MARKET IN MINUTES
Savills Research

Office Leasing

A long road to recovery

Downsizing by MNCs was partly offset by demand from the latest generation of New Economy companies.

- The first quarter was noticeably quiet in terms of transactions volumes with many tenants continuing to WFH given a 'fifth wave' of infections and related containment measures.
- More certainty may emerge in April/May about any possible pathway beyond COVID and this could result in more deals in the second and third quarters.
- The substantial volume of existing vacancy, combined with a very generous pipeline of new supply should offer plenty of upgrade opportunities over the next few years, with green buildings likely to prevail.
- Diminishing PRC demand and the loss of local professionals and expats are other factors limiting office demand in core areas.
- On a brighter note, there exists new office demand from companies trading cryptos and NFTs as more traditional firms are hit by regulation.
- Grade A office rents may take time to recover with high availability (both existing and future) and uncertain demand prospects over the next few years.

"A total of 17.2 million sq ft net of available Grade A office space over the next four years may mean a long road to recovery for the office sector with tenant preferences shifting towards contemporary builds and green certified space."

SIMON SMITH, SAVILLS RESEARCH

Savills team

Please contact us for further information

OFFICE LEASING

Ricky Lau
Deputy Managing Director
Head of Office Leasing
+852 2842 4501
rklau@savills.com.hk

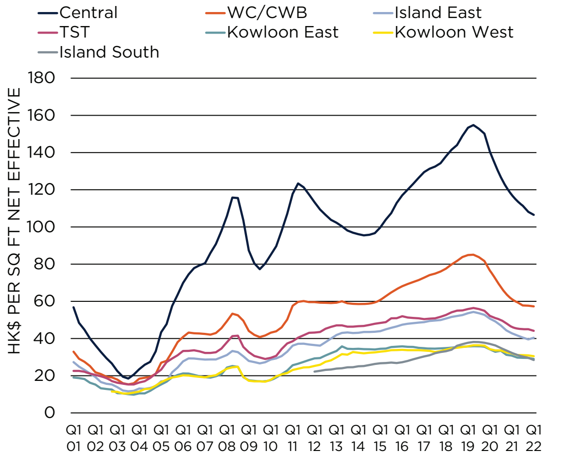
William Yiu
Deputy Senior Director
Kowloon Office Leasing
+852 2378 8664
wyiu@savills.com.hk

RESEARCH

Simon Smith
Regional Head of Research & Consultancy
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk

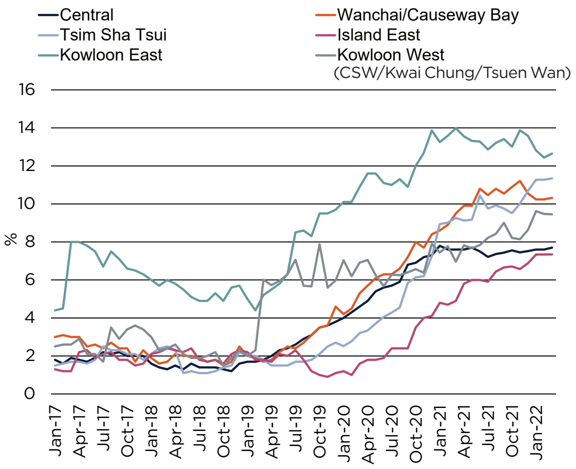
Jack Tong
Director
+852 2842 4213
jtong@savills.com.hk

GRAPH 1: Grade A Office Rents by District, Q1/2001 to Q1/2022



Source Savills Research & Consultancy

GRAPH 2: Grade A Office Vacancy by District, January 2017 to March 2022



Source Savills Research & Consultancy

MARKET COMMENTARY

The first quarter was noticeably quiet in terms of transactions volumes with many tenants continuing to WFH given a 'fifth wave' of infections and related containment measures. Coupled with stock market turbulence and a number of external uncertainties, including the Russian invasion of Ukraine and the lockdown of major cities in China, business sentiment was hit locally with Grade A office rents declining across the board. Overall average rents fell by 2.0% in Q1/2022 to reach HK$55 per sq ft net effective, 27.2% off their Q2/2019 peak.

More certainty may emerge in April/May about any possible pathway beyond COVID and this could result in more deals in the second and third quarters. It could also be the case that when decision makers gradually return to their desks and more corporate operational data becomes available, both tenants and landlords will be prepared to tackle more serious renewal / relocation negotiations, with landlords likely to prove more flexible to retain key tenants.

Many financial services firms are adopting flexible working practices as a more permanent way of working and are typically downsizing on lease expiry. If moving over to hotdesking, banks tend to lose 20% of their space with back-office functions most affected. The move to more agile business models seems most entrenched among MNCs while local businesses are tending to maintain a more traditional approach and we see this pattern emerging across the region.

The substantial volume of existing vacancy (9.8% or 6.2 million sq ft net in Q1/2022), combined with a very generous pipeline of new supply (11.0 million sq ft net from 2022 to 2025) should offer plenty of upgrade opportunities over the next few years. The trend will be exaggerated by a growing bias towards green certified buildings, and we believe that 20- or 30-year-old stock may face real challenges ahead. According to Savills' estimates, 47% of Grade A offices in Hong Kong (in terms of GFA) have already been awarded BEAM or LEED certification.

