2022 OFFICE MARKET OUTLOOK AND FORECASTS

AVISTA RESEARCH

Taper, rate hike and new virus variants looms in, Hong Kong's ultra-low interest rate is set to rise in 2022 and the direction for office market will polarize into two camps, centralized and decentralized markets. Investors and developers will favor trophy assets like core CBD offices in Hong Kong. Hong Kong's COVID Zero Strategy laid the groundwork for border reopening and provided an extra catalyst for a stable recovery in the office market.

MARKET INSIGHTS

Abundant New Grade A Office Supply in Decentralized Areas

After two years of dismal Grade A office supply but a daunting negative take-up figure in Hong Kong, several long-awaited brand-new office buildings are about to complete in the year 2022 and join the competition. They will provide approximately 4.7 million sq.ft. office space and most of them are in decentralized areas which Kowloon East accounts for 36% of the new supply.

Notable developments include AIRSIDE, the first commercial site in Kai Tak developed by Nan Fung Group, providing 1.1 million sq.ft. office area and over 700,000 sq.ft. retail space connecting to the new MTR station; Swire Properties' Two Taikoo Place offering 1 million sq.ft. office space and consolidated Swire's influence in Quarry Bay; 98 How Ming Street, a twin tower in Kwun Tong which was developed by Sun Hung Kai Properties will introduce 650,000 sq.ft. office space and 450,000 sq.ft. retail area beneath the office towers, energizing the whole Kwun Tong with better commerce ambiance.

Considering the average office take-up in the past 20 years is only 1.6 million sq.ft. per year, the unabsorbed stock in 2022 is set to overwhelm the market to a great extent and the office vacancy is poised to hit a record high, especially in Kowloon East. This will create considerable downward pressure for office rents in decentralized areas as the landlords will lure anchor tenants into their newly completed office with a lower than market rent which would likely draw down the office rent in respective areas in 2022.

Table 1: 2022 Grade A Office Market Forecast

District	Rent Forecast	Price Forecast
Hong Kong Island CBD (Central, Admiralty, Sheung Wan)	↑ 5-8%	↑ 3-5%
Hong Kong East (Quarry Bay, North Point)	↓ 3-5%	↓ 0-2%
Hong Kong South (Wong Chuk Hang)	↓ 0-2%	↓ 3-5%
Wanchai/ Causeway Bay	↑ 0-1%	↑ 0-1%
Kowloon CBD (Yau Tsim Mong, Hung Hom)	↑ 3-5%	↑ 3-5%
Kowloon East (Kwun Tong, Kowloon Bay, Kai Tak, San Po Kong)	↓ 3-5%	↓ 2-4%
Kowloon West (Cheung Sha Wan, Lai Chi Kok)	↓ 3-5%	↓ 1-3%
New Territories (Tsuen Wan, Kwai Chung)	↓ 1-3%	↓ 2-4%

SOURCE: AVISTA Research

Regained Momentum and Boosted Appeal within Core Central District

In Q4 2021, Henderson Land won the tender for the New Central Harbourfront Commercial Site 3 at a record-setting price of HKD 50.8 billion in Central, the most expensive office district in the world. According to the Development Bureau, the developer's bid is 37% or HKD 13.7 billion higher than the runner-up bid, and the design proposal part scored full marks under the unique two-envelope approach assessment. The staggering premium amount also shows its confidence in the long-term potential of Central and how strategic and unique the land parcel is. It is the second commercial site Henderson acquired in the past 5 years, after the successful bid of the former Murray Road carpark site and now named "The Henderson" which is set to become a prominent architectural icon in Central.

Over the last few decades, major developers strived to further develop their territories in the prestigious Central district. Hongkong Land's longstanding dominance in Central has not changed even if

MARKET INSIGHTS

Henderson Land snapped up the two mega size plots in a row. Hongkong Land owns 12 interconnected prime commercial buildings at the heart of Central with over 4.8 million sq.ft. whilst Henderson Land is still 1.2 million sq.ft. behind.

By the virtue of the prestige, scarcity of land, and proximity to the regulatory bodies, prime office in the Central district is still the priority for many multinational financial institutions and professional services firms when selecting their headquarters. Granted, developers and real estate investors chase after trophy assets in Central but the rationale behind is the favorable higher-than-average yield but lower-than-average vacancy rate with a highly liquid market amidst the pandemic. We expected the prime office prices in Central and its surrounding districts such as Sheung Wan and Admiralty to be boosted by the returning investment and leasing demand.

