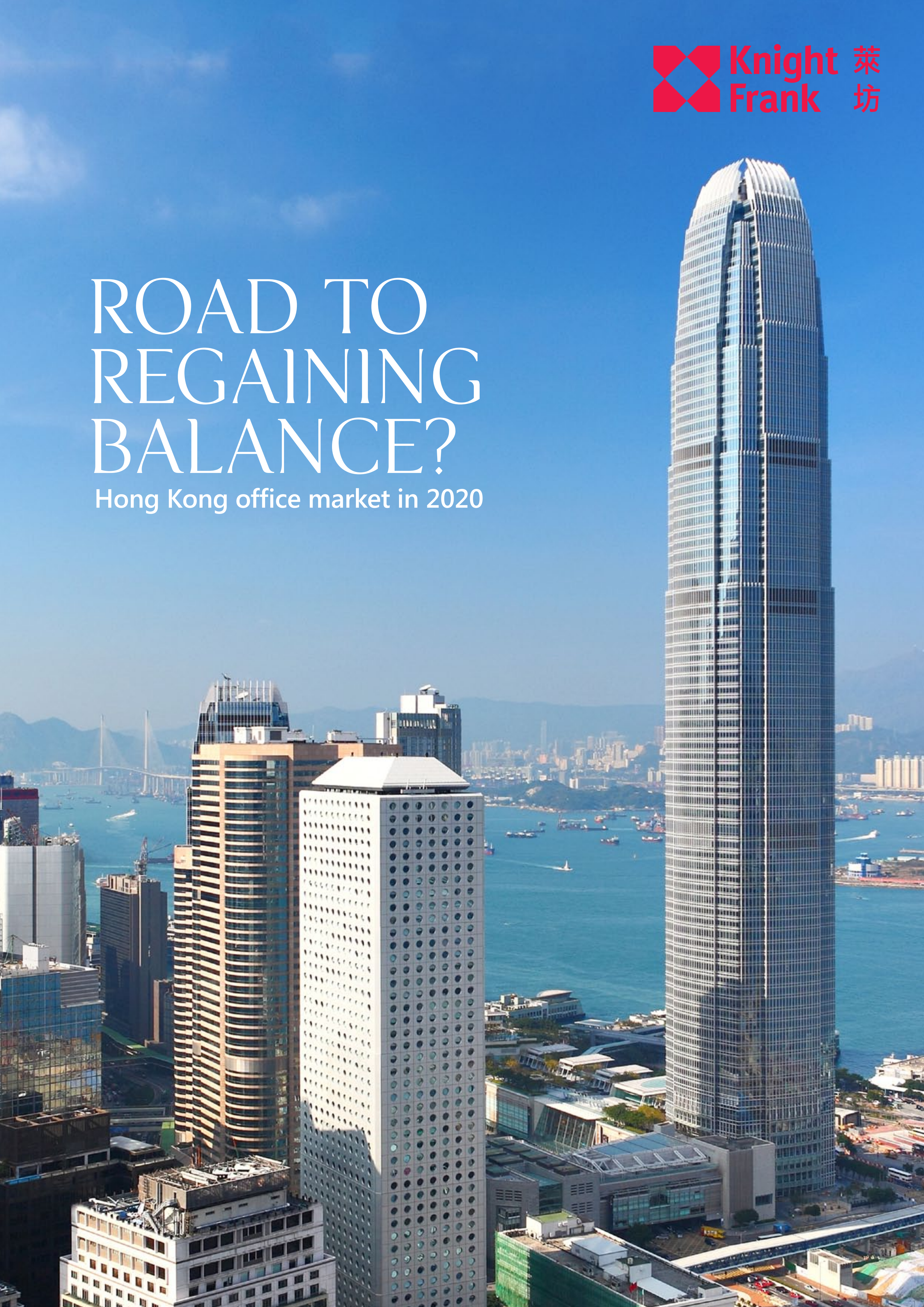
ROAD TO REGAINING BALANCE?

Hong Kong office market in 2020



THE IMBALANCE OF SUPPLY AND DEMAND WOULD SEE LITTLE CHANGE UNTIL A WIDER RANGE OF OFFICE CLUSTERS EMERGE WHEN THE NEW DECADE APPROACHES.

While short term supply is expected to remain tight during 2013-2016, a new wave of office supply may be visible when 2017 approaches.

