Singapore – November 2019

MARKET IN MINUTES
Savills Research

Office

Rents stagnate as economy slows

Compared with six months ago, leasing demand has waned quickly, as many office tenants are delaying their relocation or expansion plans.

- While the lack of demand from traditional office occupiers remained the major headwind, tech companies and flexible workplace operators, who have been major demand drivers in the past two years, have also slowed their pace of expansion.
- Nevertheless, the third quarter saw the opening of a couple of new co-working facilities in the CBD, taking up a total of about 195,000 sq ft of space.
- The net demand for CBD Grade A office buildings tracked by Savills amounted to about 338,000 sq ft for the third quarter. In line with the previous quarter, the majority of Q3's take-up was from tenant relocation into newer projects.
- The overall vacancy rate for CBD Grade A office space in the Savills basket continued to improve in Q3, down 0.7 of a percentage point (ppt) quarter-on-quarter (QoQ) to 4.9% at the end of September.
- After eight consecutive quarters of growth, the average monthly rent for Grade A CBD offices remained unchanged in Q3/2019 at S$10.08 per sq ft pm.

"Economic issues in 2020 may force rental growth to take a breather before mounting another push forward in 2021."

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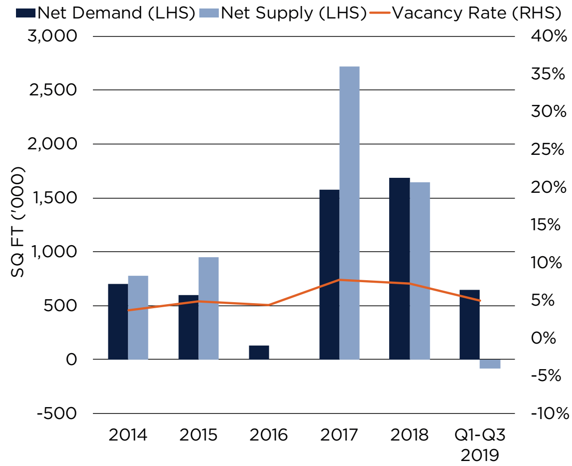
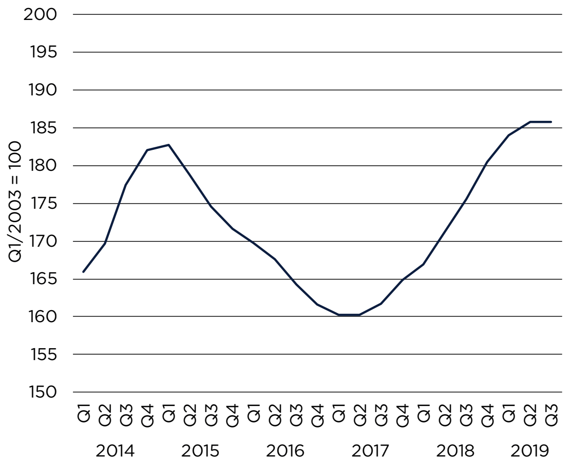
GRAPH 1: Net Demand, Net Supply And Vacancy Rate Of CBD Grade A Offices, 2014 to Q3/2019



Source Savills Research & Consultancy

GRAPH 2: Rental Indices Of CBD Grade A Offices, Q1/2014 to Q3/2019



Source Savills Research & Consultancy

TABLE 1: Micro-Market Grade A Office Rents And Vacancy Rates, Q3/2019

LOCATION	MONTHLY RENT (S$ PER SQ FT)	VACANCY RATE (%)
Marina Bay	13.12	6.7
Raffles Place	10.28	4.0
Shenton Way	9.32	7.6
Tanjong Pagar	9.04	6.0
City Hall	10.31	2.3
Orchard Road	9.58	4.2
Beach Road/Middle Road	8.16	2.7

Source Savills Research & Consultancy

MARKET COMMENTARY

Singapore's trade-reliant economy struggled in the face of global economic turbulence. Based on advance estimates released by the Ministry of Trade and Industry, economic growth in the July-September quarter was sluggish and inched up 0.1% year-on-year (YoY), the same as the previous quarter. The weakness was concentrated in the trade and manufacturing sectors, while the services industry remained relatively resilient.

Singapore's labor market was also starting to come under strain. Preliminary data from the Ministry of Manpower showed that the overall unemployment rate rose to 2.3% in September, the highest since December 2009. In the meantime, retrenchments climbed to 2,900 in the third quarter, higher than 2,320 in the preceding quarter and 2,860 in the same period of last year. In the most recent survey by ManpowerGroup, attitudes among 669 hiring managers in Singapore towards the employment outlook in the final quarter of 2019 are at their most pessimistic since the third quarter of 2017.

The sluggish economy is starting to take its toll on the office leasing market. Compared to six months ago, leasing demand has waned, as many office tenants turned cautious for their business and hiring prospects and are holding back their relocation or expansion plans. According to data from the Urban Redevelopment Authority's (URA) Realis, there were a total of 1,283[1] leasing transactions signed in Q3/2019, down significantly by 16.1% QoQ and on a YoY basis, up just 0.8% compared with the average 9.7% YoY increase for the first two quarters of 2019.

