SAIL SAFELY THROUGH THE UNCHARTED WATER

AVISTA RESEARCH

After the fifth wave of COVID-19 outbreak, rapid U.S. interest rate hike in Q2 2022, most real estate investors adopted a wait-and -see approach while some exploited the current uncertainties and enjoy the first mover advantage. In the meantime, Hong Kong government set an example for all stakeholders in Kowloon East to show further support for its long-awaited CBD2 vision as well as realizing its potential to the fullest.

MARKET INSIGHTS

"Energizing Kowloon East"

Any forward-looking view of the office leasing market has to take into account the pipeline of Grade A office supply, current rent levels, and general market demand. One can argue that we have already seen a significant adjustment in office rent amid the over-supplied cycle, yet the stark truth is market absorption was -430,000 sq.ft. in the year 2021, way below the historical average of 1.5 million sq.ft. in the past two decades and office market is anticipating another 3,800,000 sq.ft. space to complete this year. Kowloon East, also known as the office district with the highest vacancy rate well above the 10% threshold for years, is renowned for its sizable floorplate and contemporary office specification but a down-to-earth office rental.

In Q2 2022, some of the Kowloon East landlords found hope in the midst of despair as Hong Kong Government Property Agency leased 90,000 sq.ft. in multiple Grade A office buildings in Kowloon Bay and Kwun Tong for the relocation and expansion of the Department of Health, Radio Television Hong Kong, etc. Apart from the relocation of Hong Kong Mortgage Corporation to Two Harbour Square in Kwun Tong in the past year, another government-related organization Mandatory Provident Fund Schemes Authority pre-committed 80,000 sq.ft. in 98 How Ming Street in same district, in order to consolidate its premises in Kowloon Commerce Centre and Millennium City 1.

On top of that, the heated discussion over the conversion of Kai Tak commercial plots to residential use had been finalized and Town Planning Board rejected the proposal to rezone all 5 commercial sites to provide 6,000 residential units. The board member insists on keeping 2 out of 5 sites for planned commercial use and maintaining the Kowloon East CBD2 vision. Under the latest master plan, Kai Tak Development after rezoning will provide an overall commercial GFA of 20.9 million sq.ft. while the fully-fledged Kowloon East will transform into a business hub with 42 million sq.ft. which is comparable to the scale of the CBD in Central. In the near term, it will help alleviate the pressure of some desperate Kowloon East office landlords whilst allowing them to rebalance and fine-tune their leasing portfolio and tenant mix against the backdrop of cooling market sentiment.

MARKET INSIGHTS

All signs pointed to the government's objectives in concentrating the business ambiance in Kwun Tong and Kowloon Bay, amassing commercial elements for Kai Tak as well as reinforcing the CBD2 conceptual master plan are becoming more evident, especially after the growing presence of government offices in Kowloon East to attract and set an example for related industry participants. It is evident that the government's determination for the Kowloon East CBD2 vision is not just forming shape slowly but also surely.

Table 1: Recent Office Leasing Transactions in Kowloon East

Building	District	Unit	Area (in sq.ft.)	Unit Rent (HK$/ sq.ft. Gross)
98 How Ming Street**	Kwun Tong	Multiple floors	80,000	$30
One Kowloon	Kowloon Bay	10/F Whole Floor Portion 26&35/F	52,000	$26
Spectrum Tower*	Kwun Tong	19-21/F Whole Floor	23,000	$20
Landmark East AIA Kowloon Tower*	Kwun Tong	18/F	18,000	$25
Enterprise Square 5	Kowloon Bay	27/F Whole Floor	17,000	$25

*Expansion in the same office building
**Future office supply

SOURCE: AVISTA Research

MARKET INSIGHTS

Industrial segment – a dark horse contender

Hong Kong's office investment market is more at risk given elevated prices and relatively low yield compared to other asset classes in local and even regional markets while industrial properties are starting to gain ground, albeit from a lower base. As high inflation and subsequent rate hikes are here to stay at least for the second half of 2022, real estate investors already have plans to veer their money to the industrial sector in pursuit of a higher return in the mid to long run.

Industrial properties have proven relatively resilient compared with other property types including office, residential, and retail, be it in price or rental. According to the Rating and Valuation Department, average Grade A office and flatted factories produce 2.4% and 2.9% yield respectively as of April 2022, meanwhile, the risk-free benchmark rate of U.S. 10-year treasury yield has exceeded 3% in late June. Considering the Fed is set to increase the risk-free rate further, it seemed to be valid for cash-rich property investors to adopt a value-add strategy when it comes to parking money in the real estate sector. More importantly, office properties with fewer ESG features and lower market yield will be more vulnerable if the up and rising inflation and interest rate persist in the next few years.