Despite office rents having dropped over 20% from their peak in 2008 to the end of 2012, Hong Kong's central business district (CBD) is still one of the most expensive places in the world to do business. This is partly due to the limited amount of Grade-A office stock and the Hong Kong government has unveiled plans to build another CBD and relocate existing government offices, in an effort to increase long-term supply. However, whether these plans can meet future demand and when these blueprints can be delivered are still unclear.

This paper attempts to illustrate how Hong Kong's office market will appear in the next decade. It highlights characteristics of the current market and examines future development plans in key business districts, both of which will have implications on how landlords and tenants plan their leasing strategies.

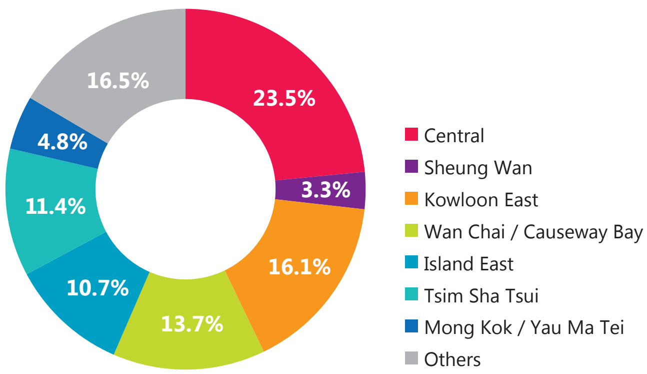
Current distribution of Grade-A offices

At the end of 2012, the total floor area of Grade-A office space in Hong Kong was over 74 million square feet (sq ft). Around 23% of this total was located in Hong Kong's traditional CBD, namely Central, while Kowloon East's share of prime office space increased to almost 12 million sq ft or about 16%.

Vacancy rates of Grade-A offices have experienced a moderate increase since the third quarter of 2011, rising around one percentage point to reach 3.4% by the end of 2012. Despite this, vacancy rates remain at a historically low level.

Figure 1

Existing stock of Grade-A office space in Hong Kong



Source: Rating and Valuation Department / Knight Frank

Figure 2
Land area of selected financial centres' CBD

Extent of the CBD area

Major financial cities, such as New York, London, Singapore and Hong Kong, face difficulties in accommodating long-term business growth. Hong Kong has the smallest CBD area of all these cities, so direct comparison with Western finance hubs is inappropriate. A comparison with Singapore is more relevant.

Singapore and Hong Kong are the preferred locations for many international corporations setting up regional offices in Asia. While Singapore's urban area is much smaller than that of Hong Kong, Singapore's CBD area covers more than 1,600 hectares—twice the size of Hong Kong's CBD. Hong Kong's limited CBD area, or rather its shortage of prime office space, has resulted in higher rents for Grade-A office premises.

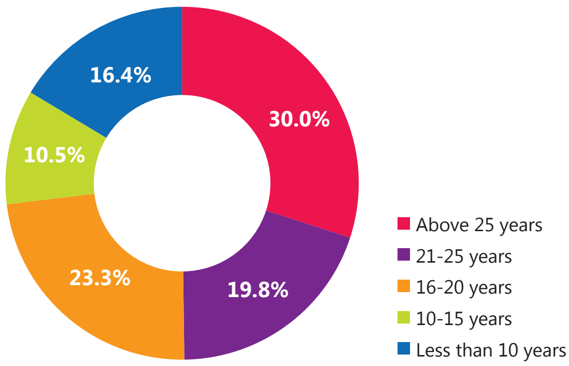
Relative age of the office market

Hong Kong is also facing an aging office market: around 50% of the city's Grade-A offices is over 20 years old.

Aging office stock is particularly noticeable in the traditional CBD and Central submarket, where office buildings completed before 1990 account for 57% of stock. Buildings completed in the last ten years account for only around 5% of stock.

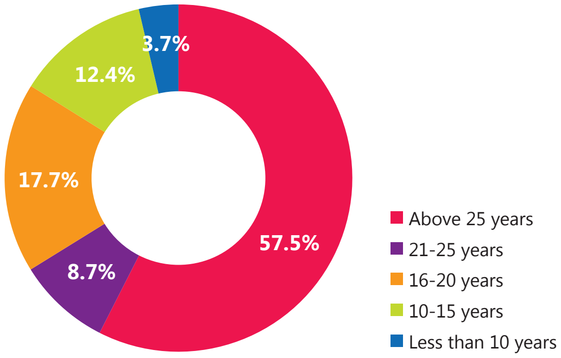
Particularly aging ones which are standalone and owned by small landlord, would see higher possibility for renovation, which would further reduce supply of Grade A office.