While the lack of demand from traditional office occupiers is expected, tech companies and flexible workplace operators, who have been major demand drivers in the past two years, have also slowed down their pace of expansion. Weakening demand for office space has also affected leasing activity in some upcoming CBD office projects, resulting in relatively low pre-commitment levels compared with those newer projects completed in the last couple of years. Although there is currently no obvious sign of downsizing, this may pose a risk if the economy does not stabilise next year as the Monetary Authority of Singapore said in its latest Macroeconomic Review released in October.

Nevertheless, the third quarter still saw the opening of a couple of new co-working facilities in the CBD. These include Spaces at One Raffles Place Shopping Centre, The Great Room at Raffles Hotel's shopping arcade, Trehaus at Funan North Tower, WeWork at MYP Centre and One&Co by East Japan Railway Company at Twenty Anson. In total, these co-working centres took up about 195,000 sq ft of space.

1 Based on the statistics downloaded on 04 November 2019.

Buying momentum for office properties in the CBD continued in the third quarter. Major transactions concluded in the reviewed quarter include Allianz Real Estate and Gaw Capital Partners' S$1.4 billion (estimated) acquisition of Duo Tower at Fraser Street; the S$655.0 million sale of 71 Robinson Road to SV Robinson; Keppel REIT's S$547.5 million sale of its strata portion of Bugis Junction Towers to Village Prop and Arch Capital's S$210.0 million purchase of Anson House at Anson Road.

DEMAND, SUPPLY AND VACANCY

The net demand of CBD Grade A office buildings tracked by Savills amounted to about 338,000 sq ft for the third quarter. As it was in the previous quarter, the majority of the take-up in Q3 was from tenants relocating to newer projects, such as Marina One, Duo Tower and Frasers Tower. As these deals were secured in 2018, this again suggests that new demand for CBD Grade A offices in the last few months has been quite limited.

This net demand, coupled with a net new supply of 136,200 sq ft from 18 Robinson at Robinson Road, meant that the overall vacancy rate for CBD Grade A office space in Savills basket continued to improve in Q3, down 0.7 of a ppt QoQ to 4.9% as of end-September. This is the lowest since Q4/2016.

Compared with the previous quarter, vacancy rates in the Marina Bay, Shenton Way, Tanjong Pagar and Beach Road micro-markets dropped in the range from 0.9% to 4.5%, while the Raffles Place, City Hall and Orchard Road areas' vacancy rates posted an increase from 0.2% to 1.1%.

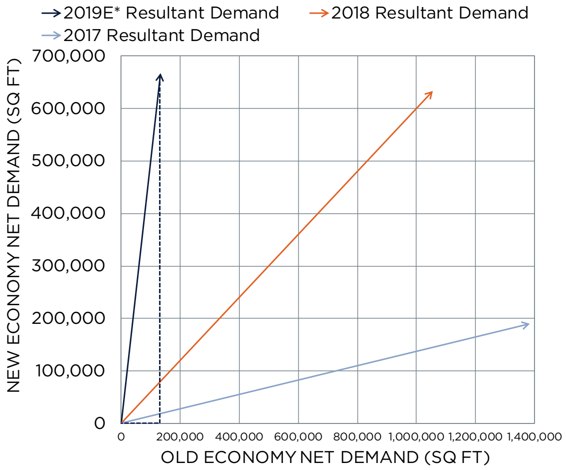
RENTS

Although the availability of vacant CBD Grade A office space reached an almost three-year low in Q3/2019, softer demand conditions halted rental increases. In the coming four quarters, the market is expected to see a substantial amount of remaining space in new projects and possible secondary stock being vacated. Landlords are lowering their rental expectations to adapt to the situation. Consequently, the average monthly rent for Savills basket's CBD Grade A offices stayed flat in Q3/2019 at S$10.08 psf, after eight consecutive quarters' growth.

OUTLOOK

The growth of the "new economy" is expected to upset historical models that predict office space demand. The new economy in our definition, refers to many companies which run on negative free cash flow. Up to around 2016, the demand drivers for CBD Grade A office space were the usual suspects including GDP and supply, where the adage was if you build, they will come. But with the advent of the new economy, the demand landscape changed and since

GRAPH 3: CBD Grade A Office Demand From 2017 to 2019*



Source Savills Research & Consultancy
* Estimate

TABLE 2: Cumulative Probability Of Risk Exposure To New Economy (Uniform Distribution)

