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MARKET IN MINUTES

Savills Research

Office

Rents are still on solid ground

The tapering supply of office space, encouraging pre-commitment levels for upcoming completions, and improving occupancy rates in most of Singapore's newer office buildings all add weight to the proposition that rental growth should continue this year.

- The office leasing market remained stable with a total of 1,339 leases commencing in the period from January to March.
- Two co-working operators, IWG's No18 and The Great Room, leased space in shopping complexes.
- In the sales market, buying activity for office properties slowed down significantly in Q1/2019.
- Based on Savills basket, the overall vacancy rate for CBD Grade A offices fell from 7.4% in Q4/2018 to 6.9% in Q1/2019.
- Average monthly rents of CBD Grade A offices in Savills basket rose 2.0% quarter-on-quarter (QoQ) to S$9.99 per sq ft (psf) in Q1/2019. However, overall rental growth on a quarterly basis has slowed down.

"Although the official rental index has softened, ground level readings show that rents have increased and should continue to do so over the medium term."

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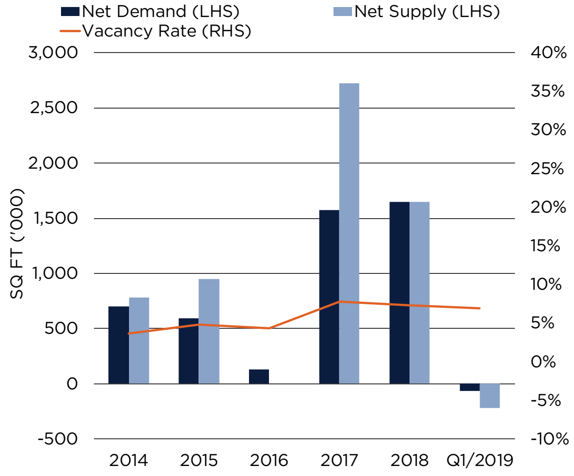
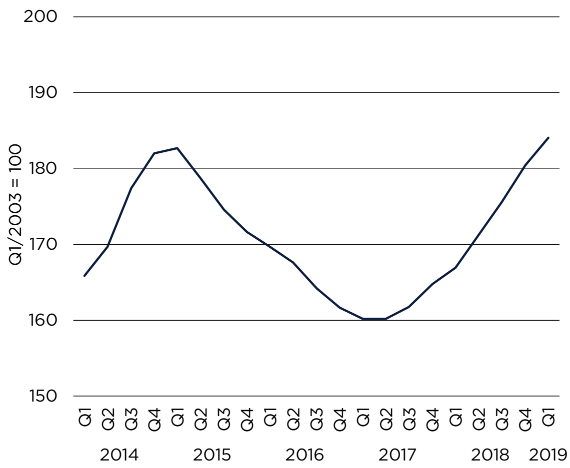
GRAPH 1: Net Demand, Net Supply And Vacancy Rate Of CBD Grade A Offices, 2014 to Q1/2019



Source Savills Research & Consultancy

GRAPH 2: Rental Indices Of CBD Grade A Offices, Q1/2014 to Q1/2019



Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents and Vacancy Rates, Q1/2019

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	13.01	10.8
Raffles Place	10.22	3.0
Shenton Way	9.21	14.9
Tanjong Pagar	8.87	7.8
City Hall	10.23	2.2
Orchard Road	9.52	3.1
Beach Road/Middle Road	8.02	8.0

Source Savills Research & Consultancy

MARKET COMMENTARY

The Ministry of Trade and Industry's advance estimates showed that Singapore's economy expanded at a slower pace of 1.3% year-on-year (YoY) in the first quarter of 2019, a moderation from the 1.9% recorded in the previous quarter. In contrast to the manufacturing sector, which contracted by 1.9% YoY, the construction sector and the services-producing industries grew by 1.4% YoY and 2.1% YoY, respectively, with the latter being supported mainly by the information & communications and business services sectors.