Figure 3
Overall Hong Kong Grade-A office stock distribution by age



Source: Rating and Valuation Department / Knight Frank

Figure 4
Central Grade-A office stock distribution by age



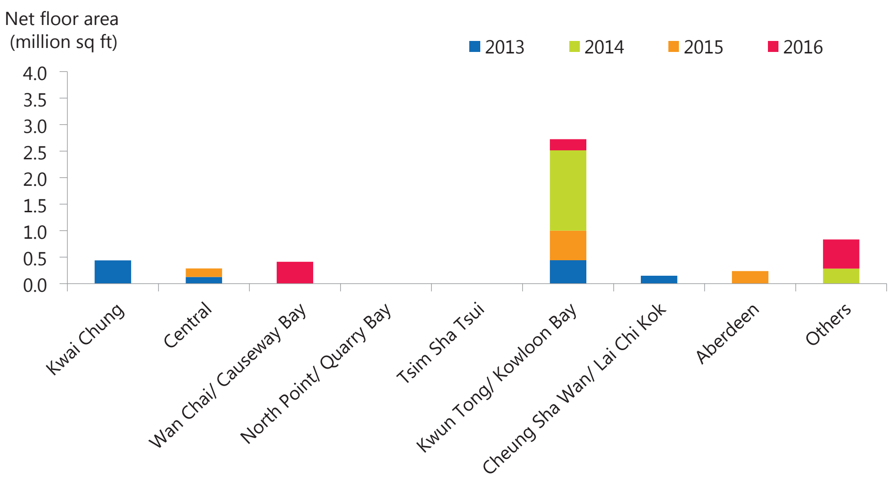
Source: Rating and Valuation Department / Knight Frank

Addressing the shortfall

In a bid to mitigate the office shortage, the government has launched ambitious plans that could provide some 50 million sq ft of new office space. However, many developments are still in the preparation stage and the effort to re-balance supply-demand levels is unlikely to be realised in the short term. We expect supply from 2013–2016 to reach an average of 1.7 million sq ft per annum, still 0.2 million lower than the long-term average. The lion's share of new supply over the next three years will be located in Kowloon East.

Hong Kong will see a substantial increase in office supply in the coming decade, as well as the emergence of new office nodes once urban districts such as CBD2 and West Kowloon have materialised.

Figure 5
New supply of Grade-A office space in 2013-2016



Source: Knight Frank

Figure 6

Major office clusters in the next decade

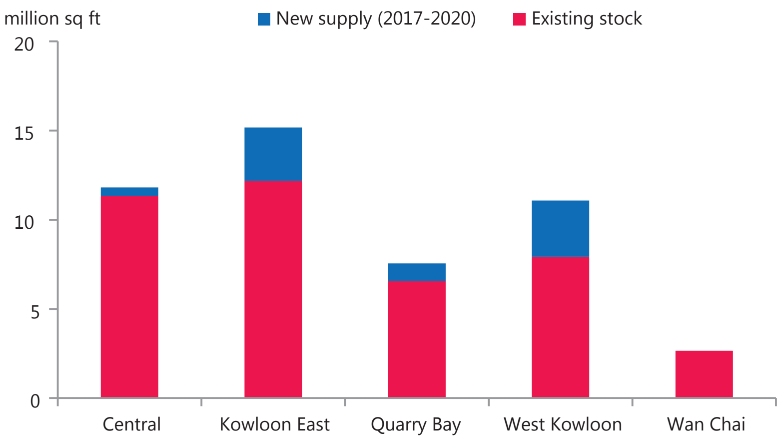
* Travelling time by car
Source: Knight Frank, Map data ©2013 Google, MapKing

In addition, the government has also moved to increase commercial land supply. the 2013-14 Budget reveals the inclusion of nine commercial sites in the latest Land Sales Programme, providing a total floor area of about 3.6 million sq ft to the market. Most of the sites are located in Kowloon East to speed up the development of the CBD2. However, as time is needed for planning and development, we therefore expect these new supply will only be released to the market after 2020.

