Hong Kong Grade A Office, Q2 2019

Rents decline for first time since Q2 2014 as space availability climbs

Overall HK Rents	HK Island Rents	Kowloon Rents	New Territories Rents
-0.6% q-o-q	-0.3% q-o-q	-0.2% q-o-q	+0.1% q-o-q

- Office leasing momentum remained weak amid the ongoing U.S.-China trade dispute.
- Excluding pre-commitments in new supply, just 12,000 sq. ft. of net absorption was recorded in Q2 2019.
- Decentralisation gained further momentum this quarter, driven by the high value-added service sector. Hong Kong East and Kowloon East remained the main destinations.
- Leasing activity by agile space operators rebounded in Q2 2019. Apart from large operators displaying interest in non-Grade A buildings, several high-end newcomers opened their first centres in Hong Kong.
- Rental growth weakened in core submarkets, with Greater Central and Wan Chai & Causeway Bay recording their first declines since Q3 2014. Overall rents suffered their first drop since Q2 2014. Rents in decentralised submarkets increased on the contrary.
- CBRE Research expects leasing activity in H2 2019 to be driven by decentralisation and consolidation amid continued economic uncertainty.
- Rents in core submarkets are forecast to weaken in H2 2019 but those in non-core areas are set to increase by 2% to 3% by year-end.

*All floor sizes mentioned in this report refer to Net Floor Area (NFA)

Indirect economic impact stemming from the U.S.-China trade conflict further dampened Grade A office leasing sentiment in Q2 2019. Despite net absorption increasing to 480,600 sq. ft. from 151,500 sq. ft. in Q1 2019, nearly all of this figure was due to pre-commitments in new supply delivered this quarter. Excluding these transactions, the quarter saw just 12,000 sq. ft. of net absorption in the secondary market.

The decentralisation trend continued in Q2 2019, with at least 440,400 sq. ft. of space relocated from core to non-core submarkets, mainly by the banking & finance, legal and insurance sectors. Leasing activity by agile space providers rebounded during the quarter, with several newcomers securing space in prime buildings to accommodate mainly corporate users.

The subdued leasing demand ensured rents declined this quarter for the first time since Q2 2014. Overall rents fell by 0.6% q-o-q, led by core submarkets, while those on Hong Kong Island and Kowloon edged down by 0.3% q-o-q and 0.2% q-o-q, respectively.

1.4 million sq. ft. of new office space was completed in Q2 2019, the highest quarterly total since Q3 2008. Around one-third of the new space was pre-leased.

HONG KONG ISLAND

Slower leasing momentum ensured a number of sizeable spaces in core submarkets were returned vacant in Q2 2019. Net absorption during the quarter was negative for the first time in three years, at -164,900 sq. ft..

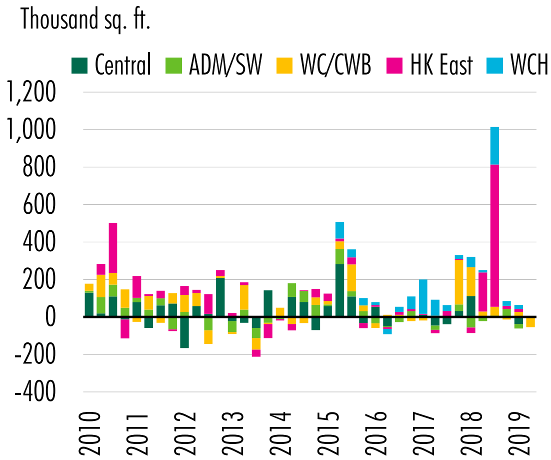
Limited new leasing demand in Greater Central saw vacancy rise further to 2.3%, the highest since Q1 2015. However, the period also saw some occupiers leverage softening rents to relocate their offices within the district. These included U.S. legal firm DLA Piper, which relocated from The Landmark to 34,100 sq. ft. in Three Exchange Square. Elsewhere, asset management firm T. Rowe Price relocated from Jardine House to a 36,000 sq. ft. space in Chater House. Chinese firms remained static, contributing just 5% of gross leasing area in Greater Central in Q2 2019.

