

PANDEMIC CONTINUES TO RATTLE OFFICE MARKET

AVISTA RESEARCH

Fifth wave of COVID-19 outbreak, geo-political tension between Russia and Ukraine as well as the commencement of U.S. interest rate hike placed tremendous pressure on Hong Kong's office market, yet It is the worst and best time for investors to plan ahead for their next acquisition. Amid the uncertain times, the new arrangements for charging land premium greatly reduce the time and cost needed for lease modification application and release the largest potential of rural land in the Northern Metropolis Area.



MARKET INSIGHTS
Pandemic Dealt a Heavy Blow to Local Economic Activities

Since the onset of the fifth wave of COVID-19 epidemic in early 2022, the accumulative local infections exceeded 1.1 million as of 1 April. Amid the tightened social distancing restrictions in Hong Kong and geopolitical tension between Russia and Ukraine, local consumption and business sentiment remained sluggish while both equity and property markets experienced turbulence in Q1 2022. The Hong Kong government introduced rent deferment with a three-month protection period for tenants in specified sectors, Employment Support Scheme as well as HK\$10,000 digital consumption vouchers to help businesses and individuals thrive against the headwinds. The latest round of Consumption Voucher Scheme will inject approx. HK\$68 billion in the retail market, equivalent to 2.5 months of the retail sales value recorded in February 2022. These relief measures are expected to cushion the economic impact on households and businesses whilst achieving dynamic “zero infection” and restoring normal business operations earlier.

Office landlords are cautious in the office market outlook with several premium office landlords turning pessimistic under the cloudy outlook for Hong Kong’s economy. Wharf REIC which owns the largest shopping centre and a portfolio of office buildings in major commercial districts reported over 10% vacancy rate in its office buildings in both Tsim Sha Tsui and Causeway Bay. It represented approx. 800,000 sq.ft. of vacant office space above Harbour City and Times Square as well as considerable pressure on the supply side.

Logistics Sectors Continue to Prosper and Back Kowloon East Office Demand

Despite COVID-19 hits most of the service sectors, robust and soaring demand in cargo and freight services significantly boosted the business of the market leaders in the logistics industry. Logistics companies like FedEx, ZIM upgraded their offices in Kowloon East, leveraging the edge of low rent for high-quality office space. Fedex leased 1.5 floors in Landmark East - AIA Kowloon Tower with a total area of 48,546 sq.ft. while the current offices of the American logistics company are located at Nanyang Plaza in Kwun Tong and KITEC in Kowloon Bay. ZIM Integrated Shipping Services relocated and expanded its office from Kin Sang Commercial Centre to Manulife Place. New letting cases of sizable office are concentrated in Kowloon East, where the vacancy rate reached 13% and is still mounting, being the most preferred location for office consolidation in the past year. Business ambience and hardware have begun to take shape in Kowloon East, that multinational corporations in banking, insurance and electronics sectors are forming a critical mass in the area, which will accelerate the whole transformation from traditional industrial hub to a genuine heart of CBD2.

Besides, consolidation and expansion of business remained active for the medical and co-working sectors as companies were capturing prime locations as their new centers at a much lower rent. EC Healthcare leased 7 floors with 22,200 sq.ft. in Fung House in Central as their new flagship medical centre to operate a number of newly acquired subsidiaries to provide one-stop medical services that cater to the demand from the Greater Bay Area.

Table 1: Recent Office Leasing Transactions in Kowloon East

Tenant	Trade	Original Office Location	New Office Location	New Office District	Unit Rent (HKD/ sq.ft. gross)
FedEx	Logistics	Nanyang Plaza & KITEC	Landmark East - AIA Kowloon Tower	Kwun Tong	\$27
ZIM	Logistics	Kin Sang Commercial Centre	Manulife Place	Kwun Tong	\$28
Philips	Electronics	Philips Electronics Building, Hong Kong Science Park	One Kowloon	Kowloon Bay	\$26
Working Family and Student Financial Assistance Agency	Government	Various locations	Two Harbour Square	Kwun Tong	\$25
Hong Kong Metropolitan University	Education	Various locations	NEO	Kwun Tong	\$30

SOURCE: AVISTA Research

MARKET INSIGHTS

Acceleration of Lease Modification Application with Standard Rates

In view of the lengthy premium assessment process in the past, the Lands Department introduced an option of charging land premium at standard rates for lease modification and land exchange while the pilot scheme will be applicable to land within Kwu Tung North and Fanling North New Development Area ("**NDA**"). The premium calculation will apply the announced standard rates and in accordance to respective areas. Assuming an agricultural use land in Kwu Tung North with 10,000 sq.ft. in site area to be developed into a residential block with 30,000 sq.ft, the developer needs to pay land premium of \$5,450 per sq.ft. gross, which is much lower than the Kwu Tung site sold for \$8,500 per sq.ft. gross by tender to Wheelock Properties in July 2021.

