

HK Property Sector (Office)

Refer to important disclosures at the end of this report

DBS Group Research . Equity

2 Feb 2024

Still no light in sight

- **Office market downcycle to persist with ongoing demand and supply imbalance**
- **Rents to head south amidst all-time high vacancy, while reversionary growth to remain negative**
- **End-users seeking to buy office space capitalising on softer prices**
- **We like [Swire Properties](#) which offers consistent long-term earnings and dividend growth without stretching its balance sheet**

Office market downturn to persist with ongoing demand and supply imbalance. Corporates remain cost conscious on business expansion amid global economic uncertainties and lackluster financial market performance. New leasing demand is limited while relocation activities are driven by corporate downsizing and office consolidation. Office rents fell 5.9% in 2023 after dropping 26% since 2020. This was led by Island East where vacancy surged to 13.5% in Dec-23 with a slowdown in office decentralisation demand. Central market has become increasingly polarised with continued “flight to quality” trend. Pre-leasing of soon-to-be-completed new office buildings is progressing slowly. Office vacancy is set to rise further from 12.8% in Dec-23. This should exert pressure on office rents which are projected to fall another 5% in 2024.

End-users seeking to buy office space, taking advantage of the currently softer prices. Despite the gloomy market outlook, en bloc office transactions have started to emerge. End users are looking to buy office space to take advantage of softer prices. The Securities & Future Commissions is a case in point. This regulatory body acquired twelve office floors at One Island East with an implied rental yield of 3.3%. We expect more office deals, mainly from end-users, to materialise. Investor demand remains subdued due to negative carry and ongoing rental corrections.

Stock recommendation. Hongkong Land and Swire Properties have delivered stronger office rental performance than their office peers. Both stocks trade at discounts of 71-72% to their respective current NAV estimates, c.2SD below their 10-year mean. Concerns over office market prospects are likely priced in at such low valuations. We have BUY ratings on both stocks on compelling valuations. Swire Properties is making good progress in its HK\$100bn investment plan without stretching balance sheet, which should underpin long-term core earnings and dividend growth. We are keeping an eye on any potential fine-tuning of corporate strategy of Hongkong Land after the new Chief Executive joins the company in Apr-24.

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Recommendation & valuation

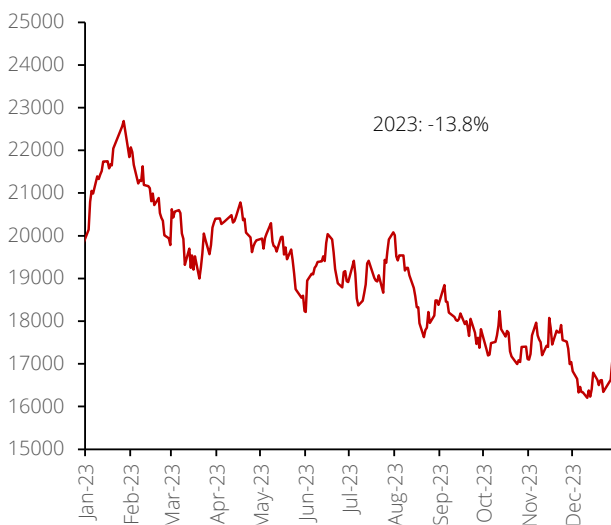
Company	Price	Target Price	Mkt Cap	Recom
Property Investors	Local\$	Local\$	US\$bn	
Swire Properties (1972 HK)	14.62	19.64	10.91	BUY
Hongkong Land (HKL SP)	3.12	3.97	6.93	BUY

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited (“DBS HK”)

Slower-than-expected leasing demand recovery In 2023, the recovery in office demand following the border re-opening was slower-than-expected. Global economic uncertainty and the lacklustre financial market have inevitably slowed the recovery trend in office demand.