Agile space operators turned more active in core locations this quarter. Major deals included Australian serviced office operator Victory Offices leasing its first space in Hong Kong at a 16,100 sq. ft. unit in The Center. Existing operators also committed to an additional 80,000 sq. ft. of space in non-Grade A buildings in the CBD during the period.

Decentralisation activity gained momentum in Hong Kong East in Q2 2019. The Securities and Futures Commission confirmed it would relocate its operations from Central to 178,800 sq. ft. of space at One Island East, marking the second largest decentralisation move on Hong Kong Island in history. The same building also recently secured an insurance firm, Aon, and a legal firm, Reed Smith Richards Butler, which will relocate from Causeway Bay and Central, respectively.

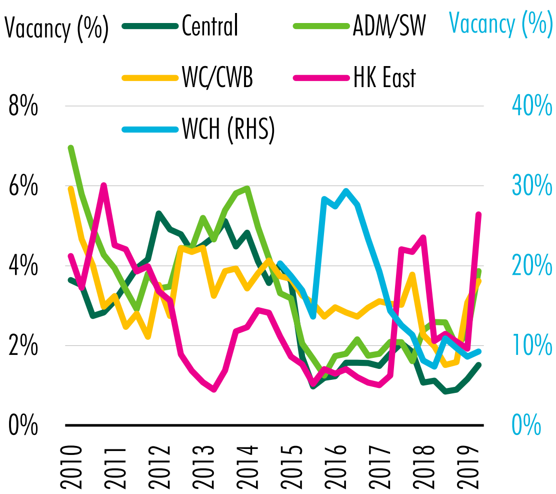
Weaker demand coupled with decentralisation continued to weigh on rental growth in core submarkets in Q2 2019. Rents in Greater Central and Wan Chai & Causeway Bay edged down by 0.5% q-o-q and 0.6% q-o-q, respectively, marketing the first negative growth since Q3 2014 for both submarkets. In contrast, Hong Kong East rents rose 1.9% q-o-q.

Figure 1: Hong Kong Island Net Absorption



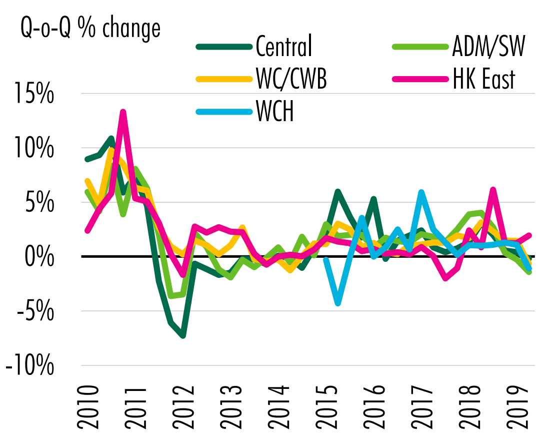
Source: CBRE Research, Q2 2019.

Figure 2: Hong Kong Island Vacancy Rate



Source: CBRE Research, Q2 2019.

Figure 3: Hong Kong Island Rental Growth



Source: CBRE Research, Q2 2019.

KOWLOON AND THE NEW TERRITORIES

Thanks largely to the completion of The Quayside (639,000 sq. ft.) in Kowloon East, which came on stream with a pre-commitment rate of 68%, net absorption in Kowloon & New Territories increased to 645,500 sq. ft., a significant improvement on the 148,500 sq. ft. recorded in Q1 2019. However, the addition of the new building meant vacancy in Kowloon East climbed 1.5 percentage points q-o-q to 15%, the highest since Q1 2010.

