MARKET IN MINUTES
Savills Research

Office Leasing

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Rents fall by 2.6% in Q2

Rental declines are expected to be mild over the remainder of 2021 before the supply challenges of 2022 and 2023.

- Grade A rents fell by 2.6% in Q2/2021 compared with a 3.5% decline in Q1/2021.
- While there is broad agreement in the business community that the worst times are behind us, questions linger over when the best times will return, and tenants remain cautious.
- Leasing demand from PRC corporates proved to be resilient over the quarter and was largely financial services driven.
- Vacancy rates are elevated at 9.3% (5.7 million sq ft) but patchy as some buildings continue to report high occupancy levels and remain quite selective regarding tenants.
- Kowloon may not be able to maintain its vacancy levels in 2022 given that 2.4 million sq ft net out of 3.9 million sq ft net of new supply will come on stream in the area.
- The proportion of Central Grade A offices occupied by PRC firms increased from 20.5% in July 2017 to 23.5% in June 2021 despite the challenging market conditions.

"Rising vacancy continues to put pressure on rents while a record IPO pipeline, growth in wealth management services and active PRC tenants are providing some support."

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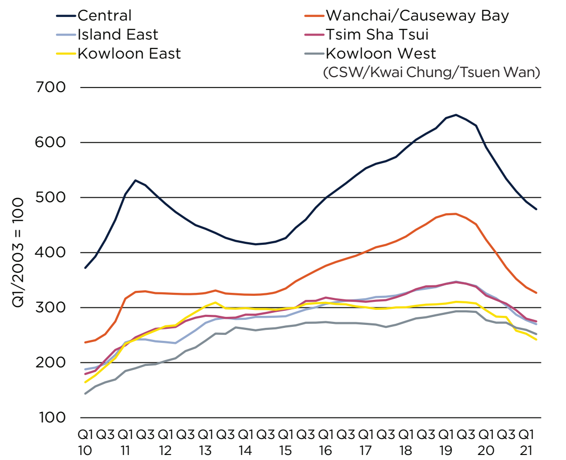
GRAPH 1: Savills Grade A Office Rental Indices By District, Q1/2010 to Q2/2021



Source Savills Research & Consultancy

TABLE 1: Grade A Office Rental Indices, Q1/2021 VS Q2/2021

DISTRICT	Q1/2021 (QOQ%)	Q2/2021 (QOQ%)
Central	-3.8	-2.8
Wanchai/Causeway Bay	-4.3	-3.0
Island East	-3.5	-2.6
Tsim Sha Tsui	-5.2	-1.8
Kowloon East	-2.2	-4.2
Kowloon West (CSW/ Kwai Chung/Tsuen Wan)	-1.4	-2.9
Overall	-3.5	-2.6

Source Savills Research & Consultancy

MARKET COMMENTARY

Grade A rents fell by 2.6% in Q2/2021 compared with a 3.5% decline in Q1/2021 as market sentiment improved slightly over the quarter with less downsizing and fewer surrender cases. In Q2/2021, rents in Central, Wanchai/ Causeway Bay and Island East fell by 2.8%, 3.0% and 2.6% respectively while overall Hong Kong Island rents recorded their lowest rate of decline since Q1/2020, registering a fall of 2.8%. Kowloon rents dipped slightly and remain relatively affordable to tenants, falling by 2.4% over the quarter. Rents in Tsim Sha Tsui, Kowloon East and Kowloon West fell by 1.8%, 4.2% and 2.9% respectively.

While there is broad agreement in the business community that the worst times are behind us, questions linger over when the best times will return, and tenants are cautious. The IPO pipeline is encouraging, however, and we note that the wealth generated by new listings is fuelling demand from private offices and wealth managers for office space. Among PRC tenants, preferences are emerging for large-scale mixed-use schemes such as IFC and Pacific Place which offer a seductive combination of retail, offices, serviced apartments and hotels. Mainland demand remains very core focused and driven by financial and professional services firms.

Operators of flexible workplace have adopted different strategies as the industry restructures. Some overextended brands have chosen to close their centres while some operators are taking advantage of cheaper space and are actively expanding. The Executive Centre is rumoured to have leased a floor in AIA Central growing their footprint in Hong Kong to 11 centres. The co-working sector is stabilizing after a few years of robust expansion, but the remote working trend is far from over. The Desk is reported to have seen a 65% growth in membership in 2020 and enjoys high occupancy levels in its seven centres in the city.

A reluctance among some core landlords to cut rents has not been shared by fringe and decentralised owners and tenants have continued to take advantage of the lower costs available in some markets to relocate. Averaging HK$114 per sq ft per month net effective in Q2, Central rents are at a 91% premium to the general market and while relatively costly, have fallen from the 96% premium recorded in Q2/2019. Despite the narrowing gap, we are still finding cases of decentralization such as Julius Baer committing to lease four floors in Two Taikoo Place suggesting that relocating to triple Grade A office buildings in decentralized areas is still appealing to corporates. On the other hand, Central rents have fallen by 26.4% from their peak in Q2/2019, and this is providing an incentive for some firms to return to the CBD - Standard and Poor's has rented two floors in Three Exchange Square according to Hongkong Land.

