Knight Frank

Asia-Pacific Prime Office

Market Focus:

Supply and Shadows

What do increasing levels of office supply and sub-leasing mean for occupiers and investors?

October 2020

Summary

- Demand for office space has been hit by Covid-19. The ensuing economic contraction across much of the region coupled with shifting attitudes to workplace strategy has led a softening of demand in the majority of markets
- While many cities still have levels of upcoming supply in line with historic averages, a number of markets have elevated supply pipelines which are likely to put downward pressure on rents
- Emerging "shadow space" (that is sub-leasing space being released into the market, often at sub-market rental levels), has the potential to put further downward pressure on rents by amplifying existing vacancies
- While numbers are difficult to fully gauge, our research into four gateway cities shows that sub-leasing space has lifted potential supply by up to 3.6%
- Occupiers should be aware of the challenges and potential risks involved in taking up a sub-lease space compared to a traditional lease agreement; particularly in the current market climate.

Introduction: Clouds on the horizon

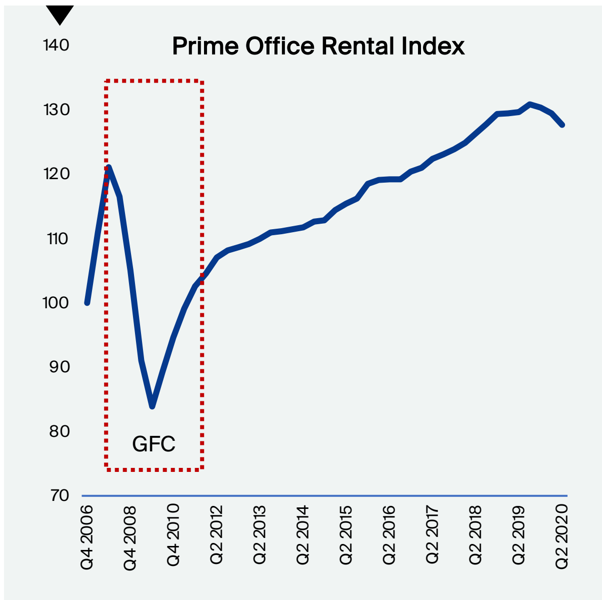
The Covid-19 pandemic has had a significant impact on sentiment within the office markets across the region. Lockdowns, travel restrictions and working from home have directly impacted the utilization of office space, while demand, measured as net absorption, is significantly down this year compared to previous years. This is being driven by three major factors:

1. With most Asia-Pacific economies in a recessionary phase, corporate occupiers from a range of sectors are expected to face challenges to their bottom lines. This will continue to translate into softer office demand across the region as occupiers undertake cost-cutting measures.

2. Following on from (1), the general uncertainty in the economic outlook is now discouraging occupiers from spending CAPEX on fit-outs for expansions or relocations at the current time.

3. With the global working from home "experiment" being undertaken in many markets, some occupiers are reviewing their strategies and space requirements. While it is unlikely to be an either/or, many corporate real estate leaders are considering adding more flexibility into their portfolios, potentially impacting office demand.

Looking at the latest office data points, this softening of demand has already started to impact average rents across the Asia-Pacific. In the most recent quarter, market rents fell -1.4% quarter-on-quarter, while the average vacancy rose 0.8ppts to 11.6%. However, weakening demand is not the only challenge facing office markets. Several have large amounts of supply in the pipeline over the coming years, while others are facing internal challenges from an increasing amount of sub-lease space.