Based on the Urban Redevelopment Authority's (URA) Realis records, the office leasing market remained stable, with a total of 1,339 leases commencing in the period from January to March. This represented a dip of 3.7% QoQ from the 1,390 recorded in Q4/2018, but still the second highest number since Q3/2013. Owing to a few new completions in the CBD, the number of leases in the Downtown Core Planning Area has increased for eight consecutive quarters since Q2/2017.

Notwithstanding the slower GDP growth, there has been a healthy level of demand for office space from a broad base of industries, particularly tech companies and co-working operators. For example, cybersecurity firm Trend Micro recently opened its Asia-Pacific, Middle East and Africa headquarters, spanning 12,000 sq ft, in Suntec City Tower Four. For co-working spaces, two notable deals were reported in the quarter. One is the lease by IWG's No18 of over 20,600 sq ft of space at level two of Capitol Singapore, and the other is The Great Room's deal to set up its fourth co-working premises with nearly 12,000 sq ft of space on the second floor of Raffles Arcade. Notably, rather than office space, these two operators have taken up space in shopping complexes. The limited large office space available for leasing coupled with higher asking rents by office landlords may have pushed these operators to explore alternatives, such as retail space and shophouses.

In the sales market, buying activity for office properties slowed down significantly in Q1/2019. Only four deals, each worth at least S$10 million, closed in the period. These included the S$160.0 million sale of six levels at Suntec City Towers to a fund managed by Alpha Investment Partners, and the S$45.5 million transaction for three levels at The Octagon at Cecil Street by a Singapore-incorporated company, which is controlled by the Murdaya family behind Indonesian conglomerate Central Cipta Murdaya.

VACANCY

Based on Savills basket, the overall vacancy rate for CBD Grade A offices fell from 7.4% in Q4/2018 to 6.9% in Q1/2019. The stock contraction caused by the withdrawal of Chevron House for its asset enhancement initiative (AEI) has been partly offset by the healthy take-up in other Grade A office buildings.

Across the submarkets, the average vacancy rate of Grade A offices in Raffles City marked the greatest quarterly decline of 1.4 percentage points (ppts), followed by those in Shenton Way (1.2 ppts), City Hall (1.0 ppt) and Marina Bay (0.5 of a ppt). Conversely, the vacancy rate in the Tanjong Pagar area had a 3.6 ppts rise while the Beach Road/Middle Road and Orchard Road submarkets inched up by 0.2% and 0.6%, respectively.

RENTS

The tapering supply of office space, encouraging pre-commitment levels for upcoming projects, and improving occupancy rates in most of the newer office buildings are all expected to bode well for rental growth in this year. Consequently, after a 9.5% yearly growth in 2018, the average monthly rent of CBD Grade A offices in Savills basket continued its upward trend, rising 2.0% QoQ to S$9.99 psf in Q1/2019.

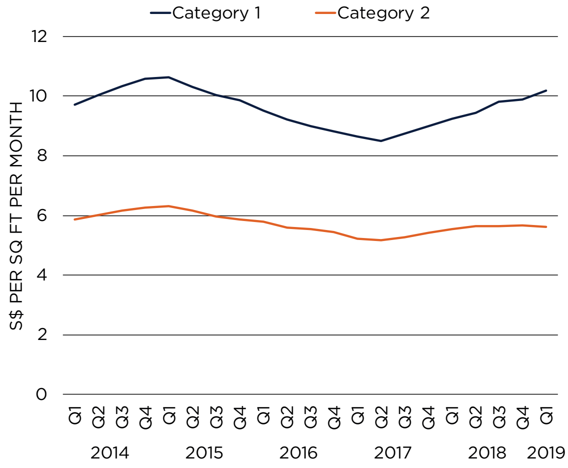
However, overall rental growth on a quarterly basis has slowed down. It could be due to tenants' resistance to the continued upswing in asking rents and/or challenging business conditions. The Grade AA office sector had the steepest decrease in rental growth at 1.3 ppts to 1.9%, followed by Grade AAA with a 1.0 ppt drop to 3.8% rental growth, and Grade A with a 0.5 of a ppt drop to 1.4% rental growth.

