EARLY SIGNS OF RECOVERY IN PROPERTY INVESTMENT MARKET DESPITE SUBDUED LEASING ACTIVITIES

AVISTA RESEARCH

The low interest rate environment and emerging economic recovery after consecutive quarters of contraction supported the revival of investment activities in office properties. Meanwhile, the risks of sooner-than-expected rate hikes and uncertainties surrounding the outbreak of the Delta coronavirus variant may pressure the office market, either on investment or leasing activity in particular.

MARKET OUTLOOK

Aware of potential risks amid market recovery in a favorable environment

Low interest rate environment with a risk of sooner-than-expected rate hikes

In mid-June, the United States (the "**U.S**") Federal Reserve (the "**Fed**") announced the decision to remain its key interest rate at a range between 0% and 0.25%. The decision implied Hong Kong's interest rate to remain at an ultra-low range in the near term under the Linked Exchange Rate System, under which Hong Kong follows the U.S. monetary policy in terms of interest rate. According to the Hong Kong Monetary Authority ("**HKMA**"), the 1-month Hong Kong Interbank Offered Rate ("**HIBOR**") was reported to be 0.08% in May 2021, which was notably below the level around 2% recorded in pre-pandemic January 2020, in tandem with the U.S. monetary easing policy. The low interest rate environment to remain in place in the near term is favourable to encourage the investors to acquire prime office buildings with lower borrowing costs, which is expected to support the office market and further boost market recovery.

However, in view of the higher-than-expected growth and inflation situation, the Fed officials signalled that there might be sooner-than-expected rate increases no later than 2023, previously stated as no later than 2024. In other words, the investors might need to be aware of the risks of sooner-than-expected rate hikes in the U.S that may be transmitted to Hong Kong's interest rate environment. The rate hikes will have an impact on the asset valuation and financing arrangements in the property investment, thereby affecting the risk-return analysis in the original investment decision-making.

Hong Kong's economic recovery underway

With an increasing vaccination rate and effective virus containment, Hong Kong's economy has been recovering from the economic recession arising from the social unrest and COVID-19 pandemic. According to Hong Kong's Census and Statistics Department ("**C&SD**"), Hong Kong's gross domestic product ("**GDP**") expanded by 7.9% year-on-year ("**y-o-y**") in Q1 2021, putting an end to the six consecutive quarters of contraction. The spread of the virus has been contained effectively in recent months alongside the rollout of vaccination program, which is expected to extend Hong Kong's economic recovery. As of 30 June 2021, 1.48 million people have been administered with 2nd vaccine dose. Moreover, there have been 43 days without an untraceable local infection until when a case of infection was confirmed on 5 June 2021. The improvement of Hong Kong's economy is expected to slow corporate downsizing and stimulate companies' confidence to increase hiring activities on the basis of positive future prospects, thereby creating a knock-on effect on companies' leasing demand for quality office space.

We believe that the decline of office rental in core CBD (Central, Admiralty, and Sheung Wan) will be narrowed alongside low interest rate environment and ongoing economic recovery in Hong Kong. We remain our prediction that there would be an overall 5-10% decline for Grade A office price and rent respectively in 2021.

MARKET INSIGHTS

Commercial attractiveness of traditional business districts

On 12 May 2021, the Lands Department announced the tender result of a commercial site (Inland Lot No. 8945) on Caroline Hill Road at Causeway Bay, which was awarded to a joint venture set up by Hysan Development Company ("**Hysan**") and Chinachem's Chime Corporation – Patchway Holdings (Hong Kong). The price of the commercial site with a total gross floor area ("**GFA**") of 1,076,391 sq.ft. was HKD 19.78 billion, representing HKD 18,374 per sq.ft., which exceeded at least 15% above the market estimated range between HKD 11 billion (HKD 10,500 per sq.ft.) and HKD 17.2 billion (HKD 16,000 per sq.ft.). The premium paid by the joint venture reflected the confidence of the developers towards Hong Kong's economic prospects in the long term, alongside ongoing growth momentum supported by China's economy. The winning bid, furthermore, is expected to strengthen the leading position of Hysan in Causeway Bay, whose commercial properties account for a GFA with over 3.8 million sq.ft. in Causeway Bay.

