MARKET IN MINUTES

Savills Research

Office

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Market pressures build

As the global economy slows and tech layoffs balloon, the office leasing market faces challenging times ahead. However, the movement towards green buildings alongside rising inflation could still support rents.

- Although there continues to be a steady flow of leasing activity and backfilling of shadow space, the market sees the challenges ahead, and some landlords have become more realistic, lowering their rental expectations.

- Office investment sales rebounded in the quarter after two consecutive quarters of decline. Similar to Q3/2022, there was only one block transaction in Q4/2022, which was the sale of a 50% stake in Lazada One for S$362.3 million.

- After two consecutive quarters of decline, the vacancy rate in Savills basket of CBD Grade A offices inched up slightly by 0.4 of a percentage point (ppt). A rise in vacancy rates was observed across all three gradings of offices, particularly for Grade AA buildings, which rose by 0.7 of a ppt quarter-on-quarter (QoQ) to 5.7% in the quarter. Nevertheless, the strong demand in the first three quarters of 2022 outweighed the fall in demand in Q4/2022, leading to a net take-up of 593,000 sq ft for the whole of 2022, higher than that for the past two years.

- As the office leasing market remains tight with the lack of significant new supply, average monthly rents in Savills basket of CBD Grade A offices rose for a fourth consecutive quarter by 0.6% QoQ to S$9.57 psf, a slightly higher rate than the 0.3% in Q3/2022. This increase in rents can be attributed to higher service charges.

- Three factors including the need for tenants to move to premium offices to comply with ESG mandates, inflation working its way through the service charge component, and the constant flow of family offices setting up here, may see our basket of offices eke out a 2% year-on-year (YoY) increase in 2023. However, there may be quarters when we may see either no or slightly negative QoQ rental changes amongst the sub-grades in our basket of CBD Grade A offices.

> "The need to comply with ESG mandates alongside inflationary pressures may support rents against the tide of economic concerns."
>
> ALAN CHEONG, SAVILLS RESEARCH

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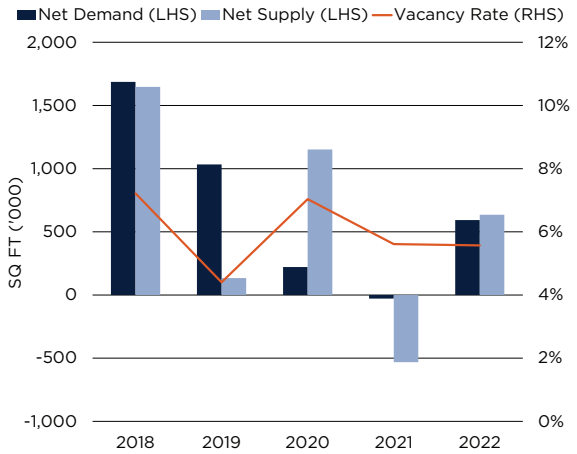
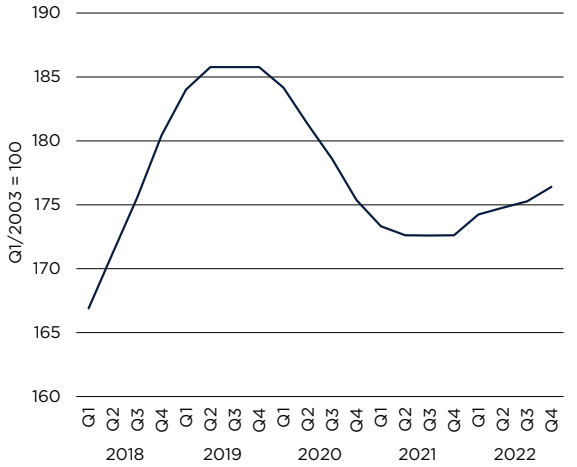
GRAPH 1: Net Demand, Net Supply and Vacancy Rate of CBD Grade A Offices, 2018 to 2022



Source Savills Research & Consultancy

GRAPH 2: Rental Indices of CBD Grade A Offices, Q1/2018 to Q4/2022



Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q4/2022

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	12.53	3.9%
Raffles Place	9.76	6.0%
Shenton Way	8.81	9.2%
Tanjong Pagar	8.50	6.7%
City Hall	9.98	5.8%
Orchard Road	8.91	1.7%
Beach Road/ Middle Road	7.82	6.4%

Source Savills Research & Consultancy

MARKET COMMENTARY

According to advance estimates from the Ministry of Trade and Industry, the Singapore economy expanded 2.2% on a YoY basis in Q4/2022, slowing from 4.2% in Q3/2022. For the year, Singapore's gross domestic product (GDP) rose 3.8%, down from the 7.6% recorded in 2021. For the service sector, following a 3.6% increase in Q3/2022, this group, which comprises the information & communications, finance & insurance and professional services sector grew 2.9% YoY in Q4/2022. All sectors within the group expanded in the quarter. Growth in the information & communications sector was attributed to robust demand for IT and digital solutions, while in the professional services sector was supported by the architectural & engineering, technical testing & analysis segment. Expansion in the finance & insurance sector was mainly driven by activities auxiliary to financial services including payment processing activities. Despite a slowdown in the growth of Singapore's economy, the labour market remained tight in Q4/2022 as total employment (excluding migrant domestic workers) rose for a fourth consecutive quarter. Nevertheless, the growth was largely attributed to non-resident employment which was concentrated in the construction sector. In addition, the number of retrenchments grew to 3,000 in Q4/2022 from the lows of the previous three quarters (800 to 1,300), which mainly came from the electronics, information technology and wholesale trade sectors. This came as the tech sector continued announcing staff layoffs.

