GLOOMY MARKET SENTIMENT WITH EMERGING RECOVERY AHEAD

AVISTA RESEARCH

The spread of COVID-19 has markedly impacted and changed the Hong Kong office market, particularly the leasing market, alongside the emergence of work-from-home arrangements. In the meantime, the roll-out of the vaccination program and the closer connection with the Mainland China economy will be reshaping the Hong Kong office market in the post-pandemic world.

Information contained hererin has been complied by AVISTA from sources deemed reliable and the opinions, analysis, and expectations etc. contained are based on such information and are expressions of belief only. Whist every effort has been made to ensure its accuracy, no representation, warranty or guarantee is made or given by AVISTA or any other person as to its accuracy or completeness. All opinions and estimates expressed in this publication are subject to change without notice. This publication is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from AVISTA.

MARKET OUTLOOK

Potential of Market Revival from the Bleak Sentiment in 2020

Virus-induced Market Corrections in 2020

Severely impacted by COVID-19, the Hong Kong office market has revealed notable market corrections in 2020. According to the Hong Kong Property Review 2021 published by the Rating and Valuation Department ("**RVD**"), the vacancy rate of Grade A offices rose to 11.8% amounting to 10.3 million sq.ft. of vacant space in 2020. In particular, the prices and rents of the Grade A offices have also recorded a double-digit percentage year-on-year ("**y-o-y**") slump over 2020, with -12.2% y-o-y and -11.4% y-o-y respectively.

Amid the raging spread of COVID-19 in Hong Kong, social distancing measures and work-from-home ("**WFH**") arrangements have been implemented to contain the spread of the virus. These measures have dented the demand for office space and induced the tenants to seek cost-effective rental solutions, which dampened the investment and leasing activity in the market.

Green Shoots of Gradual Market Recovery

Nevertheless, there are some signs ahead which are expected to facilitate the market recovery.

The vaccination program has already been rolled out in Hong Kong, which is expected to effectively contain the spread of COVID-19 and ease the social distancing measures. As of the end of March 2021, over 500,000 doses of COVID-19 vaccines have been administered. With the expectations of effective virus containment, the accompanying ease of social distancing measures would help revive the local economic activity and abate the enterprises' financial stress, thereby stimulating the demand for the workplace.

The loosening monetary conditions coupled with the discounted office price, under the prospects of vaccine-induced economic recovery, have been creating the investment opportunities of office properties for institutional investors. Over the past year, there have been strong capital inflows to the Hong Kong Dollar. According to the Hong Kong Monetary Authority ("**HKMA**"), the aggregate balance, a measure of interbank liquidity, surged to HKD 457 billion as of the end of March 2021 from HKD 54 billion in the same month a year ago. The surge in aggregate balance implies ample liquidity in the banking system and the ultra-low interest rate environment expected to persist. Therefore, the anticipated improvement of the real economy along with rich liquidity will fuel the confidence of the institutional investors to deploy their capital on the quality office assets, which will be driving the recovery of Hong Kong's office investment market.

We believe that the decline of office rental in core CBD (Central, Admiralty, and Sheung Wan) will be narrowed with the vaccination program and loose monetary conditions to revive Hong Kong's economy. We remain our prediction that there would be an overall 5-10% decline for Grade A office price and rent respectively in 2021.

© AVISTA Group. All rights reserved.

MARKET INSIGHTS

Rising MNC Tenants to Surrender Space

In light of the economic downturn and the realization of the WFH model, the tenants intended to relinquish part of the office space with the plan of flexible work option in order to relieve the financial pressure amid the COVID-19 pandemic. The surge of vacant office space surrendered by the tenants revealed the intention of cost reduction and the gloomy market sentiment. On the other hand, the increasing vacant space also positions the potential tenants with more alternatives to expand their business networks and meet their business needs in Hong Kong.

In Q1 2021, a couple of multinational corporations ("**MNCs**") were reported to surrender office space, some of which are transitioning to a hybrid working model. In early February 2021, it was reported that the Standard Chartered Bank would not renew the leases in Central for the floors with approximate 60,000 sq.ft. to save around USD 770,000 per month. Earlier in late 2020, the bank had unveiled its plan to offer flexible work options to more than 90% of its 85,000 employees over the coming three years. DBS also reportedly offloaded part of the eight floors it currently occupies in One Island East. Apart from the finance sector, Lane Crawford, one of the leading retail companies on luxury goods, was reported to surrender 19,400 sq.ft. of office space at One Island South in Wong Chuk Hang. The spread of COVID-19, therefore, has accelerated the adoption of the hybrid working model and induced the tenants to downsize their office space for the cost-reduction purpose. The increasing tenants adopting flexible work options and surrendering their space will further increase the vacant space of Grade A office in Hong Kong, thereby pressuring the office rents level.

The emerging trend of MNCs to surrender their office space will benefit the bargaining power of those enterprises that are looking for the workplace in Hong Kong. According to Land Registry, the Bank of Dongguan Co., Ltd. has leased the office space in the Two International Finance Centre, which was previously occupied by the Japanese Investment Bank Nomura, with a 3-year lease contract. Under the initiatives of Greater Bay Area, there is the closer and closer connection of Hong Kong's economy with the Mainland China economy. With the rising vacant space of the Grade A office, the potential Chinese office tenants are positioned with good bargaining power to seek the quality workplace with favourable lease terms for the coming years.

