# PROPERTY INSIGHTS

Hong Kong | Quarter 1, 2015

## Office leasing market off to a strong start

## Market Overview

The office sector witnessed a strong beginning for the year 2015, with positive net absorption and rental increase recorded across all five major business districts (Figure 1). Major transactions were driven by expansion and consolidation moves from banks and logistics companies.

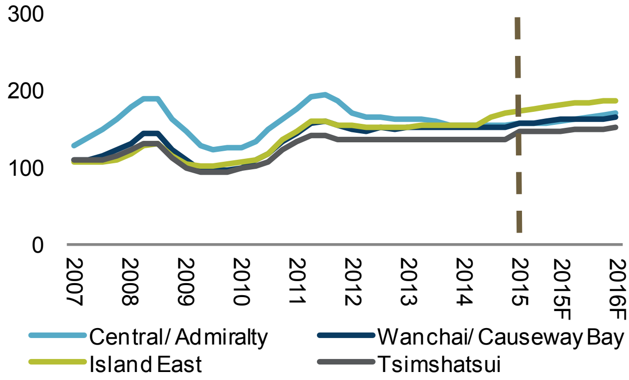
With sluggish growth from high spending overnight visitors, the retail sales of the first two months of the year dropped by 2.0% year-on-year (y-o-y), with retailers from the luxury segment the most negatively impacted. This has greatly affected retail rent affordability on the part of tenants such as watches and jewellery retailers, multinational brands, especially with respect to the tier one street shops in prime locations.

With the further tightening of the mortgage policy, the second hand residential sector faced a direct hit as developers reacted quickly by offering special bridge mortgage loans to potential home buyers, further intensifying the existing competition between the first and second hand sectors.

The luxury residential sector gained momentum after the redevelopment site of Ho Tung Gardens was transacted at an accommodation value of HK$82,258.1 (US$10,612.3) per sq ft, and several record high price transactions were recorded at the peak.

Figure 1

**DTZ office rental index (Q1 2006 =100)**




Source : DTZ Research

## Economic Overview

With mild growth of 2.2% in the last quarter of 2014, GDP increased by 2.3% in real terms for the whole year, slightly lower than the 2.9% recorded in the preceding year (Table 1).

Total exports in February 2015 reached HK$228.3bn (US$29.5bn), equivalent to an increase of 7.2% y-o-y (Table 1). However, if we consider January and February as a whole in order to minimize the disturbance caused by seasonal effect of Chinese New Year, an increase of 4.6% was recorded y-o-y.

While Composite CPI in February recorded a rise of 4.6% y-o-y, price pressures across many consumption items are easing (Table 1). Inflationary pressure is expected to stay low as imported inflation and local cost pressure will remain mild over the short term.

The seasonally adjusted unemployment rate stood at 3.3% in December 2014 – February 2015, remained unchanged for the eighth consecutive period (Table 1). The near term employment outlook, however, will definitely be influenced by the poor performance of the tourism and retail sales sectors.

Table 1

**Economic indicators**

| Indicator | Period | Unit | Value | Change y-o-y (%) |
|---|---|---|---|---|
| GDP at constant prices* | Q4 2014 | HK$bn | 573.3 | +2.2 |
| Total exports | Feb 2015 | HK$bn | 228.3 | +7.2 |
| Private consumption expenditure | Q4 2014 | HK$bn | 391.0 | +5.0 |
| Unemployment rate (seasonally adjusted) | Dec 2014 – Feb 2015 | % | 3.3 | +0.2pt |
| Visitor arrivals | Feb 2015 | Million | 5.4 | +22.4 |
| Composite CPI | Feb 2015 | - | 124.3 | +4.6 |
| Total retail sales value | Feb 2015 | HK$bn | 46.6 | +14.9 |

* In chained (2012) dollars

Source : Census and Statistics Department, HKSAR, Hong Kong Tourism Board

Following the annual growth of 7.2% in Q3 2014, private consumption expenditure increased by 5.0% y-o-y in the last quarter of the year (Table 1). As such, private consumption expenditure rose by 5.0% in nominal terms in 2014.

