This report unveils the six potential new normals in the Hong Kong commercial real estate market.

Knight Frank

The "New Normal" for Commercial Real Estate in Hong Kong

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OVERVIEW

Despite experiencing four waves of COVID-19 outbreaks and its economic worse performance on record, Hong Kong is poised for further growth. Given a sharp rebound of GDP by 7.9% in Q1 2021, and a forecast of 3.5-5.5% growth for 2021, the commercial real estate market stands out with a positive outlook while adjusting to some “new normals”

Although the residential market remained resilient, the commercial property market was hard hit. Since the first outbreak of COVID in January 2020, overall Grade-A office rents have dropped 17.3%. With almost no overseas tourists because of travel restrictions and lockdowns, prime street retail rents have declined by over 50%. Compared with the office and retail markets, the industrial property market has been relatively stable, with rents dropping only 0.5%.

Backed by the sharp rebound of GDP of 7.9% in Q1 2021 after six straight quarters of decline, coupled with the widely available COVID vaccines in the city, market confidence in various segments has strengthened. Despite the downward rental trends, there is optimism that some segments of the real estate market could bottom out in the short term.

The COVID pandemic has changed market fundamentals. Instead of believing the market will return to the previous normal after COVID, we see six potential new normals in the Hong Kong commercial real estate market.

Table 1. Economic Indicators

	2018	2019	2020	2021 Q1
GDP Growth (YoY%)	2.8%	-1.2%	-6.1%	7.9%
Composite CPI (YoY%)	2.4%	2.9%	0.3%	0.5%
Unemployment (%)	2.8%	3.3%	6.6%	6.8%

Source: Knight Frank Research / Census and Statistics Department

1

RECENTRALISATION OF OFFICE TENANTS

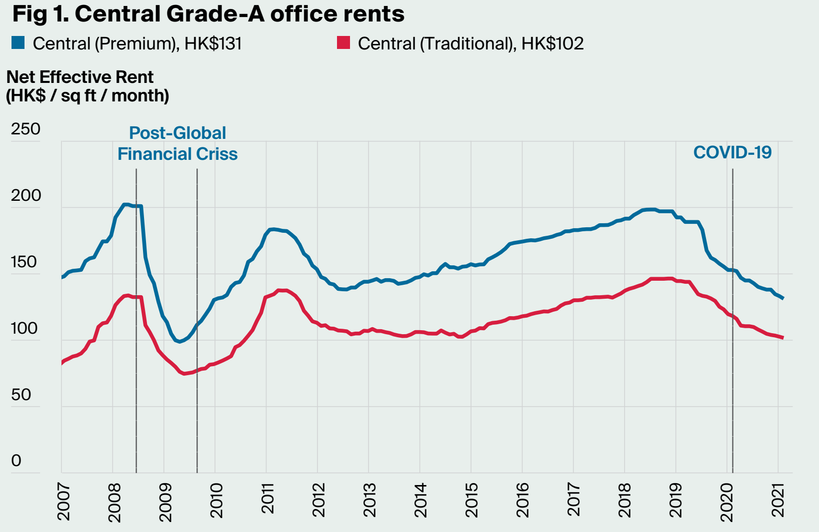
In the past 24 months, most companies have implemented strong cost-saving initiatives. Some have taken the COVID situation as an opportunity to revisit their real estate strategy over the long term. Decentralisation and downsizing have been the two key options for companies to reduce rental expenses, while others have moved to co-working space to increase flexibility and reduce risk.

Grade-A office rents in Central have been dropping since March 2019. The downward trend was exacerbated by COVID-19 since the beginning of 2020, leading to a cumulative drop of 29.8% as at the end of Q1 2021.

From a purely technical perspective, previous experience over the past 15 years has shown that whenever there is a sharp fall in Grade-A office rents in Central, it takes 18 to 20 months to return to the previous peak. In the era of the post-global financial crisis (post-GFC), premium office rents in Central tumbled 51% within nine months between October 2008 and July 2009. It required twice as long for the market to make up 80% of the drop in rents before another downward adjustment wave.

Chinese mainland companies are expected to continue to take up Central office space and potentially kick off a recentralisation trend.

Fig 1. Central Grade-A office rents



Source: Knight Frank Research

Since the current trough in the Central office market was not started by a financial crisis, it could have a shorter recovery period. If the market is set to bottom out in the second half of 2021, the downward adjustment in rents will have lasted for 24 to 26 months, so it could technically take 18 to 24 months to return to the previous peak, which would be sometime in 2023.