We expect the standard rates for premium assessment will expedite the implementation of development projects in the two NDAs, as there are clear guidelines and rates for developers to follow and conduct financial analysis, which greatly reduces the uncertainty. Meanwhile, rural landowners are more incentivised to realize the potential of their sites, that echoes the master plan of Northern Metropolis Development Strategy, releasing more sites for residential units as well as commercial space in the NDA.

Table 2: Standard Rates for Land Exchange and Lease Modification

New Development Areas	Uses Before Land Exchange			Uses After Land Exchange	
	Agriculture Use	Non-residential Building Use	Residential Building Use	Non-residential Use	Residential Use
Kwu Tung North	\$4,000/m ²	\$20,000/m ²	\$45,000/m ²	\$35,000/m ²	\$60,000/m ²
Fanling North	\$4,000/m ²	\$20,000/m ²	\$45,000/m ²	\$30,000/m ²	\$55,000/m ²

**All standard rates are expressed on a per gross floor area ("GFA") basis, except those for agricultural use which are expressed on a per site area basis.*

SOURCE: AVISTA Research



MARKET OUTLOOK

Pandemic is a Massive Setback for Hong Kong Economic Recovery

First Step Toward the Rate Hike Cycle

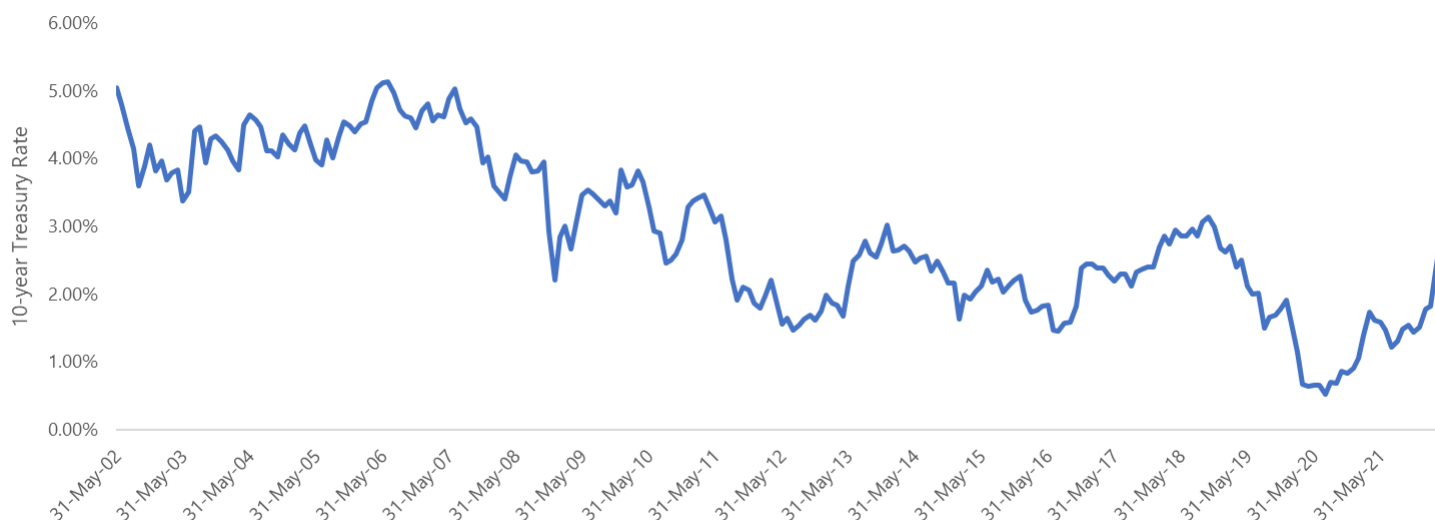
Geopolitical tension and supply chain disruption drove several commodities including oil, gas and wheat prices sky-high. The United States (the “**U.S.**”) Federal Reserve (the “**Fed**”) raised the target range for the federal fund rate by 25 basis points to 0.25%-0.5%. Soaring energy prices provided a big boost to the U.S. Consumer Price Index (“**CPI**”) which the headline CPI in March shot up 8.5% year-on-year (“**y-o-y**”). As at the end of March, international oil prices jumped over 50% quarter-on-quarter (“**q-o-q**”). In order to combat the unabated inflation, the Fed also signalled a high probability of further rate hike and reach 2.25-2.5% by end of 2022. The entrance to the rate hike cycle represents the extremely low interest rate has come to an end while Hong Kong’s borrowing cost may lag in terms of the pace but will catch up with the magnitude of U.S. rate hike eventually.