We expect an increase in new supply will begin to take effect in 2017 at the earliest, with an average of 1.9 million sq ft per year during 2017–2020.

Figure 7

Growth of Grade-A office space in major office clusters in 2017-2020



Source: Hong Kong government / Knight Frank

WE HAVE IDENTIFIED EIGHT MAJOR PUBLIC AND PRIVATE PROJECTS THAT WILL PROVIDE A SIGNIFICANT AMOUNT OF NEW OFFICE SPACE AND ALLEVIATE HONG KONG'S OFFICE-SUPPLY SHORTAGE.

1. Central Harbourfront Development

The Central Harbourfront project area extends from the Central Ferry Piers to Wan Chai and comprises eight sites. Sites 1–6 could provide a total of about 968,760 sq ft of Grade-A office space.

This project is still in the planning stage and progress appears slow. Site 3 (CDA), north of Statue Square, has the highest possibility of being completed before 2020, assuming that the earliest disposal date will be 2015. Under current proposals, this site will provide around 480,000 sq ft of Grade-A office space.

2. Kowloon East CBD2

The Kowloon East CBD2 project is one of the major centrepieces in Hong Kong's future development strategy. The project covers the redevelopment of Kai Tak Airport as well as the revitalisation of industrial spaces in Kwun Tong and Kowloon Bay, together with related public infrastructure projects. Upon completion, CBD2 could provide a maximum office space of 42.6 million sq ft. Under current proposals, the Kai Tak area could deliver over seven million sq ft of Grade-A office space before 2021, based on the government's timetable.

However, a range of uncertainties could extend the timeframe. Redevelopment proposals for the old Kai Tai airport are still under discussion and we expect public infrastructure civil works to slow-down progress on the ground. Furthermore, relocation issues, multiple ownership and the availability of other required business facilities could hold up the pace of revitalisation of old industrial space.

We therefore anticipate that only a part of the office space planned in Kai Tak will likely be delivered by 2020, plus some contribution generated by the revitalisation of older areas. We estimate that the total new supply of prime office space in Kowloon East CBD2 will be around three million sq ft by 2020.

Figure 8
Location map of redevelopment of Taikoo Place

Source: Knight Frank, Map data ©2013 Google, MapKing

3. Redevelopment of Taikoo Place

In order to cater for growing relocation demand from the core areas, Swire Properties plans to redevelop three of its industrial buildings—Somerset House, Cornwall House and Warwick House—into two office buildings with large floor plates. Around two million sq ft of prime office space will be delivered upon completion.

Cornwall House and Somerset House will be redeveloped into a 51-storey, Grade-A office building with a gross floor area (GFA) of 999,750 sq ft. Demolition and construction works are expected to commence in the third quarter of 2013, with completion in 2017.

Warwick House, meanwhile, will be redeveloped into a 46-storey, Grade-A office building with a GFA of 1,015,300 sq ft. However, we believe it is unlikely that the second office building will be completed before 2020, as construction work is scheduled to commence only after the completion of the Cornwall House / Somerset House redevelopment.

4. West Kowloon Cultural District

The West Kowloon Cultural District development project is expected to supply around 1,160,000 sq ft of office space. The first phase of development was originally targeted for completion between 2015 and 2020. However, as the project is in the planning stages, we do not expect this prime office space to be delivered onto the market until after 2020.

Figure 9
Location map of New World Centre

Source: Knight Frank & Map data ©2013 Google, MapKing

5. Guangzhou-Shenzhen-Hong Kong Express Rail Link terminus

The Guangzhou–Shenzhen–Hong Kong Express Rail Link is currently under construction, with completion targeted for 2015. The MTR is proposing to build three Grade-A office buildings above the terminus station next to West Kowloon Cultural District, which will provide a total GFA of around 2.8 million sq ft. The project is now pending approval by the Town Planning Board (TPB) and its prime office space is expected to be available by 2020.

6. Redevelopment of New World Centre

New World Centre, located on Salisbury Road in Tsim Sha Tsui, is currently being redeveloped. Around 300,000 sq ft of Grade-A offices is expected to be added to the district by 2017.

Figure 10
Location map of the redevelopment of Wan Chai government offices

Source: Knight Frank & Map data ©2013 Google, MapKing

7. Redevelopment of Wan Chai government offices

The government has proposed that its departments currently occupying Wan Chai government offices in Wan Chai waterfront be moved out to make way for redevelopment. The Wan Chai waterfront sites could provide around 1.9 million sq ft of prime office space.