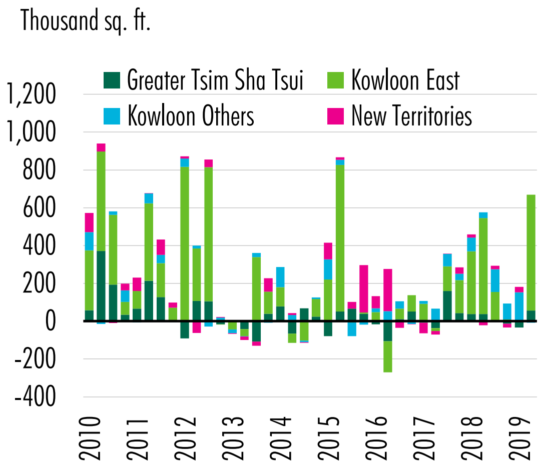
Kowloon East continued to attract decentralisation demand in Q2 2019. Major deals included Hong Kong-based insurance company FT Life leasing four floors in NEO totalling 98,300 sq. ft. to relocate its operations from Sheung Wan. This marked the company's second decentralisation move after it relocated its Tsim Sha Tsui operations to FT Life Tower in 2018. Also this quarter, shipping company Anglo Eastern committed to 59,800 sq. ft. in Kingston International Centre, decentralising from Wan Chai.

Occupiers in Tsim Sha Tsui continued to seek cost effective space elsewhere in Kowloon. U.S. retailer L.L.Bean committed to a 12,300 sq. ft. space in NEO, while technology firm DuPont signed a lease for a 9,500 sq. ft. space in China Life Center in Hung Hom. Both companies are relocating from The Gateway portfolio.

As on Hong Kong Island, agile space providers displayed stronger demand in Q2 2019. Southeast Asian serviced office operator CEO Suite leased a whole 18,800 sq. ft. floor in K11 Atelier for its first centre in Hong Kong, while a U.S. coworking operator committed to two floors in Octa Tower in Kowloon Bay for its 14th centre in the territory.

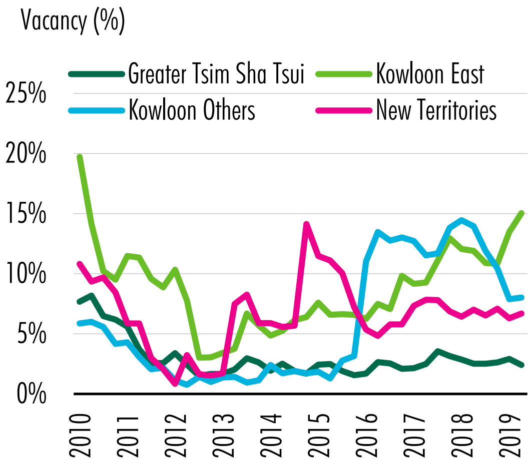
With more occupiers opting for decentralisation, space availability is increasing in Greater Tsim Sha Tsui. Rental growth in the district eased from 2.0% q-o-q in Q1 2019 to just 0.1% q-o-q this quarter. In contrast, rents in Kowloon East climbed 1.0% q-o-q on the back of growing leasing momentum in the area. Kowloon Others rents grew by 1.1% q-o-q in Q2 2019, while rents in the New Territories were flat.

Figure 4: Kowloon & New Territories Net Absorption



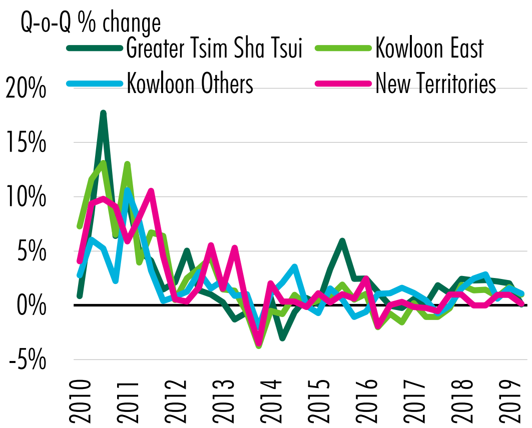
Source: CBRE Research, Q2 2019.

Figure 5: Kowloon & New Territories Vacancy Rate



Source: CBRE Research, Q2 2019.

