-commerce and 3PL tenants, policy support and the limited supply of quality logistics facilities, this market has outperformed other sectors over the past two years. With a vacancy rate below 5% over the past 10 years, both SF Express and China Merchants have built their own logistics hubs in Tsing Yi to meet expansion demand. Meanwhile, a CaiNiao Network-led consortium has won the tender to develop and manage a premium logistics centre at Kwo Lo Wan in the South Cargo Precinct of Hong Kong International Airport. The consortium is expected to invest HK$12 billion in the project with an expected completion date in 2023. We expect at least half of the space to be occupied by CiaoNiao as its sixth global fulfilment centre. Apart from building new facilities, many cash-rich operators are

**TABLE 1: Warehouse Acquisitions by China Resources Logistics, 2016 to 2022**

| YR/QTR | PROPERTY | LOCATION | GFA | PRICE | VENDOR |
|---|---|---|---|---|---|
| Q2/2022 | Kerry Godown (Shatin) | Fotan | 404,374 sq ft | HK$2,330M / HK$5,762 per sq ft | Kerry Properties |
| Q2/2022 | Kerry Godown (Chai Wan) | Siu Sai Wan | 521,253 sq ft | HK$2,290M / HK$4,393 per sq ft | Kerry Properties |
| Q3/2021 | Mineron Centre | Fanling | 152,761 sq ft | HK$695M / HK$4,552 per sq ft | Tang Shing-bor's family |
| Q2/2021 | East Asia Industrial Building Phase 1 | Tuen Mun | 466,449 sq ft | HK$2,240M / HK$4,802 per sq ft | Stan Group |
| Q2/2016 | China Resources International Logistics Centre (previously known as NWS Kwai Chung Logistics Centre) | Kwai Chung | 694,000 sq ft | HK$3,750M / HK$5,403 per sq ft | NWS Holdings Limited |

**Source** Market Sources, Real Capital Analytics, Savills Research & Consultancy

**GRAPH 10: Government Land Tender Results by Source of Capital, 2012 to 2021**




**Source** Lands Department, Savills Research & Consultancy

also looking to acquire mature properties for their own operations. For example, China Resources Logistics has bought five warehouse properties in Hong Kong, totalling over HK$11 billion, over the past decade. Its latest purchase was in May, adding two warehouses, Kerry Godown Chai Wan and Shatin, priced at HK$4.62 billion.

## THE ONGOING PROPERTY DEBT CRISIS HAS HALTED INVESTMENT IN DEVELOPMENT SITES

Aside from stabilised assets, mainland Chinese developers have also been taking part in government tenders and the acquisition of development sites. In this respect, the city saw the most activity between 2016 to 2017, with HNA group sweeping up four prime residential sites for HK$27.2 billion, setting price records with each of its bids while Goldin Financial Holdings picked up one site for HK$8.9 billion. The four HNA sites were eventually taken by various Hong Kong developers at heavy discounts after the crackdown by China's central bank on heavily-leveraged acquisitions, while the plot (Kai Tak area 4B site 4) owned by Goldin was sold for a loss to another mainland Chinese developer, Kaisa Group, for HK$7.04 billion. Investment momentum has since slowed among Chinese developers.

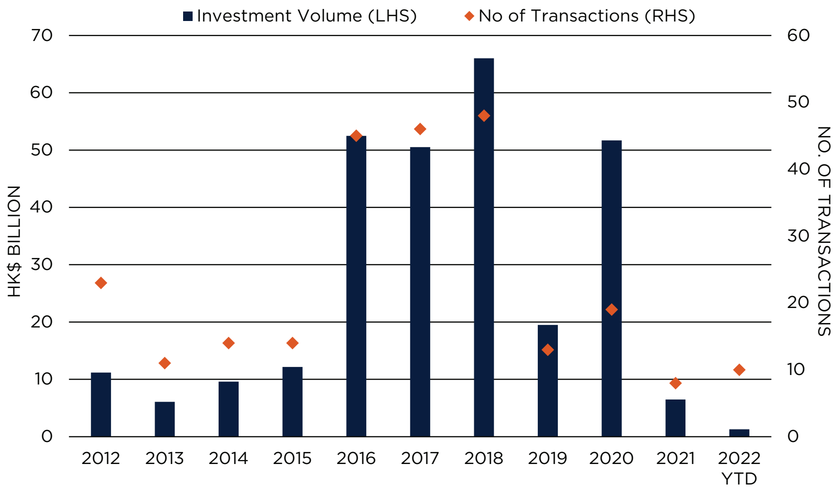
From 2021, the market has seen another round of divestment from indebted developers as they face more scrutiny under the 'three red lines' policy. As an example, the Kai Tak plot owned by Kaisa was eventually sold to a joint venture between Far East Consortium and New World for HK$7.9 billion in November 2021. The ongoing cash-flow crisis continues to weigh heavily on mainland Chinese developers, and mainland development site acquisitions have essentially ground to a halt since 2021, and we therefore expect the development market to be dominated by local players in the near term.

## OUTLOOK

All in all, mainland Chinese demand has long been a prominent driver behind the city's property markets. On the leasing front, they have continued to drive momentum and shown resilience in the office, residential and industrial markets during COVID, even if the retail market has fared less well. On the investment side, PRC buyers were the most active group of cross-border investors before the social unrest in 2019 and the current liquidity woes in the mainland property sector, two key turning points for PRC demand.

Since the near-term outlook remains under strain in Hong Kong and mainland China, with concerns surrounding the future course of the pandemic, a debt crisis

**GRAPH 11: PRC Investment Volume and No of Transactions, 2012 to 2022YTD**




**Source** Real Capital Analytics
**Note** YTD as of 1 Sep 2022

in the property sector as well as a slowing economy amid the 'zero-COVID' policy, investment activity is likely to remain limited over the remainder of 2022.

Nonetheless, the city is still an attractive investment hotspot within the Asia Pacific region, as the fundamentals which support its robust real estate market remain intact. A stable currency, mature market regulation, the free flow of market information, a low tax environment, limited restrictions on foreign ownership, and the relative scarcity of land should all ensure sustainable growth in the future. As so often in the past, these long-term drivers will begin to reassert themselves as the short-term turbulence subsides.

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