Auction Houses and Flexible Office Operators Grew Their Presence in Major CBDs

Due to the COVID-19 pandemic and tightened social distancing measures, many auction houses and art fair organizers relocated from Hong Kong Convention and Exhibition Centre to various hotel and office premises in the past 2 years. Among them, Christie's Asia pre-committed 4 floors in The Henderson totaling 50,000 sq.ft. as its Asia Pacific headquarters; Phillips leased 6 floors with 48,000 sq.ft. in WKCDA Tower in West Kowloon, an extension to core Tsim Sha Tsui CBD. Both occupiers will use their space as an exclusive year-round saleroom as well as gallery space to cater to flourishing Asian demand for traditional collectibles and Non-Fungible Tokens (NFT) art market.

Occupiers with office size change also gave rise to the reemergence of co-working and serviced office operators as they offer more agility in space configuration and minimal cost on office relocation and fitting. While some flexible office space providers were struggling to survive and surrendered their fully fitted centers to their landlord, other operators were actively looking to expand their footprint to capture the expanding demand for agile workplaces. Serviced office operator The Executive Centre expanded 47,100 sq.ft. in 28 Stanley Street in Central and co-working operator IWG took 2 whole floors with around 23,000 sq.ft. in Tower 535 in Causeway Bay.

Table 2: Major Developers' Commercial Portfolio in Central

Developer	Development	Floor Area (million sq.ft.)
Hongkong Land	One, Two, Three Exchange Square, Jardine House, Gloucester Tower, etc.	4.9
Henderson Land	New Central Harbourfront Site 3, The Henderson, One & Two International Financial Centre and Four Seasons Hotel (Portion), etc.	3.6
CK Asset Holding	Cheung Kong Center, Cheung Kong Center II and China Building	2.0
Sun Hung Kai Properties	One & Two International Financial Centre and Four Seasons Hotel (Portion)	1.8
New World Development	New World Tower, Manning House	0.8
Wheelock Properties	Wheelock House, Crawford House, The Murray	0.7

SOURCE: AVISTA Research

MARKET OUTLOOK

A Challenging but More Rewarding and Healthier Way to Economic Recovery

End of Extremely Low-interest Rate to Combat Unabated Inflation

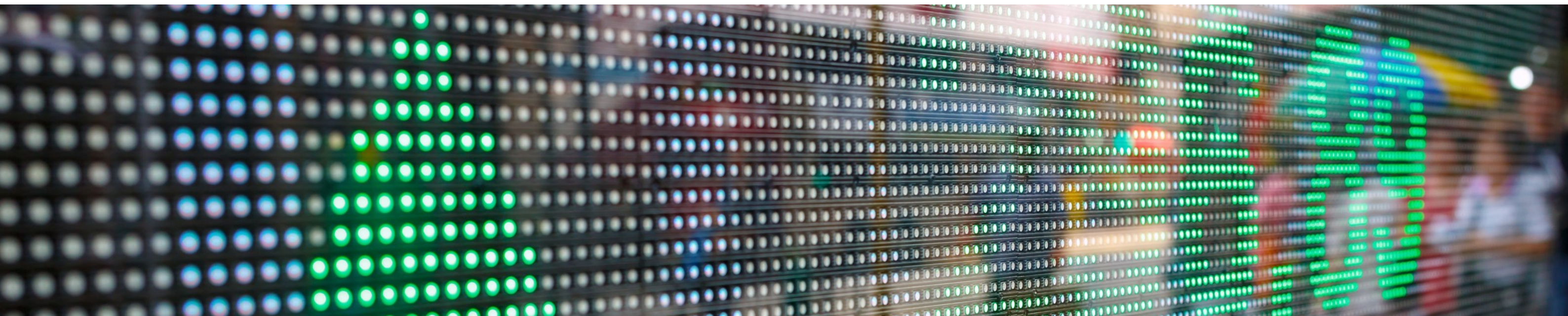
Given the concerns over the pace of price increases that persist and continued worldwide supply chain bottleneck, the United States (the "**U.S.**") Federal Reserve (the "**Fed**") signaled a higher chance of interest rate hike to happen as early as Q1 2022. The unabated inflation and strong employment in the U.S. are likely to trigger three interest rate hikes from the current near-zero level to 0.9% by the end of the year 2022. As the gap between Hong Kong and U.S. rates will widen and it is only a matter of time for Hong Kong's deposit and lending rates to increase. According to the Hong Kong Monetary Authority ("**HKMA**"), the 1-month Hong Kong Interbank Offered Rate ("**HIBOR**") in Q4 rebounded from its 10-year low of 0.04% and closed at 0.16% by end of 2021. It is market consensus that the extremely low-interest rate environment will come to an end in 2022. Nevertheless, the People's Bank of China ("**PBOC**") cut its loan prime rate and reserve requirement ratio in Q4 which aims at lowering the borrowing cost of Mainland developers and supporting the economy. In the short run, the expectation of the Fed rate hike is still favorable for the real estate investors as commercial real estate is one of the most sought-after asset classes during the period of rate hike cycle that helps investors to beat inflation and achieve a positive real rate of return.