Figure 6: Kowloon & New Territories Rental Growth



Source: CBRE Research, Q2 2019.

Outlook

Mounting global economic risks, led by the U.S.-China trade conflict, will continue to impact a number of sectors in Hong Kong in H2 2019. High-value-added service sectors including banking and finance and professional services, which are highly sensitive to financial and asset market instability, will be especially vulnerable. As a result, occupiers, especially multinationals, are expected to remain cautious towards real estate expenditure in the short term, a trend that will cap expansionary demand for office space.

As of March 2019, Chinese companies occupied 9.3 million sq. ft. of Grade A office space (11.6% of the total) in Hong Kong, with 77% of their footprint located in core submarkets. Chinese firms that have already leased space in anticipation of future business needs are likely to suspend further expansion due to the current uncertain economic conditions.

Some excess space may shortly be returned to the market in the form of shadow space. Although sitting tenants are still liable for rental payments, increased space availability in core submarkets could exert pressure on landlords wishing to maintain vacancy at current low levels.

With cost-saving set to remain a key theme for the foreseeable future, leasing activity in H2 2019 will be mainly driven by decentralisation and consolidation. In the primary market, a total of 2.2 million sq. ft. is still available for lease, 95% of which (2.0 million sq. ft.) is in non-core submarkets and will continue to drive decentralisation activity.

CBRE Research analysis shows that companies with a footprint larger than 50,000 sq. ft. occupy an average of 3.7 separate locations, representing as much as 31 million sq. ft. of Grade A office space. Occupiers may wish to consider consolidating their operations into a single or dual location for better workplace efficiency.

In view of rising availability, landlords in core submarkets are advised to adopt a more realistic stance towards leasing terms and move quickly to secure tenants. This will improve their chances of attracting high-paying location-sensitive occupiers from competitors; retaining existing tenants in their portfolios; and may even prevent a further rise in vacancy in core submarkets. CBRE Research retains its view of a 0% to 5% rental decline in core submarkets in 2019.

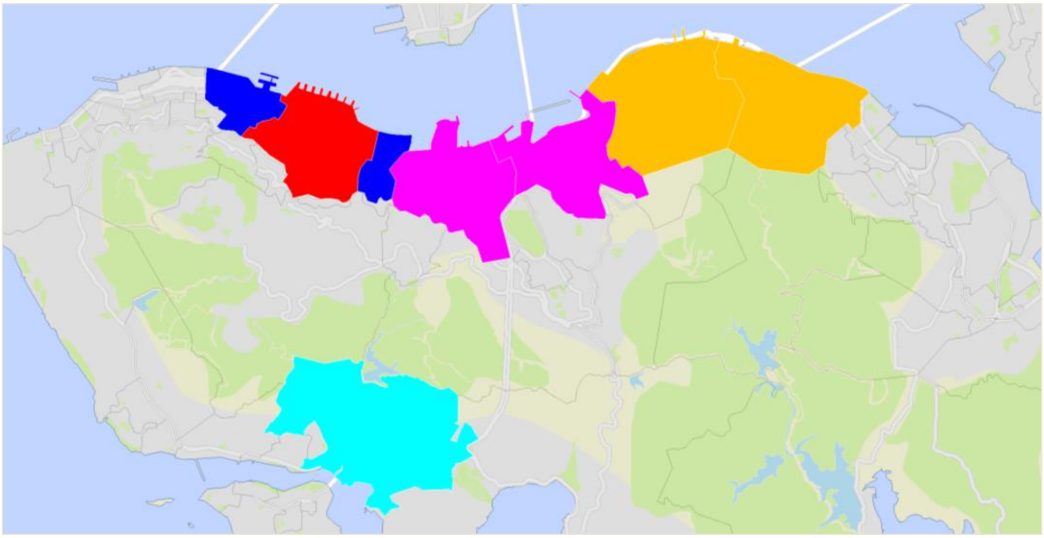
The wave of professional services firms completing decentralisation moves has created a clustering effect of high-profile occupiers in non-core submarkets. Other companies in these sectors will consider to follow suit and relocate for rental savings. Despite tight availability, Hong Kong East will continue to attract decentralisation demand from other parts of Hong Kong Island. Spillover demand may be realised in Kowloon East, which had 2.5 million sq. ft. of vacant space in Q2 2019. However, the lack of large new supply over the next 18 months will ensure empty space is gradually absorbed. Rents in non-core submarkets are therefore expected to remain resilient, and are forecast to climb by a further 2% to 3% in H2 2019.