Despite news of a slowing economy and tech layoffs, there is still a steady flow of leasing activity amid the lack of significant office completions for the past few quarters. While there had been an increase in shadow space due to the economic slowdown and tech meltdown, thus far much of these spaces were backfilled. However, undeniably, while there is enough leasing activity to keep landlords buoyant, the slew of news flowing in about the global economy was unsettling to all. Consequently, some landlords turned more realistic and have begun to lower their rental expectations. Tenants continued to adopt a wait-and-see approach on their lease renewal plans seeing how the economic situation will pan out going forward. The choice is one between renewing and downsizing while saving on fit-out cost or moving to a premises with significantly lower rents. That said, demand for premium buildings was much more stable, as evident from the lower vacancy rates. This is attributed to the lack of supply and the prestige that family offices want from setting up operations here plus tenants need to be in green rated buildings.

In the investment sales market, office investment sales rebounded in the quarter after two consecutive quarters of decline. There was only one block transaction in the final quarter of 2022, which was the sale of a 50% stake in Lazada One to Japanese fund manager Kenedix from ARA Asset Management for S$362.3 million. In addition, the growth in investment sales was also attributed to higher strata sales. (We will record the 50% stake sale of Nex@ Serangoon in Q1/2023.)

DEMAND AND VACANCY

After two consecutive quarters of decline, the vacancy in Savills basket of CBD Grade A offices inched up slightly by 0.4 of a ppt QoQ to 5.6% in Q4/2022. On a YoY basis though, the vacancy rate remained unchanged. Increases in the vacancy rate was observed across all three gradings of offices, particularly for Grade AA buildings, which rose by 0.7 of a ppt QoQ to 5.7% in the quarter. Similarly, vacancy rates of Grade AAA and A buildings grew by a moderated 0.3 of a ppt to 4.3% and 6.8% respectively in Q4/2022. On a YoY basis, vacancy rates of Grade AAA and AA buildings rose 1.0 ppts and 0.8 of a ppt respectively, while that of Grade A buildings contracted 1.7 ppts. In Q4/2022, this was the first quarter that net demand went to the negative territory of -153,000 sq ft since Q2/2021 when net demand amounted to -1,000 sq ft. Nevertheless, the strong demand in the first three quarters of 2022 outweighed the fall in demand in Q4/2022, leading to a net take-up of 593,000 sq ft for the whole of 2022. This was higher than that for each of the last two years.

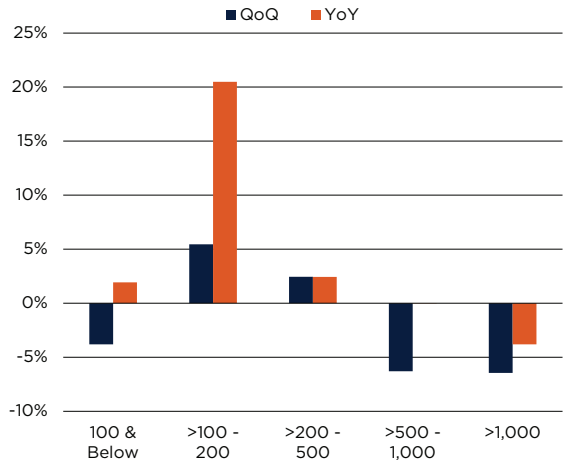
Across the micro-markets, quarterly increases in vacancy rates were observed for Beach Road/Middle Road (-1.1 ppts), Shenton Way (-0.7 of a ppt) and Raffles Place (-0.1 of a ppt) in Q4/2022. This was outpaced by quarterly growth in vacancy rates in City Hall (1.8 ppts), Marina Bay (1.5 ppts) and Tanjong Pagar (0.4 of a ppt). For City Hall, the increase came from the relocation of SMBC from Centennial Tower to CapitaSpring.

On a YoY basis, declines in vacancy rates were registered for Tanjong Pagar (-2.7 ppts), Raffles Place (-2.0 ppts) and Orchard Road (-0.4 of a ppt) respectively, while growth in vacancy levels were seen in City Hall (2.8 ppts), Shenton Way (0.7 of a ppt) and Beach Road/Middle Road (0.1 of a ppt) respectively.