Preparatory work for relocation is underway, but the government anticipates that the earliest it could be completed is 2018–2019, due to complex planning and relocation issues. We therefore expect the sites will only be available for new office development after 2020.

8. Wong Chuk Hang redevelopment

Wong Chuk Hang in Island South has started to transform from an industrial area into a decentralised business district, with the expected completion of the MTR South Island Line (East) in 2015 acting as the catalyst.

Fourteen sites (covering about 1.6 hectares) have been approved by the TPB for hotel development, accounting for 19.3% of land in the Wong Chuk Hang business area. Within the zone, developers enjoy more flexibility in redeveloping existing buildings, with a range of new commercial and office uses potentially acceptable. The industrial area is gradually transforming, but redevelopment is expected to progress at a slow pace and no critical mass of offices will be established before 2020.

In summary, we estimate that around 14 million sq ft of Grade-A office space will be completed by 2020, with West Kowloon and Kowloon East (Kai Tak, Kowloon Bay and Kwun Tong) expected to be the main sources of new office supply. After 2020, supply of prime office space will continue to be boosted, with the successive completion of the aforementioned developments.

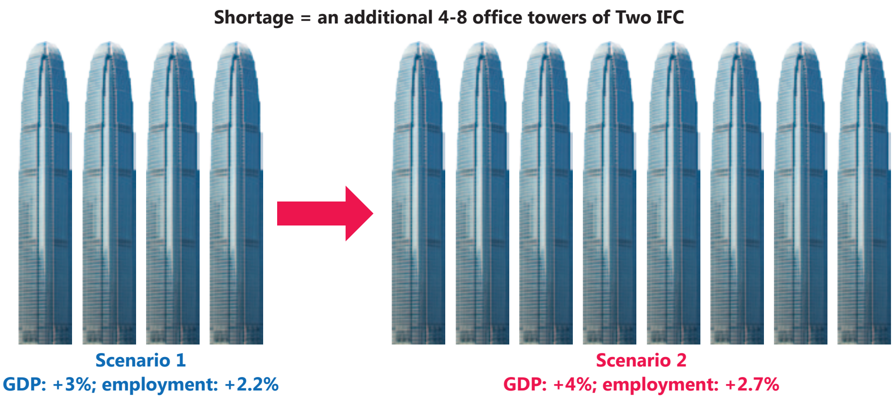
Catchable demand?

So far, we have focused on office supply in Hong Kong over the mid- to long-term, but the key issue is whether these projects can satisfy demand over this period.

Long-term demand for office premises in Hong Kong is closely correlated to the number of workers employed in the city's service sector, as they are the main occupiers of office space. Employment growth in this sector is, in turn, closely related to Hong Kong's economic performance. The number of employees in the service sector contracted about 1.1% after the Asian Financial Crisis of 1997. It also shrank in 2009, amid the onset of the financial crisis in the US, and both events severely impacted occupier office demand.

Therefore, by considering GDP growth and employment forecasts for the service sector, we can try to model how much office space will be needed between now and 2020. Under normal circumstances, Hong Kong's economy expands at an average of 3% per year, while service-sector employment grows at a rate of around 2.2%, taking a 15-year average. This growth will result in an additional office space of around 16.9 million sq ft during 2013-2020. If we look through this under more optimistic assumptions such as local economy expands at an average of 4% per year while employment of the service sectors grows at a Compound Annual Growth Rate of 2.7%, nearly an additional 21.2 million sq ft office space will be required during the next eight years.