The higher-than-expected premium paid for a commercial site located in the traditional business district may imply the advantageous attractiveness of office properties in the traditional core area compared to that in the newly developed zone amid the market recovery from the COVID-19 pandemic. Over the previous year, some tenders for the commercial sites located in the newly developed zones such as Tung Chung and Kai Tak were cancelled by the Lands Department. In particular, the tender for a commercial site (New Kowloon Inland Lot No. 6615) located in Kai Tak was cancelled in that all submitted bids failed to meet the government's reserve price in May 2020. In addition, the Lands Department also announced the rejection of the tenders for a commercial site (Tung Chung Town Lot No. 45 at Area 57) located in Tung Chung in October 2020. In comparison with newly developed zones, the office properties in traditional core areas like Causeway Bay could provide tenants intangible business support with well-developed transport infrastructure and closer connection with other business partners. On the other hand, the office buildings located in newly developed zones like Tung Chung and Kai Tak may not be able to provide business convenience as similar as that in the traditional business districts, which would lower the office demand and increase the risks for the developers. The investors, amid the current period of recovery, may be more willing to make investments for the office buildings in the traditional business districts in return for a stable market return, but may be more reserved as regards the investment in the newly developed zones in view of higher risks.

In general, the recent tender result for the commercial site on Caroline Hill Road revealed the strategic positioning of Hysan at Causeway Bay and investors' preference of seeking a stable market return from the traditional business districts amid market recovery.

Table 1: Hysan's office assets at Causeway Bay

Name	**GFA** (sq.ft.)
Lee Garden One	903,000
Hysan Place	716,000
Lee Garden Two	621,000
Lee Garden Three	467,000
Leighton Centre	430,000
Lee Theatre Plaza	314,000
One Hysan Avenue	169,000
Lee Garden Five	132,000
Lee Garden Six	80,000
Total	**3,832,000**

SOURCE: Hysan Development, AVISTA Research

MARKET INSIGHTS

Potential landmark development in Kowloon East

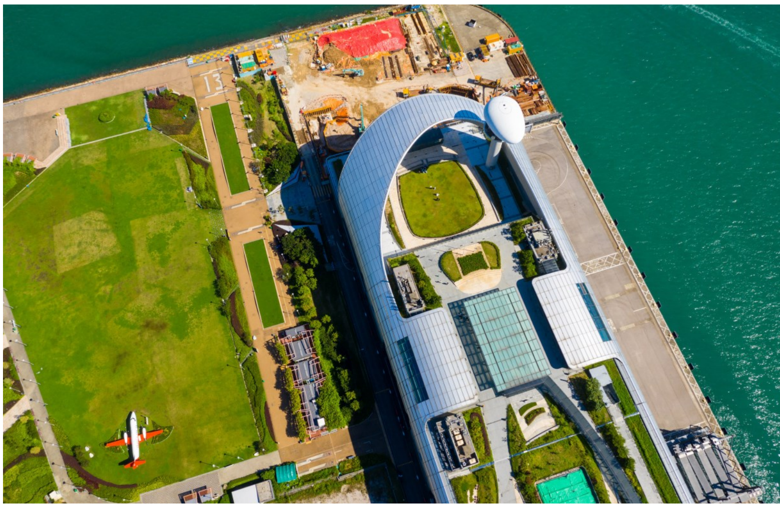
In June 2021, it was reported that a consortium led by Billion Development acquired Kowloon Bay International Trade and Exhibition Centre ("**KITEC**") covering 1,775,000 sq.ft. of GFA from Hopewell Holdings with a consideration of HKD 10.5 billion, representing around HKD 5,900 per sq.ft. The consortium plans to develop the complex into a Grade A office building, which could potentially be one of the landmark office properties in Kowloon East in the future. The transaction signaled the gradual return of investments from the investors into the commercial property, alongside Hong Kong's economic recovery.

Furthermore, it is worth noting that Billion Development has been involved in various office development projects covering over 4 million sq.ft. space in the Kowloon East district. The transaction of KITEC can further deepen the presence of Billion Development in the district with a landmark Grade A office building in the portfolio, thereby enhancing its advantageous position in the Kowloon East district and strengthening its price-setting ability. Despite the office demand in Kowloon East currently remaining subdued compared to other core areas, the attractiveness of office buildings in the Kowloon East district would be accelerated by a closer connection with the Kai Tak area, whose development is expected to gradually mature in the near future. Billion development, with a significant presence in the office development in the district, could be one of the beneficiaries.