According to the Hong Kong Monetary Authority (“**HKMA**”), the 1-month Hong Kong Interbank Offered Rate (“**HIBOR**”) in Q1 increased from 0.16% to 0.19% while 12-month HIBOR reached 1.72%, projecting more increase in the interest rate in late 2022. In the near term, interest rate hike will have a mild impact on the overall commercial real estate market in Hong Kong, but an expected high inflation and a stagnant, low capitalization rate are somewhat detrimental to property investors in the short run.

Pandemic Remains a Key Uncertainty for Hong Kong’s Economy

According to Hong Kong’s Census and Statistics Department (“**C&SD**”), Hong Kong’s gross domestic product (“**GDP**”) expanded by 4.8% y-o-y in Q4 2021, lower than the first 3 quarters in 2021, while the annual GDP increased by 6.4%. Hong Kong’s financial secretary forecasts the GDP to grow by 2-3.5% in 2022, factoring in the relief measures provided by the government but still implied a much weaker momentum. Whilst the pandemic infection figures and death toll peaked in March, business and public services are expected to resume normal operation gradually. The growth path down the road depends on the development of the pandemic in both Hong Kong and Mainland cities, since it became the setback for resumption of cross-border travel and business activities. As of the end of Q1 2022, Hong Kong’s overall vaccination rate was approximately 80%, yet virus variants remained a threat to a solid recovery as the social distancing is set to be eased in the coming months.

Figure 1: U.S. 10-year Treasury Rate



SOURCE: Bloomberg, U.S. Department of the Treasury

MARKET DATA SNAPSHOT

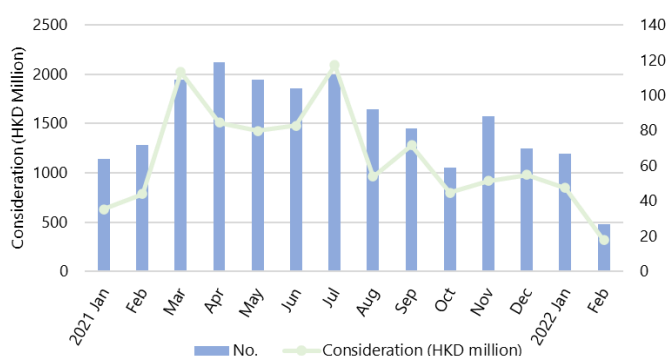
Bumpy Road for Office Investors

Office investment activities decelerated with a plunge in total considerations of office transactions completed in Q1 2022. Number of office transactions sharply reduced in Q1 2022, mainly driven by the severe virus outbreak throughout the quarter. Uncertainties over pandemic and office demand further waver investors' confidence.

According to the statistics from the Rating and Valuation Department ("RVD"), there were 67 and 27 office transactions in January and February 2022, while the transaction amounts were HK\$ 849 million and HK\$ 318 million, respectively. On a year-on-year ("y-o-y") basis, the number of office transactions increased 6% and decreased 63% in January and February 2022 respectively, while the considerations of office transactions were up 45% and down 59% respectively in these two months.

Although office price has already gone 35% downward from its peak, the Grade-A office yield is merely 2.3% which is way behind flatted factories and Grade-B office's yield of 2.9% and 2.7% respectively according to RVD. We expect the office sales market to reach a short-term bottom in Q2 2022 and more investors to purchase office premises for self-use as cash-rich investors are eyeing the discounted prime offices and their potential to appreciate once the quarantine-free travel takes place and Mainland capital returns.