Hong Kong Push for COVID Zero and a More Stable Recovery

Hong Kong's economy bounced back from the recession owing to the Coronavirus Disease 2019 ("**COVID-19**") pandemic in the 2nd half of 2021. According to Hong Kong's Census and Statistics Department ("**C&SD**"), Hong Kong's gross domestic product ("**GDP**") expanded by 5.4% year-on-year ("**y-o-y**") in Q3 2021, which is lower than the first 2 quarters in 2021. The annual GDP is estimated to increase by 5.5% to 6.5% but with a higher chance to reach the top end for the whole year of 2021. With the continued virus containment measures and growing vaccination rate in place, the outbreak of Delta and Omicron variants has been contained and closely monitored. As of the end of Q4, Hong Kong's overall vaccination rate was approximately 72% yet the virus variants may undermine the protection of vaccines over time and become a potential threat to Hong Kong's economy while the city is on its road to recovery.

While Hong Kong strives to maintain zero infections locally, other countries adopt the strategy of "living with the virus". Hong Kong's adoption of stringent measures to prevent the importation of cases will create the conditions for an orderly resumption of normal cross-boundary travel with Mainland China. The officials of the Mainland and Hong Kong are in talks to pursue quarantine-free travel and the government indicated that business executives with interests on the Mainland would be given priority when it commences. Upon successful negotiation to take place, the resumption of normal economic activities and cross-boundary investments from Mainland China will boost the leasing momentum in core CBDs.

We expect the office rents in non-core areas (Island East as well as Kowloon East and West) to shrink 3-5% as the introduction of first-hand office supply will dampen the rent growth while creating opportunities for occupiers who are looking for sizeable Grade A office space at affordable rent range. In contrast, core CBDs in Hong Kong Island and Kowloon (Central, Sheung Wan, and Tsim Sha Tsui) are predicted to outperform other districts with an expectation of the return and expansion of Mainland enterprises and more dual-primary and secondary IPOs in Hong Kong. We expect Grade A office rent and price to rise 4-6% and 3-5% respectively in core CBDs.



MARKET DATA SNAPSHOT

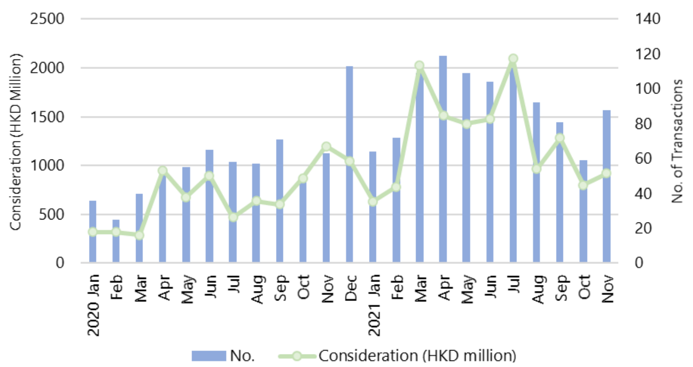
Stable Recovery in Office Property Investment

Office investment activities slowed with a slight decline in total considerations of office transactions completed in Q4 2021. Number of office transactions decelerated in Q4 2021 but the whole of year 2021 almost doubled in volume compared with the same period a year ago, showing a positive sign of recovery in demand and investors' confidence.

According to the statistics from the Rating and Valuation Department ("**RVD**"), there were 59 and 88 office transactions in October and November 2021, while the transaction amounts were HKD 800 and HKD 920 million, respectively. On a year-on-year ("**y-o-y**") basis, the number of office transactions upped by 18% and 40% in October and November 2021 respectively, while the considerations of office transactions decreased by 8% and 23% respectively in these two months.

Despite that the investment atmosphere improved over 2021, investors are only cautiously optimistic about the office market while not many sizable deals are completed with the negative wealth effect from the sharp decline in equity market. We expect the office sales market to regain momentum as more cash-rich investors acquire prime office properties in core CBDs at the currently discounted prices in 2022 as a result of an earlier than expected resumption of quarantine-free travel with mainland China and the return of Mainland Chinese capital.