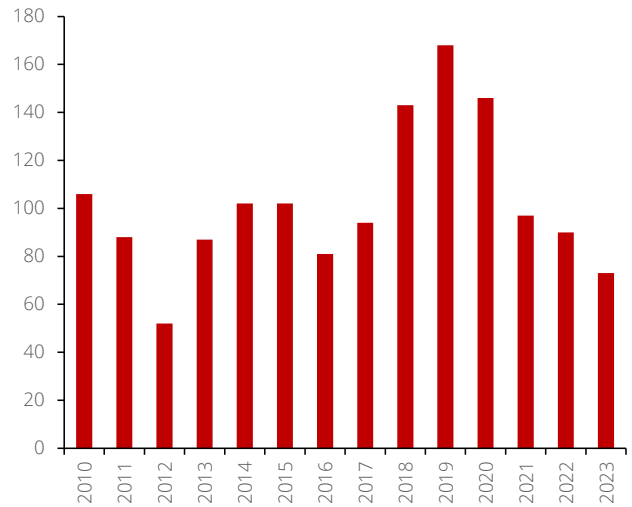
The Hang Seng Index lost 2,734 points or 13.8% to 17,047 in 2023 due to China's sluggish economic outlook and prolonged interest rate upcycle. During 2023, 73 stocks were listed in Hong Kong with a total of c.HK\$46bn raised from IPOs (2022: c.HK\$105bn). The Hong Kong Stock Exchange was ranked No.6 in terms of listing destination for funds raised, down from No.4 in 2022.

Hang Seng Index



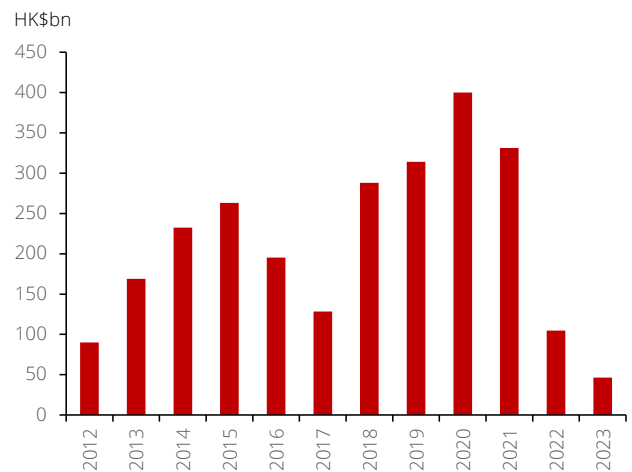
Source: Bloomberg Finance L.P.

Number of IPOs



Source: CEIC

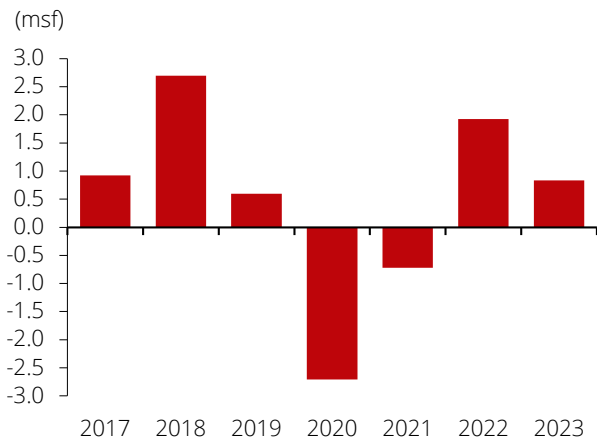
Total IPO funds raised



Source: CEIC

In 2023, overall net absorption amounted to 0.83msf, down 57% y-o-y. Were it not for some improvement observed towards the year-end, the take-up would have been lower.

Office net absorption

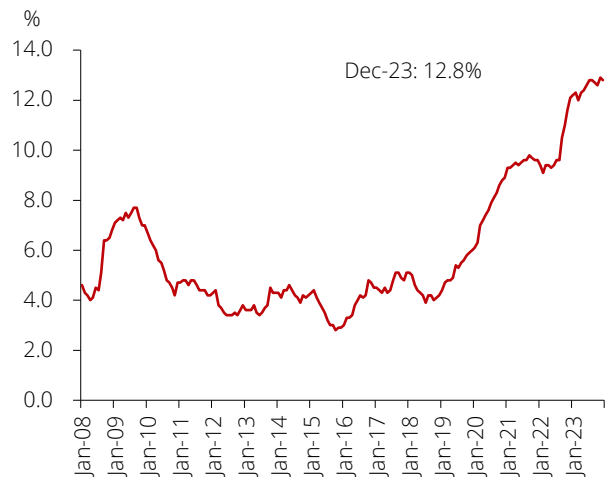


Source: Jones Lang Lasalle

Vacancy rate climbed further led by Island East. As a result, the overall office vacancy rate edged up to 12.8% in Dec-23 from Jun-23's 12.6%, primarily led by increased vacancy in Island East. Based on long-term annual average net absorption rate, it would take c.10 years for the market to absorb the current vacant space.