Table 2: Billion development's office projects in Kowloon East

Location	Name	GFA (sq.ft.)
Kowloon Bay	Capital Tower	609,117
Kowloon Bay	Billion Centre	520,000
Kwun Tong	COS Centre	510,000
Kwun Tong	MG Tower	470,000
Kwun Tong	Legend Tower	378,000
Kwun Tong	EGL Tower	360,000
Kowloon Bay	YHC Tower	320,632
Kwun Tong	TG Place	313,712
Kwun Tong	King Palace Plaza	304,368
Kwun Tong	Montery Plaza	296,260
Total		**4,082,089**

SOURCE: AVISTA Research



Market potential of Hong Kong Island South

Announced in the 2020 Policy Address, "Invigorating Island South" policy initiative will be implemented to develop the Southern District into a place for people to live and work, that consists of a series of projects including but not limited to enhancement on facilities and pedestrian connectivity in the district and redevelopment of old industrial buildings in Wong Chuk Hang. Connected by South Island line, the office buildings in Wong Chuk Hang also benefit the tenants to stay close to traditional CBD areas within a short time in transportation at a much lower cost. Moreover, there have been increasing retail projects associated with residential buildings completed in the district, such as The Southside covering 510,000 sq.ft. space, which would bring convenience to the people working in the district. With policy support and increasing convenience in the district, there could be greater market potential for the office space in the Southern District.

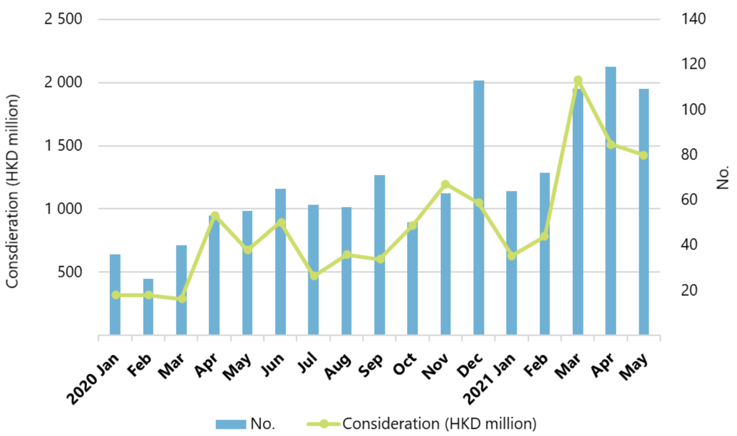
The attractiveness of office buildings in the Southern District has been revealed in the rental level recorded in the recent transactions. For instance, South Island Place located at Wong Chuk Hang recorded a lease transaction in April 2021 with a monthly rent of HKD 35 per sq.ft., which was getting closer to the rental level in Island East and situated in a similar level with the office buildings in Kowloon East. Given that Wong Chuk Hang has a closer connection with the traditional CBD area than Kowloon East, there is still potential for the rental level of office space in Wong Chuk Hang to remain increasing as the Southern District develops.

MARKET DATA SNAPSHOT

Further acceleration in office investment

The investment market for office properties remained at a solid sentiment with substantial transactions completed in Q2 2021. Both number of office transactions and consideration further accelerated to a higher record compared to early 2020, the onset of COVID-19 pandemic in Hong Kong. According to the statistics from the Rating and Valuation Department ("**RVD**"), there were 119 and 109 office transactions in April and May 2021, while the transaction amounts were HKD 1,511 and HKD 1,427 million, respectively. On a y-o-y basis, the number of office transactions surged by 125% and 98% in April 2021 and May 2021, while the considerations of office transactions also accelerated strongly by 59% and 111% in these two months. The investors have moved ahead to closely monitor prime office properties for enhancing their asset portfolio and reap the potential gains associated with economic recovery.