RENTS

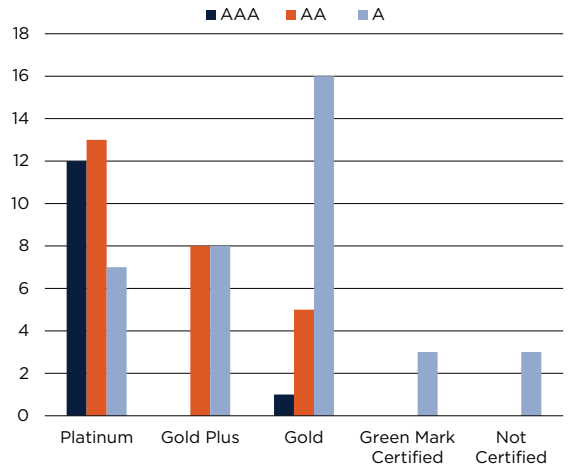
With the lack of significant new supply and the congregation of tenants towards Grade A buildings the office leasing market remains tight in Q4/2022. This led to office rents eking out a QoQ rise in the final quarter of the year. The average monthly rents of Savills basket of CBD Grade A offices rose for a fourth consecutive quarter by 0.6% QoQ to S$9.57 psf, a slightly higher rate than the 0.3% in Q3/2022. As such, office rents rose by 2.2% for the whole of 2022, a reversal from the yearly declines for the past two years when Singapore was largely affected by the Covid-19 pandemic. Across the office gradings, rents of Grade AAA offices saw rents expanding 1.7% QoQ, the largest quarterly

GRAPH 3: Rental changes for URA's Category 1 buildings by floor area (sq m)



Source URA, Savills Research & Consultancy

GRAPH 4: Green ratings for Savills basket of Grade A CBD Office buildings



Source Savills Research & Consultancy

growth since Q2/2019 when rents rose 1.0%. On a YoY basis, rents of Grade AAA offices increased 3.6%. Similarly, rents of Grade AA and A offices continued to grow by 0.2% and 0.6% QoQ, as well as 1.0% and 2.5% respectively in Q4/2022. This increase in rents can be attributed to higher service charges.

By micro-market, rents of CBD Grade A offices in Marina Bay were the most resilient, increasing by 1.7% QoQ in the quarter. This was the largest quarterly growth across all the micro-markets in Q4/2022. Increases in office rents were also observed in Raffles Place (+0.8%), Shenton Way (+0.7%), Beach Road/Middle Road (+0.6%), City Hall (+0.6%). Office rents in Orchard Road and Tanjong Pagar remained unchanged on a QoQ basis in the quarter.

OUTLOOK

Although the rental market in Q4/2022 showed surprising strength when it accelerated to a 0.6% QoQ growth versus a 0.3% increase in the previous quarter, as we turn the year, we believe that whatever transpired in 2022 was somewhat of a departure from the normal state of affairs for the CBD Grade A office market. The construction delays caused by the pandemic measures and the sudden about turn of fortunes for the tech and social media industries made market analysis more complex. Adding to this, the new supply of CBD offices for 2022 came in at only 118,000 sq ft net lettable area (Hub Synergy Point). The confluence of these developments helped lift rents. The strength of the expanding tech and social media sectors in the initial months of 2022 gave the rental market a strong enough boost that the upward rental trajectory could be sustained until the end of the year.

On the surface, a relative lack of supply of premium grade offices has allowed some market observers to weave a reason for a positive spin on rents. However, as we breakdown the rental market by leases signed, we noticed that the rental spectrum is diffracting in disharmony. Using the URA's rents for Category 1 buildings (these are modern office buildings in the CBD and are similar to Savills definition for Grade A offices), we see signs that rents for different space sizes were starting to show discord, especially for lettings of larger space. In Q4/2022, rents for the larger floor lettings (>500-1,000 and >1,000 sq m), typical of what larger multinational tenants would sign, fell 6.3% and 6.4% QoQ respectively. On a YoY comparison, rents did not change for those in the >500-1,000 sq m range and for those >1,000 sq m, they fell 3.8%. It is for lettings in the range >200-500 sq m, that we saw rents rise 2.4% QoQ or 2.4% YoY. Incidentally, Savills basket of Grade A CBD office rents refer to effective rents in the >200-500 sq m size range and the 2.4% increase corroborates with our 2.2% increase for 2022. It is only for leases that took up >100 to 200 sq m of space that rose 5.5% QoQ and 20.5% YoY. This is the typical area which a family office would sign for.

Coming into 2023, a new movement is gaining greater momentum, namely the need for multinational tenants to comply with the ESG standards of their respective country of origin. As shareholders and clients expect greener practices, tenants from countries with strict ESG standards may have little choice but to locate in offices, even for their branches offshore, which are graded Green. This mandate would result in skewed demand towards green rated Grade A offices. While the challenges encountered on the economic front may take away demand, for Grade A offices, it may be partially offset by the flight of MNCs to these building. Almost all of Savills basket of CBD Grade A offices have at least some minimum green accreditation. In conjunction with inflation working its way through the service charge component, and the constant flow of family offices setting up here, the overall gross rents for our basket of offices may still eke out a 2% YoY increase in 2023. However, there may be quarters which we may see either no or slight negative QoQ rental changes amongst the sub-grades in our basket of CBD Grade A offices.