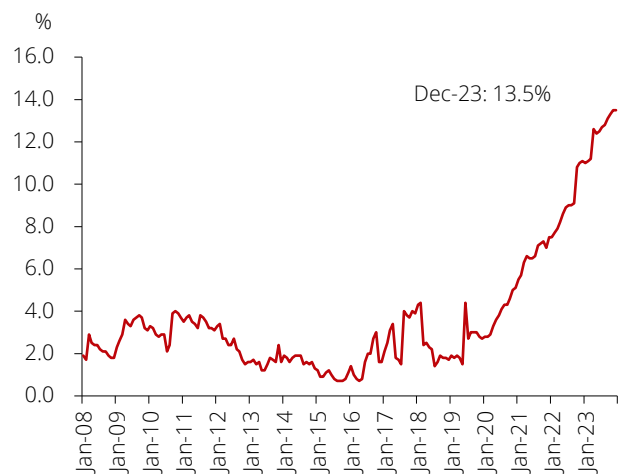
Office decentralisation trend has slowed down. Vacancy in Island East stood at 13.5% in Dec-23, up from 12.5% in Jun-23. The leasing progress of newly built Two Taikoo Place has been slow. In Sep-23, Two Taikoo Place was 56% let, unchanged from Jun-23's. Excluding Two Taikoo Place, Swire Properties' other office towers within its Taikoo Place portfolio saw their vacancy rise to 8% in Sep-23 from Jun-23's 6%. The office decentralisation trend has slowed down notably due to narrower rental differentials between CBD and decentralised locations, and high relocation costs.

Office vacancy - overall



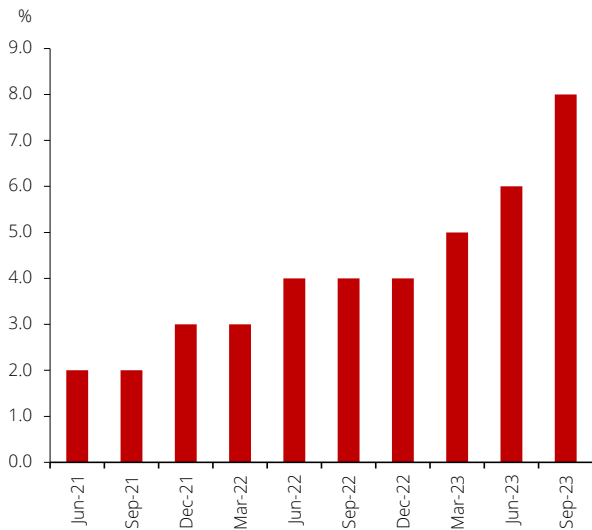
Source: Jones Lang Lasalle

Office vacancy - Island East



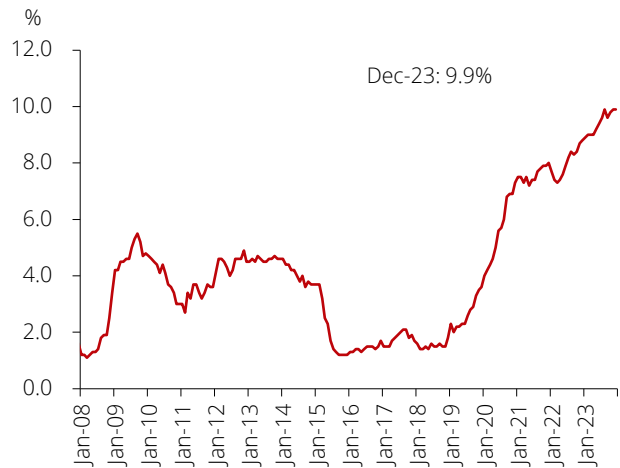
Source: Jones Lang Lasalle

Office vacancy - Taikoo Place (excluding Two Taikoo Place)