By location, rental growth continued across all submarkets, with the exception of Beach Road/Middle Road, which remained unchanged from a quarter ago. Among all submarkets, Grade A office buildings in the Marina Bay precinct showed the highest quarterly increase of 3.7%, followed by Raffles Place and Tanjong Pagar, which registered increases of 2.3% and 2.2%, respectively. Compared with a quarter ago, the rental growth in the submarkets tracked by Savills recorded a moderation between 0.5 of a ppt to 1.9 ppts, except for Orchard Road where rental growth increased by 1.1 ppts.

OUTLOOK

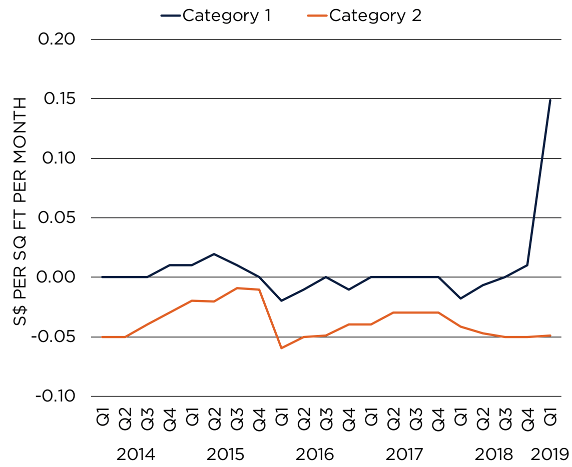
Going back to our Q3/2018 Office Briefing, we mentioned the increasing risk tied to the performance of the US and Global Equity markets. If those markets continue to languish, then 2019 may not work out to be as sanguine an environment as investors have been psyched to believe. In that briefing note, we also mentioned that the saving grace for the market would be the limited supply

GRAPH 3: Median Rentals By Date Of Lease Commencement For Category 1 & 2 Office Buildings, Q1/2014 to Q1/2019



Source URA, Savills Research & Consultancy
Note: Category 1 office buildings are defined as those located in core business areas in Downtown Core and Orchard Planning Area which are relatively modern or recently refurbished, command relatively high rentals and have large floor plate size and gross floor area, while Category 2 office buildings are the remaining office buildings which are not included in Category 1 office buildings.

GRAPH 4: Sign-on Median Rents Less Commencement Median Rents For Category 1 & 2 Office Buildings, Q1/2014 to Q1/2019



Source URA, Savills Research & Consultancy

coming on stream in 2019, which may offset any turbulence coming from cost-cutting measures by office space users.

That large office space users are currently in the throes of restructuring themselves is real, and we can see evidence of this in media reports about waves of hiring pullbacks in the financial sector. Then came the URA Q1/2019 office rental price index, which showed a 0.6% QoQ decline in rents in the Central Region. This is the first change in rental direction since the turnaround in Q3/2017. Is it then true that, because of challenging business conditions resulting in recent headcount cuts amongst large office space users, the rental index for Q1/2019 has declined?

Tempting as it may be to draw that link, we believe that the correlation is only coincidental and not the reason for the decline in rents. Also, although our Q3/2018 Office Briefing mentioned that the decline in US equity prices raised the possibility that rents in 2019 may not increase as much as expected, the QoQ fall in Q1/2019 may not be due to equity performance, at least not yet perhaps. The URA's office rental index is computed from rents of leases that have commenced. For the office market, given that lease negotiations and signings for large space users in CBD Grade A buildings can happen many quarters prior to commencement, the rental contracts under consideration were inked some months back, probably as early as Q2/2018. Global equity markets were still on a roar then.

Looking at the URA's office rental data for Category 1 buildings (new office buildings in the Downtown Core and Orchard Planning Area, which at Savills we would term as Grade A), the Commencement rents in Q1/2019 increased significantly by 2.9% QoQ. It is only in the Category 2 buildings where Commencement rents fell 0.6% QoQ. Please refer to Graph 3.

In fact, for Q1/2019, Sign-On rents rose by a sharp 4.3%, and when we look at the difference between the "forward" looking Sign-On rents and Commencement rents, there is a spike in Q1/2019. The magnitude of the difference has not been surpassed since Q3/2008.