With over 80% of visitors coming from mainland China, total visitor arrivals reached 5.6 million and 5.4 million for January and February, respectively (Table 1). Despite the fact that the number of arrivals remained on the rise, the retail sector in Hong Kong performed poorly. Although total retail sales in February rose by 18.2% y-o-y, it dropped by 2.0% for the first two months of the year as compared with the same period the previous year (Table 1). The poor performance in the retail market was mainly due to changes in tourism spending patterns, as luxury products are no longer the must-buy items for Mainland visitors and daily use products have become increasingly popular. In particular, the value of sales of jewellery, watches and clocks, and valuable gifts decreased by 15.9% in the first two months of the year compared with the same period a year earlier.

## Residential

Supported by robust pent up demand, the residential market continued to see strong momentum in the opening months of 2015. Since both the Policy Address and the Budget released in January and February respectively only focused on the supply side and no further government curb were introduced, the residential market experienced a pick-up with rising prices and transaction volumes. Hence, the number of S&Ps Agreements for all building units and land reached over 8,000 per month and the overall residential price rose by 7.1 % during the first two months of the year.

However, on 27 February 2015, Hong Kong Monetary Authority (HKMA) introduced three additional mortgage policies, in the hope of cooling down the market. As the market started to react, this combined with the seasonal effect caused transaction volumes in March to drop to 6,496. As such, total transaction volume reached 23,478 in Q1, representing a growth of 62.4% y-o-y and 2.7% q-o-q (Figure 2).

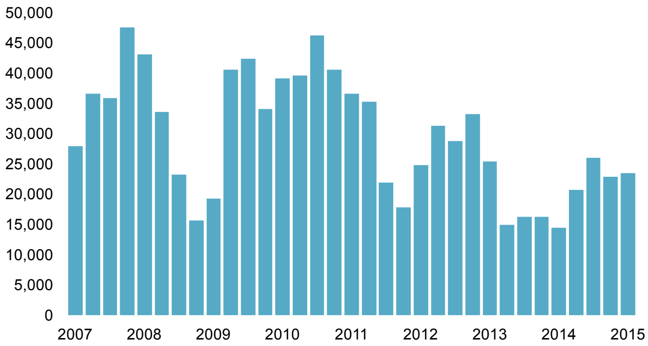
Under the latest mortgage policy, the maximum loan-to-value (LVT) ratio for self-use residential properties with value below HK$7 mn was lowered to 60%.

Property developers reacted quickly by providing second mortgage loans, intensifying the existing competition between first hand and second hand property markets. As such, the primary sector remained buoyant, with 3,743 S&Ps recorded in the first quarter of the year, equivalent to 22.3% of the total. As landlords in the secondary sector cannot offer flexible mortgage terms to buyers, the attractiveness of acquiring secondary properties has been greatly reduced. Consequently, those seeking to sell their flats immediately have to offer a greater discount.

With respect to price, while new projects continued to be offered at market prices, price in secondary market started to stabilize and the overall price was up by 7.3% in Q1. Hence, the mass residential sector was up by 8.5% in the first quarter of the year, with

Figure 2

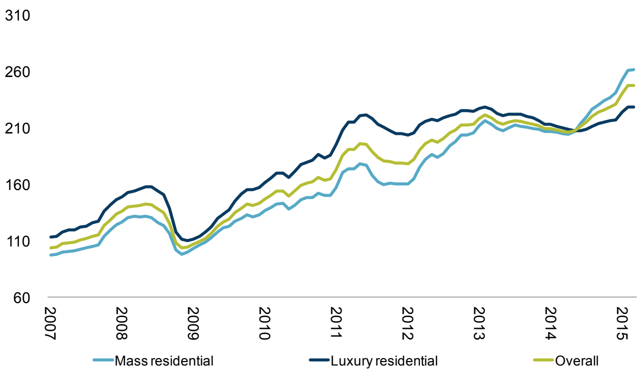
**Transaction volume of S&P Agreements (No. of S&P Agreements)**