Source: Swire Properties

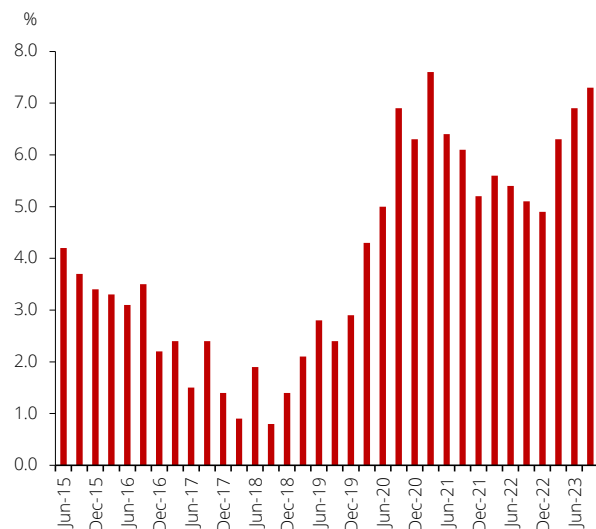
Office vacancy - Central



Source: Jones Lang Lasalle

Central office market is becoming more polarised. In Central, the overall vacancy edged up to 9.9% in Dec-23 from Jun-23's 9.4%. The Central market is increasingly polarised, driven by the ongoing "flight to quality" trend. Prime office buildings in core Central are showing resilience. Both One IFC and Two IFC, which command the highest office rents in Hong Kong, were 98% occupied. Franklin Templeton committed office space of 23,000sf at Two IFC, relocating from Chater House. Hongkong Land saw the vacancy of its Central portfolio inching up to 7.3% in Sep-23 from Jun-23's 6.9%. On a committed basis, vacancy stood at 6.8% in Sep-23, up from Jun-23's 6.2%. On the other hand, selected office buildings in the fringe Central are c.20% vacant.

Office vacancy - Hongkong Land's Central portfolio

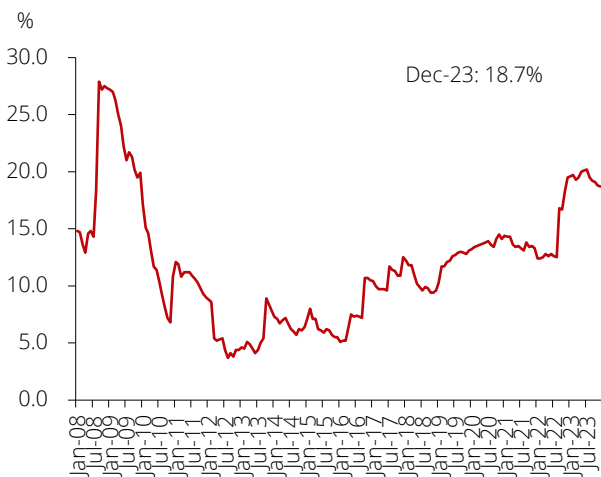


Source: Hongkong Land

MTRC grabbing space for business expansion. In Kowloon East, office vacancy had surpassed 20% in mid-23 but gradually improved to 18.7% in Dec-23. Newly built Airside and The Millennity remain <50% committed. Mass Transit

Railway Corporation (MTRC) has been taking up more office space for business expansion. This railway operator rented two floors (c.50,000sf) at Hang Seng Tower in Kowloon Bay in Aug-23.

Office vacancy – Kowloon East



Source: Jones Lang Lasalle

Elsewhere, this railway operator has leased eight floors or 134,000sf at One North in Yuen Long which will serve as offices for its projects in the Northern Metropolis. Developed by Sino Land, the newly completed One North comprises of twin office towers above a three-level retail podium. Total GFA is 0.5msf including 0.38msf for office use. It is a 5-8-minute walk from Long Ping MTR Station.