Figure 7: Selected new supply

Property	District	Size (sq. ft. NFA)	Expected completion date
The Gateway – Sun Life Tower extension	Tsim Sha Tsui	286,700	Q3 2019
218 Electric Road (Newton Hotel redev.)	North Point	101,400	Q3 2019
TWTL 393, Yeung Uk Road	Tsuen Wan	238,000	Q4 2019
Central Plaza Annex	Wan Chai	17,500	Q1 2020

Source: CBRE Research, Q2 2019.

Hong Kong Island



CENTRAL; ADMIRALTY & SHEUNG WAN; WAN CHAI & CAUSEWAY BAY; HONG KONG EAST – NORTH POINT, QUARRY BAY; WONG CHUK HANG

Figure 8: Selected leasing transactions in Q2 2019

Property	District	Size (sq. ft. NFA)	Tenant
One Island East	Quarry Bay	179,800	Securities and Futures Commission
One Island East	Quarry Bay	39,700	AON
One Island East	Quarry Bay	37,200	Reed Smith Richards Butler
Chater House	Central	36,800	T. Rowe Price
Three Exchange Square	Central	34,100	DLA Piper
Central Plaza Annex	Wan Chai	17,500	Bird & Bird

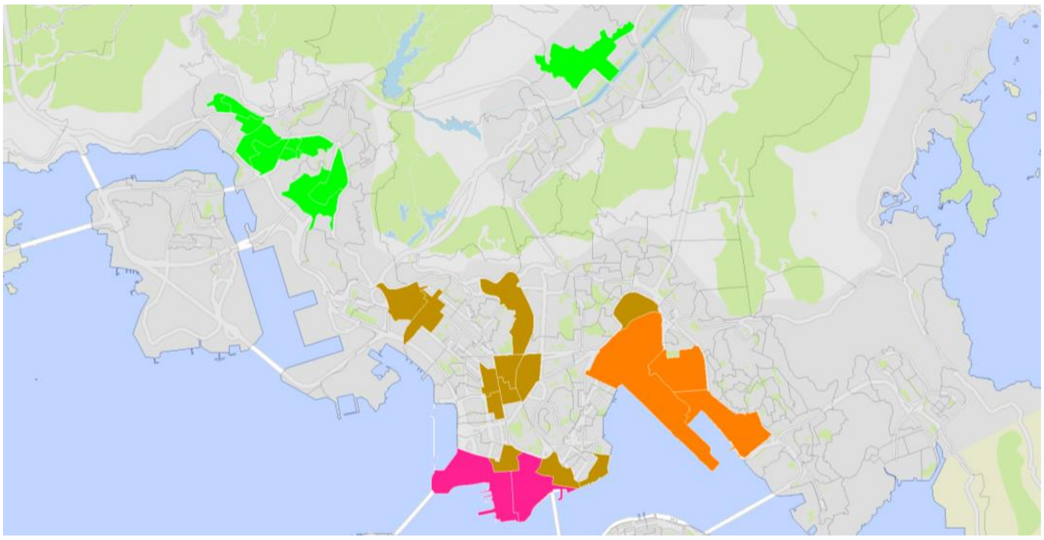
Source: CBRE Research, Q2 2019.