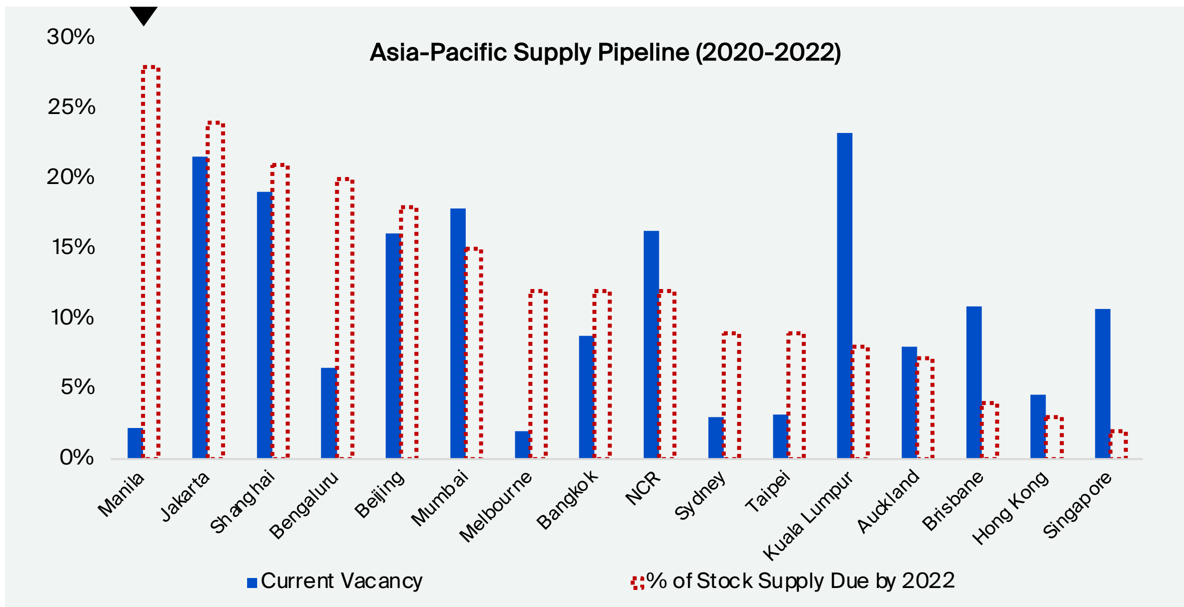
Source: Knight Frank Research

Lessons from past crisis

Looking back at the 08/09 GFC, Grade A office rents across the Asia-Pacific region on average recorded a peak to trough correction of c.30%, as shown by Knight Frank's Asia-Pacific Prime office rental index. However, so far during this pandemic, we have only seen a decline of 3% (as of 2Q 2020). A likely reason and notable difference between these two periods is that unlike in the build-up to 08/09 where rents recorded sharper increases, rents this time have grown steadily and been mostly in-line with economic growth. Furthermore, the office sector has seen growing demand from the tech industry who have emerged as large occupiers of space, unlike during the GFC where demand was still mainly driven by financial firms which were hit the hardest during the GFC.

How much stock is coming over the next few years?

Taking stock of the upcoming supply situation for the rest of this year and till 2022, the pipeline across the region is generally in line with historic averages with the exception of Jakarta, Manila, Shanghai, Beijing and Bengaluru which have elevated levels of supply amounting to around 20 to 30% of their existing stock due for completion by the end of 2022. While Manila and Bengaluru have the support of record low vacancies to buffer against the large supply impact, Jakarta, Beijing and Shanghai are expected to face a prolonged challenge as the large pipeline adds further pressure to its existing high vacancy levels. Alternatively, we do note that the potential for lockdown induced construction delays may lower its impact by pushing some projects past 2022. However, this may only be temporary and the supply pipeline will still weigh on market sentiments.