Figure 2: 2021 Jan - 2022 Feb No. of Office Transactions and Considerations



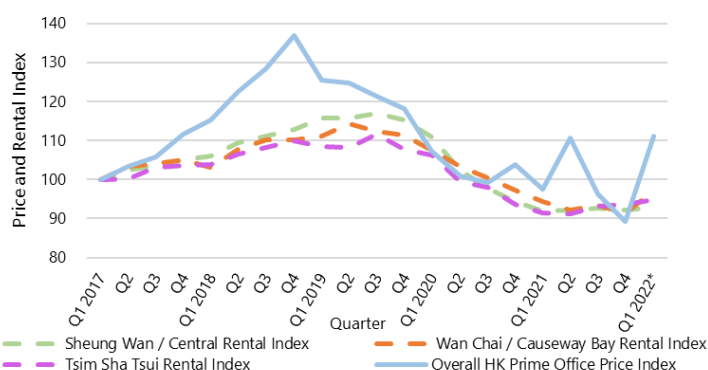
SOURCE: AVISTA Research, RVD



The fifth wave dampened the office and equity prices in Hong Kong in the past 3 months, the office rent softened especially in decentralized areas including Hong Kong Island East and Kowloon East while some core districts like Central and Tsim Sha Tsui outperformed and stayed in the positive territory. Landlords with abundant vacant office space are competing by offering more incentives to lure incoming tenants while retaining existing ones.

Looking ahead, we expect the office rent to stabilize in the core districts as businesses are ready to make up lost ground as well as the consumption vouchers will give new impetus to retail tenants where their office and operations are mainly located at the heart of CBD. Meanwhile, we remain relatively pessimistic on the office rental growth in decentralized districts as massive office supply looms in with a shrinking leasing momentum. As per our rental forecast in January, we expect office rents in decentralized districts to fall 3-5% throughout the year of 2022.

Figure 3: Q1 2017 - Q1 2022 Prime Office Rental and Price Index (Q1 2017=100)



*Insufficient transaction data and provisional figure in Q1 2022

SOURCE: AVISTA Research, RVD

MARKET DATA SNAPSHOT
Table 3: Q1 2022 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	\$21,900 (↓7%)	\$62 (↓2%)	7.1% (↓)
Central	\$36,000 (↓3%)	\$116 (↑1%)	7.3% (↓)
Admiralty	\$28,800 (↓2%)	\$75 (↓1%)	8.8% (↑)
Wan Chai	\$26,500 (↓5%)	\$55 (↑1%)	8.8% (↓)
HK Island East	\$13,300 (↓1%)	\$48 (↓2%)	6.8% (↑)
Tsim Sha Tsui	\$12,200 (↓2%)	\$59 (↑1%)	9.9% (↓)
Kowloon East	\$10,900 (↓3%)	\$30 (↓2%)	12.8% (↓)

SOURCE: AVISTA Research

Table 4: Q1 2022 Selected Office Sale Transactions

Location	Building	GFA (sq.ft.)	Floor	Consideration/Unit Price (HKD)
Wan Chai	Harbour Centre	15,929	16/F Whole Floor	\$331,323,200 @ \$20,800/sq.ft.
Kowloon Bay	Billion Centre Tower B	12,678	32/F Whole Floor	\$146,800,000 @ \$11,579/sq.ft.
Tsim Sha Tsui	Silvercord Tower 1	4,417	605-06	\$57,000,000 @ \$12,905/sq.ft.
Central	L L Tower	2,327	22/F Whole Floor	\$51,190,000 @ \$22,000/sq.ft.
Admiralty	Lippo Centre - Tower 1	1,495	1301	\$34,200,000 @ \$22,876/sq.ft.

SOURCE: AVISTA Research

Table 5: Q1 2022 Selected Office Leasing Transactions

Location	Building	GFA (sq.ft.)	Floor	Rental (monthly)/Unit Rent (HKD)
Wan Chai	8 Queen's Road East	64,796	En bloc	\$2,915,820 @ \$45/sq.ft.
Central	Three Exchange Square	11,200	16/F Whole Floor	\$1,344,000 @ \$120/sq.ft.
Hung Hom	China Life Center	25,354	11/F Whole Floor	\$1,140,930 @ \$45/sq.ft.
Tsim Sha Tsui	K11 Atelier Victoria Dockside	13,304	High Floor	\$1,130,840 @ \$85/sq.ft.
Admiralty	CITIC Tower	16,599	Mid Floor	\$1,128,732 @ \$68/sq.ft.

SOURCE: AVISTA Research