MARKET IN MINUTES
Savills Research

Office Leasing

Grade A rents contract by 3.8% in Q2

Grade A office rents are seeing their fourth consecutive quarter of decline, while the average vacancy rate has hit nearly 6%.

- Overall office rents are down by 11% from their peak in the second quarter of 2019.
- Wanchai/Causeway Bay recorded the largest decrease (-5.7%) among all office sub-markets.
- A narrowing rental gap between Central and other districts may slow decentralization.
- Co-working operators are downsizing while IWG continues their expansion in Hong Kong.
- Landlords are more willing to lower their rental expectations to keep tenants and fill vacancies.
- The vacancy rate in core areas (Central, Wanchai/Causeway Bay & Tsim Sha Tsui) has more than doubled in a year, up from 2.2% in June 2019 to 5.5% in June 2020.
- Paul Chan, the Financial Secretary, has suggested that the unemployment rate may remain near current levels over the remainder of 2020, suggesting that the vacancy rate is unlikely to fall this year, given the positive correlation between the two indicators.

"Corporate solvency has become an issue as more firms opt to downsize or close altogether in a business environment facing numerous challenges over the next six months."

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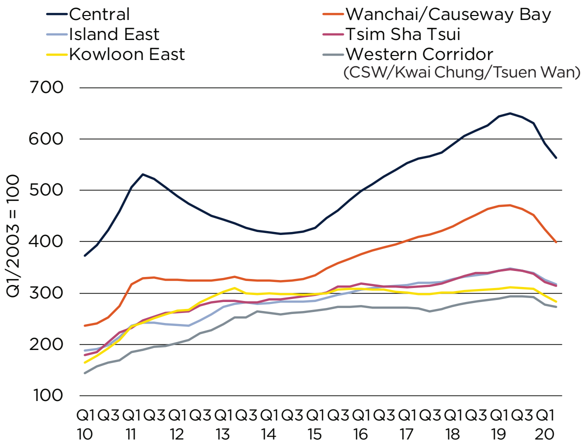
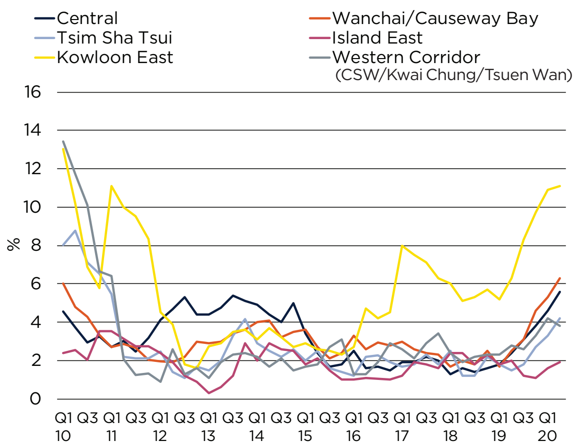
GRAPH 1: Savills Grade A Office Rental Indices By District, Q1/2010 to Q2/2020



Source Savills Research & Consultancy

GRAPH 2: Grade A Office Vacancy Rates By District, Q1/2010 to Q2/2020



Source Savills Research & Consultancy

MARKET COMMENTARY

While Grade A office rents have consolidated for four consecutive quarters for the first time since 2010, the rate of decline slowed to 3.8% in the second quarter compared with 5.2% in Q1/2020. Overall rents are now down by 11% from their peak in Q2/2019. Wanchai/Causeway (-5.7%) recorded the largest rental decrease among all sub-markets, followed by Central (-4.9%) and Kowloon East (-3.9%). Kowloon rents have performed better compared to those on Hong Kong Island since the first quarter of 2019. Rents in Kowloon and on Hong Kong Island recorded declines of 2.8% and 5.1% respectively over the second quarter.

Even given capital expenditure concerns, office decentralization has remained an option for many businesses and we have recently seen Central-based asset management firms and securities firms relocating to Wanchai/Causeway Bay and Wong Chuk Hang. It is notable that the rental difference between Central and all other business districts has narrowed to late 2017 levels. The reduced rental gap should lessen the attractiveness of moving away from the CBD given that the capital expenditure costs of relocation remain high.

Co-working operators are still being negatively affected by the pandemic as people are still being encouraged to adopt social distancing. As a result of the subdued demand, we observe major co-working operators surrendering locations in major business districts. While many flexible space operators are trimming down their presence, IWG, the parent company of Regus, is expanding, securing two floors in Hysan Place, which were surrendered by another major flexible space operator.