Source: Knight Frank Research

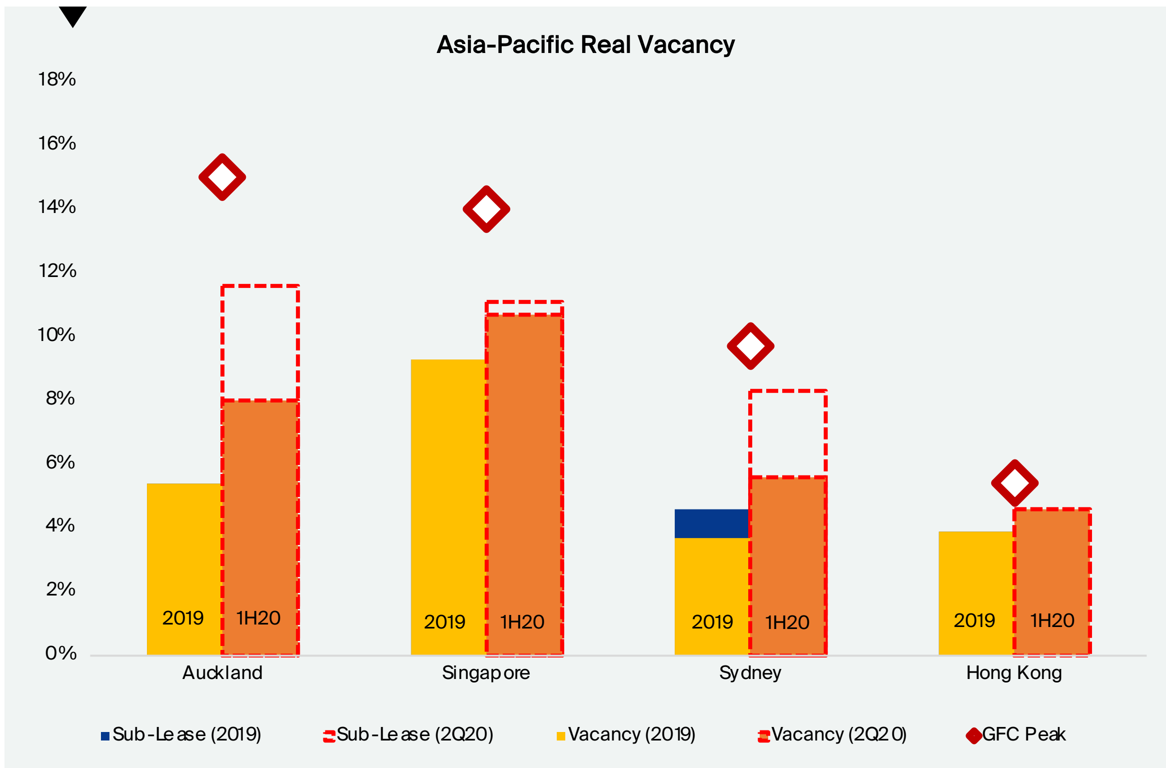
Sub-lease (aka shadow) spaces and why do they matter?

A common phenomenon during any period of economic downturn in any office market is the rise of shadow space (excess space under existing leases) which occupiers put back into the market. Sub-leasing a portion of unutilized space and recovering some of the rental cost can be an effective way to manage cost pressures particularly in comparison to early termination, relocation costs to a smaller space, and the potential impact on sentiment for the firm (both externally and internally).

While some sub-lease spaces are openly marketed, many are dealt with privately in off-market negotiations. Hence, any estimate on the total sub-lease space within a given market typically underestimates the actual underlying sub-lease space within the market. Nonetheless, an increase in sub-lease space will amplify the downward pressures already facing market rents.

How much sub-lease space is out there currently?

Noting the difficulties mentioned previously, and focusing on four gateway markets (Auckland, Sydney, Singapore Hong Kong), we calculated the total number of sub-lease spaces our local brokerage teams are currently aware of as a percentage of the total existing stock available and added that to its vacancy rate to derive the total "real" vacancy estimate for that market.



Source: Knight Frank Research

Sydney:

Based on our local team's estimates for available sub-lease space in Sydney, about 2.7% worth of the existing office stock is currently available on the market, more than is accounted for in the official vacancy rate of 5.6%. By allowing for this higher level of sub-lease space, we estimate a 'real' vacancy rate of 7.3%. This is still well below the 10% peak which resulted from the influx of uncommitted space post the 08/09 GFC. Nonetheless, the rising amount of sub-lease on the market may be one of the reasons why we have seen incentives rise significantly since the onset of the pandemic.

Auckland:

In Auckland, we estimate there is currently at least 50,000 sqm of shadow space on the market; mainly coming from the finance & insurance and professional services sectors, which in total account for around 3.6% of existing stock. Adding this to the 8% existing vacancy within the market, we have a total of around 11.6% of existing stock available for lease; still a relative distance from the 15% peak recorded during the GFC. But, there are concerns that the city's development pipeline over the coming year could add further upside pressure to vacancy and subsequently dampened rental growth prospects for the market.