In fact, the warehouse and modern industrial buildings can yield an even higher return than flatted factories especially when the single-owned landlord repurpose or redevelop the industrial use development into a logistics centre, cold storage, and even data centre.

China Resources Logistics acquired two logistics properties from Kerry Properties in Q2 2022. They are Kerry Warehouse (Shatin) and Kerry Godown (Chai Wan) which sold for HK$2.33 billion and HK$2.29 billion, respectively. Coupled with its en bloc purchase of East Asia Industrial Building Phase 1 and Mineron Centre in 2021, the group snapped up HK$7.5 billion worth of industrial buildings for self-use and expansion of its logistics portfolio.

The industrial segment offered higher flexibility, more promising leasing prospects, and potential headroom for real estate investors, we expect industrial properties to outperform Grade A office prices in 2H 2022.

MARKET OUTLOOK

Pandemic is a Massive Setback for Hong Kong Economic Recovery

Navigating through choppy waters

The United States (the **U.S.**) Consumer Price Index ("**CPI**") rocketed 8.6% and reached a record high according to the U.S. Bureau of Labor Statistics. With the growing fear of unbridled price level, the U.S. Federal Open Market Committee announced a rate hike of 75 basis points to 1.75%, the biggest increase in decades to bring down inflation. On the other hand, the aggressive quantitative tightening is seen as cooling measure for the heated commodity price and the real economy. Although Federal Reserve committees argued the tight labor market and strong growth momentum will prevent a hard landing of the U.S. economy, the borrowing costs for consumers, business owners, and investors will become prohibitively expensive.

According to the Hong Kong Monetary Authority ("HKMA"), the 1-month Hong Kong Interbank Offered Rate ("HIBOR") in Q2 increased to 0.87% from 0.32% while the 12-month HIBOR spiked from 1.66% to 3.32% since Q1 2022. The short to long-term financing costs soared and will slowly reflect on the real estate market, meanwhile, the highly leveraged investors will soon feel the heat looming in. Downturn always rid the excesses of the economy and relocates the capital to more productive parts of the real estate market, therefore, the create and destroy process will leave the bottom fishing opportunities to the cash-rich and most resilient commercial investors.

Continue to exercise caution on Hong Kong's economy

According to Hong Kong's Census and Statistics Department ("C&SD"), Hong Kong's gross domestic product ("GDP") contracted by 4.0% year-on-year ("**y-o-y**") in Q1 2022, slower than the last 4 quarters in 2021. Despite the Hong Kong government rolling out various support measures, large enterprises' business sentiment weakened in Q2 2022 and reflected the local businesses have turned more cautious since the fifth wave of the pandemic in Hong Kong in accordance with a survey conducted by the Financial Secretary Office.

The local economy is expected to gradually resume to normal with further relaxation of social distancing measures as well as the boost of consumption voucher phase II which lifts domestic demand in the short run. As of the end of Q2, approximately 65% of Hong Kong's population was administered with the 3rd dose vaccine, which paved the way for the resumption of cross-border travel. While Hong Kong is reviving from the shock of pandemics, some major cities in Mainland are still undergoing mass Covid testing and prolonged partial lockdown.

Local optimism for a reopening of the border in late Q3 to mid-Q4 2022 in the hope of the return of Mainland Chinese capital. However, the date of reopening and commencement of quarantine-free travel is still uncertain in the foreseeable future. Worse still, increasing headwinds on the external front may still cast a shadow on the economic outlook as well as the commercial property market.

MARKET DATA SNAPSHOT

A glimpse of fading investor and occupier momentum

Office investment activities rebounded with a slight increase in total considerations of office transactions completed in Q2 2022. The number of office transactions returned to a normal level in Q2 2022, mainly contributed to the prolonged transactions during the partial lockdown in town between February and March. Broadly speaking, investors are wary about how the rate hike and recession concerns will play out for the office market.

According to the statistics from the Rating and Valuation Department ("RVD"), there were 76 and 73 office transactions in May and June 2022, while the transaction amounts were HKD 696 and HKD 780 million, respectively. On a year-on-year ("y-o-y") basis, the number of office transactions decreased 30% in both May and June 2022, while the considerations of office transactions were down 51% and 47% respectively in these two months.

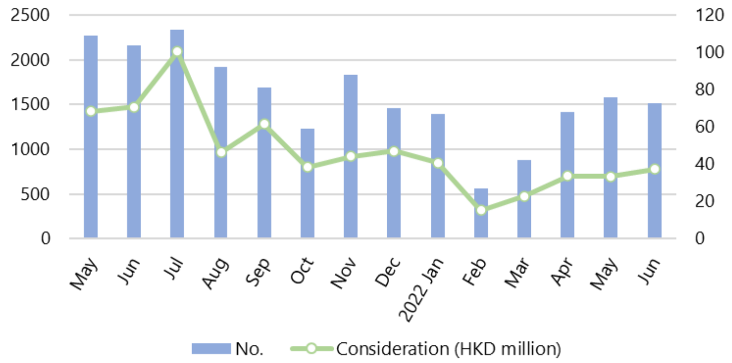
The number of keen office investors diminished, discouraged by the rising rates while the end-users are pleased to see bargained deals, even firsthand office supplies like Novo Jaffe and 888 Lai Chi Kok Road in Wanchai and Lai Chi Kok attracted considerable local corporations to purchase sizable space for their own use.