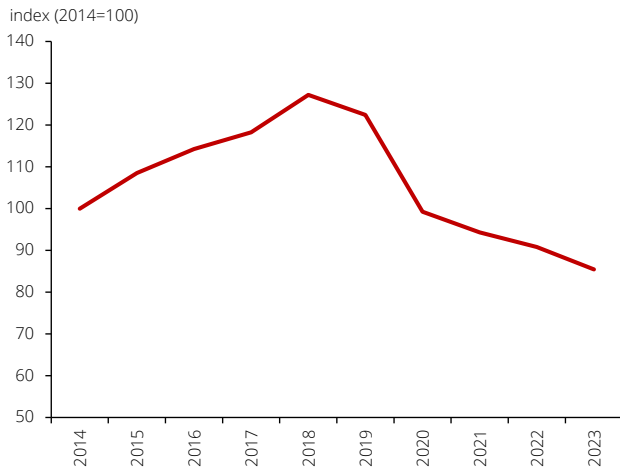
One North



Source: DBS HK

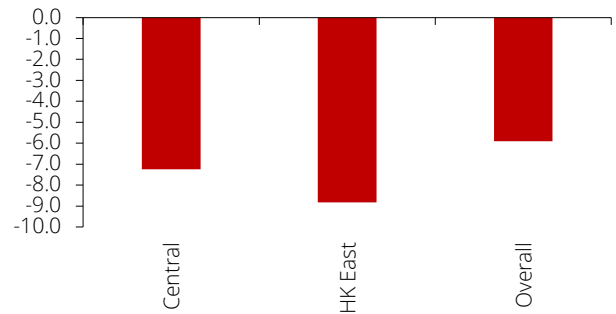
Diverging rental performance. In 2023, office rents fell 5.9% amidst growing vacancy, leading to a total rental reduction of 30% since 2020. Among major sub-markets, Island East showed the largest rental decline of 8.8% in 2023 given surging vacancy. This was followed by Central which registered 7.2% fall in office rents in 2023. Since 2020, office rents in Central have corrected by 31%. We note that Tsim Sha Tsui was the only sub-market with stable rentals. This was due to improved leasing demand from insurance firms following the border re-opening with Mainland China which resulted in vacancy improving to 9.5% in Dec-23 from Jun-23's 10.7%.

Overall office rental



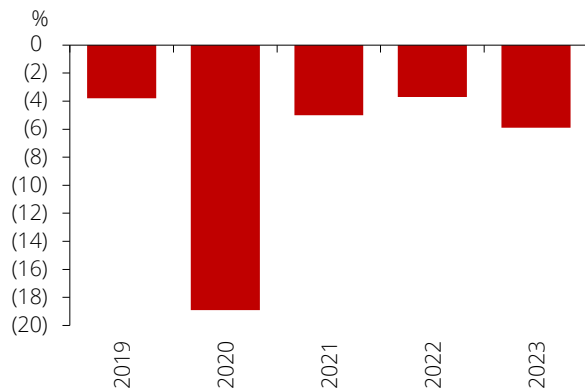
Source: Jones Lang Lasalle

Submarket office rental performance (2023)



Source: Jones Lang Lasalle

Overall office rental growth



Source: Jones Lang Lasalle

Office vacancy - Tsim Sha Tsui



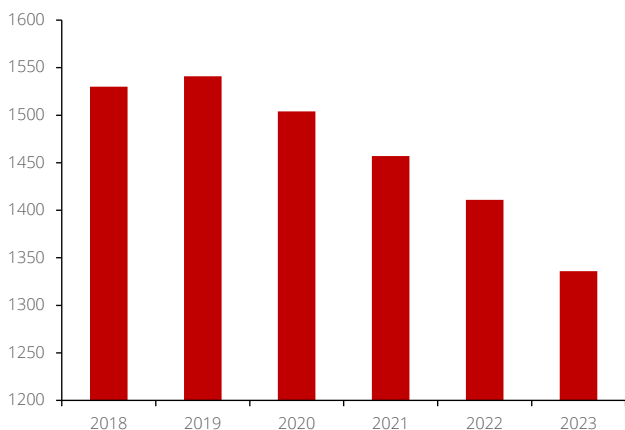
Source: Jones Lang Lasalle

Negative reversionary growth persists. Ongoing rental correction have kept office reversionary growth in negative territory. Swire Properties registered negative rental reversion of 13% for its Pacific Place office portfolio. Rental reversion of Hongkong Land's Central office portfolio is estimated to be 10-12% for 2023.

