MARKET IN MINUTES

Savills Research

Office

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Office rents show signs of bottoming out

Office leasing momentum slowed in Q3.

- Office leasing activity moderated for the quarter in review but was still higher than a year ago. In the third quarter, the demand for smaller units eased slightly from the previous quarter.
- While office demand is being driven by a flight to quality, some older buildings are under pressure as firms continue rightsizing their office footprint. Although there is an uptick in larger organisations announcing plans to reduce space, this is only likely to be realised in 2022/2023 when their leases expire.
- With the supply of office space remaining unchanged and leasing demand rising during the quarter, the CBD Grade A vacancy improved to 5.8% in Q3/2021. This was attributed to tenants who began to move in in the reviewed quarter.
- In Q3/2021, Savills CBD Grade A office rents ended six consecutive quarters of decline, with the average gross effective rent in our basket holding firm at S$9.37 per sq ft. Similarly, rents for those rated AA and A in our basket also hit bottom and landlords were pulling back on rent concessions. On the other hand, despite lower vacancy and tighter available stock, rents for Grade AAA offices in our basket fell again in Q3/2021.
- Although tech companies are expanding aggressively here, this may not offset the rightsizing moves by many companies, leading to elevated vacancies in 2022. Nevertheless, the low interest rate environment and the activity generated by tech companies expanding is boosting landlord confidence causing them to push for higher rents. We are forecasting an effective rental growth of 0% to 2% YoY in 2022 for CBD Grade A offices.

> "Tech firms expansion plans are blunting the negative impact of companies rightsizing."
>
> ALAN CHEONG, SAVILLS RESEARCH

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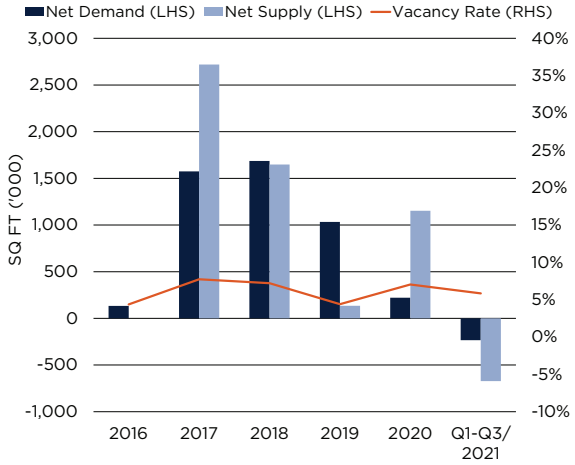
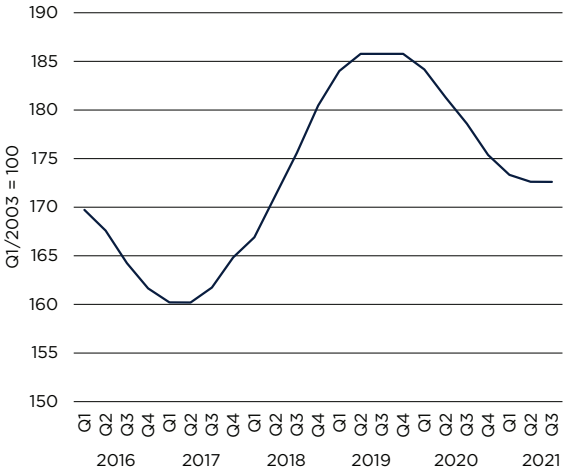
GRAPH 1: Net Demand, Net Supply and Vacancy Rate of CBD Grade A Offices, 2016 to Q3/2021



Source Savills Research & Consultancy

GRAPH 2: Rental Indices of CBD Grade A Offices, Q1/2016 to Q3/2021



Source Savills Research & Consultancy

MARKET COMMENTARY

In Q3/2021, the Singapore economy grew 6.5% YoY, a moderation from the 15.2% YoY expansion in the previous quarter when growth was boosted by a low-base effect in Q2/2020. On a quarter-on-quarter basis, the economy expanded by 0.8% in Q3, a reversal from the 1.4% contraction in Q2. While all industries saw YoY growth in Q3, momentum eased from Q2. The manufacturing sector expanded 7.5% YoY in Q3, slowing down from the 18.0% YoY growth in Q2. Compared to the growth of 10.8% YoY in Q2, growth for the services sector also moderated to 5.5% YoY in Q3. On a quarter-on-quarter basis, this sector grew 0.5% in Q3, up from the 0.3% QoQ contraction in Q2. Within the services sector, the cluster of infocomm and communications, finance and insurance and professional services registered the best showing with a 1.2% QoQ expansion, albeit at a slower pace than the 2.3% QoQ growth in Q2. Finally, on a Qquater-on-quarter basis, growth in the manufacturing sector was flat in Q3 after a 2.1% contraction in Q2.