The difference between Sign-On and Commencement rents appears to be a leading indicator of the URA rental index, and a visual inspection of the time series since 2004 does show slight evidence of this. However, we believe that there is more value-add in explaining how the dots join rather than leaving it to a black box called a leading indicator. After all, there is something that more than meets the eye as one can see from the figure above; the difference for Category 2 office buildings remained negative.

On the ground, the market colours in Q1/2019 and April 2019 have been this: rents for CBD Grade A office buildings are still on the uptrend as landlords are confident that the market can take higher rents. The tightness in supply in 2019 for CBD Grade A offices with large floor plates has created conditions for the supply side to get their way. (Presently, large CBD Grade A office floor plates, those over 20,000 sq ft, are a much sought-after commodity because such offerings are a rarity.) This view ties in with the 4.3% rental growth for Sign-On rents for URA's Category 1 office buildings.

However, for non-Grade A buildings, the market has been either flat or soft. Savills office rents for Q1/2019 show that the sharpest increase in rents is in accordance to the grading of the building. We believe that Category 2 buildings house tenants that are more affected by the slowdown in economic performance in both Singapore and the region. Many are engaged in traditional, non-tech-driven trades and embedded in traditional industries that serve both the local and regional economies.

From mid-2019 to end-2021, several large CBD Grade A office buildings (Category 1) are staggered for completion. This will make it difficult to predict overall rents for this grade of buildings. Very often, for buildings that are coming on line, how rents will settle depends a lot on the marketing strategy of the landlords. For a building that is still in the early stages of pre-letting, rents can be more flexible (tenants may have better bargaining power in asking for greater fit-outs and rent-free periods). With the sequential rollout of new buildings in the coming years, we would expect greater variation in rental terms, particularly during the initial marketing phases.

The rental market will get even trickier to predict in future because it is now becoming vogue for landlords to buffer up office space "reserved" for co-working space operators, whether third-party or their own outfits. Often the rents for this type of user may be equal to or less than rents that could be achieved if the space had been taken up by independent business users.

The generalist may dismiss all these factors and resort to the age-old supply-demand argument, with demand being crimped by slower regional economic growth and supply coming from the new completions. While that may be true to some extent—as in, demand from traditional office space users has

TABLE 2: Savills CBD Grade A Office QoQ Rental Growth (Based On Achievable Rents), Q3/2017 to Q1/2019

GRADE	Q3/2017	Q4/2017	Q1/2018	Q2/2018	Q3/2018	Q4/2018	Q1/2019
AAA	2.1%	3.9%	1.9%	4.4%	4.3%	4.8%	3.8%
AA	1.0%	2.7%	1.6%	3.5%	3.0%	3.2%	1.9%
A	0.5%	0.9%	1.0%	1.5%	1.6%	1.8%	1.4%
Overall	0.9%	1.9%	1.3%	2.6%	2.5%	2.8%	2.0%

Source Savills Research & Consultancy

been flat—it does not address the point that leasing professionals are of the view that landlords of existing and upcoming CBD Grade A office buildings are still upping their asking rents. The latter view is in line with the rise in first-quarter rents for URA's Category 1 buildings. Owing to the strength of landlords' balance sheets, they are less sensitive these days to vacancy build-ups. Thus, for space that they will rent out to third-party business users, landlords are likely to ask for even higher rents. For space where they find demand lacking, they will buffer that for co-working use and may accept a slight rental haircut. Thus the overall weighted average rent may remain flat for 2019 and 2020 as the higher renewal and third-party sign-on rents are countered by co-working space operators.

Our 2019 forecast for CBD Grade A office rental growth, where tenants are renewing or landlords are actively seeking leases, is still 8-10% YoY. Lower grade buildings may see rentals soften as their premises cater more to tenants likely affected by the current economic slowdown. The sum of all this is that the URA office rental index for the Central Region may bump along at Q1/2019 levels for the rest of the year, but nearer towards 2020, we expect the market hologram to change again.