Source : Land Registry

Figure 3

**Residential price index (Jan 2000 = 100)**




Source : DTZ Research

Table 2

**Private residential market statistics**

| | Total stock (no. of units) | price index (Jan 2000 = 100) | q-o-q change (%) | y-o-y change (%) |
|---|---|---|---|---|
| Mass Market | 1,037,237 | 261.7 | 8.5 | 27.5 |
| Luxury Market | 86,396 | 229.1 | 5.4 | 8.9 |
| Overall | 1,123,633 | 248.2 | 7.3 | 19.7 |

Source : DTZ Research, Rating and Valuation Departement HKSAR the luxury sector rising by 5.4% over the same period (Figure 3, Table 2).

Meanwhile, potential home buyers with limited financial resources may turn to the leasing market under the new mortgage regulations, a trend which is apt to drive up rents.

Looking ahead, transaction volume is expected to drop to 5,000-6,000 units per month as the second hand market has been greatly affected while the first hand market will remain active. With respect to price, the shortage of residential units is reflected by the historic low in vacancy rate. Under these conditions, price is not going to witness a major adjustment in the near term despite the new supply is being prepared to come on stream. Sites located at the Peak and Beacon Hill were both transacted at a very high price, providing support to the luxury sector. In addition, the current mortgage policy is more favourable to the luxury sector than the mass market. Therefore, it may well outperform the mass market this year.

# Office

The office leasing market witnessed a very positive beginning in 2015 with overall net absorption reaching 669,146 sq ft in Q1, which is only slightly less than the 686,849 sq ft recorded the whole year of 2014. All of the five office districts tracked witnessed positive net absorption, which is the first time that such across the board positive phenomenon has been witnessed since the last peak in Q3 2011. A number of major leasing transactions took place this quarter, with demand mainly being driven by the finance sector and shipping companies. As such, the overall vacancy rate dropped to a low level of 4.6% while the overall rent increased by 3.0% q-o-q to reach HK$61.3 (US$7.9) per sq ft per month (Table 3 and Figure 4).

In Sheung Wan/Central/Admiralty, net absorption reached 129,865 sq ft in Q1, a dramatic rise as compared with the -86,017 sq ft recorded in the previous quarter. Demand was mainly driven by the banking sector, where both expansion and consolidation moves were witnessed. To name just one example, Commonwealth Bank of Australia expanded by leasing 38,087 sq ft in Exchange Square One. As a result, vacancy dropped by 1.2 percentage points q-o-q to reach 4.9%. As leasing activity turned more active, rents in several buildings within the district reached record highs, causing the rent for the submarket to rise from HK$99.3 (US$12.8) per sq ft per month to HK$100.7 (US$13.0) per sq ft per month. This was the first time that rental growth was witnessed in this sub-market since the last peak in Q3

