Rents slip by 3.5% in Q1

Rental declines have generally moderated for now, but corporate downsizing continues and 2022 and 2023 threaten a supply overhang.

- The rate of rental decline fell to 3.5% in Q1/2021 from 5.1% in the previous quarter, representing seven consecutive quarters of falls.
- Wanchai/Causeway Bay (-4.3%) registered the largest rental fall among all sub-markets, partly because of its exposure to co-working operators and financial services firms.
- Central posted a 15-year high vacancy rate of 7.6% or 1.2 million sq ft in Q1/2021.
- Major international banks have shed over 350,000 sq ft of space over the past 12 months as Work-From-Home policies were implemented or extended and business prospects dimmed.
- PRC corporates remain active in the office leasing market, taking up space in core areas.
- A substantial IPO pipeline this year will support demand from a range of associated banks and professional services providers.

- The impact of extremely limited supply in 2020 and 2021 has been more than offset by shrinking demand which has meant several quarters of rental declines. As demand begins to recover later this year, however, substantial new supply in 2022 and 2023 should see rents come under further downward pressure.

“As news of lease surrenders becomes more commonplace, a record IPO pipeline and bullish demand from Mainland corporates should offer landlords some comfort.”

SIMON SMITH, SAVILLS RESEARCH
MARKET COMMENTARY

Over the first quarter of 2021, Grade A rents registered a fall of 3.5%, lower than the 5.1% recorded in Q4/2020 while rents in Central, Wanchai/Causeway Bay and Island East declined by 3.8%, 4.3% and 3.5% respectively. Wanchai/Causeway Bay has posted the largest rental fall among all submarkets on Hong Kong Island for a seventh consecutive quarter and rents in the district are now down 28.3% from their peak in Q2/2019 due to the closure of co-working space and the downsizing of financial institutions and business service providers. In Q1/2021, Hong Kong Island rents fell by -4.0% while Kowloon rents were relatively stable, registering a 2.8% fall. Rents in Tsim Sha Tsui, Kowloon East and Kowloon West fell by 5.2%, 2.2% and 1.4% respectively. Kowloon West rents have proved relatively resilient since Q3/2019 because downsizing has been less common for corporates situated in the area, where rents are relatively cheap.

The coworking industry is still in a consolidation phase and WeWork will close their centre in Causeway Bay, which accounted for 90,000 sq ft or one third of the total floor area of Tower 535. Some flexible workplace brands, however, are taking the opportunity to expand their footprint, evidenced by IWG, which has formed a global partnership with Standard Chartered recently, leasing 50,000 sq ft in Kwn Tong for their third centre in the city. Banks have begun to downsize and surrender space partly because of the implementation of Work-From-Home policies and partly because of downbeat business prospects. It is reported that Standard Chartered will cut their floor space in Central by eight floors (60,000 sq ft). DBS meanwhile is rumoured to have surrendered a further four floors (113,000 sq ft) after surrendering two floors (43,000 sq ft) in Island East. Deutsche Bank AG and Societe Generale were also reported to have cut and surrendered their space of 136,600 sq ft in Kowloon Station and Wanchai. The closure of WeWork’s centre in Causeway Bay was largely related to downsizing by HSBC, who relocated their business division from the co-working offices to their owner-occupied building in Central.

Against a background of corporate downsizing, PRC corporates are the exception, with financial institutions expanding their presence in Central. PRC leasing demand has been strong and remains a major demand driver, and the floor area of PRC new lettings in 2020 was actually up by 4% compared with 2019.

Since rents have fallen substantially from their peak (Central: -24.3%), corporates, who still have an appetite for either expansion or upgrading, are more willing to take up space in high-quality buildings in prestigious locations, which now represent better value for money given the market downturn. For this reason, we believe that Grade AAA and Grade AA offices in core business districts will be fully occupied before Grade A offices in decentralized markets when the market regains its momentum.

The overall vacancy rate hit 8.9% in the first quarter of 2021, up from 8.3% at the end of 2020. Hong Kong Island vacancy rose from 6.8% to 7.4%, mainly driven by an increase...
Office Leasing

in vacancy in Wanchai/Causeway Bay (from 8.4% to 9.5%). Central’s rate increased slightly from 7.3% to 7.6% over the quarter, posting a 15-year high. Kowloon side’s vacancy increased moderately from 10.3% to 10.8%, mainly driven by Tsim Sha Tsui, where vacancy rose from 7.5% to 9.5% over the quarter, due to major insurance companies and financial institutions reducing their occupancy. Kowloon East (13.8%) remained the district posting the highest vacancy rate, with a stable vacancy trend over the quarter.

Despite the weak office take-up, vacancy is not likely to rise sharply for a couple of quarters because supply levels will remain low in 2021, similar to 2020. It is estimated that only two projects in Wong Chuk Hang and Yuen Long will be completed over the year, providing only 697,596 sq ft (GFA) in total. Next year will be a different story however, as 5.4 million sq ft is due to enter the market, much of it in decentralised and fringe locations, followed by 2.8 million sq ft in 2023, much of it in core locations. With over 5.3 million sq ft of vacancy currently, it is highly likely that vacancy will pass 10% unless office demand stages a major rebound which seems unlikely at this point. Under this scenario rents will continue to soften into next year.

IPO MARKET IN 2021
If much recent news has been a bit grim, the IPO pipeline is one of the few positive aspects of the current office leasing market. After a strong year in 2020, when funds raised by IPO reached HK$398 billion, a 10-year high, the IPO pipeline will reach HK$460 billion in 2021, according to PwC. Already this year, local IPOs are reported to have surged by 822% in the first quarter compared with the same period in 2020, in terms of funds raised. There are estimated to be 170 IPOs in 2021, with US-listed Chinese enterprises and the New Economy the main drivers of activity, including JD Logistics, Baidu (listed in March 2021) and bilibili (listed in March 2021).

Companies which raise funds in Hong Kong do not necessarily set up offices here, but IPOs involve the participation of investment banks, business service providers, such as law firms and accounting firms, and securities firms. A strong IPO pipeline can therefore shore up demand for floor space, helping to support rents in Central and Wanchai/Causeway Bay which tend to be the home of choice for many such financial institutions and business service providers.