Figure 1: 2020 Jan - 2021 May no. of office transactions and consideration

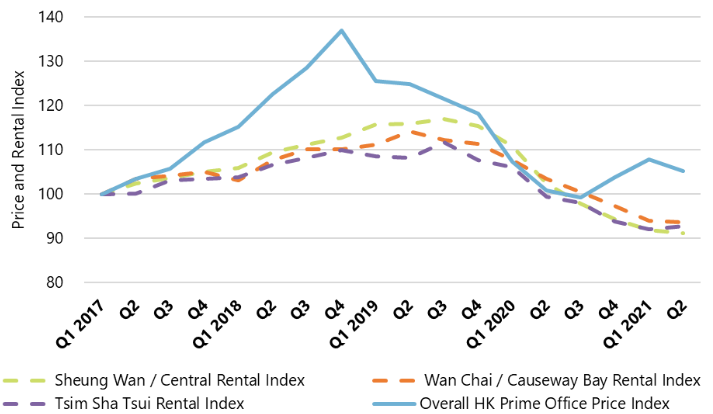


SOURCE: AVISTA Research, RVD

As a result of improving virus-containment situation and increasing vaccination rate, Hong Kong's economy is expected to resume positive growth in the near future, which would improve currently lacklustre office demand with the support of growing commercial activity. In particular, the office rentals still declined in the recent quarter, but the declining trend of office rentals since mid-2019 arising from social unrest and the COVID-19 pandemic has marginally eased. In Q2 2021, according to the RVD, the rental index of Sheung Wan/Central decreased by 1% quarter-on-quarter ("**q-o-q**") and dropped by 11% y-o-y, respectively. Furthermore, the rental index of Wanchai/Causeway Bay was reported to fall by 1% q-o-q while the rental index of Tsim Sha Tsui increased by 1% q-o-q.

Alongside the low interest rate environment and economic recovery expected to continue, we would expect the leasing market would pick up the pace of recovery, following the substantial transactions and recovery trajectory currently reported in the investment market.

Figure 2: Q1 2017 - Q2 2021 prime office rental and price index (Q1 2017=100)



SOURCE: AVISTA Research, RVD

MARKET DATA SNAPSHOT

Table 3: Q2 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	23,950 (↑1%)	62 (↓1%)	9.5% (↑)
Central	42,000 (↑7%)	114 (↓2%)	6.6% (↓)
Admiralty	29,000 (↑1%)	74 (↓4%)	8.6% (-)
Wan Chai	28,700 (↑1%)	58 (↓2%)	8.9% (↓)
HK Island East	13,850 (-)	45 (↓3%)	5.8% (↑)
Tsim Sha Tsui	12,200 (↑2%)	58 (↓4%)	10.5% (↑)
Kowloon East	10,550 (↑1%)	28 (↓3%)	13% (↓)

SOURCE: AVISTA Research

Table 4: Q2 2021 selected office sale transactions

Location	Building	**GFA** (sq.ft.)	Floor	**Consideration/Unit Price** (HKD)
Central	The Center	49,573	Low Zone	1,307,000,000 @ 26,400/sq.ft.
Sheung Wan	9 Des Voeux Road West	14,384	Top Zone	250,000,000 @ 17,380/sq.ft.
Kowloon Bay	Billion Centre Tower B	12,678	Top Zone	152,000,000 @ 12,000/sq.ft.
Admiralty	Far East Finance Centre	5,680	Low Zone	142,800,000 @ 25,100/sq.ft.
Central	9 Queen's Road Central	2,800	30/F Unit 5	126,000,000 @ 45,000/sq.ft.

SOURCE: AVISTA Research

Table 5: Q2 2021 selected office leasing transactions

Location	Building	**GFA** (sq.ft.)	Floor	**Rental** (monthly)**/Unit Rent** (HKD)
Central	Three Exchange Square	21,507	Low Zone	2,366,000 @ 110/sq.ft.
Causeway Bay	Times Square, Tower 2	38,960	Low - Mid Zone	2,299,000 @ 59/sq.ft.
Central	The Center	23,628	Top Zone	2,000,000 @ 85/sq.ft.
Southern District	South Island Place	44,928	Low Zone	1,572,000 @ 35/sq.ft.
Kwun Tong	The Quayside	50,788	05/F	1,524,000 @ 30/sq.ft.

SOURCE: AVISTA Research