OFFICE MARKET

INSIGHTS

JULY 2019

Will Kowloon see a Central2 after CBD2?

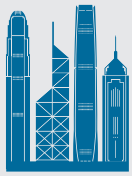
West Kowloon Terminal Site to Act as a Catalyst

Kowloon has always been considered the lower-cost alternative for office space compared to Hong Kong Island, with average rents 30-50% lower than those across the harbour. The area has also been largely avoided by the banking & finance and professional services sectors. However, in the last few years, the Government has begun shifting commercial activities to the Kowloon side with its CBD2 concept, spurring great change in the area.

Apart from the CBD2 concept, the hottest topic for Kowloon's future development is now a newer concept known as "Central2" – whereby people are expecting the commercial site atop the West Kowloon Express Rail terminal to convert Kowloon's core district Tsim Sha Tsui (TST) into the second Central of Hong Kong.

This commercial site is not only the largest of the 2019-2020 land sale programme, but also the largest of its kind in recent decades. With area of approximately 5.96 hectare, the site will be home to three office towers providing up to 3.21 million sq ft, with 2.8 million of office space, making it bigger than the International Financial Centre complex (2 million sq ft) and of similar size to the nearby International Commercial Centre (2.3 million sq ft).

West Kowloon Terminal Site



Kowloon's future developement to be Central2

Largest Commercial site for sale in 2019-20

$100 BILLION

Projected to be the first land sale in Hong Kong to surpass HK$100 billion

2.8

million sq ft office space

Rent Potential in Kowloon

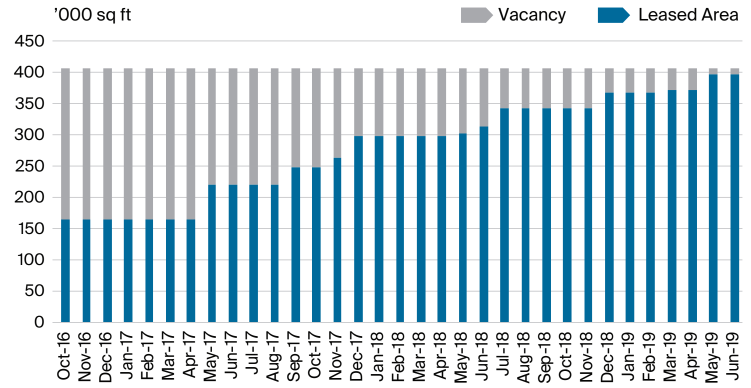
Breaking free of its traditional low-rent profile, in recent years Kowloon has seen more than one building achieve gross rent of over HK$100 per sq ft. One such example is the newly completed K11 Atelier, with gross average office rent of over HK$100 per sq ft. Considering that the building's roughly 75% efficiency rate, this figure converts to HK$133 per sq ft. Most notably, a recent lease in the building of roughly 3,000 sq ft gross was signed for up to HK$118 per sq ft gross, equivalent to HK$157 per sq ft net, an all-time record for Kowloon office transactions.

Since Mizuho Bank took residence in October 2016, the building has continued to receive a good response from the market, seeing an average absorption rate of about 9.8% per month (see figure 1). This reflects the strong potential for premium Grade-A office buildings in Kowloon.

Meanwhile, International Commerce Centre is also seeing an average of roughly HK$100 per sq ft gross. Considering the building's efficiency rate of about 70%, this translates to HK$143 per sq ft net. The building currently has less than 1% vacancy and is another good example of the area's premium Grade-A office absorption.

FIGURE 1

Vacancy and Occupancy Change in K11 Atelier



Source: Knight Frank Research

This suggests that the Kowloon market is transforming from "lower cost" to "strategic location and quality". Given average premium Grade-A building rent of roughly HK$150 per sq ft net, then assuming 3% inflation per year between now and 2025, when the West Kowloon terminal commercial site is expected to be completed, plus say a 5% premium for new-building quality, then net rent of up to HK$190 is certainly achievable in Kowloon. Further, by then Kowloon will have seen several more buildings with net rent reaching up to the level of Hong Kong Island's Grade-A and premium Grade-A market.