Accordingly, it could be expected that there will be a significant shift towards increasing presence of Chinese tenants in Hong Kong office market in a post-pandemic world. In the medium to long term, the premier office space is predicted to be progressively occupied by the Chinese companies for their business expansion in Greater Bay Area. Meanwhile, given Hong Kong continuing to be an International Financial Hub, the MNCs would still require certain workplaces for their fundamental operations, but possibly less office space than in the past under the hybrid working model.

MARKET INSIGHTS

Deterioration in Rateable Value for Office Properties

The RVD has released the latest result for the rateable value of office buildings in Hong Kong, which is the estimated annual rental value of a property at a designated valuation reference date, assuming that the property was then vacant and to let. The rateable value provides a fair and uniform base about the valuation of offices in the overall market and across different districts, thereby facilitating the comparisons.

According to the latest figures, the rateable value has revealed a sharp decline over the past year. Until 19 March 2021, the rateable value of overall office buildings in Hong Kong is estimated to have declined by 8.9% y-o-y, of which the rateable values in Wan Chai as well as Central and Western District even contracted by 9.6% and 12.2%, respectively. However, the office buildings in the Eastern district accelerated by 6.5% y-o-y, the only district revealing positive growth in rateable value.

The latest rateable value reflected the trend of downsizing and decentralization triggered by the outbreak of COVID-19. The notable decline in rateable value reflected the increasing financial stress to the landlords that receive office rents as their portfolio income. On the other hand, the increase of rateable value for the office buildings in the Eastern district has revealed the attractiveness as an alternative for the tenants to move out of the conventional CBD for the quality workplace with lowered leasing cost.

Table 1: Rateable Value in 2020 and 2021 (HKD Thousand)

District	*2020*	*2021*	*Y-o-Y*
Central and Western	34,752,894	30,524,458	-12.2%
Wan Chai	14,695,440	13,286,777	-9.6%
Eastern	5,770,908	6,143,530	6.5%
Yau Tsim Mong	14,045,704	12,424,719	-11.5%
Kwun Tong	7,244,672	7,144,543	-1.4%
Overall	84,698,917	77,120,200	-8.9%

SOURCE: AVISTA Research, RVD

Cut-down of Future Commercial Land Supply

According to the Land Sale Program 2021/22, there will be three commercial sites capable of providing around 5.15 million sq.ft. of floor area, declining by around 40% compared to the Land Sale Program last year. Meanwhile, the authority is also conducting an examination for the feasibility of rezoning five commercial sites in Kowloon East for residential use, which were reportedly located in Kai Tak Development Area but previously tendered unsuccessfully.

The significant reduction of supply in commercial sites implies the bleak market sentiment under the government's assessment, as well as the increasing focus on residential sector in their land sale strategy. It is deemed sensible to reduce the commercial sites on the land sale program at the current market correction phase, but closely monitoring the market conditions is also suggested for timely review of the strategy to meet any changes from the emerging economic recovery.

Table 2: 2021 - 2022 Commercial Land Sale Programme

No.	*Lot No.*	*Location*	*Site Area (sq.ft.)*	*Approx. GFA (sq.ft.)*
i	NKIL 6578	Kai Tak Area 4D Site 2, Kowloon	639,375.66	2,469,238.66
ii	NKIL 6589	Kai Tak Area 2A Site 1, Kowloon	215,213.42	1,420,834.80
iii	TCTL 45	Area 57, Tung Chung, Lantau Island	132,772.71	1,261,529.08

SOURCE: AVISTA Research, Lands Department

© AVISTA Group. All rights reserved.

MARKET DATA SNAPSHOT

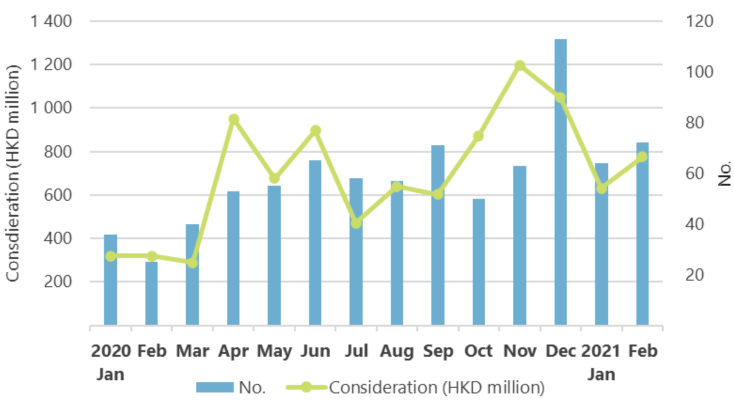
Solid Investment Activity with a Bleak Leasing Market

The office market revealed the presence of solid investment activity in Q1 2021 after the surge of transaction considerations in Q4 2020, partly driven by the policy relaxation on non-residential property transactions. According to the statistics from the RVD, there were 64 and 72 office transactions in January and February 2021, and the transaction amounts were HKD 632 and HKD 776 million, respectively. While the number of transactions remained at a similar level compared to 2020, the consideration of the transactions retreated from the surge in Q4 2020, with a drop of 40% month-on-month ("**m-o-m**") and an increase of 23% m-o-m in January and February 2020, respectively. The transaction records reflected that the investment activity for office properties remained substantial amid the market downturn in the leasing market.