Figure 11
Forecasted demand-supply imbalance by 2020

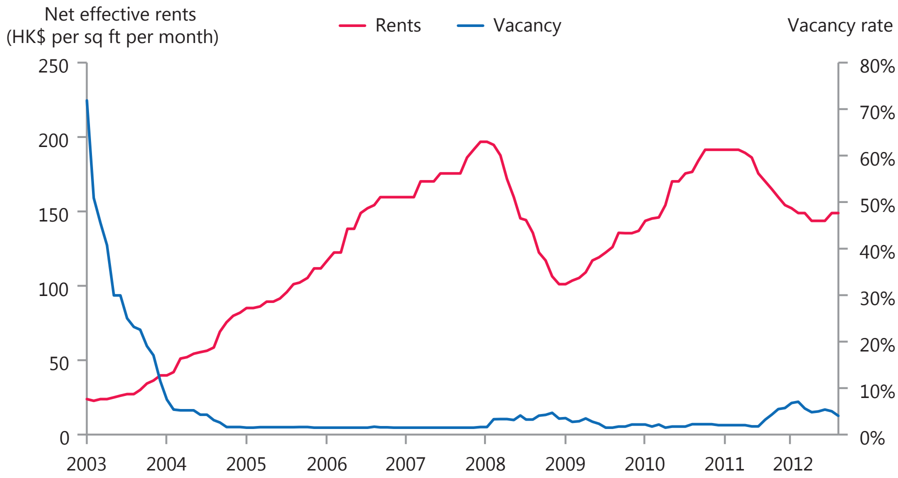


Source: Knight Frank

Based on the above projections, it is unlikely that long-term demand for office space will be satisfied by the current planning and development progress of major projects. Assuming that the current economic and employment growth continues, Hong Kong is likely to face a shortage of office space of around 4 million sq ft, which could increase to over 8 million sq ft, should the local economy expand at a faster pace.

How significant is this shortage? Our analysis shows that by 2020, an additional four to eight office towers of a comparable size to Two IFC is needed, on top of the current development pipeline. We therefore see little scope for rent correction in the overall Grade-A office market, at least until the end of this decade.

Figure 12
Rents and vacancy in Two IFC in Central



Source: Knight Frank

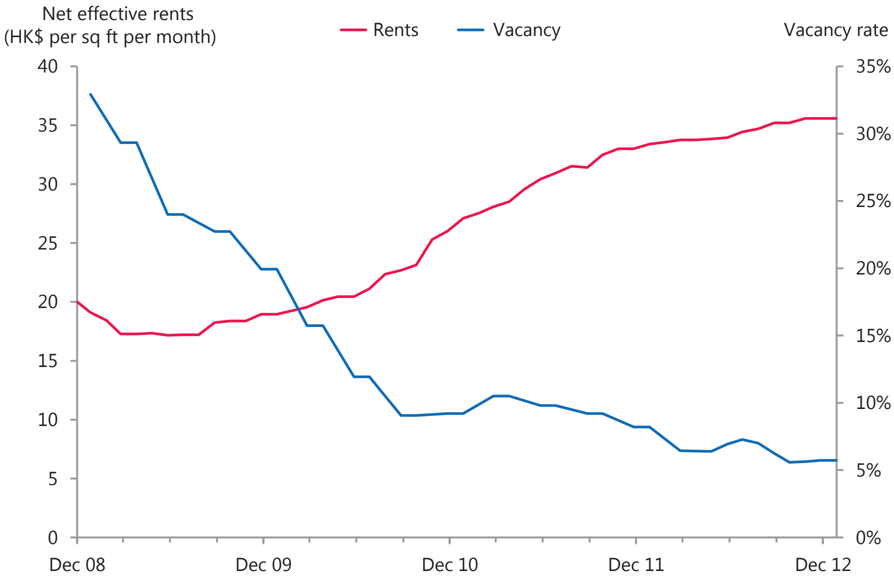
What if imbalance reversed?

What would happen if growth in the business sector slowed down over a certain period? From the previous sensitivity analysis, we would expect a surplus of three million sq ft of office space to come onto the market, if both GDP and employment population growth slowed by one percentage point. The situation would be worse if a 'black swan' event were to impact global markets.

Economic slowdown would inevitably lead to significant surplus in Grade-A office supply. However, Hong Kong's Grade-A office market—especially prime office buildings—has proven resilient to global economic headwinds over the past few years.

Two IFC is a relevant case study. This premium Grade-A building was completed at the height of the SARS epidemic of 2003. During the first year, the vacancy rate remained at above 50%, despite rock-bottom rents of around HK$20–30 per sq ft per month being offered. However, take-up swiftly improved following gradual recovery in the economy. It took less than two years for the vacancy rate to fall to a single-digit level, while rents increased to HK$100 per sq ft per month in the subsequent three years.

Figure 13
Rents and vacancy in Kowloon East



Source: Knight Frank

Another example is Kowloon East. In 2008, supply boom in the district coincided with the onset of the US financial crisis, but a similar, rapid turnaround to that of Two IFC occurred. Grade-A office rents in Kowloon East started to surge as a result of strong demand in mid-2010 and vacancy levels dropped to 10% less than two years after the onset of the crisis.