Near term, corporates remain cost conscious amid global economic uncertainties and the volatile financial market. New or expansionary leasing demand is very limited. Relocation is mainly driven by corporate downsizing or office consolidation, and hence tenants prefer office premises that are fitted out.

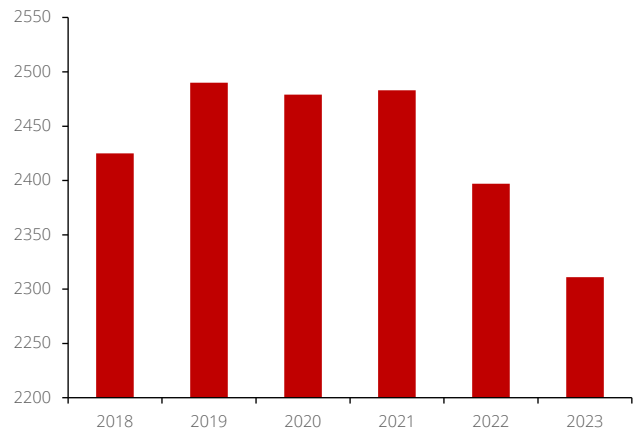
The number of regional headquarters fell 3.2% in 2022 followed by 5.3% decline in 2023. The number of regional offices mirrored a similar trend, falling 3.5% and 3.6% in 2022 and 2023 respectively. These do not bode well for office leasing demand.

Number of regional headquarters



Source: CEIC

Number of regional offices



Source: CEIC

Office pre-leasing advancing at a slow pace. Pre-leasing of soon-to-be-completed office developments are proceeding relatively slowly. Pre-commitment rate of The Henderson in Central is 40-50% while that of nearby Cheung Kong Center II was even lower. Six Pacific Place is about 30% pre-committed by tenants including Sotheby's. The upcoming completion of these new office developments should further push up vacancy rates which is expected to exceed 13% by end-24, and exert pressure on office rents.

Rents to head south. Overall, we project overall office rents to fall another 5% in 2024. Tsim Sha Tsui should continue to outperform other sub-markets with steady rents.

Rentals are expected to continue declining on new lettings or lease renewals. This, coupled with higher vacancy, is likely to continue to drag rental income for office landlords.

Major Office Supply

2024				
Cheung Kong Center II	Central	HK	493,500	CK Asset Holdings
The Henderson	Central	HK	465,000	Henderson Land
Six Pacific Place	Wan Chai	HK	218,000	Swire Props
AIA Building Redevelopment	Wan Chai	HK	253,003	AIA
NKIL 6607	Kai Tak	KIn	174,293	Far East Consotium
East 350 (Maxwell Industrial Building redevelopment)	Kwun Tong	KIn	230,160	Law's Group
2025				
Gage Street/Graham Street redevelopment Site C	Central	HK	310,000	Wing Tai Props/CSI Props
Tak Shing House redevelopment	Central	HK	140,000	Private developer
Excelsior Hotel redevelopment	Causeway Bay	HK	683,508	Mandarin Oriental
Conic Investment Building	Hung Hom	KIn	508,888	Cheung Kong Asset Holdings
7 Lai Yip Street	Kwun Tong	KIn	159,000	Able Engineering Holdings
2026 and beyond				
IL 9088	Central	HK	660,000	Henderson Land
212-232 Des Voeux Road Central	Central	HK	160,000	Tai Hung Fai Enterprise
92-103A Connaught Road West & 99-101 Des Voeux Road West	Sheung Wan	HK	303,000	Tai Hung Fai Enterprise
IL8945	Causeway Bay	HK	947,898	Hysan Development/Chinachem Group
Redevelopment of Wa Hah Factory Building/Zung Fu Industrial Building	Quarry Bay	HK	779,000	Swire Props
High Speed Rail West Kowloon Terminus Development	West Kowloon	KIn	2,564,444	SHKP
Artist Square Towers project	West Kowloon	KIn	672,000	SHKP
KIL 11273*	Mongkok	KIn	1,524,000	SHKP
Goldin Financial Global Square Redevelopment	Kowloon Bay	KIn	360,000	Goldin Financial
LN4354 in DD124	Tin Shui Wai	NT	366,000	SHKP
KCTL45**	Tung Chung	NT	441,467	Chinachem Group