Golden Resources Development and Nanyang Commercial Bank are the major owners of the two office development, respectively. While these buyers were being opportunistic and took the long view, they are rewarded with the naming rights of the office building that came at a much lower cost than in a bullish office market.

On the other hand, core and non-core office leasing markets performed widely divergent after the fifth wave of pandemics. Grade A office in the main CBD in Hong Kong Island saw a stabilization in rent while other decentralized areas recorded a 2-3% decline in Q2 2022.

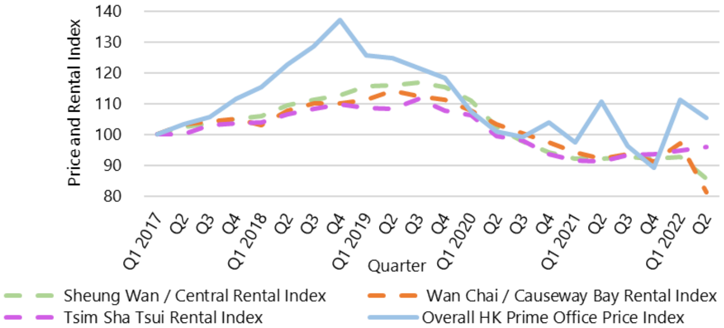
Hong Kong office leasing market has turned out as our forecast for the year 2022 earlier in January. Looking ahead, we foresee the office rent to reach lower troughs and create a new base in 2H 2022 as the precaution of pandemic variants and a possible recession are essentially in place. While the Kowloon East and West are both laden with new office supplies, the imperil status of Asia's financial hub in Hong Kong Island will also be wavered. We believe the office market to soften in 2H 2022 and expect more downward movement in decentralized Kowloon and Hong Kong Island office rental while the core office districts to be on par with 2021 year-end.

Figure 1: 2021 Jun - 2022 June No. of Office Transactions and Considerations



SOURCE: AVISTA Research, RVD

Figure 2: Q1 2017 - Q2 2022 Prime Office Rental and Price Index (Q1 2017=100)



SOURCE: AVISTA Research, RVD

MARKET DATA SNAPSHOT

Table 2: Q2 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	$22,300 (↑2%)	$62 (↑0%)	8.9% (↑)
Central	$34,000 (↓-6%)	$117 (↑0%)	7.5% (↑)
Admiralty	$28,500 (↓-1%)	$76 (↑1%)	8.5% (↓)
Wan Chai	$26,300 (↓-1%)	$55 (↑1%)	9% (↑)
HK Island East	$13,200 (↓-1%)	$46 (↓-3%)	8.5% (↑)
Tsim Sha Tsui	$12,000 (↓-2%)	$59 (↓-1%)	10.2% (↑)
Kowloon East	$10,500 (↓-4%)	$29 (↓-2%)	13% (↑)

SOURCE: AVISTA Research

Table 3: Q2 2022 Selected Office Sale Transactions

Location	Building	GFA(sq.ft.)	Unit	Considerations/ Unit Price (HKD)
Central	9 Queen's Road Central	3,290	Mid Floor Unit	$112,001,470 @ $34043
Central	Lyndhurst Tower	4,005	5/F Whole Floor	$63,751,590 @ $15,918
Wanchai	NOVO Jaffe	2,243	28/F Whole Floor	$49,350,000 @ $22,002
Tsim Sha Tsui	New East Ocean Centre	3,194	16/F Unit 09	$38,328,000 @ $12,000
Kwun Tong	EGL Tower	3,532	20/F Unit A	$32,681,596 @ $9,253

SOURCE: AVISTA Research

Table 4: Q2 2022 Selected Office Leasing Transactions

Location	Building	GFA(sq.ft.)	Unit	Rental (Monthly)/ Unit Rent (HKD)
Central	One International Finance Centre	20,390	Mid Floor	$3,221,620 @ $158
Tsuen Wan	Plaza 88	33,583	High Floor	$839,575 @ $25
Kwun Tong	Millennium City 5 BEA Tower	25,872	23/F	$750,288 @ $29
Mong Kok	Grand Century Place Tower 2	20,816	High Floor	$728,560 @ $35
Kwun Tong	NEO	7,012	Mid Floor	$231,396 @ $33

SOURCE: AVISTA Research