Figure 1: 2020 Jan - 2021 Nov No. of Office Transactions and Consideration

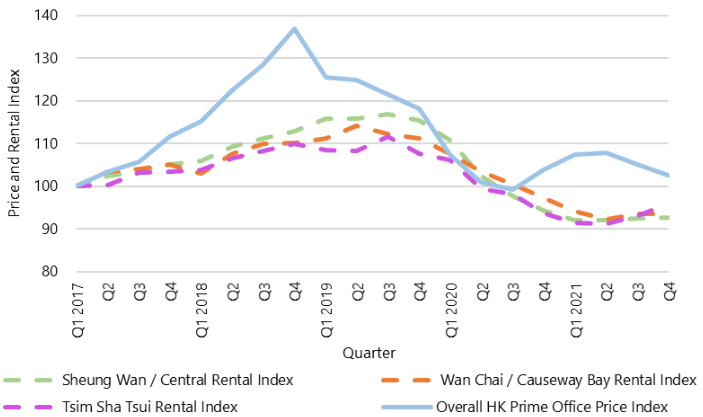


SOURCE: AVISTA Research, RVD

While worries over Delta and Omicron COVID variants dent the office and equity prices in Hong Kong during the last quarter, positive effects of consumption voucher scheme and growing vaccination rate contributed to the improved business atmosphere and subsequently the slight rebound of office rent. Thus, the office rentals bounced back in Q4 2021, notably, the office rentals of Tsim Sha Tsui rose by 3% quarter-on-quarter ("**q-o-q**").

However, the leasing demand diverges in different districts, the rental index of Central/ Sheung Wan and Wanchai/ Causeway Bay merely increased by 0.2% and 0.1% q-o-q respectively. Taking into account the massive future office supply to complete and the reopening of the border, we expect more office occupiers will take advantage of the prime office rental adjustment and the relocation demand to sustain in the first half of 2022, which will drive the rental growth in both strategic locations, Sheung Wan/ Central and Tsim Sha Tsui CBDs.

Figure 2: Q1 2017 - Q4 2021 Prime Office Rental and Price Index (Q1 2017=100)



SOURCE: AVISTA Research, RVD

MARKET DATA SNAPSHOT

Table 3: Q4 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	$23,500 (↑2%)	$64 (-)	8.4% (↓)
Central	$37,000 (↑3%)	$115 (↑3%)	7.5% (↑)
Admiralty	$29,300 (↑0%)	$76 (↑0%)	8.4% (↓)
Wan Chai	$27,800 (↓2%)	$54 (↓5%)	9.2% (↓)
HK Island East	$13,500 (↓3%)	$49 (↓1%)	6.2% (↓)
Tsim Sha Tsui	$12,500 (↑3%)	$59 (↑0%)	10% (↑)
Kowloon East	$11,200 (↑2%)	$31 (-)	13% (↑)

SOURCE: AVISTA Research

Table 4: Q4 2021 Selected Office Sale Transactions

Location	**Building**	**GFA** (sq.ft.)	**Floor**	**Consideration/Unit Price** (HKD)
Cheung Sha Wan	888 Lai Chi Kok Road	67,905	29/F Whole Floor	$1,188,340,000 @ $17,500/sq.ft.
Sheung Wan	Cosco Tower	19,745	Low Zone	$42,000,000 @ $21,271/sq.ft.
Wanchai	Capital Centre	10,380	24/F Whole Floor	$225,000,000 @ $21,676/sq.ft.
Kowloon Bay	Enterprise Square 1 Tower 2	14,153	8/F Whole Floor	$100,000,000 @ $7,066/sq.ft.
Admiralty	Bank of America Tower	1,410	1108-09	$52,170,000 @ $37,000/sq.ft.

SOURCE: AVISTA Research

Table 5: Q4 2021 Selected Office Leasing Transactions

Location	**Building**	**GFA** (sq.ft.)	**Floor**	**Rental** (monthly)**/Unit Rent** (HKD)
Central	Cheung Kong Centre	149,790	37-40, 52-55/F	$16,776,480 @ $112/sq.ft.
Kwun Tong	International Trade Tower	145,000	17-18, 22-23/F Whole Floor	$4,205,000 @ $29/sq.ft.
Central	One International Financial Centre	14,803	39/F Whole Floor	$2,146,435 @ $145/sq.ft.
Cheung Sha Wan	888 Lai Chi Kok Road	47,712	29-20/F Whole Floor	$1,431,360 @ $30/sq.ft.
Tsim Sha Tsui	One Peking	11,976	22/F Whole Floor	$838,620 @ $70/sq.ft.

SOURCE: AVISTA Research