As there has been so much talk about “decentralisation” for two years, it is worth exploring the possibility and timeline for “recentralisation” since office rents in Central are almost on par with those in the post-GFC level. While some MNC tenants are adopting a lean organisational structure, others, especially in the professional services sector in other districts, are looking into adding value in their workplaces. On the other hand, Chinese mainland companies have been actively absorbing space surrendered by MNCs even under the COVID situation. One example of this is the office space in IFC given up by Nomura being taken up by the Bank of Dongguan.

With the Chinese mainland economy set to significantly rebound in 2021, since the COVID situation is under control, Chinese mainland companies are expected to continue to take up Central office space and potentially kick off a recentralisation trend.

2

NEW RETAIL LANDSCAPE IN CENTRAL

The COVID-19 pandemic has entirely changed the retail landscape in Central, especially on the prime streets in the Queen's Road Central area. In the past, the prime streets featured a tenant mix of luxury goods retailers, as well as sky-high retail rents, and the luxury retail stores on Queen's Road Central depended mainly on visitor spending. But because of the travel restrictions during the COVID outbreak, there are no tourists in town, so many luxury retailers have shut down their shops.

Since the start of the COVID-19 outbreak, retail shops in the so-called prime street area in Queen's Road Central have been replaced by non-luxury retailers. For example, Japanese discount retailer Don Don Donki rented a 17,800 sq-ft space for its fifth outlet in the city, and value-priced French sporting goods chain Decathlon rented a 9,300 sq-ft shop previously taken by luxury travel goods and accessories retailer MCM on the ground floor and basement of 30 Queen's Road Central. Current rents in these stores are reported to be at least 50% less than the those of the previous leases. With luxury retailers being replaced and rents plummeting, the retail market in Queen's Road Central has undergone a repositioning.

The repositioning of Queen's Road Central and the emergence of Harbourfront Site 3 will alter the retail landscape by moving most of the luxury retail activity to the north edge of Central in the next four to five years

The Hong Kong Government is currently tendering New Central Harbourfront Site 3 under the "two-envelop approach", in which both price and design proposals are assessed. According to previous planning goals, upon completion, the Harbourfront Site 3 development could provide some 1.1 million sq ft of premium retail space, almost as much as the existing premium retail space in Central, mainly in IFC Mall and Landmark, totalling about 1.3 million sq ft. As the first large-scale commercial mixed-use development in Central after IFC and considering the close physical connection between Harbourfront Site 3, IFC and Landmark, the three retail developments will form the latest premium retail cluster, with a total size of about 2.4 million sq ft, similar to Harbour City and New Town Plaza, the two largest shopping arcades in Hong Kong.

The COVID-19 crisis has accelerated the transformation of the traditional prime retail streets in Central. The repositioning of Queen's Road Central and the emergence of Harbourfront Site 3 will alter the retail landscape by moving most of the luxury retail activity to the north edge of Central in the next four to five years.

3

MODERN LOGISTICS TAKING OVER

Modern logistics, unlike traditional logistics, is seen as the physical integration of materials handling, production, storage and transportation, and also includes higher-level non-physical and commercial business functions, such as shipment tracking, management services, product maintenance, integrated packaging solutions, and just-in-time (JIT) activities, like correct language labelling and end-market regulations. These value-added services are normally undertaken by third-party logistics (3PL) providers, which require a large floor area to work efficiently and allow economies of scale.

Modern logistics buildings have higher requirements for building specifications. For instance, all floors in a modern logistics building must have direct vehicular assess, but general industrial buildings do not have this. This has made it a technical challenge to convert older general industrial buildings into modern logistics buildings. But there is strong demand for modern logistics space worldwide because of its higher value in the industrial supply chain over traditional industrial space and the wider application of e-commerce in recent years.

With the ever-increasing application of e-commerce, demand for modern logistics will inevitably continue to rise at a rapid rate

The COVID pandemic instantly changed consumer behaviour in Hong Kong, as it has worldwide, especially regarding the stay-at-home economy and online shopping because of travel restrictions and anti-epidemic social-distancing rules. According to the Hong Kong Census and Statistics Department and Statista, the overall Hong Kong e-commerce market has seen strong growth, with revenue potentially reaching HK$87.6 billion by 2025, for an annual growth rate of 10.5%. The current e-commerce penetration rate in Hong Kong is estimated to be 73.1%, corresponding to about 5.5 million e-shoppers, and it is expected to hit 83.8%, or 6.5 million e-shoppers, by 2025. With the ever-increasing application of e-commerce, demand for modern logistics will inevitably continue to rise at a rapid rate.

There is currently about 2.3 million sqm of modern logistics space in Hong Kong. With the COVID situation driving demand from the wider application of e-commerce, total demand for modern logistics space could be up to 3.1 million sqm by 2025, so another 0.8 million sqm will be needed to fill the supply gap in the next four to five years.