Table 3

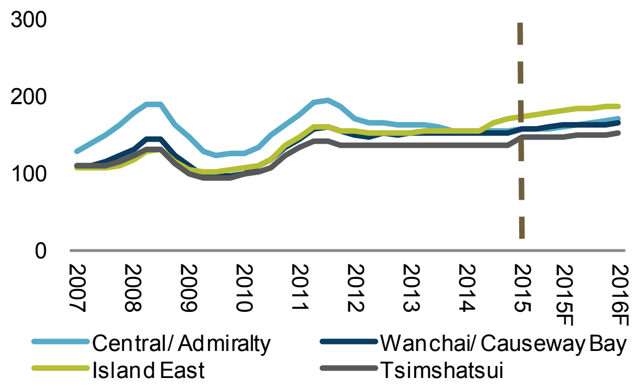
**Grade A office market statistics**

| District | Total stock (million sq ft) | Availability ratio (%) | Monthly Rent (HKD per sq ft) | Change q-o-q (%) |
|---|---|---|---|---|
| Sheung Wan/ Central / Admiralty | 29.5 | 4.9 | 101 | +1.3 |
| Wanchai / Causeway Bay | 16.0 | 4.0 | 49 | +3.7 |
| Island East | 11.0 | 2.3 | 42 | +2.4 |
| Tsimshatsui | 9.3 | 2.9 | 36 | +6.8 |
| Kowloon East | 13.5 | 7.7 | 34 | +8.9 |
| Overall | **79.2** | **4.6** | **61** | **+3.0** |

Source : DTZ Research

Figure 4

**DTZ office rental index (Q1 2006 =100)**




Source : DTZ Research

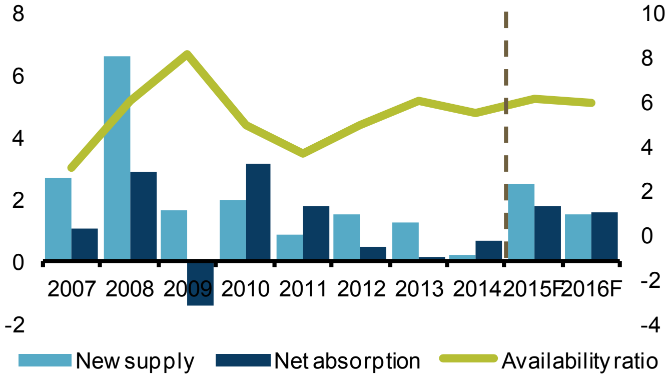
2011. As many companies in the finance sector are planning to increase their headcount, this trend, combined with the proposed Shenzhen-Hong Kong stock connect, means that demand for office space in the CBD will stay strong for at least the short term.

While the business environment continued to mature in Kowloon East, tenants from different industries are considering relocating to the area, in addition to the many relocation moves which have already occurred. Shipping industry has been active in the area. While Orient Overseas Container Line rented three floor of office space (54,942 sq ft) in One Harbour Square, Israel's largest shipping company, Zim Integrated Shipping Services, took up two floor of office space (42,186 sq ft) in Pioneer Place. As such, net absorption reached 287,113 sq ft and the vacancy rate dropped from 9.9% in Q4 2014 to 7.7% in Q1 2015. Because of the low base of comparison, rent jumped by 8.9% q-o-q to reach HK$33.8 (US$4.4) per sq ft per month, which is the highest growth among the five sub-markets (Table 3, Figure 4).

Looking ahead, over 2.5 million sq ft is expected to enter into the market in 2015, in which 2.0 million sq ft coming from Kowloon East. Through the twin towers in One Bay East were acquired by Manulife and Citibank respectively for self occupation, several additional projects which poised to come on stream based on the regeneration of former industrial buildings in the area, and this will have a constraining effect on rental growth for this sub-district overall.

Figure 5

**Grade A office supply (GFA sq ft million), net absorption (GFA sq ft million) and availability ratio (%)**




Source : DTZ Research

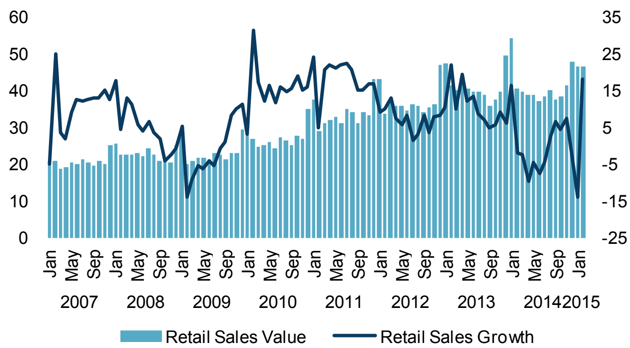
## Retail

Although the number of visitors entering Hong Kong recorded an annual growth rate of 11.6% for the first two months of the year, the amount of overnight visitor grew merely at 1.9% within the same period. The appreciation of USD, combined with the effect of protests against parallel traders in the New Territories were major factors in reducing the attractiveness of Hong Kong as a destination for tourists. Under these conditions, retail sales recorded a drop of 2.0% for January and February as compared with the same period a year earlier (Figure 6).