We observe that PRC tech firms are still expanding as it was reported that Alibaba have committed to one more floor (about 17,000 sq ft) in Times Square while ByteDance, the owner of TikTok, entered into a 3-year lease for about 3,000 sq ft in the same building. Some major PRC financial institutions (CMB International, Minsheng Bank and Orient Finance) have also signed up for additional office space in Central while their foreign counterparts consider downsizing.

The vacancy rate rose to 6.02% in June 2020 (3.55 million sq ft net), up from 5.39% in March 2020 (3.18 million sq ft net). As one of the beneficiaries of decentralization, Island East (1.9%) was the district with the lowest vacancy rate since the area is dominated by the Swire portfolio secured on long leases with good covenants. Vacancy rates in Central and Wanchai/Causeway Bay hit 5.6% and 6.3% respectively at the end of second quarter, up sharply from 2.4% and 2.5% one year ago. The weak leasing market combined with cost-driven decentralization are behind the rising vacancy in Central and Wanchai/Causeway Bay. Vacancy rates in Kowloon increased as well with Tsim Sha Tsui and Kowloon East recording vacancy rates of 4.2% and 11.1%, up from 3.3% and 10.9% in first quarter of 2020.

TABLE 1: Grade A Office Rental Indices, Q1/2020 VS Q2/2020

DISTRICT	Q1/2020 (%)	Q2/2020 (%)
Central	-6.2	-4.9
Wanchai/ Causeway Bay	-6.2	-5.7
Island East	-4.0	-2.7
Tsim Sha Tsui	-4.7	-2.3
Kowloon East	-4.1	-3.9
Kowloon West (CSW/ Kwai Chung/Tsuen Wan)	-5.1	-1.6
Overall	-5.2	-3.8

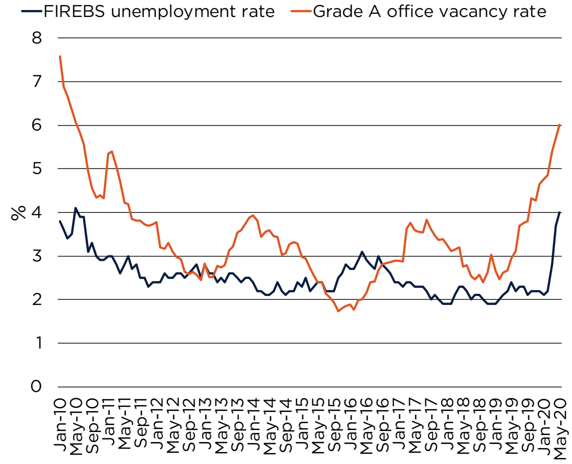
Source Savills Research & Consultancy

TABLE 2: Major New Lettings, Q2/2020

TENANT	BUILDING	AREA (SQ FT)
FWD Life Insurance	Millennium City 1	41,168
KWG	The Center	25,609
AIG Insurance HK Ltd	One Island East	21,428
Warner Music (HK) Ltd	Manhattan Place	20,850
Comasia Ltd	One Harbour Square	18,972

Source Savills Research & Consultancy

GRAPH 3: Savills Grade A Office Vacancy Rates And FIREBS* Unemployment Rate, January 2010 to May 2020



Source Census and Statistics Department, Savills Research & Consultancy
* FIREBS stands for Finance Insurance Real Estate and Business Services

VACANCY RATE AND UNEMPLOYMENT RATE

In April 2020, Paul Chan, the Financial Secretary of Hong Kong, mentioned that GDP could shrink by 4% to 7% due to the enduring effects of the pandemic. He also warned that the unemployment rate could rise to a level higher than during the global financial crisis of 2008/09 (5.5%)

We observe that the unemployment rate increased to 5.9% in May, the highest it has been since April 2005. The FIREBS unemployment rate also rose substantially to 4.0% in May, hitting a 10-year high. The FIREBS jobless rate has remained at around 2.0% over the past three years.

Grade A office leasing demand in Hong Kong is mainly driven by the health of sectors such as finance, insurance, banking and business services and a period of weak business prospects quickly feeds through into the office vacancy rate. As the FIREBS unemployment rate and Grade A office vacancy are positively correlated with each other, as unemployment is expected to remain at current levels or even trend higher over the remainder of 2020, it looks likely that the vacancy rate will remain high over the coming six months.