Fig 2. Major modern logistics centres in Hong Kong

Source: Knight Frank Research

4

EXPECTED RETURN OF SIZABLE TRANSACTION OF COMMERCIAL

Transaction volume rose by
207%
in 2H 2020

Major Industrial transaction
HK$7.8bn
in 2020

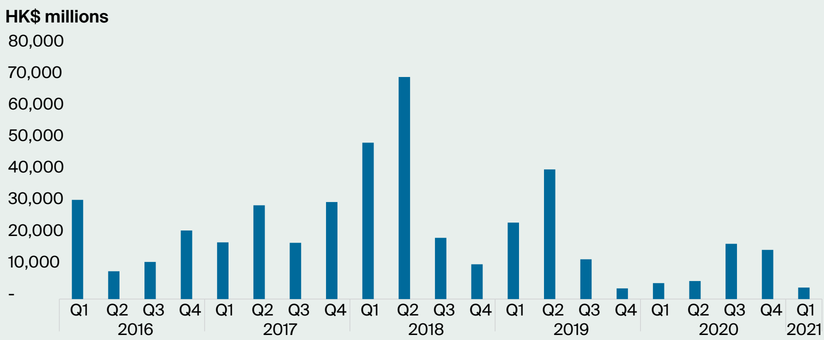
The impact of the COVID-19 pandemic has been seen across all segments of the commercial real estate market over the past year. With a series of social-distancing and travel restrictions in place since early 2020, business activity was hindered across the board in Hong Kong, not to mention the investment market. Many investors froze their plans and adopted a wait-and-see attitude. Total transaction volume of commercial properties valued at HK$500 million or above plunged by 83% YoY to HK$10.8 billion in the first half of 2020, according to data from Real Capital Analytics (RCA).

Entering the second half of 2020, many people gradually adapted to the “new normal” in their work and life style. With investors regaining confidence in the market outlook, transaction activity began to recover. In 2H 2020, the volume of major commercial property transactions was three times that in 1H 2020. There were a number of significant transactions, including a HK$9.84-billion purchase led by fund managers Gaw Capital Partners and Schroders Pamfleet of the CityPlaza One office building from Swire Properties. In terms of property type, industrial property was the only sector that weathered the market downturn. Major industrial property transactions totalled HK$7.8 billion in 2020, on par with the level in 2019.

With the rollout of vaccination programme and the declining number of COVID cases, overall business performance has continued to improve. Many investors have started to revisit potential opportunities to acquire bargain assets, with a preference for Hong Kong’s Grade-A office space, which is underpinned by sound economic fundamentals and well-established financial markets. Even when Hong Kong was battling the pandemic and with the adoption of work-from-home policies by some companies, physical space was still widely recognised as important for collaboration and building a company’s cultural identity. Therefore, investment demand for Hong Kong Grade-A office space is expected to remain robust in the long term.

Industrial property sales momentum is also expected to grow steadily in the post-COVID era, thanks to the government’s implementation of the standard rates pilot scheme for lease modification. This is expected to facilitate and shorten the process of industrial revitalisation and redevelopment, which is expected to prompt more industrial property investment.

Fig 3. Total transaction volume of commercial properties valued at HK$500 million or above



Source: RCA, Knight Frank Research

5

STRONGER BUYING APPETITE FOR DATA CENTRE SITES

Telecommunications has become more essential than ever for individuals and businesses under the COVID-19 situation. With travel restrictions and city lockdowns in place, people have learned how to effectively communicate with each other overseas. TeleGeography, a telecommunications market research firm, reported that global internet traffic saw a stunning 51% surge on an annual basis in 2020. This wider application of telecommunications has also led to higher demand for data centres.

In recent years, data centres in Hong Kong have been seen as good investments with tremendous growth potential, thus attracting investors to enter the market targeting great investment returns. Hong Kong is an attractive location for data centres because of its advanced telecommunications infrastructure, reliable power supply at reasonable cost, limited climate risks, and strong demand from local companies for cloud services.

Purchase sentiment for data centre sites remained robust during the COVID outbreak with major transactions being completed

Most of the existing data centres in Hong Kong are located in Tseung Kwan O (18%), Tsuen Wan (16%), Chai Wan (12%), Kwai Chung (11%) and Shatin (8%), according to Cloudscene. The total GFA of data centres in Hong Kong was estimated to be 5.2 million sq ft as at the end of 2020. This is expected to increase by 75%, or around 3.9 million sq ft, to a total of 9.2 million sq ft by 2026.

Currently, the primary source of land supply for data centres is government land auctions. Other potential sources include waiver and lease modification applications, and sales of sites in the open market. Data centres, especially the higher-tier ones, have specific operational requirements regarding electricity generation, transmission and distribution networks, high headroom, and large site area for building support facilities. This makes it technically challenging to convert older industrial buildings into data centres, so greenfield sites are highly attractive to investors.