Figure 9: Key submarket statistics

District	Q2 2019 net absorption (sq. ft. NFA)	YTD 2019 net absorption (sq. ft. NFA)	Vacancy rates	Rents (HK$/sq. ft./mth)	Q-o-Q rental Change	YTD rental change	High / Low (HK$/sq. ft./mth)
Hong Kong Island	-164,900	-161,900	3.6%	93.1	-0.3%	+0.2%	169.4 / 25.9
Central	-52,000	-90,500	1.5%	139.2	-0.2%	+0.2%	169.4 / 72.0
Admiralty & Sheung Wan	-112,800	-136,100	3.9%	93.6	-1.4%	-1.7%	127.3 / 70.8
Wan Chai & Causeway Bay	-55,400	-28,200	3.6%	77.4	-0.6%	+0.7%	120.2 / 48.6
Hong Kong East	68,200	83,700	5.3%	54.6	+1.9%	+3.2%	71.0 / 36.4
Wong Chuk Hang	-12,900	9,200	9.2%	35.5	-1.1%	Flat	42.5 / 25.9

Source: CBRE Research, Q2 2019.

Kowloon & New Territories



GREATER TSIM SHA TSUI - TSIM SHA TSUI, TSIM SHA TSUI EAST; KOWLOON EAST - KOWLOON BAY, KWUN TONG; KOWLOON OTHERS - JORDAN, MONG KOK, HUNG HOM, CHEUNG SHA WAN, SAN PO KONG, KOWLOON TONG; NEW TERRITORIES - KWAI CHUNG, TSUEN WAN, SHA TIN, SHEUNG SHUI, TUNG CHUNG

Figure 10: Selected leasing transactions in Q2 2019

Property	District	Size (sq. ft. NFA)	Tenant
NEO	Kwun Tong	98,300	FT Life
Kingston International Centre	Kowloon Bay	59,800	Anglo Eastern Shipping
Octa Tower	Kowloon Bay	41,900	a U.S. coworking operator
Festival Walk	Kowloon Tong	28,900	City University of Hong Kong
NEO	Kwun Tong	24,600	OneConnect (Ping An Bank)
K11 Atelier Victoria Dockside	Tsim Sha Tsui	18,900	CEO Suite
AIA Kowloon Tower, Landmark East	Kwun Tong	16,500	The Continuity Company Limited

Source: CBRE Research, Q2 2019.

Figure 11: Key submarket statistics

District	Q2 2019 net absorption (sq. ft. NFA)	YTD 2019 net absorption (sq. ft. NFA)	Vacancy rates	Rents (HK$/sq. ft./mth)	Q-o-Q rental Change	YTD rental change	High / Low (HK$/sq. ft./mth)
Kowloon	660,500	779,300	9.6%	49.4	-0.2%	+1.6%	124.7 / 22.4
New Territories	-15,000	14,700	6.7%	35.3	+0.1%	+1.1%	38.8 / 24.8
Greater Tsim Sha Tsui	57,100	23,700	2.4%	65.8	+0.1%	+2.1%	124.7 / 37.8
Kowloon East	611,700	614,200	15.0%	35.6	+1.0%	+2.7%	49.4 / 23.0
Kowloon Others	-8,200	141,400	8.0%	41.1	+1.1%	+2.7%	63.6 / 22.4

Source: CBRE Research, Q2 2019

CONTACTS

Oliver Rigg
Head of Advisory & Transaction Services, Hong Kong
+852 2820 8193
oliver.rigg@cbre.com.hk

Marcos Chan
Head of Research, The Greater Bay Area and Hong Kong
+852 2820 2886
marcos.chan@cbre.com.hk

Sharon Chan
Associate Director
+852 2820 2841
sharon.chan@cbre.com.hk

Jerry Ng
Senior Manager
+852 2820 1517
jerry.ng@cbre.com.hk

Peter Leung
Manager
+852 2820 1492
peter.leung@cbre.com.hk

CBRE HONG KONG OFFICES

Hong Kong Office
Suite 1204-06, 3/F & 4/F, Three Exchange Square
8 Connaught Place
Central, Hong Kong

Kowloon Office
Suites 1201-03 & 14, 12/F, Tower 6, The Gateway
9 Canton Road, Tsim Sha Tsui
Kowloon, Hong Kong

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