Leasing activity also started to moderate in Q3/2021, compared with the last three quarters since Q4/2020 when occupier demand from the technology and financial services sectors picked up. Even though some tech firms are still looking for suitable options to increase their real estate footprint, most of them are slowing their pace of expansion. Nonetheless, the leasing volume recorded in Q3/2021 was still higher than a year ago. The same trend is observed in the total value of rental contracts, which also fell on a quarter-on-quarter basis but remained higher than a year ago. Notably, the demand for smaller units also eased slightly from the previous quarter. In the Central Area, the number of leasing transactions in the <100 sq m size category accounted for 32% of all leases in Q3/2021, down from the 36% recorded in Q2/2021. The proportion for larger unit sizes, those >1,000 sq m, remained stable, making up 3% of total leasing volume.

DEMAND AND VACANCY

While flight to quality continues to drive office demand for new buildings, some older buildings are still feeling the pressure from firms seeking to right-size their office space. Despite an uptick in larger organisations announcing plans to reduce space, this is only taking place in 2022/2023 when their current leases expire. Meanwhile, office availability is likely to become even tighter as more tech firms such as Bytedance, Amazon and Facebook, plan on expanding. Thus, even though leasing activity slowed in Q3/2021, tech firms are in the process of planning for expansion.

In Q3/2021, CBD Grade A offices tracked by Savills recorded a net demand of around 470,000 sq ft. Much of that came from Bytedance. With the supply of office space remaining unchanged and leasing demand rising during the quarter, the CBD Grade A vacancy level fell 1.4 ppts QoQ to 5.8% in Q3/2021. The drop in vacancy level could be attributed to tenants who committed earlier and only begun moving in in the reviewed quarter. Notably, the significant take-up in buildings such as One Raffles Quay and 79 Robinson Road are likely because their new tenants namely ByteDance and Boston Consulting Group took physical possession of their new office space respectively. As a result, the vacancy rate in Marina Bay and Shenton Way fell, while that in other areas such as Tanjong Pagar and Beach Road/ Middle Road went up in Q3/2021.

RENTS

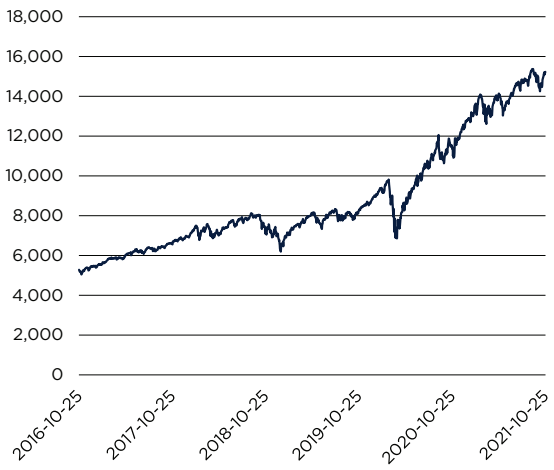
In Q3/2021, Savills CBD Grade A office rents ended six consecutive quarters of decline with the average gross effective rent in our basket holding at S$9.37 per sq ft. Similarly, rents for those rated AA and A in our basket also hit a trough and moving on, landlords are attempting to reduce their rent concessions. While rents for Grade AA offices inched up by 0.2% QoQ, Grade A offices remained

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q3/2021

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	12.20	4.2
Raffles Place	9.53	8.3
Shenton Way	8.61	6.1
Tanjong Pagar	8.47	10.2
City Hall	9.67	3.0
Orchard Road	8.91	2.2
Beach Road/Middle Road	7.43	6.8