Purchase sentiment for data centre sites remained robust during the COVID outbreak with major transactions being completed. For instance, in July 2020, China Mobile snapped up a site in Fo Tan for HK$5.6 billion to construct a data centre. And in February 2021, Mapletree acquired a site in Fanling for a 217,000-sq-ft data centre development for HK$813 million.

COVID has highlighted the importance of data centres. With the market in Hong Kong maturing, buying appetite of any site available will only become stronger.

Despite the strong efforts by developers, investors in Hong Kong are generally not taking as much consideration of ESG elements as investors in other parts of the world

6

NOT ENOUGH CONSIDERATION OF ESG ELEMENTS BY HK INVESTORS FOR REAL ESTATE

In recent years, people worldwide have expanded the use of environmental, social and governance (ESG) criteria in every respect, from their daily life to business operations and formulating an investment strategy. However, not everyone understands what ESG is and its underlying purpose. Instead of focusing simply on financial performance, many investors believe the ESG performance of a company or asset also affects their long-term decision in making an investment.

In the real estate sector, there is a stronger focus on the ESG elements because of their close ties with financial and cost-saving incentives. The Global Real Estate Sustainability Benchmark (GRESB) set and assessed the ESG benchmarks for sustainable real estate assets to provide a set of standardised data for capital markets. The GRESB assessments show that there have been ongoing improvements in the results of the global real estate sector over the years.

In Hong Kong, many more developers are paying more attention than ever to ESG elements, from internal policies and governance to project planning, and from green financing to leasing, operations and facilities management. For example, New World Development issued its first green bond in Hong Kong worth US$310 million for its Greater Bay Area projects.[1] Link REIT incorporated its progress on sustainability into the annual report as a core gauge of the organisation’s health. The REIT also took the lead in issuing some of Asia’s first green convertible bonds tied to eco-friendly improvements.

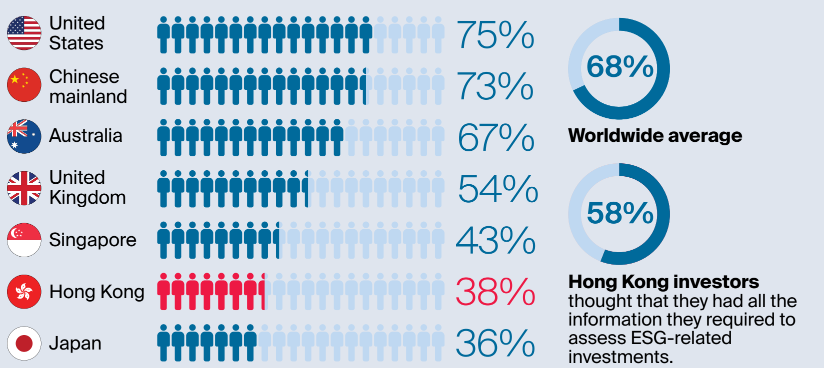
All of Swire Properties’ projects under development have achieved the highest green building certification ratings.[2] Green buildings have played a crucial role in ESG in Hong Kong real estate, as currently over 90% of the electricity in Hong Kong is consumed by buildings, according to the Hong Kong Green Building Council.

Some forward-looking MNCs also drive the ESG agenda as this is an increasingly important part of their office leasing strategy, as well as their fitout decision making process. For example, Ernst & Young Hong Kong recently partnered with Sustainable Office Solutions, a new ESG start up, to reuse, repurpose and recycle their existing fitout.

Despite the strong efforts by some leading developers and occupiers, local investors in Hong Kong are generally not taking as much consideration of ESG elements as investors in other parts of the world are, not even under the COVID-19 pandemic. According to an attitude survey of Knight Frank’s Wealth Report 2021, 38% of investors in Hong Kong indicated that COVID-19 had made them more interested in ESG-focused property investments than they were 12 months earlier. In comparison, 75% of respondents in the United States indicated the same change under COVID-19, along with 73% in the Chinese mainland, 67% in Australia, 54% in the United Kingdom, 43% in Singapore and 36% in Japan. In addition, only 58% of Hong Kong investors thought that they had all the information they required to assess ESG-related investments, compared to a worldwide average level of 68%.

Regardless of huge potential benefits over the long term, Hong Kong investors have not found sufficient incentives in ESG-focused property investments and are lagging behind other parts of the world in attempting to understand ESG-focused property investment.

Fig 4. Global interest in ESG-focused property investments



[1] Green Building Approach, Challenges & Opportunities by New World Development Company Limited.
[2] Green Building: Challenges and Opportunities by Swire Properties.

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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