The spread of COVID-19 has triggered the large-scale adoption of the WFH model or hybrid working model, which heightened the intention of the MNC tenants to surrender office space for cost-saving mentioned in the previous section. Accordingly, the leasing market has been under pressure with increasing vacant space surrendered by tenants, particularly by the MNCs. In Q1 2021, the rental index of Sheung Wan/ Central decreased by 4% q-o-q and plunged by 18% y-o-y respectively. The rental indices of Wanchai/ Causeway Bay and Tsim Sha Tsui fell by 4% quarter-on-quarter ("**q-o-q**") and 2% q-o-q.

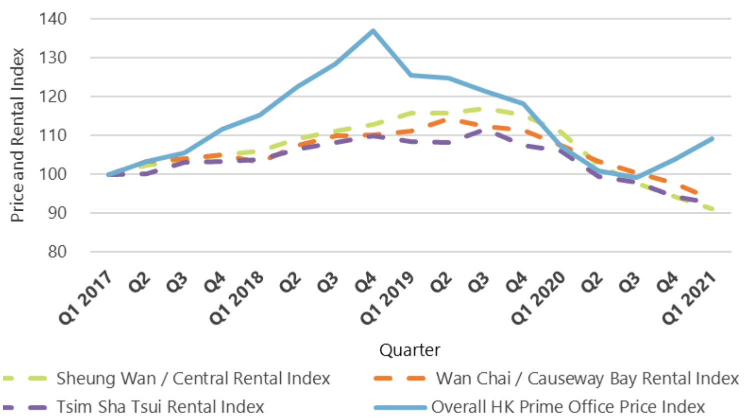
With the expectation of effective virus-containment under the vaccination program and closer connection with the Mainland China economy, we would expect the economic recovery on the way to support the leasing market as well as a significant shift of increasing presence of Chinese tenants in the market in the medium to long term.

Figure 1: 2020 Jan - 2021 Feb No. of Office Transactions and Consideration



SOURCE: AVISTA Research, RVD

Figure 2: Q1 2017 - Q1 2021 Prime Office Rental and Price Index (Q1 2017=100)



SOURCE: AVISTA Research, RVD

MARKET DATA SNAPSHOT

Table 3: Q1 2021 HK Grade A Office Performance of Selected Districts

District	***Average Price** (HKD/sq.ft.)* **(q-o-q change)**	***Average Rental** (HKD/sq.ft.)* **(q-o-q change)**	***Vacancy Rate*** **(q-o-q change)**
Sheung Wan	23,800 (↑6%)	63 (↑1%)	8.1% (↓)
Central	39,200 (↑2%)	116 (↓2%)	6.7% (↑)
Admiralty	28,800 (↑5%)	77 (↓3%)	8.6% (↓)
Wan Chai	28,500 (↓5%)	59 (↓1%)	10.2% (↑)
HK Island East	13,850 (-)	46 (↓2%)	5.3% (↑)
Tsim Sha Tsui	12,000 (↓6%)	60 (↓1%)	8.8% (↑)
Kowloon East	10,450 (↓1%)	28 (↓2%)	14.6% (↑)

SOURCE: AVISTA Research

Table 4: Q1 2021 Selected Office Sale Transactions

Location	***Building***	***GFA** (sq.ft.)*	***Floor***	***Consideration/Unit Price** (HKD)*
Central	The Center	25,412	Mid Zone	870,000,000 @ 34,200/sq.ft.
Admiralty	United Centre	10,244	Top Zone	215,000,000 @ 21,000/sq.ft.
Kwun Tong	Montery Plaza	12,042	Top Zone	200,000,000 @ 16,600/sq.ft.
Tsim Sha Tsui	Star House	9,621	Mid Zone	144,000,000 @ 15,000/sq.ft.

SOURCE: AVISTA Research

Table 5: Q1 2021 Selected Office Leasing Transactions

Location	***Building***	***GFA** (sq.ft.)*	***Floor***	***Rental** (monthly)**/Unit Rent** (HKD)*
Tsim Sha Tsui	The Gateway Tower 5	149,337	26-37/F	8,363,000 @ 56/sq.ft.
Central	Two International Finance Centre	48,200	Mid Zone	8,194,000 @ 170/sq.ft.
Quarry Bay	Devon House	163,280	Low - Mid Zone	7,837,000 @ 48/sq.ft.
Central	Cheung Kong Center	7,042	Low Zone	1,197,000 @ 170/sq.ft.
Wan Chai	Great Eagle Centre	15,929	Mid Zone	988,000 @ 62/sq.ft.

SOURCE: AVISTA Research

© AVISTA Group. All rights reserved.