Based on past examples, vacant, high-quality office space was eventually taken up, even in the face of strong economic turmoil, due to sustained long-term demand for office space. We therefore remain positive about the long-term outlook for premium, Grade-A office buildings in the city, given that Hong Kong's role as a major global financial centre is unlikely to change.

LOOKING AHEAD

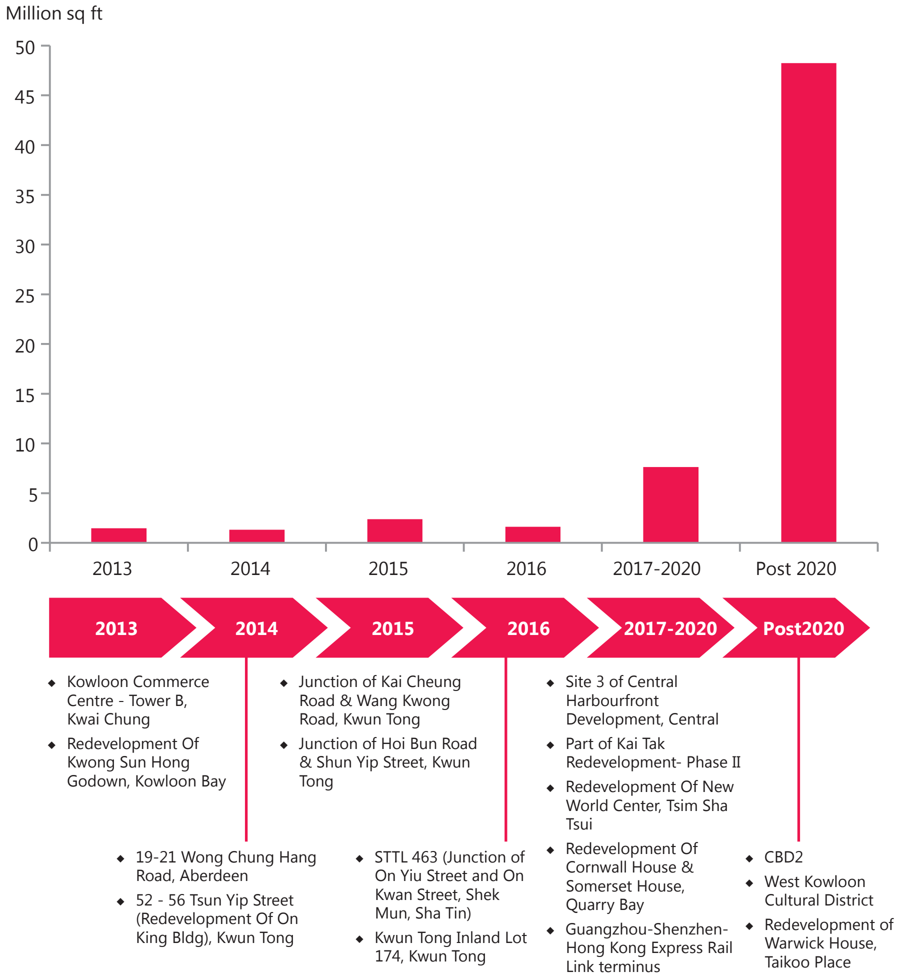
Whether plans for Hong Kong's forthcoming major projects can be realised and whether the resulting new office developments match, lag, or outpace long-term growth in demand remain to be seen, but we are able to make certain observations.

Supply in the short term will rely on the private sector and the amount of supply coming onto the market is unlikely to be sufficient, so the supply demand imbalance will remain. However, landlords may start to feel the impact of the planned office clusters as the major developments start to materialise, probably in 2017 at the earliest.

Competition for tenants may increase over the long term. Landlords may view the fiercer competition as a threat, but these planned developments will offer new opportunities and potentially new sites for developing quality office buildings. The development progress of these future office clusters need to be closely monitored and landlord and tenant responses need to be matched accordingly.

Figure 14

Projected Grade-A office supply (2013-post 2020)



Source: Knight Frank

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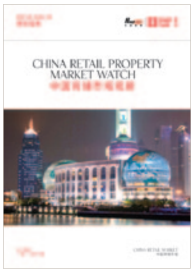

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