Office

Rental growth starts to taper off

Although business conditions are becoming more challenging, leading to an increase in both shadow space and vacancy, rents are holding up because landlords are finding the rate of lease expiries in the CBD Grade A market manageable.

- The market continued to receive a considerable number of leasing enquires with office sizes mostly in the range of 3,000 to 7,000 sq ft. Such demand comprises a mixture of modest expansion and downsizing from various industries.

- On the strata-titled office front, keen buying interest, particularly from Ultra-High Net Worth Individuals (UHNWIs), continued. In contrast, office block transactions remained relatively subdued as institutional investors stood on the side lines.

- From data compiled by Savills, the net take-up of CBD Grade A offices contracted by some 471,000 sq ft in Q1/2023, leading to the overall vacancy rate for CBD Grade A offices rising 1.7 percentage points (ppts) to 7.4% in Q1/2023. This is the second straight quarter increase for vacancy. Quarterly increases in vacancy rates were broad-based across the various grades.

- The average monthly rents of CBD Grade A offices in Savills basket continued rising, albeit at a glacial pace of 0.2% QoQ to S$9.59 psf in Q1/2023. Nonetheless, after a 2.2% growth for the whole of last year, rental growth is beginning to taper off.

- The host of new macro factors impacting office space demand may imply that we cannot make mid to long term forecasts based on the past decade and must start from scratch. Nevertheless, in the longer term, office rents here can still find support only if the supply of Grade A space in the CBD is constrained. For 2023, due to challenges on the economic, banking and technology fronts, we are maintaining our inflationary driven 2% YoY rental growth with vacancy levels ranging from 7% to 8%.

> "The CBD Grade A office market has entered unchartered waters under the influence of a host of new macro trends."
>
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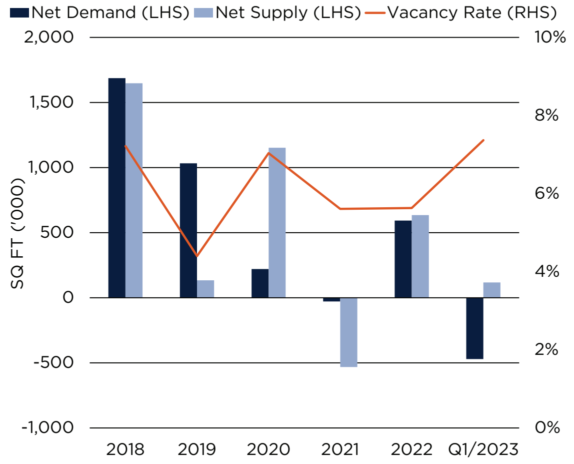
GRAPH 1: Net Demand, Net Supply and Vacancy Rate of CBD Grade A Offices, 2018 to Q1/2023



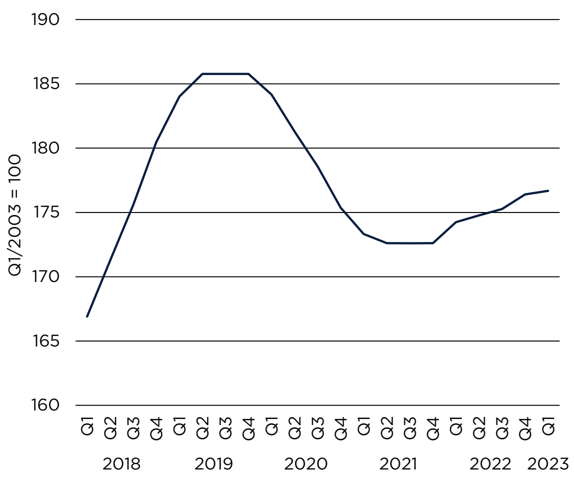
Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q1/2023

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	12.54	4.7%
Raffles Place	9.86	9.1%
Shenton Way	8.84	10.5%
Tanjong Pagar	8.50	12.6%
City Hall	9.98	5.5%
Orchard Road	8.91	1.2%
Beach Road/ Middle Road	7.86	8.4%

Source Savills Research & Consultancy

GRAPH 2: Rental Indices of CBD Grade A Offices, Q1/2018 to Q1/2023



Source Savills Research & Consultancy

MARKET COMMENTARY

It was a rough first quarter for Singapore's economy in 2023. Advance estimates from the Ministry of Trade and Industry (MTI) showed that Singapore's economy grew by a marginal 0.1% YoY in the January-March period, slower than the 2.1% expansion recorded in the previous quarter. On a seasonally adjusted QoQ basis, the gross domestic product (GDP) contracted by 0.7% after two consecutive quarters of growth. It has caused the concerns of a technical recession to increase amidst the cloudier global economic outlook. Overall, the weaker external demand was the main drag for the worse-than-expected economic performance in Q1/2023 and caused the manufacturing sector to shrink by 6.0% YoY. On the other hand, both the services and the construction industries performed well in the reviewed quarter and expanded 1.8% and 8.5% from the same period of last year. However, their growth only helped to partially offset the plunge in manufacturing.