* GFA includes office, retail portion and government accommodation. The development plan has yet to be finalised

** assumed 35% of total GFA is earmarked for office development

Source: DBS HK, Lands Department, Local Press

En bloc office deals resurfacing. Despite the office leasing market showing no signs of bottoming, en bloc office transactions started to re-emerge towards the end of 2023. End-users are looking to purchase office premises for their own use, taking advantage of softer office prices. According to Jones Lang LaSalle, office capital values fell 5.3% in 2023 and had tumbled 32.3% since the beginning of 2020.

In Nov-23, Securities and Futures Commission (SFC) reached an agreement with Swire Properties to purchase twelve

office floors at One Island East in Quarry Bay for HK\$5.4bn or c.HK\$18,200psf. These comprise 42-54/F, excluding 49/F which is used as a refugee floor and kept unoccupied, with GFA of 296,000sf. SFC is the existing tenant of 45-54/F and the transaction of these floors was completed in Dec-23. The sale of 42/F, 43/F and 44/F will be completed in 2028, 2026 and 2027 respectively. Although SFC has signed an eight-year lease for its office premise at One Island East in 2020, its long-term strategy is to buy its own assets for permanent office use to eliminate rental expense and minimize the disruption in the event of office relocation.

One Island East



Source: DBS HK

Completed in 2008, One Island East provides GFA of 1.54msf. This makes it the largest office tower in Swire Properties' Taikoo Place portfolio. The property is strategically located, about an 8 minute-walk from both Quarry Bay and Taikoo MTR Stations.

Based on disposal price and total net rental income of HK\$178m in 2022, we estimate the exit yield at 3.3%. Overall, we see the deal as positive to Swire Properties. The exit yield, though slightly higher than those for Cityplaza One in 2020 & Cityplaza Three and Cityplaza Four in 2018, remains attractive considering the current high interest cost.

Disposal proceeds could be used to fund Swire Properties' new investments with better growth prospects. This enables Swire Properties to proceed with its HK\$100bn investment plan without over-stretching its balance sheet in the current high interest rate environment. The property divestment gain to Swire Properties is estimated at HK\$4.36bn, giving strong boost to its underlying profits.

In Dec-23, Henderson Land Development agreed to sell Harbour East in North Point on an en bloc basis to China-based sportswear brand Li Ning (2331 HK) for HK\$2.21bn, or HK\$15,333psf. In early 2018, Henderson Land sold a nearby office building, 18 King Wah Road, to a China-based firm for c.HK\$10bn or c.HK\$30,000psf. The drop in selling price reflects a combination of declining rentals and rising yield. According to Jones Lang LaSalle, office rents in Island East have fallen 21% since 2018.

Harbour East



Source: DBS HK

Completed in 2019, this premium office building is redeveloped from the former Newton Hotel Hong Kong. Harbour East is also opposite AIA Tower, another office tower held by Henderson Land. With total GFA of 144,000sf, the brand new office tower comprises twenty two office floors (130,077sf) above a two-storey retail arcade (13,923sf).

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It is only a three-minute walk from Fortress Hill MTR Station from which it takes 10 minutes to Central by subway, and enjoys easy access to different parts of Hong Kong via the Central-Wan Chai Bypass and the Island Eastern Corridor. Harbour East is >65% let currently and will serve as Li Ning's headquarters in Hong Kong to facilitate the company's overseas business expansion.

Based on disposal price and rental income of HK\$49.5m in 2022 in which the property's occupancy averaged 60%, we estimate gross yield at 3.7% (or 3.3% for estimated NPI yield) assuming the property is fully leased. Taking into account the prolonged interest rate upcycle and challenging office market outlook, the exit yield is attractive from Henderson Land's perspective.