We also notice a heightened ESG awareness among European firms followed by the US while PRC companies are often still more concerned about traditional building attributes. Besides widening the potential tenant pool, attaining a green rating can also lower the potential cost of capital, a good example of which is the Hysan / Chinachem Caroline Hill Road Commercial Project which secured the largest green loan in Hong Kong with the project aiming to obtain the highest ratings of green and wellness certificates, including China Green Building Label, LEED and BEAM Plus certifications.

Demand from Mainland firms is currently being hampered by border closure, debt concerns (especially among the developers), 'common prosperity' and a more tightly regulated New Economy. The IPO market has been equally hard hit and saw only 11 companies listed on the HKEx main board in the first quarter of the year raising HK$13.3 billion, the lowest since Q1/2013.

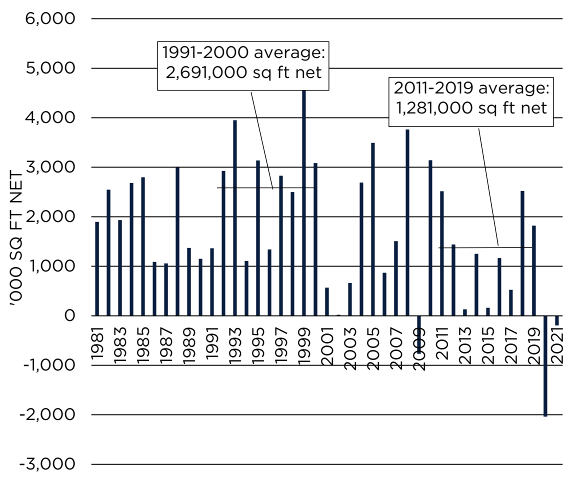
BNOs continue to leave Hong Kong with numbers reaching over 100,000 and this

TABLE 1: Examples of Financial Services Firms Downsizing, 2H/2020 to 1H/2021

FIRM	LOCATION	DOWNSIZE AREA (SQ FT)
Deutsche Bank	ICC	104,000
Standard Chartered Bank	Standard Chartered Bank Building	65,000
Nomura	Two IFC	56,000
UBS	Two IFC & Li Po Chun Chambers	33,000
BNP Paribas	Two IFC	23,000
Societe Generale	Three Pacific Place	16,000
National Australia Bank	Three Pacific Place	15,000

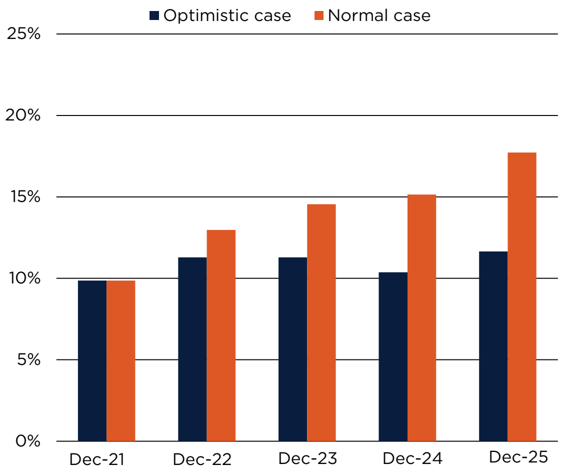
Source Savills Research & Consultancy

GRAPH 3: Grade A Office Take-up, 1981 to 2021



Source Rating and Valuation Department, Savills Research & Consultancy

GRAPH 4: Grade A Office Vacancy Forecasts under Optimistic and Normal Scenarios, 2021 to 2025



Source Savills Research & Consultancy

year they have been joined by expats leaving for Singapore or returning home after becoming increasingly fed up with local restrictions. This 'brain drain' could impact Hong Kong's appeal compounded by the fact that many PRC professionals are still uncertain of the situation in Hong Kong.

On the bright side, there exists new office demand from New Economy companies involved with blockchain, cryptos and NFTs. Of note, many of these new start-ups, which have made substantial profits over the past few years, are being run by young talents and entrepreneurs. This new generation favour modern and well-designed offices on the periphery of traditional business districts, such as The Chelsea, H Code, 33 Des Voeux Road West, The Wellington and Tower 535 with smaller floor plates and a much more contemporary feel, rather than more traditional Grade A offices. New tenants in fringe Central include Mantra Dao, Satori and 8 Block Capital.

The total existing availability (6.2 million sq ft net) and future new supply (11.0 million sq ft net from 2022 to 2025 with minimal pre-commitment) means there could be up to a total of 17.2 million sq ft net of available Grade A office space over the next four years. Looking at historical office absorption, the highest take-up was between 1991 and 2000, when 2.7 million sq ft net of Grade A office space was absorbed per annum. A more 'normal period' was between 2011 and 2019, when 1.3 million sq ft net of Grade A office space was taken up each year.

As WFH becomes the norm for an increasing number of MNCs and some local businesses, according to our estimates this could result in a 20% reduction in office space required by these corporates going forward. Therefore, under both optimistic and normal scenarios and considering the impact of WFH, we assume annual office take-up to be 2.2 million sq ft net and 1.0 million sq ft net per annum respectively over the next four years. Under such assumptions, Grade A office vacancy rates would remain unchanged (at 11.7%) by 2025 under the optimistic scenario and would surge to 17.7% under the normal scenario. Both scenarios point to a long road to recovery, with Grade A office rents likely to continue to drift down over the near term.