Leasing demand from PRC corporates proved to be resilient over the quarter and China International Capital Corporation (CICC) has been actively taking up vacant units in One IFC, becoming one of the major tenants in the triple Grade A office tower. Other PRC financial institutions, such as Huatai Financial Holdings and Forthright Financial Holdings, are also expanding their presence in Hong Kong's financial hub against a background of decentralization and corporate downsizing.

Vacancy rates are high at 9.3% (5.7 million sq ft) but patchy as some buildings continue to report high occupancy levels and remain quite selective regarding tenants. Most office workers are back at their desks suggesting a limited long-term impact from WFH and local CEOs have shown a preference for more traditional office culture and pre-COVID ways of working. The rise in vacancy was mainly driven by increases in availability on Hong Kong Island, where the vacancy rate rose from 7.4% to 8.0%. The vacancy rate in Central declined slightly to 7.5% from 7.6% over the quarter. Wanchai/Causeway Bay hit a post-March 2003 vacancy rate high of 10.8% while Island East achieved a lower vacancy

TABLE 2: Major PRC New Lettings, Q2/2021

TENANT	BUILDING	AREA (SQ FT)
Huatai Financial Holdings (Hong Kong) Limited	The Center	25,596
China International Capital Corporation Limited	One International Finance Centre	19,854
Forthright Financial Holdings Company Limited	Cosco Tower	15,706
China Life Franklin Templeton	One Exchange Square	13,909

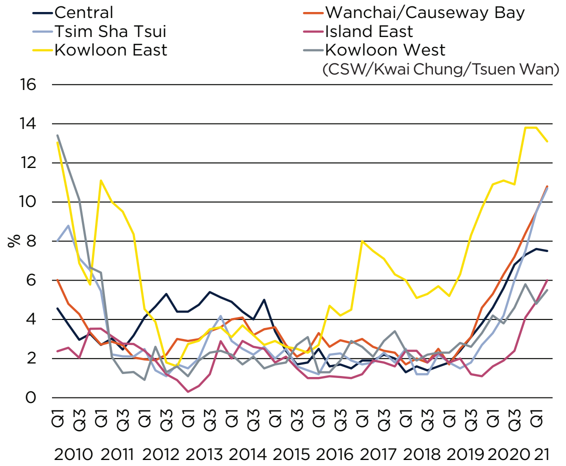
Source Savills Research & Consultancy

TABLE 3: Major New Lettings (Excl PRC), Q2/2021

TENANT	BUILDING	AREA (SQ FT)
Manulife (International) Limited	International Trade Tower	144,669
Julius Baer	Two Taikoo Place	96,892
DFS Group Limited	One Taikoo Place	60,936
Farfetch	International Trade Tower	35,750

Source Savills Research & Consultancy

GRAPH 2: Grade A Office Vacancy Rates By District, Q1/2010 to Q2/2021



Source Savills Research & Consultancy

rate compared to other districts on Hong Kong Island since the district's major office portfolio recorded a rate of availability of only 1.3% in June 2021. Kowloon saw a relatively stable trend as vacancy increased marginally to 10.9% from 10.8% in Q1. The vacancy rate in Kowloon East dropped from 13.8% to 13.1% after securing several major leases over the quarter such as Manulife who committed to lease multiple floors (144,700 sq ft) in International Trade Tower.

Kowloon may not be able to maintain its vacancy levels in 2022 given that 2.4 million sq ft net out of 3.9 million sq ft net of new supply will come on stream in the area. Kowloon East will see new supply of 1.6 million sq ft net from three Grade A office buildings. The completion of these new buildings is likely to drive up vacancy in the district to over 15% as there haven't been any major pre-lease commitments yet. Kowloon West will undergo a dramatic change as 1.9 million sq ft net of Grade A space will be completed over the coming two years, accounting for about 75% of existing Grade A stock in the district.

PRC CORPORATES IN CENTRAL

PRC firms started their active expansion in the Hong Kong office market in the early-2010s with a particular focus on the Central Grade A office market, the hub of financial and professional services firms. Leasing demand from PRC firms has been driven by financial services (about 70% of new PRC lettings in Central over the last decade). In July 2017, we estimate that about 20.5% of Central Grade A office space was occupied by PRC firms.

Despite the trade disruption, the social unrest and COVID, PRC firms remain committed to the Hong Kong market. Against a backdrop of economic recession in 2020, corporates tended to halt expansion or downsize but the floor area of new PRC lettings rose by 4% YoY over the year. As a result, the proportion of Central Grade A offices occupied by PRC firms rose to 23.5% in June 2021. One IFC and Two IFC, both iconic buildings in the financial centre, have both seen a rising PRC presence, from 15.7% to 24.0% over the four years.