Singapore:

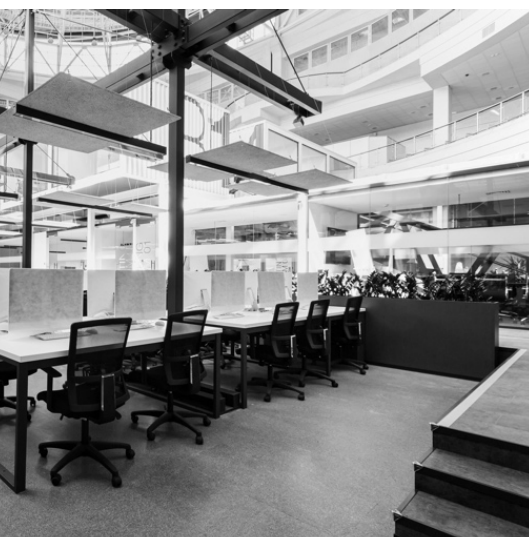
Singapore's office market has seen vacancy rise in recent months amidst the city-state's challenging economic conditions. However, observable sub-leases within the CBD remain low at around 15,800 sqm, accounting for around of 0.4% of the existing stock. Combining this with its existing 10.7% vacancy rate, the 11.1% total "real" vacancy is well below the 14% GFC peak. With economic conditions expected to remain soft for the foreseeable year and the city-state's large exposure to the export services sectors which comprises 40% of GDP, there are risks that vacancy could trend much higher; putting downward pressure on rents.

Hong Kong:

Hong Kong saw its vacancy rate rise significantly, 0.7% to 4.6% in Q2, most recently as the city continues to deal with the economic fallout of the pandemic and the ongoing social unrest. However overall sub-lease space on the market remains manageable with no major visible mandates at the moment. Furthermore, with substantial rental declines, some tenants have taken the opportunity to upgrade their office to more premium buildings at attractive packages. Companies from the professional services sector that are fundamentally strong will remain focused on Central despite economic headwinds. Going forward, with market conditions remaining uncertain, we foresee that the overall vacancy of office space will remain at historically elevated levels. Landlords are expected to be more flexible in lease negotiations as they strive to retain tenants.

Sub-leasing considerations

Considerations	For Occupiers	For Asset Owners
Contractual Obligations	▪ Check leasing contract to verify whether sub-leasing is allowed in the lease and under what conditions. ▪ Occupiers taking a sub-lease are subject to master lease risks, if in the event the master lease is terminated prematurely.	▪ Check leasing contract to ensure permit for sub-leasing. ▪ Sub-lease clauses (especially for large tenants) should be flagged at the due diligence stage prior to acquisition.
Inform the Landlord	▪ Prior to embarking on a sub-lease, occupiers should inform their landlords as most sub-lease approvals require landlord confirmations.	▪ Owners should work with the tenant to find an alternate lease arrangement if a sub-lease can be avoided. • E.g. If owner has other office assets, to assist the tenant in seeking out alternate locations within the portfolio. • E.g. Owner may be aware of existing tenants looking for larger space within building.
Cost Considerations	▪ If contract rents are below market rents and sub-lease space is significant, occupier could negotiate with owner for early termination and minimal penalties to allow for landlords to maximize rental income. ▪ If contract rents are below market rents, occupiers should do cost benefit analysis as sub-lease rents could go below market and minimize cost savings. ▪ Occupier should consider what to do with existing fitouts and furniture in the sub-lease space (e.g. sold at depreciated price, transferred etc.) ▪ If sub-lease runs the course of the master lease, the master tenant will still be liable for reinstatement costs.	▪ If contract rents are below prevailing market rents, owners can consider allowing an early termination of contract to maximize rental income. ▪ Owners should prevent sub-lease rents from severely under-cutting (especially for large spaces) the building's current asking rents.



What does this all mean?

- Sub-lease space undoubtedly will continue to rise over the near term as occupiers actively look to reduce their real estate costs.
- Despite sub-leases offering a cost effective solutions for office space requirement, potential occupier may want to rethink their workplace strategy before committing to a new space.
- Despite the increase in sub-lease space on the market, occupiers should be aware of the potential risks they carry compared to a traditional lease agreements, especially given the market outlook which are in favor of occupiers.
- Sub-leasing space coming into the market at sub-market rental levels, will likely amplify pressures on rents.

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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