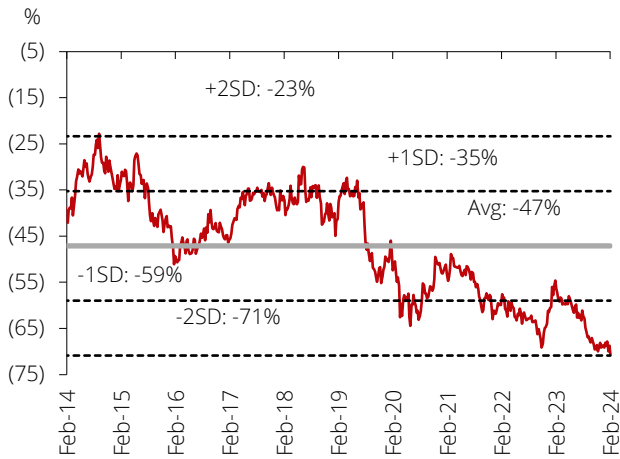
Overall, we expect to see more en bloc office deals, mainly from end-users. Investment demand, however, should remain low as the current funding costs is much higher than market yield and we expect office rents to correct further in the year ahead.

Stock recommendation. Divestment of twelve office floors at One Island East in Quarry Bay should result in substantial gains of HK\$4.36bn to Swire Properties. About c.HK\$3.3bn will be booked in FY23, boosting the company's underlying earnings by c.30%. More importantly, disposal proceeds would be used to fund new investments with better prospects. In Sep-23, Swire Properties agreed to acquire a 40% stake in New Bund and Yangjing plots in Shanghai for Rmb9.7bn. Overall, the company is making good progress on its HK\$100bn investment plan with c.50% now committed to new and ongoing investments in Hong Kong, China and South East Asia. This should underpin its long-term earnings expansion and dividend growth. Trading 71% below our assessed current NAV with dividend yield of 7.1-7.5% for FY23-24, the stock offers good long-term value. BUY with HK\$19.64 TP.

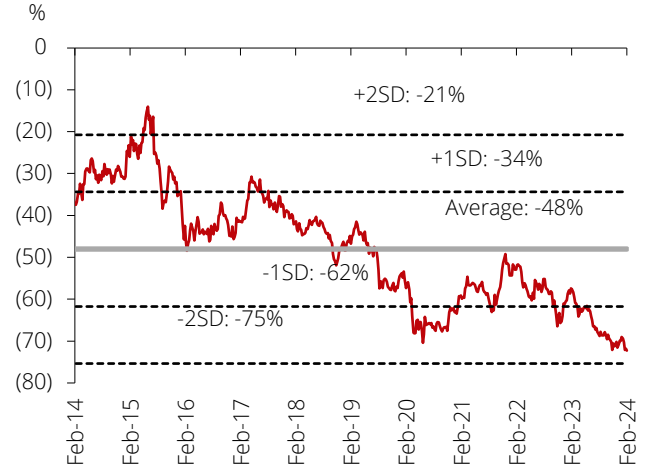
Office vacancy of Hongkong Land's Central portfolio has inched up to 7.3% or 6.8% on a committed basis in Sep-23. This still compares favourably with the overall Central office market. About 33% of the leases are scheduled for renewal or rental review. With average expiring rent of HK\$111psf, office reversionary growth should remain in negative territory. The shortfall in office income should be offset by higher contributions from the company's luxury retail and Singapore office portfolios. Despite resilient rental earnings,

Hongkong Land's FY23 earnings should be dragged by lower planned sales completions in China and higher interest costs. Michael Smith was appointed as Chief Executive starting from Apr-24. Investors would watch for any fine-tuning of its corporate strategy. Following the recent share price retreat, the stock is now trading at 72% discount to our appraised current NAV with estimated dividend yield of 7.1% for FY23-24. Concerns over an uncertain outlook of Central's office sector should be priced in. We keep our BUY rating at this stage with US\$3.97 TP.

Swire Properties – Discount to NAV



Hongkong Land – Discount to NAV



Swire Properties – Historical yield



Hongkong Land – Historical yield



Source: Bloomberg Finance L.P., DBS HK

Source: Bloomberg Finance L.P., DBS HK

HK Property Sector (Office)

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*Share price appreciation + dividends

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Sources for all charts and tables are DBS HK unless otherwise specified.

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