YEAR	2017	2018	2019E
1 - P(X ≤ x)	0.0092	0.1426	0.8048

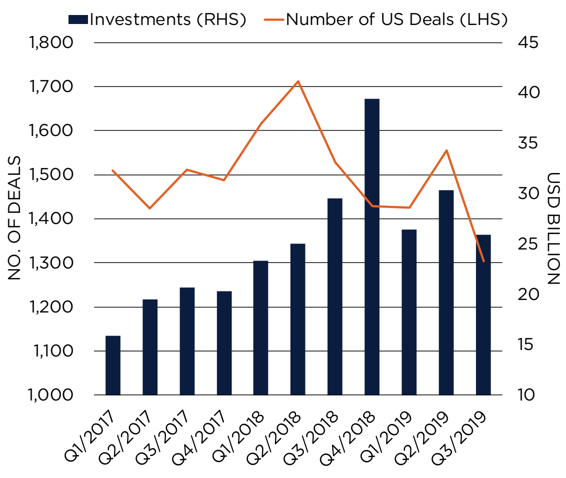
Source Savills Research & Consultancy

TABLE 3: Old Economy Demand For 2020 Under GDP Growth Scenarios

GDP GROWTH FOR YEAR 2020	CBD GRADE A OFFICE NET DEMAND (SQ FT)
2.4%	853,000
1.0%	602,000

Source Savills Research & Consultancy

GRAPH 4: Number of Deals and Investments Made By US Venture Capital Firms



Source PWC MoneyTree Q3/2019

2017, CBD Grade A office demand has been growing at levels exceeding what they would be just based on the economic fundamentals. Demand derived from economic fundamentals is closely correlated with GDP. However, demand came in much higher in 2017, 2018 and the first three quarters of 2019 than the old economy could absorb (most companies in the old economy operate on a surplus).

The reason that GDP does not adequately capture much of the business activity under the coupling of a new-old economic construct is due to the way it is computed using the income approach. Under this method, there are two major components of GDP: compensation (to workers) and gross operating surpluses of businesses. Unfortunately, because the approach of many new economy businesses is to capture market share at the expense of current profitability, the burgeoning of such companies results in a subtraction from the overall pool of operating surpluses. This means that when the new economy gets coupled to the pre-existing one, it drags down GDP growth. We have seen since 2017 that the demand for Grade A CBD office space has been higher than what economic fundamentals would expect. A case in point would be co-working operators, many of whom are running on negative free cash flow. From 2017 to date, they have been the saviour of the office market by absorbing almost all the secondary stock left vacant after previous tenants moved to new builds. Many members parked in co-working spaces are often also not running on positive free cash flow. Besides operating out of co-working premises, some of these entities also took up space in traditional serviced offices or signed up with landlords directly.

For the Grade A CBD office market, we have represented take-up on a graph as two components, the old economy on the x-axis and the new economy on the y-axis (the way demand for both kinds of firms are computed has been mentioned in our Q2/2019 office briefing note). Graph 3 shows how the resultant (blended) demand behaved from 2017 to 2019.

From 2017 onwards, the blended demand for CBD Grade A offices has been veering towards firms in the new economy. In 2019, the total net demand is estimated at 800,000 sq ft, comprising 133,000 sq ft from old economy users (the dark blue horizontal dotted line) and about 667,000 sq ft from new economy users (the dark blue vertical dotted line). CBD Grade A office space demand is thus becoming extremely dependent on new economy firms. Next comes the risk of this development.

From Graph 3, we see that the more the blended demand vector pivots towards the vertical axis, the greater the risk that the office market is dependent on non-free cash generating companies. Table 2 shows the risk of exposure to the new economy for CBD Grade A offices. It is read as the probability of full risk exposure of office demand to the new economy.

Given the recent problems confronting major new economy companies, 2020 may be a year of turbulence as both new economy firms and their investors consider how to deal with the need to reign in excessive cash burn. Although new supply this year is limited, from 2020 on, there will be greater completions and if the demand side faces headwinds from slower global economic growth compounded by lower funding for the new economy, the risk of rents softening increases. Table 3 shows what net demand (from old economy companies) may be for next year under two GDP growth scenarios.

Although the take-up for 2020 appears healthy, should the new economy flounder, any negative take-up from new economy users will subtract demand shown in Table 3.

On a positive note, for the first three quarters of 2019, CBD Grade A office rents in 2019 have already risen by 2.9%. It is highly unlikely that those gains will be erased in the fourth quarter. For 2020, as uncertainty levels rise, downward pressure on rents can be expected. However, any decline is expected to be slight because of landlords' financial strength and firm sentiment in the investment sales market, fuelled by entities which raised copious amounts of capital and finally, groups seeking a safe harbour for their capital. Also, with more and more bonds falling into negative yielding territory, long term capital from the Euro zone will be on the prowl for investments even if yields are already considered compressed by historical standards. This could mitigate any softness on the tenancy side. Our rental forecast for CBD Grade A office space for 2020 is therefore in a range of 0% to minus 2% YoY. By 2021, if the new economy finds it's footing again, that should support rents.

TABLE 4: CBD Grade A Office Rental Forecast

YEAR	2019E	2020F	2021F
Grade A CBD Rental Changes YoY	4.0%	0% to -2%	-1% to +2%

Source Savills Research & Consultancy