Tenant Mix Trend in Kowloon also Changing

To date, the Banking & Finance industry, one of the highest-budget tenant sectors in the market, has located only back up operations in Kowloon. However, this is changing as we see more and more companies relocating their Hong Kong Island front office to Kowloon.

The CBD2 area is now home to Citibank and JPMorgan's front offices, a result of large-scale consolidation in the companies' respective long-term real estate strategies. In the TST area, we are also seeing more and more Japanese and Taiwanese banks, whom have long been present in the area and are now expanding and consolidating further with their front line offices.

This pattern continues to progress. In 2016, banking and finance accounted for just 26.58% of major occupiers in the central part of Kowloon, a figure that rose to 35.23% in 2018 and elevated banking and finance to a fast-developing sector among major occupiers in the TST area.

FIGURE 2

Tenant Mix Distribution in 2016-17

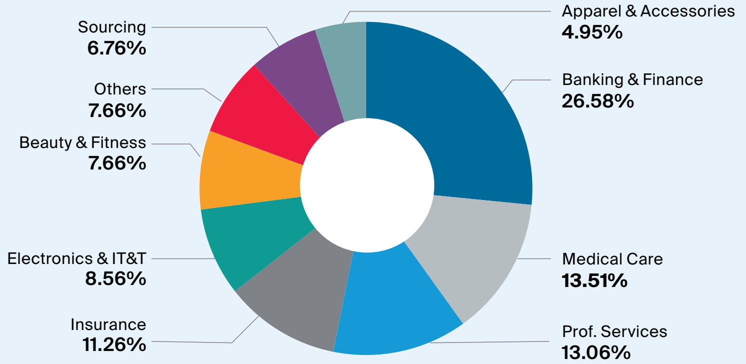
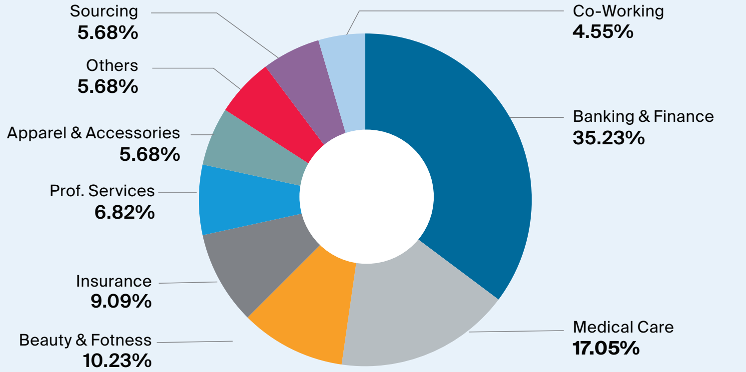


FIGURE 3

Tenant Mix Distribution in 2018-19



Short & Long Term Differences

The West Kowloon terminal site will likely be the first in Hong Kong history to surpass HK$100 billion land price, assuming a mid-range figure of up to HK$30,000 per sq ft. Adding an estimated HK$100 billion in development costs, the total consideration of the parcel could reach as much as HK$200 billion. The huge potential impact of the project leaves us very optimistic that it will catalyze the whole of Kowloon into a new commercial hub – a "Central2" formation, in addition to the CBD2 concept. In fact, if net rent can reach up to HK$190 per sq ft, as deduced above, then over HK$200 billion the mature yield is still over 3.5% - a very reasonable return compared to today's investment vehicles. The biggest limitation is the huge amount of capital involved that will likely push developers to form conglomerates or joint ventures through which to bid and run.

Kowloon's short-term prospects, however, are not as optimistic as those of the long-term, particularly given the limited stimulus as well as economic and political concerns.

Market Outlook

Our housing forecasts for the second half of 2019 remain rather conservative at a 1-3% rental increase, despite our highly optimistic long-term view of a maturing West Kowloon.

The recent forfeiture of deposit by Goldin Group on the awarded Kai Tak commercial site has revealed the shaken confidence of some developers in the short- to mid-run amid looming political and economic uncertainty. There are still more adjustments coming in the Kowloon market before a new upward trend is expected to develop based on the "Central2" concept becoming more widely recognised and accepted.

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