In tandem with a slowdown in Singapore's economy and global headwinds, the performance of the labour market also showed some signs of softening in the reviewed quarter. Advanced estimates for Q1/2023 indicated that total employment (excluding Migrant Domestic Workers) grew for the six straight quarter by 34,500, however, there was a moderation of increase for both resident and non-resident employment. The number of retrenchments rose for the third consecutive quarter to 4,000. The increase was broad-based and mainly contributed by electronics manufacturing, professional services, information & communications, and construction sectors. Besides business reorganisation/restructuring, which had been the main reason since last quarter, the business downturn for these industries emerged as another top reason in the quarter.

In the reviewed quarter, the picture of the office leasing market was one of complexity. On one hand, the market continued to receive a considerable number of leasing enquires with office sizes mostly in the range of 3,000 to 7,000 sq ft. Such demand comprises a mixture of tenants from different industries embarking on modest expansion or downsizing. On the other hand, as was mentioned in our previous reports, the stock of shadow space was and is still growing. This arose from the economic slowdown, continuous tech layoffs and turmoil in the global banking industry. Affected companies, especially tech firms and banks, have already put-up space for sub-letting or if they can, return those excesses to the landlords. Many tenants are also reconfiguring the usage of their space to cut costs. Nonetheless, as the natural expiration dates for most of these shadow spaces are still some way off, there is less pressure on landlords to drop rents for now. In fact, for top of the Green buildings, rents are still rising. Coupled with limited new supply for most of this year, the leasing market is still favouring landlords. Landlords know this and thus, although we see vacancy levels rising, rents are still rising, albeit at a pedestrian pace.

The office investment market is pitting fears of higher interest rates and an increasing probability of seeing property values dip, against the inflow of foreign funds looking to diversify from other assets, a tale of two buyers' market emerges. On the strata-titled office front, keen buying interests, particularly from Ultra-High Net Worth Individuals (UHNWIs), continued. For example, the sixth and 12th floors in the upcoming 20-storey freehold office project Solitaire on Cecil were sold at S$3,867 per sq ft (psf) and S$4,196 psf of strata area respectively. In contrast, the office block transactions remained relatively tepid as institutional investors stood on the side lines. In the quarter, the freehold commercial building at 39 Robinson Road was sold to a joint venture led by China-based Yangzijiang Shipbuilding for S$399.0 million, or S$2,970 psf based on net lettable area[1]. The other significant deal is the S$80.0 million sale of GSM Building at Middle Road to the local LHN Group.

DEMAND AND VACANCY

From data compiled by Savills, the net take-up of CBD Grade A offices contracted by some 471,000 sq ft in Q1/2023, as a result, the overall vacancy rate for CBD Grade A offices rose 1.7 ppts to 7.4% in Q1/2023. This is the second straight quarter's increase for vacancy. Quarterly increases in vacancy rates were broad-based by grade. Grade A buildings saw the greatest rise of 2.1 ppts to 8.9%, immediately followed by Grade AA which increased 2.0% to 7.7%. Grade AAA offices' vacancy was 5.5% in Q1/2023, reflecting a relatively moderated increase of 1.2 ppts from a quarter ago.

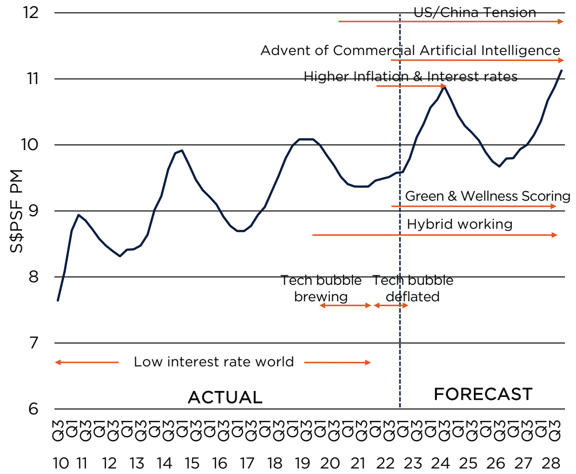
By location, the rise in vacancy rate was led mainly by the Tanjong Pagar and Raffles Place micro-markets. These increased 5.9 and 3.1 ppts QoQ respectively. The increase in Tanjong Pagar mainly came from the unfilled space in the newly completed Hub Synergy Point, while the relocation of KPMG from Hong Leong Building to Asia Square Tower 2, together with the space gave up by some tech firms, partly lifted up the vacant stock in Raffles Place. Other than the City Hall and Orchard Road areas where the vacancy rates inched down 0.3 and 0.5 of a ppt respectively, other micro-markets (including Marina Bay, Shenton Way and Beach Road/Middle Road) posted a quarterly vacancy increase from 0.9% to 2.0%.