In greater details, sales of jewellery, watches and clocks, and valuable gifts reached HK$17,774 mn (US$2,293mn) for the first two months of the year, which was down by 15.9% from the peak last year and was only slightly higher than the level in 2012. This is

Figure 6

**Total retail sales (Value HK$bn, yearly growth %)**




Source : Census and Statistics Department HKSAR consistent with the results announced by major jewellery retailers like Chow Tai Fok and Lukfook Jewellery, with both retailers having witnessed a sales drop in Hong Kong and Macau during the Chinese New Year period. Meanwhile, Prince Jewellery and Watch has decided to lease out four floors of retail space in their headquarters in building Tsim Sha Tsui rather than self-occupying the space. In a similar reflection of the diminished market prospects, Emperor Watch and Jewellery announced that it was going to give up one of its stores in Russell Street where it has operated for twelve years.

In the meantime, sales of clothing, footwear and allied products dropped by 3.3%, and those international brands selling high end products recorded even deeper dives, undermining their ability to pay high rents in tier one street shops in prime locations. Hence, upon lease renewals, landlords have been prompted to reduce their rents by as much as 30% as compared with the peak. However, at the same time, it should be noted that many retailers are still reluctant to give up prime location premises easily due to scarcity of such good retailing positions.

As rent affordability by major tenants in the traditional shopping districts continued to drop, rents in Hong Kong Island and Kowloon dropped even more significantly. While the former witnessed a rental decrease of 18.5% q-o-q, the latter dropped by 13.8% over the same period (Table 4 and Figure 7). To name just one example, shop C&D of the ground floor of Entertainment building was transacted at a monthly rent of HK$4.5mn (US$0.6mn). As compared with the leasing contract signed in Q1 2012, this represents a drop of 25% in rent.

Looking forward, the fine tuning of the individual visitor scheme in combination with the aforementioned factors is anticipated to cause the number of visitors from Mainland China during the

Table 4

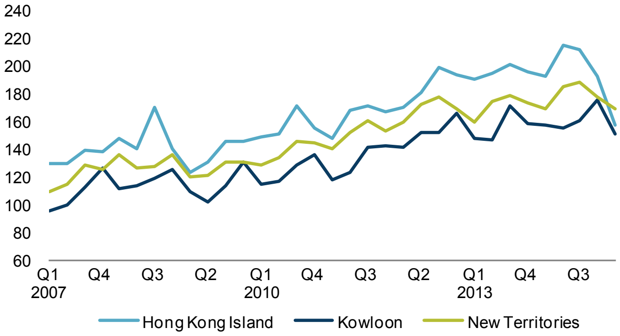
### Retail market statistics

| | Rental Index (Q1 2000 = 100) | q-o-q change (%) | y-o-y change (%) |
|---|---|---|---|
| Hong Kong Island | 157.1 | -18.5 | -18.5 |
| Kowloon | 151.1 | -13.8 | -4.1 |
| New Territories | 169.0 | -5.1 | -0.3 |

Source : Rating and Valuation Department HKSAR, DTZ Research

Figure 7

### Retail rental index (Q1 2000=100)




Source : Rating and Valuation Department HKSAR, DTZ Research

Labour Day Golden Week to record negative growth as compared with a year ago, which may further affect the performance of the retail sector. However, retail sales continue to be supported by strong domestic demand as the labour market and the stock market continue to perform strongly. We expect that rents for prime location will continue to drop to a more realistic level, with tier 2 street shops dropping substantially more than the tier 1 street shops. However, we do not expect tenant replacement to occur in the very prime locations, where rents are expected to remain at a very high level.

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