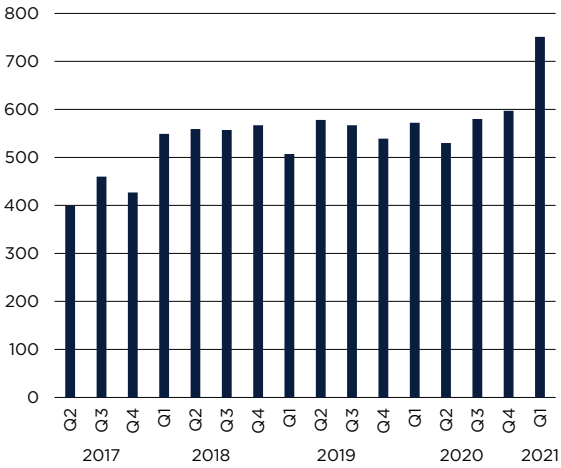
Source Savills Research & Consultancy

GRAPH 3: NASDAQ Composite Index



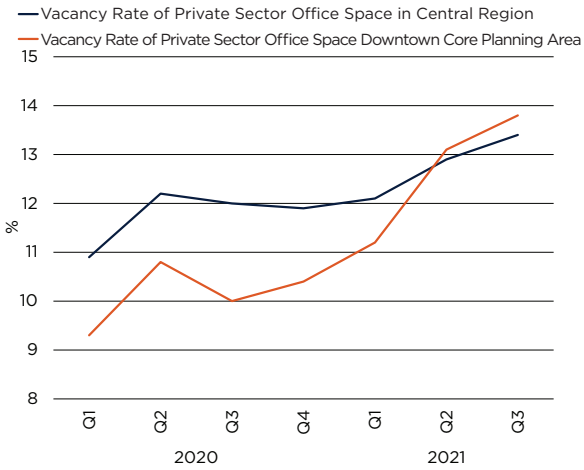
Source St. Louis Federal Reserve, Savills Research & Consultancy

GRAPH 4: Number of Late-stage Venture Capital Deals Done Globally, Q2/2017 to Q1/2021



Source Statista, Savills Research & Consultancy

GRAPH 5: Vacancy Rates for Central Region and Downtown Core, Q1/2020 to Q3/2021



Source Realis, Savills Research & Consultancy

unchanged from Q2. Despite lower vacancy and tighter available stock, rents for Grade AAA offices in our basket fell again in Q3/2021, down by 0.5% from the previous quarter. This could be due to some Grade AAA office buildings which are under pressure to recalibrate their rents to attract new or retain existing tenants. As a result, rents in Marina Bay, where most Grade AAA offices are located declined by 0.4% QoQ in Q3/2021.

On the other hand, other key business districts such as Raffles Place and Shenton Way micro-markets where there is a blend of Grade A and AA offices, saw quarter-on-quarter rental growth remaining flat in Q3/2021. Meanwhile, rents in Tanjong Pagar were lifted by a few Grade AA office buildings in the basket, reversing six straight quarters of rental decline with a 0.5% QoQ increase. (Table 1)

OUTLOOK

For much of 2021, the thesis for a recovery of office rents has been based on demand coming from technology companies, particularly those from China. As for 2022, the proposition that the CBD Grade A office market will finally experience recovery rested heavily on more Chinese tech companies beating a path here. Then came the recent series of reforms by the Chinese authorities of the online, private tuition, real estate, commodity, and consumer sectors, undermining the rebound narrative.

The fallout from these changes may be short term and should engender better social stability and reduce economic volatility in China. But how will these actions affect the Singapore office leasing market? On the one hand, it seems like much ado about nothing because Bytedance are expanding aggressively. However, in the field of Chinese social media and tech companies, they seem like an outlier. Leaving aside Bytedance, the outcome will probably be a hiatus in the expansion plans of Chinese companies in Singapore. If these moves do not spawn negative complications, then we may just have to sit through a few quarters for the new rules of engagement to take root and let the Chinese economy adjust before expansion restarts.

But even if Chinese companies arrive here late or do not arrive in strength, the demand shortfall may still be partially offset by the expansion of new-to-market wealth management firms and Western tech companies. For the possibility that the latter can fulfil its role as replacement demand for the Chinese tech firms, that possibility arises from the observation that the prices of major US tech and social media companies have been rising sharply. (Please refer to Graph 3.) Even for tech companies which are not listed, the number of late-stage deals done globally has not waned despite the pandemic and spiked in Q1/2021. (Please refer to Graph 4.). The upshot of this is that such companies have amassed reserves for expansion.

What remains is the question of whether demand from Western tech companies can fully take up the space left over from those rightsizing. After all, since the beginning of the pandemic, we have been observing rising vacancy rates in both the Central Area and Downtown Core. (Please refer to Graph 5.) We believe that even if it cannot, it does not necessarily mean that CBD Grade A office headline rents and asset values will decline. Increasingly in both private and public equity markets, traditional fundamental measures are beginning to fade as influencers of valuation. In its place are metrics such as the ability of a company to capture market share, tempo rate, closing rate, customer retention rate etc, many of which are measures to boost exit valuations for investors. Thus, the zeitgeist of the past and current decade has realigned from the 1990s when the need for companies to create economic value add was paramount. This tech landscape, especially those in the social media, alternative energy, disruptive technology and software application space, has now changed every sector of the economy. As the office sector plays host to many of the tech companies, explosive growth in the latter sector will spill over as derivative demand for space. That the brick and mortar, non-venture capital funded landlords can take on lower occupancies while maintaining rental growth and high asset valuations is made possible with the liquidity provided courtesy of global central banks. Thus, the scenario that vacancy levels may stay elevated while headline rents and values for CBD Grade A offices rise, is therefore a real possibility. For 2022, we therefore forecast a 0% to 2% increase in effective rents for CBD Grade A offices.