RENTS

The average monthly rents of CBD Grade A offices in Savills basket continued its upward trend, edging up 0.2% QoQ to S$9.59 psf in Q1/2023. Nonetheless, after a 2.2% growth for

1 The Proposed Acquisition is conditional upon the satisfaction of the customary conditions for transactions of such nature at completion of the Proposed Acquisition, which is expected to take place in April 2023.

GRAPH 3: Actual and Forecast of CBD Grade A Office Rents (Machine Learning) – Naïve Case



Source Savills Research & Consultancy

the whole of last year, rental growth has started to taper off in view of higher vacancy levels. Global economic uncertainties and influx of shadow space caused by tech-sector meltdown and business restructuring have formed obstacles for further rental increases.

By grade, the Grade AAA office sector had the highest rental growth at 0.4% QoQ, followed by both Grade AA and Grade A with a 0.1% quarterly increase. By location, positive QoQ rental increases were observed in Raffles Place (1.1%), Beach Road/Middle Road (0.5%), Shenton Way (0.3%) and Marina Bay (0.1%). Office rents in City Hall, Tanjong Pagar and Orchard Road remained unchanged from a quarter ago.

OUTLOOK

The CBD Grade A office market is at a crossroads, faced with several possible paths which it can take over the next decade. While economic challenges continue to increase and the tech sector, which just six months ago the market believed to be the driver of office space demand, faces more funding troubles, rents are still rising, albeit at a pedestrian pace. However, these issues are contemporaneous to short term in nature. Beyond this, the green and greener movement plus other sustainability and wellness issues arise for both landlords and tenants. Juxtaposed with the above issues is also the adoption of hybrid working for many industries. All these are new confounding factors that the office market has to grapple with, likely rendering the market structure of the past 15 years almost irrelevant.

So whilst demand for Grade A CBD office space may still be driven by the economic variables, namely GDP or its components, the elasticity of demand may change drastically, leaving forecasts from models built on data from the past 15 to 20 years questionable. This means that the accuracy of even machine learning based models is suspect. But is that so?

We believe that in a situation where the market is expected to undergo upheavals, using a baseline may still offer a glimpse of the future. Using a machine learning time series forecasting function, rents are forecast to continue trending up until end-2028. Using a machine learning algorithm, Graph 3 shows how Savills Grade A CBD rents may perform from Q2/2023 to Q4/2028. The trend is positive and in the medium term (until end-2024), based on previous rental behaviour, it should be riding the up-phase of the cycle. The rental forecast was built mostly on data from the last decade where low interest rates and a rapidly expanding tech industry subsisted. Before the SARs-CoV-2 lockdown, the practice of hybrid working was not prevalent.

Moving forward, we see that the "world" is now being impacted by many more factors. How the office market may pan out for the rest of this decade in this paradigm where there are superpower tensions, a medium-term affliction of high inflation and interest rates, hybrid working, sustainability and wellness scoring and lastly, the most important factor, the rapid adoption of Artificial General Intelligence (AGI) is not only not easily modelled but impossible to do so.

However, we do believe that for 2023, rental growth will be subdued, and driven by cost push factors. Thus, the sharp upswing in rents that a naïve model churns out for this year is unlikely to materialise. The main reasons for this year's performance are economic and banking related and the restructuring of the tech industry. As a base case, beyond the immediate issues, hybrid working, tenant's cost to fit out a sustainable office space and AGI are likely to ease demand pressures. However, we are not discounting the possibility that if these new practices and adoption of technology spawn new industries, demand for office space may revive strongly.

The upshot from this is that we cannot make a forecast based on the past because of the myriad of macro interventions. We have to start from scratch. Nevertheless, office rents here can still find support only if the supply of Grade A space in the CBD is constrained.

For 2023, we are maintaining our 2% YoY growth for Grade A CBD office rents with vacancy levels hovering at around 7% to less than 8%.